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EFFICIENT BREACH THEORY THROUGH THE LOOKING GLASS

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

INTRODUCTION

At the heart of efficient breach theory is the common law remedy of expectation damages. This remedy requires a party who breaches a contract to pay damages in an amount that would make the victim of breach as well off as she would have been had the breach not occurred. In principle, this gives each party to a contract an incentive to perform when performance is efficient, but not otherwise. The parties, therefore, will complete those contractual projects that are valuable and abandon those that are wasteful, all without potentially costly post-contractual renegotiation. Proponents of efficient breach theory applaud this result and reject any attempt to condemn or punish a party who breaches so long as the victim is compensated, this even if the

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breach is intentional, by repudiation. Under basic efficient breach theory, no purpose would be
served to induce performance that costs the provider more than such performance benefits the
recipient.

Efficient breach theory in its simplest form stops there, however, and though frequently
refined, remains substantially incomplete because it neglects a category of cases that forms a
conceptual half of efficient breaches. That is, efficient breach theory largely ignores those con-
tracts for which one party’s breach terminates a contract to the benefit, not injury, of the party
who does not breach. Doctrinally, a party who breaches cannot sue for damages on the contract
and thus cannot collect any benefit conferred by the breach. But one might ask why this should
be so. Such suit surely would offend those who would find it immoral for a person to profit from
her broken promise. But efficient breach theory is amoral by nature. So the theory fails to ex-
plain why the expectation remedy disallows damages for the party in breach. Put another way,
those who analyze contract law from an economic perspective frequently note that expectation
damages award the benefits of termination to the breaching party; indeed, it is this fact that en-
dows a party with efficient incentives when she contemplates repudiation. When the breach in-
jures no one, however, the surplus does not belong entirely to the party in breach. The question
becomes one of why not, or of whether the rule should be otherwise. The answers, it turns out,
are not obvious.

Just as property rights analysis until recently overlooked the potential advantages of
forced purchases as an alternative to traditional liability rules, contracts analysis has overlooked
the potential advantages of an award to the party in breach as part of the expectation remedy,
such an award a put by the promisor of the promisee’s obligation to pay for the promisor’s per-
formance. The objective of this article is to explore the potential benefits, and costs, of an award
to the party in breach and to determine whether a justification for the current law exists within
the framework of efficiency theory. In addition, a new light is shed on express contractual alter-
natives to expectation damages as well as on the mitigation doctrine.

Part I elaborates on contract law’s disallowance of an award to the party in breach, also
referred to as negative damages, and identifies the prior literature. Part II describes more fully
the theory of efficient breach. Part III posits a case in which parties are fully informed about the
consequences of contract termination, then relaxes the complete-information assumption and re-
veals that disallowance of negative damages can yield inefficient breach decisions ex post as
well as inefficient investment decisions ex ante; other potential advantages to the allowance of
negative damages are discussed as well. As part IV demonstrates, however, the case for allow-
ance of negative damages is not fully made, because such allowance could impose offsetting
costs, most prominently from premature breach, costs that might be only partially mitigated by a
rule that allowed negative damages only where the party in breach would not otherwise have
breached. Part V describes impediments to express negative-damages clauses in contracts and
identifies high liquidated-damages and specific-performance clauses as means to ameliorate the
disallowance of negative damages; the analysis thus provides a new argument for enforcement of
such clauses. Part VI examines the mitigation doctrine in light of the law’s disallowance of nega-
tive damages; the weakness of the mitigation obligation may now be defended as a substitute for
negative damages. Finally, a conclusion is offered.
I. **THE PARADOX OF NEGATIVE DAMAGES**

In United States v. Algernon Blair,\(^1\) a construction subcontractor had partially performed under an agreement with the general contractor when the latter repudiated the contract and released the sub from further performance. The subcontractor invoked the doctrine of quantum meruit and claimed $37,000 in restitution for the benefit it conferred on the general contractor, which hired a substitute to complete the work that the subcontractor had begun. The trial court did not reach the value of the sub’s restitution claim. Instead it awarded nothing because, in the court’s estimation, the subcontractor would have lost more than $37,000 had it fully performed. An appeals court reversed and remanded: “For it is an accepted principle of contract law, often applied in the case of construction contracts, that the promisee upon breach has the option to forego any suit on the contract and claim only the reasonable value of his performance.”\(^2\)

Though the case is couched in terms of quantum meruit, it also stands for the proposition that a party in breach of contract cannot sue for damages on the contract. In the appellate opinion, the court addressed the plight of the contractor, who might have benefited from the bargain that it repudiated. The court quoted a venerable article by Fuller & Purdue: “[I]n suits for restitution there are many cases permitting the plaintiff to recover the value of benefits conferred on the defendant, even though this value exceeds that of the return performance promised by the defendant. In these cases it is no doubt felt that the defendant’s breach should work a forfeiture of his right to retain the benefits of an advantageous bargain.”\(^3\)

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\(^1\) 479 F.2d 638 (4th Cir. 1973).

\(^2\) *Id.* at 640, quoting *Susi Contracting Co. v. Zara Contracting Co.*, 146 F.2d 606, 610 (2nd Cir. 1944).

Consider also the hoary case of Bush v. Canfield,¹ where the court encountered a defendant, like that in Algernon Blair, who breached his contract and requested a reduction in the plaintiff’s restitution award. The plaintiff was a buyer who had agreed to pay $7 per barrel for flour and gave the seller a $5,000 deposit. At the time and place for delivery, the market price for flour was $5.50. The seller was unable to deliver (or, in any case, did not deliver) and so the buyer sued for the return of the deposit, which the seller resisted on the ground that the failure of delivery enabled the buyer to obtain flour on the market at a lower price. The court ruled against the seller: “[I]t is not for him to say, that if he had fulfilled [the contract], the plaintiffs would have sustained a great loss, and that this ought to be deducted from the money advanced.”⁵

Note that the result in these cases is not limited to cases in which one party foolishly breaches the contract. A defendant might breach because performance has become prohibitively costly, yet try to defend against a restitution claim on the ground that the nonbreaching party would not have benefited from performance either. The doctrine plainly disallows the defense, whether or not the party who repudiates makes a rational choice.

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

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¹ 2 Conn. 485 (1818).
² Id. The law does permit a party in breach to collect in restitution a benefit that it conferred, provided that the promisee is not thereby deprived of the benefit of its bargain. See Restatement (Second) of Contracts §374 (1981). Collection is not permitted, however, for any savings the promisee garners as a result of its release from the contract.
The doctrine seems straightforward, then. A party who breaches a contract breaks a promise and is in the wrong. She deserves no benefit from that contract. Some would defend this as a philosophical matter. Hume described the material benefit to society of promise keeping, but then added that “a sentiment of morals concurs with interest, and becomes a new obligation upon mankind.” More recently, Charles Fried said this: “There is a convention that defines the practice of promising and its entailments. This convention provides a way that a person may create expectations in others. By virtue of the basic Kantian principles of trust and respect, it is wrong to invoke that convention in order to make a promise and then to break it.”

Such philosophy notwithstanding, it is accepted wisdom that Anglo-American contract law takes an amoral approach to promises. More than a hundred years ago, Oliver Wendell Holmes said this: “The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else.” Holmes’s statement has become the basis for an approach to contract law that allows a party to breach yet escape legal characterization as a wrongdoer. Such a party does not break a promise, but rather exercises an option to fulfill one promise over another: the payment of damages, if any, rather than performance of the activity specified. As expressed by Justice Scalia: “Virtually every contract operates, not as a guarantee of particular future conduct, but as an assumption of liability in the event of nonperformance.”

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9 Whether Holmes meant to suggest this is a matter of debate. See Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 Fordham L. Rev. 1085 (2000). But neither Holmes’ intent nor any inconsistency in the law’s adherence to the principle is relevant to this article. Rather, the Holmes quote, as it has been interpreted, reflects a school of thought that has not heretofore addressed the paradox of negative damages.
Or, in the words of Judge Posner: “In Holmes’s vivid formulation, the obligation created by a contract is an obligation to perform or pay damages for nonperformance, and if the second alternative remains, then, since it is an alternative, the obligation created by the contract is not impaired.”

The Holmesian view of contract obligation is a legal concept, not one founded in ethics, or even in business practice. The distinction is important. There may be a moral content to promises, but this does not imply that a promisor’s legal obligation to perform extends beyond financial remuneration. A promisor who chooses to pay damages rather than perform may be seen to behave badly if the parties do not expressly or even implicitly agree that the promisor has that option, and the promisor may be shunned by others in the business community who expect performance, but if a sense of morality or a desire to protect reputation do not induce performance then the law will not intervene. Hume and Fried would like it otherwise. Hume saw government itself as a means by which “men cure their natural weakness, and lay themselves under the necessity of observing the laws of justice and equity.” But the law is with Holmes, not Hume.

The question arises, then, if the law does not characterize a party in breach as a wrongdoer, why is it that she cannot collect from a nonbreaching party who, vernacular aside, is a beneficiary rather than a victim of the breach. To be sure, there is a clear distinction between paying and collecting, and thus a damages floor of zero may seem salient. But it is not immediately clear what justifies such a floor. If the law does not revile the party in breach, one wonders why she should not collect, particularly because collection can leave the party not in breach with

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11 Horwitz-Matthews v. Chicago, 78 F.3d 1248 (7th Cir. 1996).
13 Hume, supra note 6 at 537.
the full benefit of his bargain. Consider, for example, a simplified version of *Bush*, where the seller breaches a contract for the sale of a single barrel of flour at a price of $7 and the buyer covers, i.e., obtains substitute performance on the market, with a $5 purchase. The buyer could pay the seller $2 and still receive her due, a barrel of flour for a total cost of $7. Contract doctrine says the $2 difference stays with the buyer, but it isn’t apparent why. Note that the law does not *generally* disfavor a benefit to the breaching party. Had the cover price been $8 instead of $5, and had the seller breached because he could not access the market or otherwise supply a barrel of wheat for less than, say, $9, the buyer would have collected $1 in damages, enough to provide the benefit of her bargain, but not more. The savings from the breach, here the $1 difference between the buyer’s cover price and the seller’s cost, would be retained *entirely* by the breaching seller. So one wonders why the law allows a breaching party to retain, but not collect, the surplus from breach.

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

Yet, the prior literature on the economics of negative damages is sparse and arises in a desultory set of narrow contexts: In the examination of the impossibility or impracticability doctrine, Alan Sykes and Michelle White, independently, observed that negative damages might be
an appropriate response to promisor risk aversion;\(^{14}\) in the analysis of a signaling model, Herma-
lín & Katz described a potential role for negative damages where one party is unaware of the
other’s type;\(^{15}\) as part of a mechanism design, Aaron Edlin noted that negative damages would
undermine an attempt to assign one party the breach decision;\(^{16}\) in the analysis of cover and
bankruptcy ipso-facto clauses, respectively, Tom Jackson and Che & Schwartz observed that
where prices may fluctuate between breach and performance, or where a court must estimate
damages, an expected award is skewed by the truncation at zero of the damages distribution;\(^{17}\) in
a discussion of restitution, George Cohen defended the disallowance of negative damages as a
means to dampen strategic behavior by a party who seeks to avoid the uncompensated transac-
tions cost of performance;\(^{18}\) as part of a discussion on promisee insecurity, Dick Craswell and
Geotz & Scott, independently, considered whether a party may terminate a contract based on her
counterparty’s perceived inability to perform;\(^{19}\) in the context of the mitigation doctrine, MacIn-
tosh & Frydenlund noted a connection between the disallowance of negative damages and the

\(^{14}\) See Alan O. Sykes, The Doctrine of Commercial Impracticability in a Second Best World, 19 J. LEG.
STUD. 43 (1990); Michelle J. White, Contract Breach and Contract Discharge Due to Impossibility: A Unified Theo-

\(^{15}\) See Benjamin E. Hermalin & Michael L. Katz, Judicial Modification of Contracts Between Sophisticated

\(^{16}\) See Aaron S. Edlin, Cadillac Contracts and Up-Front Payments: Efficient Investment under Expectation

\(^{17}\) See Thomas H. Jackson, “Anticipatory Repudiation” and the Temporal Element of Contract Law: An
Economic Inquiry Into Contract Damages in Cases of Prospective Nonperformance, 31 STAN. L. REV. 69 (1978);
Yeon-Koo Che & Alan Schwartz, Section 365, Mandatory Bankruptcy Rules and Inefficient Continuation, 15 J. L.
ECON & ORG. 441 (1999).


\(^{19}\) See Richard Craswell, Insecurity, Repudiation, and Cure, 19 J. LEG. STUD. 399 (1990); Charles J. Goetz
967 (1983).
parties’ breach decision, described below, but did not offer substantial (or correct) analysis.\(^{20}\) A goal of this article is to provide a general analysis that fills the gap in the literature.

## II. EFFICIENT BREACH THEORY

Efficient breach theory is a cornerstone of the economic analysis of contract law. The theory begins with the observation, noted above, that the expectation damages remedy for breach requires a promisor to provide the promisee the full benefit of her bargain, but no more. So, if a contractor agrees to paint a house for $10,000 and then reneges, the contractor must pay the homeowner the difference between the value of performance and $10,000. Suppose that the value of a paint job to the homeowner exceeds $14,000, which, assume, is the amount the contractor’s competitor would charge to do comparable work. The contractor would thus owe the homeowner $4,000.\(^{21}\) With that amount, and the $10,000 the homeowner had been bound to pay the contractor, the homeowner can hire the competitor and get what she expected from the initial contract, a painted house in exchange for (net) $10,000.

Now consider the contractor’s incentives at the time of the performance-or-breach decision. If, at that time, the contractor’s cost of performance exceeds $14,000 she will want to terminate the contract. She may not breach; she may instead seek a release from the homeowner. She may do this to satisfy a moral obligation or to preserve her reputation. If the landowner is recalcitrant, however, the expectation remedy provides the contractor with an out, a payment of $4,000 in damages. If, at that time set for performance, the contractor’s costs are less than $14,000 then matters are simpler still. Whether motivated by moral obligation, a desire to protect


\(^{21}\) This calculation implicitly incorporates the promisee’s duty to mitigate, discussed in part VI, below.
reputation, or narrow self-interest, the contractor will perform, despite any loss on the contract, a loss she would incur if her costs exceed the $10,000 contract price. Because $14,000 is also the social value of performance, determined in this case by the cost of the competitor’s work,\(^\text{22}\) the contractor’s private incentive also assures an optimal performance-or-breach decision: perform when it is efficient to do so, terminate otherwise. Thus, expectation damages can usefully induce the parties to behave in a mutually beneficial fashion even where they cannot fully specify such behavior in advance, an observation first made by Shavell.\(^\text{23}\)

As an alternative, the law might simply hold the promisor to her bargain and rely on a negotiated release where termination is efficient. Suppose that, in the above illustration, a court ordered the contractor specifically to perform or, the functional equivalent, set the damages for the contractor’s breach at a punitive level, say $10,000, while the contractor’s cost of performance is $18,000. In this case, if the contractor performed it would suffer an $8,000 loss. But the parties might renegotiate instead and could settle on an amount between $4,000 and $8,000 that the contractor would pay the homeowner for a release. (Assume that while the contractor’s competitor would do comparable work, the work would not be identical and the contractor, therefore, could not unilaterally substitute the competitor’s performance for its own.)\(^\text{24}\) The result would be an efficient termination of the contract. An analogous illustration easily could show how renegotiation might prevent inefficient termination of the contract were the damages award set too low.

\(^{22}\) For simplicity, assume that the market for a painter’s services is competitive and that the price of substitute performance also reflects its social value.


\(^{24}\) Where there is a thick market for performance, the distinction among a penalty, specific performance, and expectation damages fade as a promisor can on her own substitute a competitor’s performance and not breach the contract at all. *See* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 275 (1979). *Cf. supra* note 48.
to induce the contractor’s performance even if the contractor, rather than its competitor, could more cheaply do the work. Still where the parties behave in a narrow, self-interested fashion, as some will, at least some of the time, these results could be achieved only after negotiation and without a settled expectation of the outcome, which could range across the entire surplus generated by an efficient resolution. The cost of negotiation over a surplus is unnecessary under expectation damages, which fixes the promisor’s obligation. 25 Expectation damages may lead to litigation, of course, but frequently will not, at least where the parties know the outcome in advance. 26 Thus, the costs of protracted negotiation count against specific performance or a damages rule that is punitive or undercompensatory.

In this illustration, the parties might have addressed the performance-or-termination decision in a different way, relying neither on expectation damages nor negotiated settlement. They might have specified that the contractor would be obligated to perform if and only if her realized costs were less than the market rate for the work, here $14,000; they then could have separately allocated the risk of a cost increase that would excuse performance and could have adjusted the contract price accordingly. 27 But it may not be useful to specify a contractor’s costs as a basis for obligation as these costs may be difficult to observe or to verify in a court. 28 Even so, one might

25 But see Craswell, supra note 19, which observes that where information about the cost and benefit of performance is asymmetric, the parties would engage in contested negotiation even under an expectation remedy.

26 But see, e.g., Johan A. Sebert, Jr., Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation, 33 UCLA L. REV. 1565 (1986).

27 Relative risk aversion would determine how the parties would allocate risk, but the effects of risk aversion are beyond the scope of this article.

28 A recent literature has developed on how parties might shape their contractual obligations given the difficulty of verification. See, e.g., Albert H. Choi and George G. Triantis, Completing Contracts in the Shadow of Costly Verification (1997) (unpublished manuscript), arguing, among other things that parties sometimes intentionally include difficult-to-verify terms and incur the potential for costly litigation as a signal or in order to enhance the promisor’s performance incentives. Such analysis is beyond the scope of this article. Suffice it to say here that parties will not always prefer difficult-to-verify terms. Cf. Barry E. Adler, Avarice-Based Forfeiture (1997) (unpublished manuscript), arguing that difficult-to-verify terms may yield costly pooling of heterogeneous party types.
imagine that the market price for contractor services is easily observable and stable enough that the parties presume the homeowner will be willing to pay that price. That is, the contractor’s cost might be the only variable subject to significant uncertainty. In this case, expectation damages induces efficient performance or breach, a decision motivated by the unverifiable contractor’s cost, all while a court is never asked to verify such cost. This is the genius of expectation damages.30

There is, moreover, another potential advantage to expectation damages, one that looks back in time to before the performance-or-termination decision. In the above illustration, imagine the (risk neutral)31 contractor’s expected cost at the time of performance is a stochastic variable, the distribution of which the contractor can affect in advance with an investment, in the employment of a skilled manager, for example. The contractor’s private incentive to so invest depends in part on the damages it would be forced to pay should a high-cost realization make

29 In this illustration, one might quibble with the conclusion that the homeowner’s willingness to pay the competitor’s price is fairly presumed. Yet, in practice, the cost of cover is a relatively uncontroversial basis for damages, with judicial and scholarly attention paid only to exceptional cases, those where the cost of cover would be excessive except to the most idiosyncratic promisee. See, e.g., Ian Ayres & Kristin Madison, Threatening Inefficient Performance of Injunctions and Contracts, 148 U. PENN. L. REV. 45 (1999). In any case, suffice it to say here that the expectation remedy in this illustration requires less information than would a remedy that depended, in addition, on the promisor’s cost, such as where a court first had to determine whether the promisor’s cost exceeded the market rate for the promised performance then, if the answer to that question were no, had to determine injury to the promisee. A remedy based on the promisor’s cost instead of the promisee’s benefit, such as one proposed by Richard Brooks, would require different rather than greater information. Brooks would permit the victim of breach to elect between specific performance and a disgorgement remedy, where the victim’s damages would be measured by the difference between the contract price and the promisor’s cost. He argues persuasively that this remedy, like expectation damages, would yield efficient performance-or-termination decisions. See Richard R.W. Brooks, The Efficient Performance Hypothesis, 116 YALE L.J. 570 (2006). But the distinction between Brooks’ proposal and expectation damages is inapposite to the discussion here.

30 Not all would agree that expectation damages are genius. Scott and Triantis, for example, have argued that in thin-market settings parties should be encouraged to contract around expectation damages, to achieve efficient risk allocations, for example. See Robert E. Scott & George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law, 104 COLUM. L. REV. 1428 (2004). For reasons given in the text, though, parties might expressly contract for expectation damages even if they were not the default. The matter is not discussed further here.

31 For the sake of simplicity, here and hereafter all parties are assumed to be risk neutral. The passage of time and the time value of money are also ignored. None of these assumptions drive any conclusion presented here.
performance inefficient. The socially optimal investment is one that reflects a $4,000 damages award, the true cost of breach, and if the contractor instead anticipated, say, a negotiated payment of between $4,000 and $8,000 it would overinvest. Similarly, if the anticipated award were an amount below true cost, the contractor would underinvest in precaution compared to the social optimum. These costs of deviation from the expectation remedy would be borne by the parties jointly, however a price adjustment allocates the loss and whether or not renegotiation yields an efficient breach decision ex post.

This is not to say that expectation damages yield ideal results. They do not. Where parties invest in a contractual project, as did the contractor in the above illustration, expectation damages yield too much investment, at least where each party is able to pay any damages award against it. This is because, where each party expects fully compensatory damages from breach, each treats the performance of the other as certain and invests in its own end of the project as if it will fully benefit from the other’s performance, as the other will either perform or pay for its failure to do so. The socially optimal investment, by contrast, would cause each party to discount its own investment based on the possibility that the project might efficiently be abandoned. The parties may contractually predetermine (or “liquidate”) moderate damages in order to separate the breach remedy from actual investment, and thus cure the overinvestment incentive, but liquidated damages can create their own inefficiencies, such as perverse incentives to breach ex post when the realized costs and benefits of performance differ from expectations at the time of contract.

\[32\] As suggested above in the text, if there is a risk of promisor insolvency, this result will not hold. See Steven Shavell, The Judgment Proof Problem, 6 Internat’L Rev. L. & Econ. 45 (1986); see also Craswell, supra note 19. This complication is ignored here for simplicity.
Theories on the overinvestment incentive of expectation damages, the stochastic nature of cost, and the role of liquidated damages have usefully been pioneered or refined by Shavell, Craswell, Triantis & Triantis, Cooter, and Goetz & Scott, among others. Theoretical qualifications and refinements aside, however, expectation damages are both the doctrinal norm and a tolerably proficient mechanism for the encouragement of efficient breach and investment decisions. This is particularly so given that the law curbs the excesses of expectation damages with a variety of doctrines, including those that disallow unforeseeable and speculative damages.

III. THE VIRTUES OF NEGATIVE DAMAGES

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

Disallowance of negative damages breaks the connection between the promisor’s private incentive and social welfare. This has been largely overlooked, perhaps because simple analysis assumes symmetric, complete information. Consider the following illustrations, based loosely on Algernon Blair. In the initial set of illustrations, the promisor has private information that performance is inefficient, or a unique opportunity to discover this fact, but would benefit from performance nonetheless. That negative damages can promote efficiency in this setting is the central insight here, but not the only relevant observation. Thus, in a subsequent illustration, judicial estimation leads to overcompensation for the promisee in the event of breach, a result that negative damages would counter. And in a final illustration, a promisor, turned promisee, engages in strategic litigation over the question of whether there has been a breach and by whom, again an outcome that negative damages would counter.

A. Promisor Private Information

A contractor agrees to construct a landowner’s building over a period of time for a specified price. As time passes, the contractor’s prospective costs rise as the value of the landowner’s use for the building declines, each change an observable result of market fluctuation. Each party recognizes the plight of the other, as would any court. Assume that the cost of completion ex-
ceeds the contract price, which in turn exceeds the value of completion to the landowner. There
are no externalities. One or the other party will repudiate the contract and terminate the project.40
It does not matter whether the contractor or the landowner breaches. The result is the same in
either case, efficient termination and, under the expectation remedy, no damages to either party.
Thus, in this standard story of efficient breach, where the parties who must make a termination
decision and the courts possess complete information, efficiency theory offers no challenge to
the disallowance of negative damages.

Matters change when one relaxes the assumption of symmetric, complete information. An
efficient breach decision subject to expectation damages requires that a promisor know not
only her own cost but also the promisee’s benefit. Thus, as is commonly known, and as intimated
in part II, a party’s ignorance of her counterparty’s benefit can yield an inefficient breach deci-
sion. Not well understood is that the disallowance of negative damages exacerbates this problem
where only one party knows that breach is efficient and that party will nevertheless benefit from
the contract. In essence, as the Appendix sets out formally, the disallowance of negative dam-
ages may force a promisor to externalize the benefit created by her decision to terminate a con-
tract and can, therefore, leave the promisor with an insufficient incentive to breach. Therefore,
where the promisor has private information, neither party may breach even where termination of
the contract is efficient. Significantly, where negative damages are disallowed, inefficient per-
formance may occur in the plausible and stubborn circumstance that a party’s private informa-

40 In a richer illustration the decision to terminate would depend on the variance in costs and benefits as
well as the cost of deferring the termination decision, none of which is described here, or needs to be given the pur-
poses of the illustration.
tion is limited to its own cost, with information about the other party’s benefit symmetric and complete.41

Another version of the contractor illustration may clarify. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As time passes and work begins, there is a substantial influx of construction inputs and the general market for contractor services shifts so that the landowner could now obtain comparable substitute performance for $15 million, but would also suffer a $2 million dislocation cost from delay that would result in the switch as a new contractor could not redeploy immediately and would have to learn the job specifications. The increase in supply for construction inputs corresponds with a general recession and the value of the building project to the landowner has declined to $16 million. In addition to these commonly known circumstances, unbeknownst to the landowner, the contractor has suffered an internal management crisis that has increased its cost of production relative to that of its competitors. Consequently, it would cost the contractor $18 million to complete the project.

In this illustration, termination is efficient because it would cost the contractor $18 million to provide a building worth $16 million and if the contractor were replaced, the total cost of construction would be $17 million (including the dislocation cost); the project should be abandoned.42 Yet, under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because, while it would pay no damages, neither would it collect any. The alternative for the contractor is to per-

41 MacIntosh & Fryerlund, supra note 17, note the potential for information asymmetry to yield inefficient breach decisions under expectation damages, but they treat the problem as largely insoluble unless one party has superior information about the other party’s affairs, an unexplained assertion disputed here.
42 But see supra note 38.
form and earn a $2 million profit. If the landowner believes that the contractor is typical—and by hypothesis it has no reason to assume otherwise—then the landowner will not repudiate, as if it did it would expect to pay damages of $5 million. The alternative is to pay the $20 million contract price for a building worth $16 million and lose $4 million. Were negative damages allowed, however, the contractor would repudiate the contract and collect $4 million from the landowner, the difference between the contract price and the value of performance, an amount that reflects the contractor’s $2 million expected profit at the time of repudiation and the $2 million surplus from contract termination. The allowance of negative damages—in essence, a put by the promisor of the promisee’s obligation—would harness the promisor’s private information, and the disallowance of negative damages is thus shown to do harm.

Despite the foregoing, the parties might negotiate for efficient termination even where negative damages are disallowed. The landowner could, for example, attempt to induce termination with a blind offer to pay the contractor for cancellation of the contract on the chance that performance is inefficient. In this illustration, there is a range for agreement between $2 million and $4 million. But without information about the contractor’s true costs, the landowner’s offer

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43 In a richer illustration, the expected damages would be stochastic and the landowner would not assume with certainty that contractor is typical. Consequently, disallowance of negative damages would be at work in the damages calculation as well, perhaps to increase the landowner’s expected damages from repudiation because the landowner would treat the contractor’s costs as a distribution centered on or near $15 million, with damages increasing dollar for dollar with the reduction of costs between $15 million and $0 but decreasing for costs only up to $20 million. This phenomenon would tend to offset any undercompensation from the elimination of the contractor’s real option, described by Triantis & Triantis, supra note 35. See also Adler, supra note 38 and the illustration below in this part. For simplicity it is assumed here that the court would accurately assess damages and that the landowner assumes with certainty or near certainty that the contractor is typical.


45 Cf. Ayres, supra note 44 at 96, which contemplates a form of truncated auction, where a promisee can through an offer of supplemental payment for performance increase the damages paid by a promisor in the event of the promisor’s breach (thus not negative damages), and observes that such an auction can harness a promisee’s private information, where such information exists.
could be out of range or appear to be, or be in fact, aggressively low, and might lead to bargaining expense or breakdown as a narrowly self-interested contractor might require, or simply hold out for, a greater amount.\textsuperscript{46} In this setting, moreover, information asymmetry could be difficult to overcome. The contractor would not readily reveal its true cost because, armed with information of what would be a sufficient offer, the landowner would not negotiate, but rather would exploit such information through immediate repudiation, and a payment to the contractor of only $2 million.\textsuperscript{47}

Variants of this illustration yield similar observations. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As time passes and work begins, there is a substantial influx of construction inputs and the general market for contractor services shifts so that the landowner could now obtain comparable substitute performance for $15 million. In this version of the illustration, the building project remains valuable to the landowner, so if the contractor and landowner terminated their relationship the landowner would replace the contractor with a competitor at the going rate for the work, but would also suffer a $1 million dislocation cost from delay that would result from the switch. If the contractor unilaterally abandoned the project but tendered the work of a competitor, imposition of the dislocation cost would constitute a breach of the contract.\textsuperscript{48} Unbeknownst to the landowner, as before, the

\begin{footnotes}
\footnote{46} It is well established that bilateral monopoly negotiation can be costly where information is asymmetric. \textit{See}, e.g., Robert Gibbons, \textit{Game Theory for Applied Economists} 218 (1992).

\footnote{47} Matters would not change significantly if the landowner prepaid for the building as even a party in breach can collect in restitution so long as such collection does not deprive the promisor of the benefit of its bargain. \textit{See supra} note 5 and accompanying text.

\footnote{48} This is a pivotal assumption in this version of the illustration, one suggested previously in note 24. If the contractor could itself hire a competitor to do the work and keep the landowner bound to perform in return, the problem addressed by this illustration would vanish. The assumption is not strong, however, at least not universally so. As discussed more fully below in part III(c), a breach such as the imposition of a dislocation expense in this illustration—perhaps for failure to meet a progress schedule—may be considered material and thus release a promisee from its contractual obligations. \textit{See} Restatement (Second) of Contracts §241 (1981). Moreover, it is some-}

Draft of September 27, 2007
contractor has suffered an internal management crisis that has increased its cost of production relative to that of its competitors. Consequently, it would cost the contractor $18 million to complete the project.

In this illustration, as in the last, termination is efficient, here because a competitor can construct the building for $3 million less than it would cost the contractor at a dislocation cost of only $1 million. Yet, under expectation damages and the disallowance of negative damages, it may be that neither party will terminate. The contractor will not repudiate unilaterally because, while it would pay no damages, neither would it collect any, as before. The alternative for the contractor, again, is to perform and earn a $2 million profit. If the landowner assumes that the contractor is typical—and again, by hypothesis, it has no reason to assume otherwise—then the landowner will not repudiate, as if it did it would expect to pay damages of $5 million and suffer the $1 million dislocation cost, each in addition to the $15 million for the cost of completion by another contractor, for a total cost of $21 million. The alternative is to pay the $20 million contract price. Were negative damages allowed, however, the contractor would repudiate the contract and collect $4 million from the landowner, which again reflects the contractor’s $2 million expected profit at the time of repudiation and the $2 million surplus from contract termination. The disallowance of negative damages again causes harm. Again the parties might renegotiate, but just as in the prior illustration, renegotiation would be plagued by information asymmetry as

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49 But see supra note 40.
50 But see supra note 43.
the contractor would not reveal its alternative opportunity or the landowner would exploit such information through immediate repudiation, and a payment to the contractor of only $2 million.\footnote{The parties might have contracted ex ante so that the contractor could unilaterally substitute performance of a competitor despite what the default rule would consider a material breach. However, the parties would not be confident ex ante that this provision would be invoked only where it would be efficient. See supra note 48.}

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

This illustration matches the prior one with the exception that the contractor’s cost of performance now includes a stochastic opportunity cost with a value that is a function of invest-
ment in search. It becomes quickly apparent that the contractor will underinvest in search.\textsuperscript{52} To see this, assume provisionally that ex post renegotiation on the contract is prohibitively costly. In this case, neither party will repudiate the contract even if the alternative opportunity materializes. As before, the landowner would expect to pay $21 million if it repudiated and would prefer to pay the $20 million contract price instead.\textsuperscript{53} Also as before, the contractor will not repudiate if negative damages are disallowed. If the contractor performs on the contract it will earn a $5 million profit; this amount is the contract price less the contractor’s costs, which here are common with its competitors. If the contractor breached instead it would neither pay nor collect damages, as before, but would earn only $3 million in profit from the alternative job. Performance, thus, would be certain even though society would benefit by $2 million if the contractor repudiated and took the alternative work; this amount is the difference between the $3 million in value foregone when the contractor declines the alternative project for which it is uniquely suited less the $1 million in dislocation costs saved by such action. Were negative damages permitted, the contractor would repudiate, collect $4 million from the landowner and earn $3 million on the alternative project, a total that reflects its $5 million expected profit on the contract and the $2 million termination surplus. But, as just demonstrated, if negative damages are disallowed, where renegotiation is impossible, this surplus will be forgone in all cases and the contractor will invest nothing in search.

Matters improve if renegotiation is possible. But the contractor’s underinvestment in search will persist here even if the parties could without transaction cost renegotiate for an efficient outcome ex post should the opportunity materialize. This is so because even if the contrac-

\textsuperscript{52} Were both parties in a position to search, the aggregate level of search could be excessive, a point discussed in note 74 and accompanying text.
tor could be counted on to negotiate rather than repudiate upon knowledge of the contractor’s realized alternative opportunity, the parties can be expected to divide the social surplus from such opportunity. Consequently, ex ante, the contractor will not expect to gain $2 million if the opportunity arises, but some fraction of that amount. Because it bears the full cost of search, though, it will invest less than is socially optimal.\textsuperscript{54} Again, the disallowance of negative damages is shown to be costly, here perhaps counterintuitively, because a promisor might not seek to increase its cost of performance where it alone has an opportunity to do so.\textsuperscript{55}

This observation, moreover, extends the potential usefulness of negative damages beyond the circumstance of information asymmetry at the time of the performance-or-breach decision. Even if one assumed that the promisee would learn of the promisor’s mitigation opportunity should it materialize, if negative damages were permitted, the promisor would have at least a chance to repudiate first and capture the benefit of the opportunity. This chance could induce the promisor to invest in search, suboptimally, to be sure, but to some extent.

\textbf{B. Judicial Estimation of Damages}

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

\textsuperscript{53} Cf. supra note 50.

\textsuperscript{54} This is a standard result. \textit{See}, e.g., Alan Schwartz & Robert E. Scott, \textit{Precontractual Liability and Preliminary Agreements}, 120 HARV. L. REV. 661 (2007).

\textsuperscript{55} As a conceptual matter, the disallowance of negative damages could remain and expectation damages could be modified merely to permit compensation for reasonable investment in creation of the opportunity for efficient breach. \textit{Cf.}, Brooks, \textit{supra} note 29, which argues that a victim of breach might efficiently be entitled to disgorgement remedy reduced by the promisor’s reasonable expenditures. As described above in part II, however, the
mate this value. Given such uncertainty, because the disallowance of negative damages truncates at zero the distribution of a damages award, the contractor’s expected liability from repudiation is inflated above an unbiased estimate of the landowner’s loss from termination. Rather than breach and pay this inflated expected amount, or bear the cost of a negotiated termination, the contractor might perform even if termination were efficient.

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

usefulness of expectation damages is premised on the observation that efficient levels of activity may be difficult to verify.

56 This is illustration is stylized and ignores the variance in costs, as opposed to their estimation, between the time of repudiation and the time of performance. Triantis & Triantis, supra note 35, observes that cost variance may yield an offsetting tendency for undercompensation given current judicial implementation of the expectation remedy, which, according to Triantis & Triantis, fails to account for the promisee’s own breach option. But even if this is so, the law could, in principle, correct both biases rather than allow them to compete as they will not always perfectly offset one another. See also supra note 50.
equally likely possibility of an approximately $5 million negative liability, and the proper incentives would be restored.\(^{57}\)

These ex post effects of a damages distribution truncated at zero have been observed elsewhere, by Jackson and by Che & Shwartz, for example, albeit in narrower contexts.\(^ {58}\) It is important to stress the ex ante consequences as well. Anticipation of an excessive damages award can lead a promisor to overinvest in precaution. For example, in this illustration, the contractor might invest in preparation for the project, ordering and storing materials in advance, for example, to reduce its expected cost of completion at the time of performance. How much the contractor would so invest would depend on the consequences of a high realization. Here the value of the project, ex post, was little more than the contract price and one might imagine that even at the time of contract the expected value of the project did not greatly exceed the expected cost. The contractor’s optimal investment in precaution would be correspondingly small, but the contractor will overinvest where it anticipates that breach would cost it up to $1 million—plus perhaps the cost of negotiation in an attempt to settle on a lower amount\(^ {59}\)—even if the landowner is not injured.\(^ {60}\) This phenomenon exacerbates the well known overinvestment incentive generated by the fact that expectation damages reflect actual rather than optimal investment by the parties.\(^ {61}\)

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\(^{57}\) This conclusion is a simplification. As discussed above in part II and below in part IV expectation damages creates a general tendency to overinvest in reliance and in precaution. Negative damages may generally exacerbate this problem, as discussed below, but with respect to overinvestment generated by judicial estimation the effect is palliative.

\(^{58}\) See supra note 17.

\(^{59}\) Cf. supra note 46 and related text.

\(^{60}\) The text generalizes the result in Che & Schwartz, supra note 17, which observes that the truncation of damages at zero induces the promisor to invest too little in the avoidance of insolvency.

\(^{61}\) See supra notes 33-37 and related text.
There is more. Some breach is stochastic (an accident) rather than deterministic (by repudiation). Thus, one could plausibly consider an alternative model for the effect of precaution, one where precaution reduces the probability of breach. Still, the disallowance of negative damages induces promisor overinvestment because the expected damages award would exceed actual damages. In this illustration, breach would in fact cost the landowner almost nothing, but the contractor would expect to pay damages of $1.25 million. The allowance of negative damages would restore proper incentives in this case as well.

C. Uncertain Breach

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

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62 See, e.g., Craswell, supra note 34; Cooter, supra note 36.
63 See supra note 57.
64 See Craswell, supra note 19; cf. Goetz & Scott, id.
terminated. The law, to some extent provides this result through the related doctrines of material breach and adequate assurance of future performance. If the promisor has materially breached a contract, or (at least under the Uniform Commercial Code) if the promisee otherwise has reason to be insecure about future performance, the promisee may terminate the contract and collect damages from the promisor. The promisee thus has a relatively robust incentive to terminate when it is efficient to do so.

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

65 See Craswell, supra note 19.
Consider the following. A contractor agrees to construct a landowner’s building over a period of time in exchange for $20 million. As the project progresses, the contractor recognizes that its cost of completion will be $22 million, an amount that is $2 million less than any competitor would charge to finish the project. Completion of the project is worth $25 million to the landowner. Thus, performance is efficient, but the contractor would prefer to be relieved from its contractual obligation. A term of the contract requires that the landowner continually drain the building site so that there is no standing water during construction. The landowner drains the site periodically, but some water remains. A dispute arises as to whether the water that cannot be removed is significant.

The contractor claims that the landowner has materially breached the agreement and seeks termination. The landowner argues that the breach is minor and can be remedied by a trivial increase in the price paid for construction. If the breach is minor, or even if it is not but the landowner will reliably pay any damages from its continuing failure to remove water, the contractor should remain bound. But these determinations are difficult. The line between immaterial and material breach is not bright, and courts struggle over the distinction. Thus, a court might rule in favor of the contractor even if the landowner’s breach is insubstantial and the contractor’s grievance entirely strategic. As Goetz & Scott warned, the result could be termination of an efficient project or costly negotiation to prevent this outcome.67 Moreover, even if the project is not terminated and renegotiation is costless, renegotiation would force the landowner to sacrifice some portion of its expected return from the contractual project. That is, in renegotiation, the

67 See Goetz & Scott, supra note 19. See also Craswell, id. For similar analysis in related contexts, see George L. Priest, Breadth and Remedy for the Tender of Nonconforming Goods under the Uniform Commercial Code: An Economic Analysis, 91 HARV. L. REV. 960 (1978); Alan Schwartz, Cure and Revocation for Quality Defects: The Utility of Bargains, 16 B.C. L. REV. 543 (1975).
landowner would expect to pay the contractor between $22 million and $24 million to complete the project when the contract price was only $20 million. Ex ante, anticipation of such ex post renegotiation, which will occur with a positive probability, reduces the landowner’s incentive to invest in reliance on the contractor’s performance and increases the landowner’s incentive wastefully to take precaution against trivial breaches, which can have nontrivial consequences.

Now assume that the law generally allowed negative damages. Then, in this illustration, if the court found the landowner’s breach material, the landowner would nevertheless collect $2 million in damages, the loss that the contractor would have incurred were the contract performed. Craswell has argued that such a return would eliminate the contractor’s strategic incentive, but this is an overstatement. Despite its liability for negative damages, the contractor might seek to terminate the contract because it anticipates renegotiation with the landowner where it will extract some portion of the $2 million advantage it has over its competitors. Still, the loss to the landowner would be reduced as compared to the circumstance where negative damages are disallowed, and thus the landowner would have a relatively stronger incentive to invest in reliance and weaker incentive wastefully to invest in precaution against trivial breach. Moreover, the law could be amended not only to allow negative damages here but, at least in principle, also to prohibit renegotiation, in which case the contractor would in fact have no incentive strategically to terminate the contract.69

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

68 See Craswell, supra note 19 at 419.
69 Prohibitions on renegotiation are often theoretically desirable but may prove difficult to enforce in practice. See, e.g., Alan Schwartz & Joel Watson, The Law and Economics of Costly Contracting, 20 J. L. ECON. & ORG. 2 (2000).
pectation remedy induces overinvestment in reliance. So it is conceivable that the risk of strategic termination is a useful mitigation of that incentive, one that balances the incentive for wasteful precaution induced by such risk, albeit roughly. Suffice it to say, though, that there are a number of potential advantages to the allowance of negative damages, advantages that the law and commentators have largely overlooked perhaps because the concept itself seems absurd. The analysis in this part is designed to dispel that impression and to prompt greater attention to the issue.

IV. **The Vices of Negative Damages**

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

An initial point in this regard is straightforward. In some cases, even in the absence of negative damages, a promisor will terminate a contract from which neither party would benefit. Where negative damages are disallowed, the promisee in such a case might not seek a payment from the promisor. Even if she did, the promisor might simply refuse to pay and in the subsequent litigation a court would not have to determine the full extent of what the promisee would have lost under the contract, but only that there would be a loss; any loss would imply an award of zero. Were negative damages allowed, every repudiation of a contract would entitle one party or the other to a payment that depended on the precise value of performance. Of course, this value is routinely relevant even in the absence of negative damages, germane to every case where expectation damages are positive, and so the allowance of negative damages would not burden the parties or courts with an additional or novel fact to settle on or litigate over. Still, the
allowance of negative damages would increase the number of cases in which a precise valuation is pertinent and this would entail additional transactions cost.\textsuperscript{70}

Another clear-cut cost to the allowance of negative damages would arise where the promisor can affect the value to the promise of the promisor’s performance, or the cost of the promisee’s performance, the promisor may succumb to a perverse incentive. That is, the promisor may expend resources in an attempt to lower the value of the contract to the promisee then breach and collect the fruits of its wasteful efforts. (A related strategic, and wasteful, practice would be for a sophisticated promisor to seek out naïve promisees who overestimate the value of performance, then terminate contracts with them.) A promisor may seldom have such an opportunity, though, and so this cost of negative damages might not generally be a problem.

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

Consider, for example, a modified version of the Algernon Blair illustrations from part III. A contractor agrees to construct a landowner’s building over a period of time in exchange for

\textsuperscript{70} These costs might be avoided if the law disallowed negative damages only where the promisor would have breached in any case, but to apply such a rule, the court would have to determine the promisor’s costs, adding
$20 million. At the time of contract, the parties anticipate the possibility of a universally observable exogenous event, or set of exogenous events, that would simultaneously reduce the value of the building to a range between $18 million and $20 million, depending on the landowners’ prior investment in the project, and increase the contractor’s cost of completion to a range between $20 million and $22 million, depending on the contractor’s investment in precaution. If negative damages were allowed, anticipation of such an event or events would provide an incentive for wasteful investment by both parties. To see this, note that even where the value-reducing contingency is realized, the landowner would like the value of the building to be near $20 million because, if the contractor repudiated, the landowner’s liability would decline as the benefit from performance approached the contract price; similarly, the contractor would like its cost to be near $20 million because, if the landowner repudiated, the contractor’s liability would decline as its cost approached the contract price.

This said, the exacerbation of the overinvestment incentive is not certain, because the incentive to overinvest, induced by negative damages, would have an offset. Just as the prospect that a party might pay negative damages gives it an incentive inefficiently to reduce its costs or increase its benefits, the prospect that the party might receive negative damages mitigates that inefficient incentive. In the current illustration, for example, in the absence of negative damages, the contractor profits only if its realized costs are below the contract price and thus the contractor will want to reduce these costs even if it anticipates that the landowner will breach. Were negative damages permitted, however, the contractor would anticipate a positive probability that it would repudiate the contract and collect damages from the landowner, damages based on the difference between the contract price and value of performance to the landowner, not based on the transactions cost not required by a general disallowance of negative damages. Cf. supra 72 and accompanying text.
contractor’s own costs; if the contractor repudiated, its investment in cost reduction would prove wasted and the prospect of such waste would reduce its incentive to lower its cost. A parallel story can be told about the landowners’ incentives and thus negative damages will not unambiguously exacerbate the overinvestment incentive. Still, the prospect of such exacerbation may be counted as a potential cost of negative damages.

Wasteful investment, if any, induced by negative damages could be reduced if the law allowed negative damages only where performance otherwise would have occurred.\(^{71}\) In this illustration, where information is symmetric, whether the contractor or landowner repudiated the other would have, with or without negative damages, and so a court could decline to award such damages; as a result neither party would overinvest in anticipation of negative damages. However, a determination that a contract would have been performed but for negative damages could be difficult for a court even where a calculation of negative damages might be relatively easy. Consider, for example, the illustrations in part III(A) above. There, when the contractor breached, a court could award negative damages, just as it could ordinary expectation damages, based only on the difference between the contract price and the value of performance; the court would not have to determine the contractor’s costs, which might be difficult to verify. Were the value of performance itself difficult to measure, even straight-forward negative damages might be difficult to calculate, just as ordinary expectation damages would be,\(^{72}\) but a conditional award increases the information required for a correct determination. Consequently, allowance

\(^{71}\) Compare Craswell’s observation that an insecure party should be permitted to make a termination decision only if there would be no uncertainty about that party’s willingness to perform but for its insecurity. See Craswell, supra note 19 at 426.

\(^{72}\) Cf. supra note 29. Also, in an illustration from part III(A), the amount of negative damages would be reduced by the transactions cost of cover—described above as the dislocation cost caused by substitute performance—but this amount, while perhaps difficult to estimate, might not be substantial relative to the overall damages and, moreover, would not determine whether damages would be awarded at all.
of negative damages subject to the condition that the contract would have been performed might be unworkable even where an unqualified allowance of negative damages could function. So it would claim too much to suggest that negative damages could be purely beneficial, a medicine with no side effects. (The same observation limits the usefulness of more exotic uses of negative damages, where the surplus from breach might be split between the promisor and promisee, e.g., perhaps to balance the benefits and costs of negative damages discussed above and below.) Like the expectation remedy itself, negative damages are useful in some but not all information settings.

This observation raises another set of concerns about the allowance of negative damages. The potential benefits of negative damages, discussed in part III above, turn in part on the presence of asymmetric information, in particular a case in which the promisor but not the promisee knows that termination is efficient. But sometimes information between the parties is differently asymmetric and sometimes it is symmetric. In either circumstance, the allowance of negative damages could be inefficient.

Take, for example, a case in which a promisor and a promisee will each lose in the event both sides perform, but each mistakenly believes that performance is efficient based on an erroneous estimation of the other’s benefits and costs, respectively. To illustrate simply, assume a contract price of $20 million, a contractor’s cost of $22 million, and a landowner’s value of $18 million, but assume that the landowner estimates the contractor’s cost as $17 million while the contractor estimates the landowner’s benefit as $23 million. In the absence of negative damages, each party would, if it could, freely disclose to the other the true nature of its circumstance as, for each party, the best possible outcome would be for the other to repudiate. Thus, an efficient termination may be likely. If negative damages were allowed, however, each party might with-
hold information that might cause the other to repudiate and instead attempt to learn more about the other’s circumstance in the hope that a revised estimate would allow it, rather than its counterparty, profitably to repudiate. Mutual misinformation of this sort may be less common than the one-sided asymmetry that favors the allowance of negative damages. Still, just as the disallowance of negative damages may sometimes yield inefficient performance or costly renegotiation, at other times so might the allowance of negative damages. Further, although the disallowance of negative damages only where either party might have collected such damages could, in principle, eliminate the incentive to withhold information here, just as in the case where negative damages might be disallowed for a party who would have breached in any case, administration of such a rule could prove difficult.

Turn now to the assumption of symmetric information. Given this assumption, in the illustrations above, where the contractor’s realized cost of completion exceeds the contract price and the landowner’s realized benefit is below the contract price, one party or the other will repudiate the contract regardless of whether negative damages are allowed. If negative damages were allowed, there would be a race to repudiate. In this simple case, where information is both symmetric and complete, the race is costless. Matters change, however, if one assumes that the cost or benefit of completion is uncertain.

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

73 Cf. Edlin, supra note 16, where a race to repudiate would undermine a contract designed by the parties to make repudiation by one of the parties impossible, thus vesting in the other any incentive to repudiate. As Edlin himself observes, such contracts are not uniformly useful, as they are less than ideal when it is efficient for both parties to invest in the contractual project.
Assume, however, that only search will reveal whether the contractor has this (mitigation) opportunity and that neither the contractor nor the landowner has an advantage over the other in search, perhaps because the contractor’s skills are general. That is, assume that information is incomplete but symmetric. Under these assumptions, the disallowance of negative damages may be efficient. Given such disallowance, the landowner could simply, and credibly, announce that it will not negotiate for termination, then search, alone and optimally. Upon any discovery of a mitigation opportunity for the contractor, the landowner would repudiate, force mitigation, and capture the entire surplus from termination. Were negative damages permitted, either party could benefit from repudiation of the contract and each might have an incentive to search. This could be suboptimal as a shared benefit from search for a substitute project could lead to wasteful duplicative search or perhaps costly negotiation to avoid such excess.⁷⁴

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

⁷⁴ A standard result in search models such as this is that a race produces too much search because no searcher internalizes the loss suffered by a rival. See Jean Tirole, The Theory of Industrial Organization 396 (1988). It is possible to alter standard assumptions about the cost, utility, and timing of search by each of multiple parties such that multiple-party search becomes efficient. Suffice it to say here that such outcome would not be assured. Cohen, supra note 18, makes a similar point with the observation that a buyer and seller on a sales contract may compete to find a higher-value third-party buyer. Contrast MacIntosh & Frydenlund, supra note 20, which assumes, without analysis, that the potential for duplicative search for a mitigation opportunity is beneficial.
Consider the following version of the prior illustration. A risk neutral contractor agrees to construct a risk neutral landowner’s building over a period of time in exchange for $20 million. The value of the building to the landowner is at all relevant times $22 million and (for simplicity) no other contractor can do this work. At the time of contract, both parties anticipate that the contractor’s cost of construction will be just under $20 million. Subsequently, however, the contractor has an opportunity to bid on another project, one that would yield the contractor $4 million in profit if its bid is accepted. (Alternatively, one might assume that there is a chance the contractor’s direct costs of completion will increase by $4 million.) Both parties assess a 75% probability that the contractor can win this project, which it cannot complete and still perform on its contract with the landowner. (Or the parties assume that there is a 75% chance of an increase in prospective costs.) Assume that these values are verifiable to a court (which would not always but could sometimes be the case). Were negative damages permitted, the landowner would repudiate, given the chance. To see this, note that if the landowner did not repudiate, it would receive either performance or expectation damages, each worth $2 million; if it repudiated, it would expect \(0.75(4\text{ million})\), or $3 million, which is the contractor’s expected loss from performance.\(^{75}\) In anticipation of this, the contractor would try to repudiate first, pay the landowner $2 million in damages and retain its expected $3 million in profit from the alternative job (or avoid an expected direct loss in that amount). If repudiation terminated the project, though, the parties would forgo the 25% probability that performance rather than termination would have been in their mutual interest. The disallowance of negative damages eliminates the landowner’s incentive to repudiate early, and thus also eliminates the contractor’s incentive to do so (even if delay

\(^{75}\) For simplicity the distinction between an ex ante and ex post calculation of damages is ignored. For a general discussion of this distinction, see, e.g., Royce de R. Barondes, An Alternative Paradigm for Valuing Breach
in termination were somewhat costly, in the landowner’s forgone mitigation opportunity, for example).

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

The competition that would be inherent in the allowance of negative damages, then, could lead to too much search while continuation remained likely to be efficient and too little search (or patience) after efficient termination became more likely, a situation that could be remedied perhaps only through costly renegotiation. Because disallowance of negative damages can, at least in some instances, assign the benefits of search to a single party, disallowance may alleviate, not exacerbate, the problems of inefficient search and termination decisions. In particular, where information is likely to be symmetric, the disallowance of negative damages is most easily justified.

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

V. **EXpress Terms**

The difficulties and tradeoffs described in parts III and IV may not all be inevitable, of course. If the law’s disallowance of negative damages imposes greater cost than benefit, the simplest response is an express agreement that authorizes such damages. However, just as information asymmetry can burden negotiation for efficient termination at the time of the performance-or-termination decision, a point discussed above, such asymmetry can similarly burden an attempt to negotiate for a negative-damages clause in advance of that decision. For example, to avoid the search underinvestment problem identified in part III(A), the parties might negotiate at the time of contract for a promisor’s right to collect negative damages upon termination. In the above illustrations, this would induce the contractor to search optimally. But the parties would
have to adjust the contract price to reflect the prospect of negative damages, and this could be
difficult. The contractor may have a clear idea of how much search is optimal and how likely
termination will be at the close of such search. Perhaps efficient termination is likely so that the
contractor should be willing to accept a large price reduction for the option to collect negative
damages. But the contractor may insist that only a small reduction is required and the landowner
may not know what to believe.

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

One might speculate, nevertheless, that at the time of contract formation, as opposed to
the time of the performance-or-termination decision, the value of a negative-damages option may
not be difficult for either party to estimate fairly, albeit imprecisely. That is, far in advance of the
termination decision, information asymmetry may be relatively mild. And at the time of contract
formation, without an impending performance decision, there is time to resolve any asymmetry
that does exist. Still, parties do not, in fact, include negative-damages provisions in their con-
tracts, or at least such provisions are not common, either at the time of contract formation or
thereafter. (A commodities or securities contract may permit a seller to tender cash rather than
the commodity or security to be traded, but these are wagers on market prices, not transactions
where performance may have become inefficient.)
A reason for the absence of negative damages provisions may be that parties rarely if ever anticipate that the benefits of a negative-damages clause will outweigh the costs. But this is not necessarily the case. Parties may predict that a negative-damages clause would be unenforceable as unconscionable (and, thus, that the disallowance of such damages is a mandatory, rather than default, rule). Liquidated damages are unenforceable if they are set in excess of expected or actual loss, and negative damages, paid as they would be to the party in breach, one that had suffered no loss from such breach, are quintessentially excessive by this standard.

Another possibility is that parties do not wish to deviate from the norm and identify themselves as one who contemplates a failure to perform. Recall from part I above the Humian notion that one is morally obligated to do what one promises. This moral sentiment may be translated into business ethics and practice. No business person wants conflict to be the result of her contract. Even a remedy, such as expectation damages, designed to be fully compensatory may not be in practice, particularly so in a legal system that has each litigant bear its own expenses. Like one who contemplates marriage, a business may shy away from a partner who wants to discuss breakup even before the union. This may be a reason that liquidated damages clauses are not more common and why a clause that would permit a party both to terminate the relationship and collect damages would be a difficult innovation.

More importantly, perhaps, the absence of negative-damages clauses may be explained by the very nature of the tradeoffs inherent in negative damages themselves. That is, because parties cannot easily limit the allowance of negative damages to circumstances where they would

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76 See Restatement (Second) of Contracts §356(1) (1981), which provides that “[d]amages for breach … may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.”

77 See Sebert, supra note 26 and compare accompanying text.
be beneficial, they may accept the default rule of expectation damages, conditioned by the mitigation doctrine, or adopt an alternative express term. Acceptance of the default rule is discussed in the next part of this article. Consider first whether the common provision of liquidated damages, or what is sometimes its functional equivalent, a specific-performance provision, might be seen in the light of the above analysis as an alternative to negative damages.

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

A high liquidated-damages clause or a specific-performance clause would not always yield efficient outcomes. Where termination is efficient, but where unilateral repudiation is not in the interest of either party, negotiation forces the parties to share the benefits of termination.
This is less than ideal if the efficacy of termination can be discovered only through search. As noted above, in anticipation of sharing even an efficient unique searcher will underinvest in search, and a negotiated cure to such inefficiency might prove impossible. Thus, the problem of part III(A) would not be solved entirely. Moreover, neither a liquidated-damages clause nor a specific-performance clause would adequately address the contractor’s continuation bias, borne from variance in judicial estimation, illustrated by part III(B). Similarly, neither clause would reduce the incentive for strategic use of the material breach doctrine, the phenomenon illustrated in part III(C). Thus, it is not surprising that draconian damages or performance clauses are not ubiquitous, even as a substitute for negative damages.

Still, it may be that a contract with a high liquidated-damages clause, or with a specific-performance clause, is evidence of the parties’ attempt to balance competing concerns raised by the disallowance of negative damages as a default rule. This default, then, as part of the expectation remedy, provides an argument, supplemental to those extant,78 for judicial enforcement of so-called “penalty” clauses and of specific-performance clauses.

VI. THE MITIGATION DOCTRINE

In principle, the expectation remedy awards the victim of breach its loss from the failure of performance less any part of the loss the victim could have avoided. Consider once more the above illustrations where a contractor agreed to construct a building for a landowner. When the contractor repudiated and the landowner valued the building by more than the price of substitute performance, the landowner’s expectation damages were measured by the difference between the market price for performance and the contract price (plus any other injury caused by the breach)

not by the potentially greater difference between the value to the landowner of the building and the contract price.79 If the landowner failed to hire substitute performance, the consequential loss would be borne by the landowner, not the contractor. Doctrinally, a court would say that the landowner failed to mitigate its injury from the contractor’s breach.

This account of the mitigation doctrine, however, is too broad and insufficiently detailed. In practical application of the mitigation doctrine, the victim’s duty to mitigate is limited. The victim need not accept any and every alternative project in mitigation. In some cases, it seems that the victim need not accept substitute performance unless that performance is fungible with that promised under the contract.80 In a now famous example, the actress Shirley MacLaine (Parker) was under contract with Fox to perform in the movie “Bloomer Girl.” Fox cancelled the movie and requested that she act in a substitute movie, “Big Country, Big Man.” MacLaine declined yet won damages from Fox for its repudiation of the Bloomer Girl contract, damages unreduced by MacLaine’s refusal to mitigate with earnings from Big Country. As stated by the California Supreme Court, the duty to mitigate does not extend to a project that is “inferior” in quality to the contractual project.81 At least in some jurisdictions, then, although a victim of breach must mitigate with a project at an inferior price, she may avoid mitigation if the project is of inferior quality.

79 There is, of course, the possibility that the value of performance to the promisee will be less than cost of substitute performance. But this possibility is inapposite to the discussion here. Cf. note 29.

80 See Restatement (Second) of Contracts §350 (1981), which reports that the law excludes recovery for loss only if avoidable “without undue risk, burden or humiliation.” The comments, illustrations, and cases associated with this section suggest that the mitigation obligation does not require a party to take on work of a different nature. For example, although Comment E states that “discrepancies between the transactions” do not alone form a basis for a party to refuse mitigation, Illustration 11 to that comment provides that work as a farm laborer is not regarded as a substitute for work as a farm supervisor. This principle, moreover, is not limited to employment cases. See, e.g., Landry’s Seafood House v. Snadon, 2007 WL 2018798 (Tex.App.-Dallas), finding that after a tenant’s repudiation of a lease, the mitigation obligation does not require a landlord to accept a substitute tenant unless that tenant is “suitable under the circumstances.”
Ostensibly, this limitation is inconsistent with efficient breach theory. It might seem that a better rule would require the victim to mitigate with any alternative project if the project would reduce damages (and thus societal loss) to any extent, even if the alternative project is somewhat unsatisfactory to the victim of breach and, consequently, would not fully eliminate damages. Edlin, for example, has argued for this result. Thus, the actual mitigation obligation may seem wastefully weak as compared to the ideal.

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

In this context, the limited mitigation obligation may be seen as a compromise between the allowance of negative damages, which would provide a robust incentive for efficient repudiation, and disallowance which avoids the costs of the repudiation race described above in part IV.

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81 Parker v. Twentieth-Century Fox, 3 Cal. 3rd 176 (1970). See also, supra note 80.
82 See Edlin, supra note 16.
The result is similar to that of a liquidated-damages clause or a specific-performance clause, described above in part V, in that, like these clauses, the limited mitigation obligation effectively prevents unilateral promisee repudiation, but at a cost, of course, as a weak mitigation doctrine will in some settings yield an insufficient incentive to mitigate.

**CONCLUSION**

The analysis offered here identifies a gap in contracts theory scholarship on the topic of negative damages, a topic that might also be referred to as expectation damages in the case of victimless breach. The disallowance of negative damages likely imposes some costs, where a promisor has private information that breach is efficient but profits from the contract, for example, and generates some benefits, where a costly repudiation race would otherwise ensue, for another. Where parties do not adequately consider breach remedy at the time of contract formation, it is possible that efficiency would be served if as a default rule negative damages were permitted rather than disallowed, at least under circumstances where the court determines (difficult though this may be) that the party in breach would not have breached but for the allowance of negative damages; this default might be appropriate if one assumed that negotiation over a negative-damages clause would be expensive or impossible post-formation. These and other questions require further analysis; this article is but a step toward a general theory.

Even under current law, where the default rule disallows negative damages, the analysis presented here offers guidance. The arguments contained in this article should give courts pause, or additional pause, before they insist on an expectation remedy and disregard a contract clause for liquidated damages, even if high, or specific performance. These arguments, moreover, offer some support for the common law limitation on the obligation to mitigate, which may be weak, but usefully so.
Appendix

Consider a contractual relationship with the following characteristics:

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

It follows that:

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

Further:

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

Thus:

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