YOU *DO* HAVE TO KEEP YOUR PROMISES: A DISGORGEMENT THEORY OF CONTRACT REMEDIES

STEVE THEL* & PETER SIEGELMAN**

ABSTRACT

Contract law is generally understood to require no more of a person who breaches a contract than to give the injured promisee the "benefit of the bargain." The law is thus assumed to permit a promise-breaker to keep any profit remaining from breach, after putting the victim in the position he would have been in had the promise been performed. This conventional description is radically wrong: across a wide range of circumstances, standard contract doctrines actually do require people to keep their promises, or to disgorge their entire profit from breach if they do not. Rather than protecting the expectation interest of injured promisees, therefore, the law of contract remedies is better characterized as enforcing "promisor expectation" or disgorgement, a regime that puts breaching promisors in the position they would have been in had they performed, even when that means overcompensating injured victims.

We offer two explanations for why we so often see "promisor expectation" remedies, even though contracting parties would prefer the remedy of perfect promisee expectation damages. First, promisor expectation is often much easier for courts to compute or implement than promisee-based remedies. Second, promisors themselves prefer to be subject to the promisor expectation regime because it allows them to commit credibly to perform their promises. Such commitments are valuable but cannot be sustained if the law awards damages that fall short of perfect promisee expectation, as it

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* Wormser Professor of Law, Fordham Law School.

** Roger Sherman Professor of Law, University of Connecticut Law School. We are grateful to Ian Ayres, Alexandra Lahav, Sachin Pandya, Gideon Parchomovsky, Mark Patterson, Joseph Perillo, Ariel Porat, Richard Squire, and seminar participants at the University of Connecticut and Bar-Ilan University Schools of Law for helpful comments.

invariably does. By agreeing to a remedial scheme that makes it unprofitable or impossible for them to profit from breach, promisors can credibly commit to perform and thus realize a higher contract price ex ante. An "overcompensatory" remedy thus paradoxically serves the interests of promisors by providing them a valuable bonding mechanism.

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INTRODUCTION

> "The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses."
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> —O.W. Holmes, Jr., *The Common Law*, 301 (1881)

> "It is no reason for not enforcing a contract that the defendant can make ... more money by avoiding his agreement than by carrying it out."
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> —*Roberts v. City of Cambridge*, 49 N.E. 84, 84 (Mass. 1898)

Suppose that Jack promises Jill to deliver a pail of water in one week for a price of $10, payable on delivery. Jill values the pail of water at $12. Before the time for delivery arrives, though, Mr. X offers Jack $17 for the pail of water. Jack has only one pail, so he decides to breach his contract with Jill and sell the water to Mr. X instead. What happens next?

According to the conventional wisdom represented by the quotation from Holmes in the epigraph, if Jill, the injured promisee, sues Jack, the promisor, for breach, she can recover her expectation interest—the "benefit of the bargain"—which in this case is the $2 surplus she would have had if Jack had performed and she had paid him the contract price. Jack, meanwhile, has received $17 from Mr. X. Even after paying the damages he owes Jill, Jack is still $5 better-off than he would have been if he had kept his promise to her. That extra $5 is his to keep, because the law of contract remedies supposedly requires only that he fully compensate Jill for her losses, leaving her with no claim to anything beyond that amount.

In a nutshell, our thesis is that this description of contract remedies, although universally accepted by scholars, is radically wrong. The second quotation in the epigraph has it right: across a wide range of circumstances, standard contract doctrines *do* in fact require Jack to surrender the entire extra $5 profit from breach.

Therefore, the law of contract remedies is better characterized as enforcing "*promisor* expectation" (rather than *promisee* expectation), a regime that puts breaching promisors such as Jack in the position they would have been in had they performed, *even when that means "overcompensating" injured promisees*. Putting the breaching promisor in the position he would have been in had he performed the contract can usually be succinctly described by saying that the promisor has to *disgorge* his profits from breach to the promisee, and we will use "disgorgement" and "promisor expectation" as synonyms in what follows.

In this Article, we show why contract remedies as actually implemented by courts do entail promisor expectation/disgorgement, and then offer a normative defense of these rules. Before getting there, however, we set forth three implications of our findings.

The first implication concerns the relationship between economic and philosophical approaches to contract. The former, pioneered by Holmes—and in modern times exemplified by Judge Richard Posner[1]—understands contracts as options that entitle the promisor to perform or pay damages, as he chooses. The latter—represented, for example, by Charles Fried[2] or Seana Shiffrin,[3] and arguably supported by recent psychological research[4]—sees contracts as promises that promisors are morally obligated to keep. Our view is that the conflict between these two perspectives is largely beside the point. It is widely understood that, in practice, ordinary expectation damages are unavoidably undercompensatory, meaning that Jack would pay Jill less than the full $2 that would compensate her for the injury he caused.[5] In the light of this fact, the economists have it wrong: exercising the option to breach does not compensate the injured promisee and in fact is usually *not* permitted. At the same time, the philosophers also have it wrong: although bargained-for

1. *See, e.g.*, RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 119-20 (7th ed. 2007). A substantial field of literature in law and economics develops this perspective, and, indeed, an entire subfield of economics called "contract theory" takes off from this insight. *See, e.g.*, PATRICK BOLTON & MATTHIAS DEWATRIPONT, CONTRACT THEORY (2005).

2. *See, e.g.*, CHARLES FRIED, CONTRACT AS PROMISE (1981).

3. *See, e.g.*, Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708 (2007).

4. *See, e.g.*, Tess Wilkinson-Ryan & David A. Hoffman, *Breach Is for Suckers*, 63 VAND. L. REV. 1003 (2010).

5. *See infra* note 198 and accompanying text.

promises are in fact binding, it is not because of the moral force of the promise. Rather, promisors, operating in the shadow of the existing remedial regime, affirmatively choose to be bound because it raises the value of the contract to them.

The second implication relates to the role, if any, of the promisor's motive in breaching a contract. The conventional wisdom is that contract remedies are designed to compensate injured victims, which seems to leave courts no scope to consider the reasons for the injurer's behavior: it should not matter much to Jill whether Jack deliberately sold her pail of water to someone else or accidentally fell down and spilled it while attempting delivery. And yet the cases are full of references to "willful breach," and courts routinely suggest that they are augmenting damages because a promisor breached deliberately.[6] Our theory resolves this tension, based on the role of promisor expectation as a bonding mechanism that allows promisors to commit credibly to performance in settings in which they could not otherwise make such assurances. The promisor's motives for breach may be of no consequence to an injured promisee, but they are quite relevant to the question of whether the parties would have been willing to permit the breach when they entered their agreement. The award of disgorgement when a breach is "willful" binds promisors to perform precisely when performance is appropriate.

Finally, consider the controversy over "efficient breach."[7] Proponents of efficient breach theory point out that perfect expectation damages permit a breaching promisor to keep any surplus left over after he has compensated the injured promisee.[8] The existence of

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6. On willful breach, see generally Richard Craswell, *When Is a Willful Breach "Willful"?: The Link Between Definitions and Damages*, 107 MICH. L. REV. 1501 (2009); Patricia H. Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 ARIZ. L. REV. 733 (1982); and Steve Thel & Peter Siegelman, *Willfulness Versus Expectation: A Promisor-Based Defense of Willful Breach Doctrine*, 107 MICH. L. REV. 1517 (2009).

7. The basic idea originated with Robert Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970). Charles G. Goetz and Robert E. Scott made important legal developments in *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977), and the economics were developed by Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980). Opposition to the idea of efficient breach is exemplified by Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989).

8. *See, e.g.*, Goetz & Scott, *supra* note 7, at 558-59.

such a surplus is precisely the necessary and sufficient condition for a breach to be efficient—meaning that at least one party gains and no one loses.[9] Critics of efficient breach typically argue that the promisor's surplus is morally *not* his to keep,[10] but that argument is hard to reconcile with the existence of the traditional expectation damages rule. We suggest that efficient breaches in which the promisor keeps the surplus from breach are, in practice, very rare, precisely because the conventional expectation damages rule applies only in limited circumstances.[11] The efficient breach controversy is thus largely a red herring.

I. THE ARGUMENT

A. The Conventional Wisdom

Contract law is usually thought to be concerned with compensating the interests of injured promisees, not with punishing breaching promisors or with preventing breaches.[12] One of the first contract principles law students learn is that "[t]he purpose of the law is to 'put the plaintiff in as good a position as he would have been in had the defendant kept his contract.'"[13] Contract remedies are usually both defined and evaluated in terms of how they compensate promisees for their losses. The Restatement of Contracts, following Lon Fuller and William Perdue,[14] introduces its treatment of contract remedies with the axiom that the purpose of contract remedies is to protect one of three promisee interests—expectation, reliance, or restitution.[15] The Restatement does not even mention the possibility that a disappointed promisee is entitled to the

9. *See id.* at 558.
10. *See, e.g.*, Friedmann, *supra* note 7, at 13.
11. *See infra* notes 86-87 and accompanying text.
12. *See* Hawkins v. McGee, 146 A. 641, 643 (N.H. 1929).
13. *Id.* (quoting 3 SAMUEL WILLISTON, THE LAW OF CONTRACTS § 1338 (1920)).
14. *See generally* L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pts. 1 & 2), 46 YALE L.J. 52 (1936), 46 YALE L.J. 373 (1937).
15. RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981); *see also* U.C.C. § 1-106(1) (2002) ("[R]emedies ... shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed."); RESTATEMENT (SECOND) OF CONTRACTS § 329.

breaching promisor's gains from breach.[16] Academic discussion of contract remedies is also typically addressed to how best to compensate promisees for breached promises, almost invariably starting from the same premise as the Restatement—that the purpose of contract remedies is to protect the interests of promisees.[17]

As long as compensation is assured, on this view, the promisor is free to break his promise.[18] And the decision to breach may end up being profitable for the promisor because it is conventional wisdom that a breaching promisor may retain any remaining gains from his breach.[19] Prohibiting breach, or requiring breaching promisors to surrender their profits (also known as "disgorgement"), looks like an aberration when viewed from this perspective, because it is hard to see how a promisee who has been fully compensated is entitled to the breaching promisor's remaining profits as well.

B. Prior Scholarship on Disgorgement

Although the academic scholarship on contract remedies is vast, little of it focuses on promisor expectation or disgorgement, either as a descriptive account of what the rules actually accomplish or as a normative question. Those scholars who have discussed the matter have generally come down in favor of the traditional promisee expectation regime and have been critical of the idea that promisees can or should recover their promisors' gains from breach.[20] The outstanding example of this point of view is also the most important prior treatment of the subject, Allan Farnsworth's attack on the disgorgement principal.[21] Widely influential as a contracts scholar,

16. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344.

17. *See* Richard Craswell, *Against Fuller and Perdue*, 67 U. CHI. L. REV. 99, 105-06 (2000).

18. *See* Goetz & Scott, *supra* note 7, at 558.

19. *Id.* at 558-59.

20. *See generally* David Campbell & James Devenney, *Damages at the Border of Legal Reasoning*, 65 CAMBRIDGE L.J. 208 (2006); J.J. Edelman, *Restitutionary and Disgorging Proprietary Awards for Wrongs*, *in* UNJUST ENRICHMENT AND THE LAW OF CONTRACT 193 (E.J.H. Schrage ed., 2001); Peter Jaffey, *Efficiency, Disgorgement, and Reliance in Contract: A Comment on Campbell and Harris*, 22 LEGAL STUD. 570 (2002); Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 TEX. L. REV. 2021 (2001); Ernest J. Weinrib, *Punishment and Disgorgement as Contract Remedies*, 78 CHI.-KENT L. REV. 55 (2003).

21. *See* E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985).

Farnsworth was also a reporter for the Second Restatement of Contracts, which incorporated his views on remedies by failing to recognize disgorgement as one of the interests protected by contract law.[22] Farnsworth's article provides the classic case against requiring promisors to disgorge their gains from breach.[23] Concluding that "the principle is recognized in [only] a few categories of contract disputes," Farnsworth argued that its extension would be unwise, largely because of the tenuous causal relationships among the promisor's profit, his decision to breach, and the harm to the promisee.[24]

An important theoretical contribution to the analysis of the disgorgement remedy was made by Avery Katz, who saw the possibility of a disgorgement-type remedy, which he termed "liquidated specific performance," as an alternative to the classic triumvirate of expectation, reliance, and restitution.[25] Katz's insight into the "Case of the Missing Remedy" was partly taxonomic: he showed how disgorgement can be decomposed into the same primitive components as the other three remedies.[26] In addition, however, he offered a normative theory that "promisor expectation" will be attractive when we turn to considerations beyond the efficiency of the promisor's decision to breach or perform.[27] For example, if we are concerned with the possible moral hazard of over-reliance resulting from indiscriminate protection of the promisee's reliance interests, disgorgement remedies look more attractive.[28]

More recently, Melvin Eisenberg offered a more direct criticism of Farnsworth's theory, arguing that injured promisees *do* sometimes

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22. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981).

23. *See* Farnsworth, *supra* note 21.

24. *Id.* at 1342-43. We disagree with both the descriptive and normative conclusions Farnsworth reached. Nevertheless, his article stands as the touchstone for any analysis of disgorgement, and we refer to his views throughout this Article.

25. Avery Katz, *Reflections on Fuller and Perdue's* The Reliance Interest in Contract Damages*: A Positive Economic Framework*, 21 U. MICH. J.L. REFORM 541, 542-47 (1988) (describing the "liquidated specific performance" remedy as similar to expectation—in that it is "forward-looking"—and similar to restitution—in that it is "promisor-centered").

26. *Id.* at 545, 547-56.

27. *See id.* at 556-61.

28. Because the promisee cannot predict the promisor's breach, and because the promisee's actions in reliance on the promise will not change her recovery, the prospect of recovering the promisor's profits will not lead to overreliance on the promise by the promisee. *See id.* at 559.

have a cognizable interest in the gains earned by a breaching promisor.[29] Still, Eisenberg sees disgorgement as a secondary remedy that is not generally available, and, when it is available, he sees its role as protecting an interest of the promisee.[30] Although the depth and breadth of Eisenberg's scholarship is compelling, we disagree with both propositions, as discussed below.

An important recent article by Richard Brooks also focuses on the possibilities of disgorgement as a contract remedy.[31] Brooks shows that the standard contractual remedy—expectation damages, which assign the promisor an option to breach or perform—is not the only way to secure efficiency.[32] A disgorgement regime is also capable of generating efficient performance and does so without granting the promisor the same option to perform.[33] Instead, a disgorgement remedy requires the promisor to buy his way out of having to perform by securing the promisee's consent for a breach.[34] Brooks thus concludes that efficiency does not require granting promisors the option to perform embodied in the expectation damages remedy; if other considerations, such as moral ones, require performance, we could adopt the disgorgement default without sacrificing efficiency.[35] We agree, and suggest that disgorgement is in fact far more common than Brooks assumes for the sake of his argument.

In the remainder of this Article, we use the standard contract example—the sale of a widget—to show that through a variety of well-established devices for handling breaches, across a wide variety of situations, contract law consistently requires breaching promisors to perform or surrender any gains they realize if they breach. In Part III, we explain the desirability of the disgorgement regime, which parties are largely free to circumvent if they choose. We show that promisor expectation remedies are consistently much easier to

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29. *See* Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559 (2006).

30. *See id.* at 597-98; *cf.* Hanoch Dagan, *Restitutionary Damages for Breach of Contract: An Exercise in Private Law Theory*, 1 THEORETICAL INQUIRIES L. 115 (2000) (arguing that good faith considerations provide a normative justification for some restitutionary damages).

31. *See* Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 YALE L.J. 568 (2006).

32. *See id.*

33. *See id.* at 583-84.

34. *See id.*

35. *See id.* at 596.

administer than promisee expectation remedies would be. More importantly, promisor expectation remedies serve the interests of promisors themselves, by allowing them to commit inexpensively to performance—a commitment for which they are compensated—in a way they could not if remedies were based on promisee expectation.

II. THE AVAILABILITY OF PROMISOR EXPECTATION REMEDIES IN CONTRACT LAW

A. What's a Widget?—The Continuity of Promisor Expectation Remedies

Widgets are commonly used to explain contract remedies.[36] Commentators often use them to explore particular issues relevant to this Article, including efficient breach,[37] specific performance,[38] and disgorgement.[39] In this Article, we use a hypothetical offered by Allan Farnsworth, in which we break our promise to sell you a widget:

> Suppose that [we] have made a contract under which [we agreed] to sell you a widget for $100, cash on delivery. At the time [we] made the contract, we valued the widget at $90 and you valued it at $110, so the contract seemed advantageous to [all] of us. But instead of delivering the widget to you, [we] found another buyer willing to pay $125 and sold it to that buyer, realizing $25 over our contract price. Since you still valued the widget at $110, [we] offered you $10 out of that $25. Can you recover $25 from [us]?[40]

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36. *See, e.g.*, Robert Childres, *Buyer's Remedies: The Danger of Section 2-713*, 72 NW. U. L. REV. 837, 842 (1978); Subha Narasimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123, 1132-34 (1986).

37. *See, e.g.*, POSNER, *supra* note 1, at 119-20.

38. *See* Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 286-87 (1979); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1374-75 (1982).

39. *See, e.g.*, Farnsworth, *supra* note 21, at 1341-42.

40. *Id.* at 1341.

Scholars have used widgets to show that you cannot[41] and should not.[42] Indeed, if it were possible to award you your expectation perfectly, you would not want to.[43] In fact, however, the answer to Farnsworth's question depends on what a widget is, even though we are not supposed to ask.[44] We get $125 when we sell the widget, but we have to pay you damages for our breach.[45] The measure of what we have to give you, however, depends on the subject of the contract—that is, what a widget is. We consider several possibilities.

1. Hypothetical Cover—"Promisor Expectation" When the Price of Performance Is Clear

Suppose a widget is something available in a thick market in which all trades occur at the same price.[46] For the breach of bargained-for promises like this one, the standard remedy is supposed to be the promisee's expectation—you are to be put in the position you would have been in had we kept our promise.[47] However, when courts determine remedies, they do not typically inquire into what the promisee would have done with fungible goods had the contract been performed.[48] Instead, courts award damages equal to

41. *Id.*

42. *See* POSNER, *supra* note 1, at 119-20.

43. *See* Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369 (1990). Schwartz also holds that supracompensatory remedies like disgorgement are undesirable as a normative matter. *Id.* at 369-70.

44. Webster's Dictionary cites the Harvard Law Review as using the term "widget" to mean "an unnamed article considered for purposes of hypothetical example as the typical product of a company." WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 2613-14 (Philip Babcock Gove ed., 1971).

45. *See* Farnsworth, *supra* note 21, at 1341-42.

46. *See* Schwartz, *supra* note 38, at 280-82 (distinguishing developed from undeveloped markets). Lisa Bernstein has suggested that even markets for notionally homogenous commodities such as a standard grade of industrial cotton are not truly "thick." *See* Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms, and Institutions*, 99 MICH. L. REV. 1724, 1745-46 (2001). The reason is that large quantities of a particular grade of cotton for delivery at a specific time and place, so as to meet just-in-time production needs, are very difficult to obtain; perfect cover is an illusion. *See id.* She may be right, but that does not affect the substance of our argument.

47. U.C.C. § 1-106 (2002); RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. a (1981); POSNER, *supra* note 1, at 118-22; Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988).

48. Courts may require the promisee to show she was ready, willing, and able to perform,

hypothetical cover, giving the disappointed buyer the difference between the contract price and the market price at the time of the breach,[49] together with incidental damages, including the cost of arranging cover if the buyer purchased a substitute.[50]

Thus, in Farnsworth's hypothetical, a court would not ask what you were going to do with the widget or how much you valued it. Leaving incidental damages aside, your recovery under the market

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and when courts do, they are in some sense inquiring into what the promisee would have done had there been no breach. *See* EDWARD YORIO, CONTRACT ENFORCEMENT: SPECIFIC PERFORMANCE AND INJUNCTIONS § 6.4, at 143-45 (1989 & Supp. 2010). However, if the promisee would not have performed, the promisor would have been excused from performance anyway, and thus any profit the promisor has realized from failing to perform is not a profit from breach. *See infra* notes 55-57 and accompanying text (discussing causation).

49. U.C.C. § 2-708(1) ("[T]he measure of damages for nonacceptance or repudiation by the buyer is the difference between the market price at the time and place for tender and the unpaid contract price."); *id.* § 2-713(1) ("[T]he measure of damages for nondelivery or repudiation by the seller is the difference between the market price at the time when the buyer learned of the breach and the contract price."); RESTATEMENT (SECOND) OF CONTRACTS § 350 cmt. c ("[T]his principle has inspired the standard formulas under which a buyer's or seller's damages are based on the difference between the contract price and the market price on that market where the injured party could have arranged a substitute transaction for the purchase or sale of similar goods.... Similar rules are applied to other contracts, such as contracts for the sale of securities, where there is a well-established market for the type of performance involved, but the principle extends to other situations in which a substitute transaction can be arranged, even if there is no well-established market for the type of performance."); *id.* § 344 cmt. b; E. ALLAN FARNSWORTH, CONTRACTS § 12.12, at 783 (4th ed. 2004) ("[T]he standard formulas according to which a buyer's or seller's claim for damages for total breach is based on the difference between the contract price and the price on the market."); Childres, *supra* note 36, at 841-42 ("The market price-contract price differential remedy or measure of damages rests at the core of our understanding of English and American law; it has been the cornerstone of Anglo-American damages law, in whatever field. Perhaps this is why it is so difficult to realize and so equally hard to acknowledge the fact that this damages measure makes no sense whatever when applied to real life situations."); Narasimhan, *supra* note 36, at 1123-24 ("[E]xchanges of promises are usually enforceable to the extent of the value of the promised performance—the expectation measure. This value is the difference between the market price for the promised performance at the time of breach and the price placed upon that performance by the contract."); Ellen A. Peters, *Remedies for Breach of Contracts Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two*, 73 YALE L.J. 199, 253, 257-58 (1963) (discussing "the time-honored market-contract differentials"); David Simon, *A Critique of the Treatment of Market Damages in the* Restatement (Second) of Contracts, 81 COLUM. L. REV. 80, 81 (1981) ("For over 150 years, under established principles of common law as well as applicable codes, market damages have served as a standard minimum measure of recovery whenever a market was available to fix the value of the missing performance."); John D. Clark, Comment, *The Proposed Revisions to Contract-Market Damages of Article Two of the Uniform Commercial Code: A Disaster Not a Remedy*, 46 EMORY L.J. 807, 808 (1997).

50. *See* U.C.C. §§ 2-712(2), 2-715.

damage rule will be the difference between the contract price and the market price of the widget at the time of the breach. If the $125 price we received when we sold to the other buyer was the market price, you *do* recover the $25 from us—that is, the difference between the $125 market price at time of breach and the $100 contract price—and we are left with $100, which is what we would have had if we had performed. Thus, when a widget is something that is available in the market and the breaching party sells it at the market price, the standard remedy forces breaching promisors to surrender any gains from breach.[51]

The market damage rule also requires promisors to surrender gains from breach when promisees value performance more than the market does. Change Farnsworth's hypothetical so that at the time of our breach, you really want widgets and would be willing to pay $160 for one, but we sell to someone else at the market price of $125. In a sense, your expectation is $60, but so long as widgets are available in the market for $125, you may be limited to the difference between contract price and market price: $25.[52] Because you could take that $25 and the $100 you have yet to pay us and buy a widget in the market, $25 apparently protects your expectation interest.[53] Whether or not it does, however, the remedy computed on the contract-market price differential still puts us in the position we would have been in had we performed and thus achieves promisor expectation, since by breaching we realized only $25 more than we would have realized by performing, and that is exactly what we have to give to you.

In addition, the rule achieves promisor expectation when the breaching promisor values performance more than the market does. Suppose, for example, that when we breach our widget contract, we have come upon an especially profitable use for the widget, so that we value it at $160. If we breach to realize the value of this use,

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51. *See* John P. Dawson, *Restitution or Damages?*, 20 OHIO ST. L.J. 175, 188 (1959) ("[T]he difference-money formula ... will operate ordinarily to recapture most of the profit that the defaulting promisor can realize through breach—*provided* the values are measurable.").

52. *See* RESTATEMENT (SECOND) OF CONTRACTS § 350.

53. The adequacy of contract-market damages as protection for expectation depends on whether the promisee in fact covers at the time of breach and, if not, on whether prices rise or fall thereafter. But the decision about whether to cover and, if so, when, is properly the promisee's to make. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 6-4, at 211-13 (5th ed. 2000).

your recovery may be limited to $25, leaving us with a profit of $35. This $35, however, is not a gain from breach. As Farnsworth explained, instead of breaching, we could have simply bought another widget in the market for $125, delivered one to you, and kept one for ourselves to realize our $160, netting $35 *without* breaching.[54] Because we could have realized the $35 without breaching, if we *do* breach, and so long as we pay you $25, we do not gain by doing so.[55] Farnsworth offered this explanation as a caution against requiring us to surrender $35 in this situation, and his point is well taken. The power of Farnsworth's insight, however, really lies in its showing that the $35 is not a gain from breach at all.[56] Even if the law explicitly required breaching promisors always and everywhere to disgorge all profits from breach, it would not require us to give you our $35 in this situation.[57]

Farnsworth acknowledges that the hypothetical cover remedy requires the breaching promisor to surrender his profits, but suggests that it protects expectation as well: "If we assume a competitive market in which the price at which I sell is the same as the price at which you buy, there is a neat fit between the market damage rules on the one hand and both the expectation and disgorgement principles on the other."[58] Farnsworth overstates the match between the market damage rule and expectation, though. In

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54. Farnsworth, *supra* note 21, at 1343-44; *see also* Schwartz, *supra* note 38, at 286-91 (suggesting that sellers and buyers generally have similar cover costs).

55. By the same token, if the seller breaches and sells to a third party who is for some reason willing to pay more than market price, say $160, the portion of the breaching seller's profit that reflects the difference between his selling price and the market price, or $35, is not a profit from breach. The seller could have earned it without breach by buying a second widget in the market for $125 or producing another widget. Even then, however, the seller might have to surrender the profit earned by selling to the third party under cases treating the breaching party's sale price as evidence of market price. *See infra* note 136 (discussing cases in which the breaching party's sale price is used as market price).

56. Eisenberg levels a similar criticism, suggesting that "Farnsworth's caus[ation] argument is not really an argument against protecting the disgorgement interest in contract law." Eisenberg, *supra* note 29, at 566. Similarly, when a buyer covers at less than market price, if the cover transaction would have been available to the breaching seller as well, disgorgement is accomplished whether the buyer's remedy is computed on the basis of market or cover price.

57. Similarly, if a buyer takes delivery but refuses to pay and then resells for more, there should be no disgorgement, because the buyer could have resold even if he had not breached. He would have taken delivery in any case.

58. Farnsworth, *supra* note 21, at 1370.

the interesting cases—in which the parties value performance differently or both value performance more than the market does—the market damage rule overcompensates promisee expectation but accomplishes promisor expectation exactly.

The market damage rule often awards promisees more than their expectation. If a promisee values performance less than the market does at time of breach, the market damage remedy exceeds her expectation. This situation is likely to be common, inasmuch as breach is most likely when market price has risen between the time a contract is made and the time performance is due, and the new market price may exceed the value the promisee places on performance.

The most famous case of the contract-market remedy leading to supracompensatory remedies that exactly equal the promisor's gain from breach arises when a seller breaches his promise to sell goods to a middleman, who has agreed to resell the goods to a third party for a fixed markup. In such cases, courts typically award the middleman/promisee the contract-market differential when the breaching seller sells the goods to someone else, even while recognizing that this remedy exceeds the promisee's expectation.[59]

The overcompensation produced by the contract-market measure is perhaps best illustrated in the very case Farnsworth hypothesizes—the standard efficient breach scenario—in which you get $25 even though your expectation is only $10. Push the hypothetical further by supposing that your needs have changed since we entered the contract, and that you actually regret the contract because you have come to value the widget at less than the contract price of $100. The

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59. *See* TexPar Energy, Inc. v. Murphy Oil USA, Inc., 45 F.3d 1111, 1113-14 (7th Cir. 1995); KGM Harvesting Co. v. Fresh Network, 42 Cal. Rptr. 2d 286, 293 (Ct. App. 1995); Sun-Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612, 614-15 (Ct. App. 1983); Tongish v. Thomas, 840 P.2d 471, 473-76 (Kan. 1992). For an excellent discussion of these cases, including a critique of those that do not award the contract-market remedy, see VICTOR GOLDBERG, FRAMING CONTRACT LAW 225-32 (2007). Some cases, notably *Allied Canners & Packers, Inc. v. Victor Packing Co.*, 209 Cal. Rptr. 60 (Ct. App. 1985), limit the middleman's remedy to the markup. In none of these cases awarding only the markup did the defendant deliberately sell the subject of the contract to a third party at a higher price. *See infra* note 153 and accompanying text. Rather, all apparently involved (un)fortuitous breaches. Thus, at most, these cases stand for the proposition that a breaching party may sometimes be entitled to keep losses avoided by breach, at least when the breach was not willful and the savings were fortuitous. *See* WHITE & SUMMERS, *supra* note 53, § 6-4, at 221-23; Thel & Siegelman, *supra* note 6, at 1524-25.

contract-market measure still gives you $25, which is again more than your negative expectation.[60] Thus, in the paradigmatic efficient breach situation, in which many insist the law should permit—indeed *encourage*—the promisor to breach and sell to someone else, the standard contract-market remedy bypasses any inquiry into the promisee's expectation and allows her to recover the breaching promisor's entire gain. Contrary to common understanding, the law does not facilitate efficient breach.

The fact that the market damage formula often overcompensates promisees for their expectations has not escaped notice. The formula is often explained as a sort of statutory liquidated damage clause that simply works to inhibit breach.[61] Familiarity has not protected the formula from criticism, however.[62] Indeed, the market damage rule has been attacked precisely because it departs from the compensatory goals generally thought to underlie contract remedies.[63]

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60. *Cf.* 2 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 2-713:1 (2002) ("Sometimes the buyer may no longer need the goods that the seller has refused to deliver, and, therefore, he does not want to buy others in their stead. In these cases, cover is not an appropriate remedy, but the buyer is entitled to recover damages under Section 2-713 that are measured by the difference between the market price and the contract price, together with incidental and consequential damages, but less expenses saved on account of the seller's breach."); Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U. L. REV. 1679, 1724 (2008) (suggesting recovery for party in breach).

61. *See, e.g.*, WHITE & SUMMERS, *supra* note 53, § 6-4, at 212-13 ("[T]he drafters did not intend for this section [U.C.C. § 2-713, which sets the contract-market remedy] to put the buyer in the same position as performance would have.... A third, and perhaps best, explanation of 2-713 is that it is a statutory liquidated damage clause, a breach inhibitor the payment of which need bear no close relation to plaintiff's actual loss. This explanation ... is consistent with the belief that plaintiffs recover too little and too infrequently for the threat of damages to be an optimal deterrent."); Childres, *supra* note 36, at 841; Peters, *supra* note 49, at 259 ("Perhaps it is misleading to think of the market-contract formula as a device for the measurement of damages.... An alternative way of looking at market-contract is to view this differential as a statutory liquidated damages clause, rather than as an effort to calculate actual losses. If it is useful in every case to hold the party in breach to some baseline liability, in order to encourage faithful adherence to contractual obligations, perhaps market fluctuations furnish as good a standard as any."); Simon, *supra* note 49, at 81 ("The objective value fixed by the market represents only a rough approximation of lost gains, and may often exceed the subjective loss of the particular plaintiff. Nevertheless, the prevailing view is that the market measure should be adhered to even if the plaintiff's actual loss was less.").

62. *See* David W. Carroll, *A Little Essay in Partial Defense of the Contract-Market Differential as a Remedy for Buyers*, 57 S. CAL. L. REV. 667, 667 (1984) ("Theoretical discussions are in unanimous support of [the] criticism ... [that] contract-market differential measure of damages in sale-of-goods cases is inaccurate and inconsistent with the compensation principle of contract damages."); *id.* at 693-705 (discussing criticism).

63. *See, e.g.*, Simon, *supra* note 49, at 80 (criticizing *sub silentio* changes in the

The introduction to Robert Childres's posthumous article criticizing the UCC's adoption of the market damage rule nicely captures the point:

> Section 2-713 of the Uniform Commercial Code [the market damage rule] should not have been enacted and should be repealed. Given the small chance of repeal, the observer should be made aware that the Code's scheme for buyer's remedies is sensible only if section 2-713 is ignored. This is so, for section 2-713 fails because it is a hypothetical remedy; it lacks any relevant relation to damages actually suffered.[64]

In sum, the hypothetical cover always accomplishes promisor expectation even as it often exceeds the recovering promisee's expectation.

2. Specific Performance—Promisor Expectation When the Price of Performance Is Not Clear

a. The Ordinary Remedy

The fact that contract law consistently requires breaching promisors to surrender their gains may be obscured by focusing on the market damage remedy, because in contracts for the sale of goods in a thick market, the promisor's gain from breach often matches the promisee's expectation. To find cases in which the promisor's gain from breach and the promisee's expectation consistently differ —and thus cases in which courts must consciously choose between awarding promisee expectations or promisor gains—something other than a good available in a thick market must be substituted as a "widget" in Farnsworth's hypothetical. The obvious choice is a unique good or service. The parties may value this unique subject differently, and because they cannot obtain substitutes in the market for the same price, or perhaps at any price, the promisor's gain from breach may exceed the value of the promisee's expectation interest in performance.

Restatement); Clark, *supra* note 49, at 808-09 (discussing proposals to change the U.C.C.).

64. Childres, *supra* note 36, at 837.

Contracts for unique goods and services are of course the domain of the specific performance remedy. When a promisor breaches a promise to sell something that is not available elsewhere, the promisee is typically entitled to an injunction requiring the seller to perform.[65] Thus, if the widget we have promised to sell you is a Rembrandt painting[66] or a piece of real estate,[67] a court will order us to deliver it to you.[68] If we sell it to another before you bring suit, you can recover it from our buyer if she had notice of our contract.[69] In any event, you can recover our gain from breach, even if that gain exceeds your expectation.[70]

Specific performance prevents the promisor from breaching and thus ensures that he earns no profit from avoiding the first contract. But specific performance also more directly allows the promisee to recover the promisor's profit from breach, because, as Guido Calabresi and Douglas Melamed showed, a promisee who has, or could get, an injunction against breach can "cash out" the injunction by agreeing to drop it in exchange for a payment from the

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65. RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c (1981) ("If goods are unique in kind, quality or personal association, the purchase of an equivalent elsewhere may be impracticable, and the buyer's 'inability to cover is strong evidence of' the propriety of granting specific performance."); *see also* U.C.C. § 2-716(1) (2002) ("Specific performance may be decreed where the goods are unique or in other proper circumstances."); *id.* cmt. 2 (stating inability to cover is strong evidence that specific performance is appropriate); Schwartz, *supra* note 38, at 275 (examining "the paradigm case for granting specific performance under current law, the case of unique goods"); *id.* at 272 (discussing "paradigm cases").

66. *See* Pusey v. Pusey, (1684) 23 Eng. Rep. 465 (Ch.); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 360 illus. 1 (discussing specific performance of contract to sell a Rembrandt painting). *See generally* YORIO, *supra* note 48, §§ 2.4.2, 11.2.2.

67. *See* YORIO, *supra* note 48, § 10.1, at 260 ("For contracts involving real estate, specific performance has been the norm."); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. e.

68. In the case of real estate, the seller could probably also force the breaching buyer to take it. YORIO, *supra* note 48, § 10.3.1, at 281 ("Traditionally, when a buyer reneged on a promise to purchase realty, specific performance was almost universally available."). This two-way option suggests that what specific performance protects is not so much subjective value as the special value created by the deal, because the breaching buyer does not deprive the seller of anything but cash, which is fungible.

69. Third-party buyers with constructive notice of the contract are typically required to convey to the promisee, and recording of the original contract provides such notice. *See* YORIO, *supra* note 48, § 5.5, at 113 (collecting cases); *see also* RESTATEMENT (FIRST) OF RESTITUTION §§ 168, 172, 201 (1937); *id.* ch. 13, intro. cmt.

70. *See, e.g.*, Rogers v. Davis, 34 Cal. Rptr. 2d 716, 719-20 (Ct. App. 1994); Timko v. Useful Homes, Inc., 168 A. 824, 824-25 (N.J. Ch. 1933); *see also* Dawson, *supra* note 51, at 186; Schwartz, *supra* note 38, at 291 n.56.

promisor.[71] Because the promisee can use the injunction to demand a payment up to the promisor's gains from breach, specific performance does not just prevent breach; when combined with bargaining between the parties, it gives the promisee an entitlement to all of the breaching promisor's gains from breach—and thus accomplishes disgorgement or promisor expectation.[72]

b. Ancillary Equitable Remedies

Of course, courts cannot always force promisors to perform completely and promptly, so injunctions alone cannot always prevent promisors from gaining from their breaches. When a promisor cannot be made to perform completely, courts use a large, though underappreciated, menu of equitable remedies to supplement specific performance. These remedies are explicitly designed to deprive breaching promisors of any gains from breach, reinforcing our contention that the animating principle at work here is disgorgement.

For example, when a promisor cannot fully perform, courts typically abate part of the purchase price; crucially, they set the amount of the abatement to deprive the promisor of the gain from breach rather than to compensate the promisee for the value of performance denied her.[73] When the time for performance has

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71. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1118-19 (1972).

72. "It is said that 'an injunction is for sale,' meaning that the person who holds it may sell it to the enjoined party if the price is right." JESSE DUKEMINIER & JAMES E. KRIER, PROPERTY 863 (3d ed. 1993) (discussing Tulk v. Moxhay, (1848) 41 Eng. Rep. 1143 (Ch.)). A more contemporary example is *Northern Indiana Public Service Co. v. Carbon County Coal Co.*, 799 F.2d 265 (7th Cir. 1986), in which the plaintiff coal producer sought specific performance of a long-term contract under which the defendant power company was obliged to purchase fixed quantities of coal at specified minimum prices. *Id.* at 267-68. As Judge Posner characterized it, the coal company, Carbon County, was "[probably] ... seeking specific performance in order to have bargaining leverage with NIPSCO [the power company]." *Id.* at 279. "By offering Carbon County more than contract damages (i.e., more than Carbon County's lost profits), NIPSCO could induce Carbon County to discharge the contract and release NIPSCO to buy cheaper coal." *Id. But see* Ward Farnsworth, *Do Parties to Nuisance Cases Bargain After Judgment?: A Glimpse Inside the Cathedral*, 66 U. CHI. L. REV. 373, 374 (1999) (suggesting that, in practice, injunctions rarely get dropped in exchange for payment by the enjoined party).

73. *See, e.g.*, McBee v. Vandecnocke Revocable Trust, 986 S.W.2d 170, 174 (Mo. 1999) (holding purchase price of real estate abated by amount of insurance payment seller received

passed, courts also regularly award promisees supplemental monetary remedies when they get around to ordering specific performance. Here again, the adjustment is typically calculated to deprive the promisor of his gains from breach.

Disgorgement is achieved in these cases through "the marvelous remedy known as an 'equitable accounting,' [in] which ... the promisor [who] fails to perform ... becomes a 'trustee,' holding whatever was promised in trust for the promisee's benefit."[74] As a "trustee," the breaching promisor must account to the promisee for whatever he earned from the subject of the contract between the breach and judgment.[75] An equitable accounting is *not* a mechanism to compensate the promisee for what she would have earned had the promisor performed. The accounting focuses not on what the promisee expected from performance, but instead on what the promisor gained from the breach.[76] Thus, when courts order specific performance, they also do whatever is necessary to put breaching promisors in the position they would have been in had they performed.[77]

c. Negative Injunctions

Even when specific performance is not available, negative injunctions can prevent promisors from profiting by breach. Courts are reluctant to order specific performance of personal service contracts,

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after building burned, notwithstanding the value of building being contested). *See generally* YORIO, *supra* note 48, § 9.2.2.2, at 215.

74. YORIO, *supra* note 48, § 9.2.2.2, at 215.

75. *Id.* at 216.

76. *See, e.g.*, Sandusky Props. v. Aveni, 473 N.E.2d 798, 800-01 (Ohio 1984); Bissonette v. Hanton City Realty Corp., 529 A.2d 139, 143 (R.I. 1987); *see also* 1 GEORGE E. PALMER, THE LAW OF RESTITUTION § 1.5(c) (1978); YORIO, *supra* note 48, at 213 ("[T]he theory underlying an equitable accounting ... is restitution, not damages. The promisee is not entitled to compensation in the amount that he would have actually earned on the property during the period of breach but to restitution in the amount that the promisor earned (or could have earned) and that it would be unjust to allow him to retain.").

77. *See* YORIO, *supra* note 48, § 9.6.3, at 241; *id.* § 9.5, at 228; Farnsworth, *supra* note 21, at 1378-79 ("[M]ake the assumption that each widget is unique. You would then have a right to specific performance of our contract and, if I frustrated that right by selling the widget to another buyer, the generous rule that is already law requires me to disgorge my entire profit."); Schwartz, *supra* note 38, at 291 n.56 ("The constructive trust remedy that a right to specific performance enables the promisee to invoke thus can overcompensate.").

even if the promised service cannot be acquired elsewhere.[78] However, they will enter negative injunctions prohibiting the promisor from providing the promised services to anyone else,[79] and will specifically enforce covenants not to compete.[80] Instead of requiring promisors to surrender gains from breach,[81] injunctions against working for others or competing directly prevent promisors from gaining from breach at all, even if they would gain more from breach than their promisees would from performance.

d. Efficient Breach

Requiring promisors to perform or surrender their profits from breach has sometimes been criticized, or praised, for preventing efficient breaches.[82] We think this is a red herring. Disgorgement remedies will likely have only second-order effects on the incidence of efficient nonperformance of contracts, although they will of course alter the distribution of gains that result when a better alternative to performing arises.

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78. *See* RESTATEMENT (SECOND) OF CONTRACTS § 367 cmt. a (1981). Courts sometimes order specific performance of promises to perform discrete acts. *See, e.g.*, Mitchell v. Mitchell, 685 N.E.2d 1083, 1085-86, 1090 (Ind. Ct. App. 1997); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 367 cmt. b.

79. *See, e.g.*, Lumley v. Wagner, (1852) 42 Eng. Rep. 687, 693 (Ch.); RESTATEMENT (SECOND) OF CONTRACTS § 367 illus. 1. A negative injunction is available only when no substitute for the promisor's services is available, but courts are increasingly willing to find uniqueness. *See, e.g.*, Arias v. Solis, 754 F. Supp. 290, 294-95 (E.D.N.Y. 1991); *see also* YORIO, *supra* note 48, § 14.3. But again, when the promised service is available in the market, contract-market damages will effectively require a breaching promisor to surrender profits from breach anyway. *See supra* note 51 and accompanying text.

80. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. b ("The breach of a covenant not to compete may cause the loss of customers of an unascertainable number or importance.... In such situations, equitable relief is often appropriate.").

81. *Compare* Cincinnati Siemens-Lungren Gas Illuminating Co. v. W. Siemens-Lungren Co., 152 U.S. 200, 204-07 (1894) (ruling that when licensor made sales in licensee's exclusive territory in breach of contract, licensee was entitled to recover the profits licensor made from those sales), *with* Bausch & Lomb v. Sonomed Tech., Inc., 780 F. Supp. 943, 971 (E.D.N.Y. 1992), *aff'd in part, vacated in part, and remanded*, 977 F.2d 720 (2d Cir. 1992) (refusing to use the profits earned by breaching promisor as measure of losses suffered by promisee). *See also* Dawson, *supra* note 51, at 189.

82. *See, e.g.*, Eisenberg, *supra* note 29, at 570-71 (arguing that efficient breach is bad law and bad economics). Eisenberg is a supporter of disgorgement on that basis, among others. Friedmann, *supra* note 7, at 2, also falls into this category.

The most vigorous exponent of the theory of efficient breach, Judge Richard Posner, implicitly recognizes that gains from breach are likely to exceed the promisee's expectation only when the subject of the contract is unique or otherwise not available in the market.[83] As is well-known, Posner's position is that if a third party is willing to pay enough for the widget so that the promisor is able to realize a profit after compensating the promisee for her expectation, then the promisor *should* sell the widget to the third party, and the law should do no more than require the promisor to pay the promisee's expectation.[84] The conventional, and equally well-known, answer to Posner is that even if the law requires the promisor to give the widget to the promisee, the third party can just buy it from the promisee, or get an assignment from her.[85]

Posner rejoinds: "But this would have introduced an additional step, with additional transaction costs—and high ones, because it would be a bilateral-monopoly negotiation."[86] Posner's response may be faulted for failing to recognize that the promisor-third party negotiation would be a bilateral monopoly negotiation as well. Indeed, the third party may find bargaining with the promisee easier, because the promisee knows what her value is, while the promisor cannot be sure what he will have to pay to the promisee as damages.[87] Nevertheless, Posner's bilateral monopoly point is telling, because the promisee-third party negotiation will be a bilateral monopoly negotiation *only* if the widget is not available elsewhere—otherwise, the promisee would have no monopoly power—and then specific performance, and promisor expectation, is the rule. If a widget is available in the market, the third party can simply go to the market, just as either of the two principals can. As we explained above, if the third party *does* buy from the promisor instead of in the market, the promisor will have to surrender his gain from breach under the contract-market formula. Moreover, when widgets are available in the market, the transaction costs of the promisor selling to the promisee and the promisee selling to the

83. *See* POSNER, *supra* note 1, at 118-26, 130-31.
84. *Id.*
85. *See* Friedmann, *supra* note 7, at 5.
86. POSNER, *supra* note 1, at 120.
87. *But see* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 97 (1989).

third party are likely to be much lower than the cost of negotiating, or litigating, a release from the promisee.

Thus, the efficient breach question arises only when the subject of the contract is not available in the market. But the promisor is not allowed to gain from breach in this situation either, because this is when specific performance is available. Efficient breaches are thus likely to be rare, even under the conventional, promisee-based expectation remedy.

3. The Inadequacy Test—Promisor Expectation in Between

In sum, then, the objective market damage remedy for fungible goods and the specific performance remedy for unique goods both put breaching promisors in the position they would have been in had they performed. But what is the law between these extremes? That turns out to be an important question because the extreme cases of perfectly homogenous or absolutely unique goods may seldom, if ever, actually exist. For many contracts, substitute performance is neither completely impossible nor absolutely perfect, and whatever substitute is available must be acquired in a market in which different buyers pay different prices.

A breaching promisor's ability to gain from breach in these contexts turns on how courts construct remedies. If courts use specific performance or remedies calculated by reference to the promisor's actions, disgorgement or promisor expectation will obtain. On the other hand, if courts determine expectation damages by reference to the *promisee's* actual loss, the promisor may be able to profit from breach. In fact, the test for when courts will grant specific performance tracks this distinction precisely. In other words, our strong claim is that, at least for the sale of goods, every breach is subject either to the market damage rule or to specific performance, both of which accomplish disgorgement and frequently overcompensate promisee expectation.

Contracts for the sale of unique goods may be the clearest candidates for specific performance, but they are not the only contracts for which specific performance is available. Although Douglas Laycock may have announced the death of the irreparable injury

rule prematurely,[88] promisees are entitled to specific performance in many cases, and the clear trend is to make specific performance available more often.[89]

It is commonly said that specific performance is available only when damages are "inadequate."[90] In practice, what that means is that specific performance is available unless substitute performance can be obtained at a determinable price in the market,[91] in which case the contract-market measure of expectation equals the gain from breach anyway. It is no defense that specific performance will deprive the promisor of gains that exceed the promisee's expectation, and courts will not deny specific performance simply because the promisor would gain more from breaching than the promisee would gain from performance.[92]

The paradigm case in which damages are adequate—and specific performance is unavailable—is the contract for sale of fungible goods.[93] Two factors make money an adequate remedy in such cases: "the availability of substitutes on the market and the ability to assess damages with reasonable certainty."[94] Specific performance is appropriate when either factor is absent[95]—when substitutes are

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88. *See generally* DOUGLAS LAYCOCK, THE DEATH OF THE IRREPARABLE INJURY RULE (1991) (arguing that inadequacy is not a prerequisite for specific performance).

89. *Id.* at 266 ("A plaintiff who has prevailed on the merits is presumptively entitled to choose either a substitutionary or specific remedy."); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 359 cmt. a (1981) ("There is, however, a tendency to liberalize the granting of equitable relief by enlarging the classes of cases in which damages are not regarded as an adequate remedy.... Doubts should be resolved in favor of the granting of specific performance or injunction."); FARNSWORTH, *supra* note 49, § 12.4, at 743 ("[T]he modern trend is clearly in favor of the extension of specific relief."); HAWKLAND, *supra* note 60, § 2-716 cmt. 1 ("This Article seeks to further a more liberal attitude than some courts have shown in connection with the specific performance of contracts of sale."); YORIO, *supra* note 48, § 11.1, at 289-90. *See generally id.* ch. 10-18 (surveying the availability of specific performance).

90. RESTATEMENT (SECOND) OF CONTRACTS §§ 357, 359(1). *But see* LAYCOCK, *supra* note 88 (arguing that courts do not in fact require inadequacy to order specific performance).

91. U.C.C. § 2-716 cmt. 2 (2002) (stating that inability to cover indicates specific performance is appropriate); *id.* § 2-713 cmt. 3 (stating that lack of market price indicates specific performance is appropriate); RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. a; LAYCOCK, *supra* note 88, at 274.

92. LAYCOCK, *supra* note 88, at 268 ("A remedy will not be withheld merely because its expense exceeds the benefit to plaintiff."); YORIO, *supra* note 48, § 5.4.2, at 110 (same).

93. RESTATEMENT (SECOND) OF CONTRACTS § 360 illus. 6.

94. YORIO, *supra* note 48, § 2.4, at 35.

95. *Id.* at 35-36; *see also* Allegheny Energy, Inc. v. DQE, Inc., 171 F.3d 153, 160 (3d Cir. 1999) ("'[A]n action for damages is an inadequate remedy when there is no method by which the amount of damages can be accurately computed or ascertained.' Damages cannot be

not available *or* when their price is unknown, so that expectation cannot be assessed with reasonable certainty.[96]

There is nothing wrong with the aphorism that specific performance is available only when the subject of the contract is priceless, but it is important to remember what priceless means in this context. "Priceless" does not mean "beyond all value;" it means "at no known price." Specific performance is available not only when the subject of a contract cannot be obtained for *any* price, but also—and much more commonly—when it is impossible to know what the "correct" price is.[97] The standard for inadequacy—the absence of

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accurately ascertained 'where the subject matter of an agreement is an asset that is unique or one such that its equivalent cannot be purchased on the open market.'" (citation omitted) (quoting Clark v. Pa. State Police, 436 A.2d 1383, 1385 (Pa. 1981); Tomb v. Lavalle, 444 A.2d 666, 668 (Pa. Super. Ct. 1981))); Aeronautical Indus. Dist. Lodge 91 Int'l Ass'n Machinists v. United Tech. Corp., 87 F. Supp. 2d 116, 134 (D. Conn. 2000) ("Injunctive relief is appropriate where ... monetary damages would be extremely difficult, if not impossible, to ascertain."); Magellan Int'l Corp. v. Salzgitter Handel GmbH, 76 F. Supp. 2d 919, 926 (N.D. Ill. 1999) (finding inability to cover as grounds for specific performance); Sedmak v. Charlie's Chevrolet, Inc., 622 S.W.2d 694, 699-700 (Mo. App. 1981) (awarding specific performance for sale of customized Indy Pace Car edition Corvette—one of approximately 6,000—because procuring substitute was difficult, though not impossible).

96. *See* U.C.C. § 2-713 cmt. 3 (stating that lack of market price indicates specific performance is appropriate); *id.*§ 2-716 cmt. 2 (stating that inability to cover indicates specific performance is appropriate); RESTATEMENT (SECOND) OF CONTRACTS § 360 ("In determining whether the remedy in damages would be adequate, the following circumstances are significant: (a) the difficulty of proving damages with reasonable certainty, (b) the difficulty of procuring a suitable substitute performance by means of money awarded as damages, and (c) the likelihood that an award of damages could not be collected."); *id.* cmt. b (suggesting specific performance when a promisee cannot prove any monetary loss); *id.* cmt. c (suggesting specific performance when a promisee cannot obtain substitute); FARNSWORTH, *supra* note 49, § 12.6, at 747-48 (marginal captions: "uncertainty of damages" and "availability of substitute"); YORIO, *supra* note 48, § 2.4, at 35; *id.* § 11.2.2; *see also* LAYCOCK, *supra* note 88, at 22 (arguing that legal remedies are almost never found adequate).

97. The difficulty of computing damages accounts for the availability of specific performance when breach would injure the promisee's reputation, goodwill, or future profits. *See, e.g.*, Walgreen Co. v. Sara Creek Prop. Co., 966 F.2d 273, 274, 277-78 (7th Cir. 1992); Laclede Gas Co. v. Amoco Oil Co., 522 F.2d 33, 40 (8th Cir. 1975); Fleischer v. James Drug Stores, Inc., 62 A.2d 383, 387 (N.J. 1948); Oglebay Norton Co. v. Armco, Inc., 556 N.E.2d 515 (Ohio 1990) (per curiam); Evans Marshall & Co. v. Betola S.A., (1973) 1 W.L.R. 349, 380 (Q.B.O.) (Eng.); *see also* YORIO, *supra* note 48, § 2.4.1, at 36-37. Indeed, specific performance of contracts to deliver heirlooms or art may best be explained not on the ground that no amount of money would satisfy the promisee's expectation, which seems unlikely, but on the more palatable ground that there is no telling how much money is necessary. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. b. This notion is in keeping with Abraham Bell and Gideon Parchomovsky's thesis that the basis of property rules in general is to protect subjective valuation that arises from stable ownership. *See* Abraham Bell & Gideon

substitute performance at an ascertainable price—identifies and enforces the very contracts in which gains from breach are not likely to be captured by subjective expectation remedies. Between them, then, specific performance and the objective contract-market remedy accomplish disgorgement across a wide variety of contracts, even when the promisor's gains from breach exceed promisee expectation.

B. Promisor Expectation Elsewhere in Contract Law

1. The Exclusive Benefit Rule

Contracts in which the relationship of the parties is itself the source of the breaching promisor's opportunity to profit are another common situation in which a promisor's gain from breach is likely to differ from the promisee's lost expectation. When parties enter into a long-term relationship in which one of them will make decisions that affect the interests of the other, the active party often agrees, explicitly or implicitly, to act on behalf of the passive party. That, in turn, creates the opportunity for the active party to profit at the passive party's expense.[98] Relationships such as these are commonly referred to as fiduciary relationships, and the active party is commonly referred to as a fiduciary.[99]

Parchomovsky, *A Theory of Property*, 90 CORNELL L. REV. 531, 531, 615 (2005).

Further evidence that administrative difficulty with the assessment of damages is more important than uniqueness in leading courts to award specific performance comes from the handful of cases denying specific performance of contracts to sell unique goods or real estate when the buyer has already contracted to resell them, allowing courts easily to assess the seller's subjective valuation. *See* YORIO, *supra* note 48, §§ 10.2.2, 11.2, at 297. *But see* Loveless v. Diehl, 364 S.W.2d 317, 318-20 (Ark. 1963) (awarding specific performance for sale of land that buyers had already committed to resell and could not have purchased on their own).

98. If you give us your money for management, we can sell you Florida swampland that we already own. Our power to take advantage of you in this way is made possible only by the contractual relationship. Absent the contract, we would have no way of legally getting access to your money or of getting you to invest in our fraudulent scheme.

99. *See* RESTATEMENT (SECOND) OF AGENCY § 387 (1958); RESTATEMENT (FIRST) OF RESTITUTION § 190 cmt. a (1937) ("A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation. Fiduciary relations include among others the relation of trustee and beneficiary, guardian and ward, agent and principal, attorney and client. Each member of a partnership is in a fiduciary relation to the other partners. The directors and officers of a corporation are also fiduciaries, as are receivers, and executors and administrators."); Victor Brudney, *Contract Law and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595, 595 (1997).

The exact parameters of a fiduciary's duties are notoriously difficult to state either clearly or succinctly, precisely because it is difficult at the outset of a relationship to define what the fiduciary is to do in the wide variety of circumstances that may come to pass.[100] Indeed, this very difficulty is the root of the agency problem—if the beneficiary/principal could simply tell the fiduciary/agent exactly what to do, the contract would be complete and there would be no need for delegation of any discretion to the agent. But because complete contracting is impossible, the parties have to impose duties on the agent that are less clear. Much of the complexity of agency, trust, and corporate law addresses the obligations of fiduciaries, but, broadly speaking, they come down to a duty of care[101] and a duty of loyalty.[102]

A fiduciary's breach of either duty may injure the beneficiary. However, a fiduciary who breaches the duty of care will often generate no tangible increase in his own profits by virtue of his laziness, and, in any event, the injury to the beneficiary is likely to swamp whatever benefit the fiduciary gains from shirking.[103] Breaches of the duty of loyalty, on the other hand, are more likely to yield clear profits to the fiduciary, and indeed the prospect of profit is what is likely to induce such breaches in the first place.[104] For example, an employee might take a bribe from a customer, a trustee might purchase property from the trust, a partner might use

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100. *See* Brudney, *supra* note 99, at 596-97.

101. *See* RESTATEMENT (SECOND) OF TRUSTS § 174 (1959); RESTATEMENT (SECOND) OF AGENCY § 379 (1958); AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1994) [hereinafter PRINCIPLES OF CORPORATE GOVERNANCE].

102. *See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939); Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928) ("Joint adventurers, like copartners, owe to one another ... the duty of the finest loyalty."); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 170(1) (1992) ("The trustee is under a duty to administer the trust solely in the interest of the beneficiaries."); *id.* § 170(1) cmt. a ("A trustee is in a fiduciary relation to the beneficiary and as to matters within the scope of the relation he is under a duty not to profit at the expense of the beneficiary and not to enter into competition with him without his consent, unless authorized to do so by the terms of the trust or by a proper court.... The principle stated in this Section is applicable not only to trustees but to other fiduciaries."); RESTATEMENT (SECOND) OF AGENCY § 387; PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, §§ 5.01-5.04; *see also* Brudney, *supra* note 99, at 600.

103. *Cf. In re* Rothko, 372 N.E.2d 291, 296 (N.Y. 1977); Richard V. Wellman, *Punitive Surcharges Against Disloyal Fiduciaries—Is* Rothko *Right?*, 77 MICH. L. REV. 95, 95-96 (1978).

104. *See* Brudney, *supra* note 99, at 599.

partnership property for personal purposes, or a corporate officer might usurp a corporate opportunity. In such cases, the fiduciary realizes a profit by breaching an obligation assumed at the creation of the consensual relationship, a profit which would not have been available at all but for the existence of the broken contract. The breach of duty may injure the beneficiary, but her damages, if any, will not necessarily equal the profits of the breaching fiduciary. Accordingly, if beneficiaries were limited to recovering their damages, breach of the fiduciary duty of loyalty might be profitable.

Beneficiaries are not limited to recovering their damages, however. A fiduciary who breaches the duty of loyalty is accountable to the beneficiary for all his profits from breach,[105] even if the beneficiary would not have been able to earn them.[106] This right is independent of the beneficiary's right to be compensated for

105. 3 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 205 (4th ed. 1988); Brudney, *supra* note 99, at 603 n.17 ("[T]here is no doubt of the disgorgement and constructive trust requirements."); *id.* at 609 ("Deterrent sanctions like constructive trusts ... are the hallmark of fiduciary obligations."); *see also* ROBERT COOTER & THOMAS ULEN, LAW & ECONOMICS 234 (3d ed. 2000); Dawson, *supra* note 51, at 187.

106. *See* UNIF. P'SHIP ACT § 21 (1914), 6 U.L.A. 194 (2001); RESTATEMENT (THIRD) OF TRUSTS: PRUDENT INVESTOR RULE § 205 ("A trustee who commits a breach of trust is ... accountable for any profit accruing to the trust through the breach of trust .... In addition, the trustee is subject to such liability as necessary to prevent the trustee from benefiting personally from the breach of trust."); *id.* § 206; RESTATEMENT (SECOND) OF AGENCY § 388 ("Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal."); *id.* §§ 403, 404, 407; RESTATEMENT (FIRST) OF RESTITUTION § 190 (1937) ("Where a person in a fiduciary relation to another acquires property, and the acquisition or retention of the property is in violation of his duty as fiduciary, he holds it upon a constructive trust for the other."); *id.* §§ 190 cmt. c, 192 cmt. a, 193 cmt. a, 194 cmt. c, 202; *id.* § 197 ("Where a fiduciary in violation of his duty to the beneficiary receives or retains a bonus or commission or other profit, he holds what he receives upon a constructive trust for the beneficiary."); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, § 5.04 cmt. a; *see also* RESTATEMENT (SECOND) OF TRUSTS § 202; *id.* § 203 ("The trustee is accountable for any profit made by him through or arising out of the administration of the trust, although the profit does not result from a breach of trust."); RESTATEMENT (SECOND) OF AGENCY § 404(A); Robert C. Clark, *Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 73 (John W. Pratt & Richard J. Zeckhauser eds., 1985) ("Case law on managers' fiduciary duty of care can fairly be read to say that the manager has an affirmative, open-ended duty to maximize the beneficiaries' wealth .... But with respect to the fiduciary's rights, the law leans exactly the other way.... Essentially, the fiduciary cannot take any compensation from the beneficiaries or any other advantage from his official position (even when doing so does not seem to deprive the beneficiaries of any value they would otherwise get) except to the extent provided in an above-board actual contract or in accordance with explicit statutory permissions.").

damages; and it is no defense that the transaction was fair to the beneficiary, that the beneficiary was not damaged, or that the fiduciary's profit exceeded the beneficiary's loss.[107]

Thus, a corporate officer who wrongfully earns secret profits while acting on behalf of the corporation must give them to the corporation, even if the corporation could not have earned those profits itself.[108] If a corporate officer wrongfully competes with the corporation, the remedy is similar.[109] If an interested director wrongfully makes a contract with the corporation, the contract is voidable at the election of the corporation, even if the transaction is fair and has not harmed the corporation.[110] Here again, the fact that the fiduciary's profits were greater than those the corporation could have earned is no defense.[111]

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107. *See* RESTATEMENT (SECOND) OF TRUSTS § 170 cmt. b ("A trustee with power to sell trust property is under a duty not to sell to himself either by private sale or at auction, whether the property has a market price or not, and whether or not the trustee makes a profit thereby. It is immaterial that the trustee acts in good faith in purchasing trust property for himself, and that he pays a fair consideration."); RESTATEMENT (SECOND) OF AGENCY §§ 388 cmt. a, 389 cmt. c, 404 cmt. a; RESTATEMENT (FIRST) OF RESTITUTION § 192 cmt. a ("Where, however, the beneficiary does not consent, the transaction is voidable, even though it is fair and reasonable.... The rule stated in this Section is applicable to trustees, executors or administrators, guardians, agents, partners, directors and officers of a corporation, and others who are empowered to dispose of property for the benefit of others who have an interest in it."); *id.* §§ 193 cmt. c, 197 cmt. c, 199, 200, 202 cmt. c; SCOTT & FRATCHER, *supra* note 105; Brudney, *supra* note 99, at 602-03 ("These strictures contemplate not merely compensating beneficiaries for losses, but forcing disgorgement of the fiduciary's gains even when the beneficiary is not shown to have been harmed."); *see also* RESTATEMENT (FIRST) OF RESTITUTION § 191(2)(d) (stating that consent is inoperative if the transaction is not fair and reasonable).

108. *See, e.g.*, Hawaiian Int'l Fins., Inc. v. Pablo, 488 P.2d 1172 (Haw. 1971); ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW § 9.05[E] (1999); *cf.* Joseph T. Bockrath, Annotation, *Liability of Corporate Officer or Director for Commission or Compensation Received from Third Person in Connection with that Person's Transaction with Corporation* § 7, 47 A.L.R.3d 373, § 7 (1973) (noting officer or director must account to corporation for compensation received from a third party, even if corporation not harmed).

109. PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, § 5.06 cmt. g.

110. *See, e.g.*, Globe Woolen Co. v. Utica Gas & Elec. Co., 121 N.E. 378, 379-80 (N.Y. 1918).

111. *See, e.g.*, Energy Res. Corp. v. Porter, 438 N.E.2d 391, 393-94 (Mass. 1982) (holding that a third party's unwillingness to deal with corporation is not a defense when disclosure was not made); *cf.* Irving Trust Co. v. Deutsch, 73 F.2d 121, 124 (2d Cir. 1934) (holding a fiduciary liable notwithstanding the corporation's inability to finance the project, so long as the corporation was solvent); Klinicki v. Lundgren, 695 P.2d 906, 919-20 (Ore. 1985) (en banc); PRINCIPLES OF CORPORATE GOVERNANCE, *supra* note 101, § 5.05 (stating that failure of a fiduciary to disclose an opportunity to a corporation makes the fiduciary liable without further inquiry).

Fiduciary duties are sometimes treated as distinct from contractual ones, and fiduciary relationships as outside the scope of contract law.[112] On the other hand, it has become almost conventional to describe such relationships as contractual.[113] The debate over whether to characterize fiduciary duties as contractual largely focuses on whether they are mandatory or simply default rules. This Article is not concerned with that question; even if fiduciary duties are only default rules subject to negotiation, when the parties do choose to be governed by the duties, their breach entitles beneficiaries to recover the profits from breach. In the end, fiduciary duties attach only upon entering a consensual relationship.[114] Perhaps such relationships are seen as noncontractual precisely because the exclusive benefit rule that is their hallmark[115] clashes with the erroneous prevailing contract paradigm of promisee expectation. That, in any case, is apparently how Farnsworth saw it: "The more significant distinction between fiduciary obligations and contractual ones is remedial—the disgorgement principle applies to breach of a fiduciary obligation while the [promisee] expectation principle applies to a breach of contractual obligation."[116]

2. Promisor Expectation by Characterization

Courts also accomplish promisor expectation by the way they characterize the relationship of the parties or the elements of standard remedies.[117] Thus, calling an employment contract an agency relationship triggers not simply fiduciary duties but the exclusive benefit rule as well.[118] For example, consider *Snepp v. United States*,

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112. *Cf.* RESTATEMENT (SECOND) OF TRUSTS § 197 cmts. b & d.

113. *See* Brudney, *supra* note 99, at 596 n.2 (collecting sources).

114. *Id.* at 596 ("Neither 'contract' nor 'fiduciary' exists in nature."); James J. Edelman, *When Do Fiduciary Duties Arise?*, 126 L. Q. REV. 301 (2010).

115. Brudney, *supra* note 99, at 601; Farnsworth, *supra* note 21, at 1356.

116. Farnsworth, *supra* note 21, at 1356.

117. Eisenberg makes related observations. Sometimes, he notes, courts characterize the promisee's expectation as the promisor's profits from breach and then simply order disgorgement so as to protect expectation. Eisenberg, *supra* note 29, at 587-92. In other instances, disgorgement is used to protect a promisee's diffuse interest in something—for example, national security—that cannot be measured, at least in terms of money. *Id.* We agree.

118. *Cf.* RESTATEMENT (SECOND) OF CONTRACTS § 73 illus. 12 (1981) ("A is employed to drive B's horse in a race. C owns the dam of B's horse and is entitled to a prize if B's horse wins the

in which the defendant was a former employee of the CIA who had agreed not to publish anything about the agency without its prior approval.[119] Without the agency's permission, the defendant published a book about the CIA's activities in South Vietnam, and the Agency sought his profits from the book.[120] The Supreme Court held that, by publishing the book, the employee "breached a fiduciary obligation and that the proceeds of his breach are impressed with a constructive trust."[121] The tenor of the Court's opinion, over a vigorous dissent,[122] suggests that the Court adopted its fiduciary characterization of the relationship precisely to require the employee "to disgorge the benefits of his faithlessness."[123]

A court can also require a breaching promisor to surrender its gains from breach by recharacterizing the subject of the contract. The fascinating history of Elvis Presley's gold-leafed piano provides an example.[124] Philip Brodnax bought the piano and subsequently leased it to Elvis Presley Enterprises, Inc. (EPE), which operates Presley's home, Graceland.[125] The lease gave EPE the right to promote the piano but provided that "Lessee shall not sell photographs, souvenirs, miniatures, or any other commercial items with regard to the Piano without the express consent" of Brodnax.[126]

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race. C promises A a bonus if he wins the race. A's driving in the race is consideration for C's promise, but B may be entitled to the bonus.").

119. 444 U.S. 507, 507-08 (1980) (per curiam). A remarkably similar English case, *Attorney General v. Blake* (2001) 1 A.C. 268, 291 (H.L.) (appeal taken from Eng.), was decided in a similar fashion by the House of Lords.

120. *Snepp*, 444 U.S. at 507-08.

121. *Id.* at 510.

122. *Id.* at 516 (Stevens, J., dissenting). The dissent argued that a constructive trust should not attach if the book did not include confidential information, but acknowledged that the case presented

> an employment relationship in which the employee possesses fiduciary obligations arising out of his duty of loyalty to his employer. One of those obligations, long recognized by the common law even in the absence of a written employment agreement, is the duty to protect confidential or "classified" information. If Snepp had breached that obligation, the common law would support the implication of a constructive trust upon the benefits derived from his misuse of confidential information.

Id. at 516-18.

123. *Id.* at 515.

124. *See* 148 Inv. Group, Inc. v. Elvis Presley Enters., Inc., No. 93-6444, 1995 WL 283785 (6th Cir. May 10, 1995) (per curiam).

125. *Id.* at *1.

126. *Id.*

Graceland's gift shops nevertheless sold the souvenirs, earning EPE net profits of approximately $110,000.[127] Brodnax sold the piano and assigned his cause of action to an investment group, which brought an action against EPE alleging breach of contract and conversion.[128] The trial judge awarded the plaintiff the amount of EPE's entire net profit, plus interest.[129]

On appeal, EPE argued that the plaintiff was entitled to only "a reasonable share of the profits, not all of [them]."[130] The court of appeals proceeded from the premise that the complaint was for breach of contract, so the plaintiff was entitled to damages that would place it, as nearly as possible, in the position it would have been in had the contract been performed.[131] Although Brodnax admitted that if EPE had sought his consent he probably would have negotiated a royalty agreement, under which EPE would have retained some profits from souvenir sales, the court nevertheless concluded that he was entitled to all of EPE's profits.[132] As the court saw it, under the contract, Brodnax had the right not just to negotiate, but the right to say no.[133] Inasmuch as "EPE's conduct deprived Brodnax of his bargained-for right to refuse consent," the plaintiff was entitled to EPE's profits as "the damages attributable to EPE's breach."[134]

The preference for objectively determinable remedies also frequently leads courts to manipulate the technical rules that govern remedies in a way that accomplishes promisor expectation, because the promisor's post-breach actions are discoverable. For example, the market damage remedy measure of expectation that is standard in contracts for fungible goods could allow a promisor to breach profitably by selling fungible goods to a third party willing to pay

127. *Id.*
128. *Id.*
129. *Id.*
130. *Id.*
131. *Id.*
132. *Id.* at *2.
133. *Id.*
134. *Id.* Courts have used similar reasoning to require surrender of profits from breach when promisors have breached agreements not to use business plans or other information without consent, even when those profits exceed the profits the promisees would have received from performance. *See* Landsberg v. Scrabble Crossword Game Players, Inc., 802 F.2d 1193, 1195-96 (9th Cir. 1986); Reeves v. Alyeska Pipeline Serv. Co., 56 P.3d 660, 662-63 (Alaska 2002).

more than the market price.[135] However, courts typically treat the promisor's resale price as the market price, thus allowing the promisee to capture the promisor's entire gain.[136]

3. Promisor Expectation Through Rescission

A promisee may also be able to capture a breaching promisor's gains by electing to rescind the contract instead of enforcing it. After a substantial breach of contract, the promisee may forgo damages and seek restitution instead.[137] The promisee is then entitled to the reasonable value of the performance she rendered, less the value of any performance she has received.[138] The promisee's recovery is not

135. *Cf.* FARNSWORTH, *supra* note 49, § 12.11, at 776-77.

136. *See, e.g.*, Murphy v. Lischitz, 49 N.Y.S.2d 439, 442 (Sup. Ct. 1944) ("[T]he sum which defendants realized on the resale of the liquor is not uncertain or speculative. It is the best evidence of the market value or the value of the contract to the plaintiff. Therefore, a measure of damages which would compel defendants to pay over the difference between the contract price and the resale price is just and equitable. If the defendants have been unjustly enriched by reason of their wrongdoing, they should not be permitted to profit thereby."), *aff'd*, 52 N.Y.S.2d 943 (App. Div. 1945), *aff'd*, 63 N.E.2d 26 (N.Y. 1945); *see also* Cedar Point Apartments, Ltd. v. Cedar Point Inv. Corp., 756 F.2d 629, 630 (8th Cir. 1985); Roth v. Speck, 126 A.2d 153, 155-56 (D.C. 1956) (using hairdresser's wages from new employer as measure of damages for former employer); Rooney v. Weeks, 194 N.E. 666, 667 (Mass. 1935); Triangle Waist Co. v. Todd, 119 N.E. 85, 85-86 (N.Y. 1918) (similar); Dorville Corp. v. Jackson, 104 N.Y.S.2d 161, 162 (App. Div. 1951); YORIO, *supra* note 48, § 10.2.7, at 280; Dawson, *supra* note 51, at 186; Farnsworth, *supra* note 21, at 1371 ("[C]ourts have often applied traditional damage rules in such a way as to favor disgorgement. They have done this ... by ... looking to the seller's actual resale price as evidence of market price, thus stripping the party in breach of profit and depriving that party of recompense for the skill and industry to arrange a sale above the market."); H. B. Chermside, Jr., Annotation, *Employer's Damages for Breach of Employment Contract by Employee's Terminating Employment*, 61 A.L.R.2d 1008, § 4 (2009) ("In assessment of damages to be awarded the employer where the employee has abandoned his employ, it has been held in a number of cases that the pay scale of the employee in his next employment affords some evidence of the worth of his services to his original employer."); *cf.* Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 378 (1978) (suggesting that courts treat breaching promisor's resale price as evidence of market value). Eisenberg also suggests that disgorgement can be a surrogate for expectation damages. *See* Eisenberg, *supra* note 29, at 577.

137. *See* RESTATEMENT (SECOND) OF CONTRACTS § 373(1) & cmt. a (1981). On the promisee's right to both restitution and damages, see JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS § 15.7 (5th ed. 2003).

138. *See* United States v. Algernon Blair, Inc., 479 F.2d 638, 642 (4th Cir. 1973); Boomer v. Muir, 24 P.2d 570, 573 (Cal. Dist. Ct. App. 1933); Osteen v. Johnson, 473 P.2d 184, 187 (Colo. App. 1970); RESTATEMENT (SECOND) OF CONTRACTS § 373 & illus. 1; PERILLO, *supra* note 137, § 15.4, at 624-26.

limited to expectation damages, or even to the contract price, except in cases in which the promisee has fully performed and the promisor's only remaining obligation is to pay money.[139]

Thus, a promisor who breaches a particularly advantageous contract will be required to pay the value of what he has received, even if he would have been entitled to keep it for less if he had honored the contract.[140] The purpose of the remedy is not to protect the promisee's expectation but to prevent unjust enrichment of the promisor.[141] The effect of this remedy is to accomplish disgorgement by requiring the breaching promisor to surrender the profits it realizes by its breach to the extent they arise from the performance of the promisee.[142]

The pursuit of the promisor expectation remedy may also explain the puzzling rule that a promisee is not entitled to restitution when she has fully performed and the promisor's only remaining obligation is to pay money.[143] When the promisor's only remaining obligation at the time of breach is to pay money, he has no other profits to surrender. Any profits he might earn by withholding the money could be realized by using other money, so such profits cannot be said to arise from breach.[144] When the promisor owes an unliquidated obligation, however, his nonperformance may leave him a profit arising from the breach, and the rule forbidding restitution does not apply.

Although restitution will often put a promisor who entirely fails to perform in the position he would be in if he had performed, the rescission/restitution remedy does not always lead to disgorgement.[145] In particular, when the promisor breaches in order to take

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139. *See* Oliver v. Campbell, 273 P.2d 15, 20 (Cal. 1954) (en banc); RESTATEMENT (SECOND) OF CONTRACTS § 373(2); PALMER, *supra* note 76, at 378-79; PERILLO, *supra* note 137, § 15.6.

140. *See* RESTATEMENT (SECOND) OF CONTRACTS § 373 cmt. d (losing contracts).

141. *See* FARNSWORTH, *supra* note 49, § 12.19, at 821.

142. *See, e.g.*, Earthinfo, Inc. v. Hydrosphere Res. Consultants, Inc., 900 P.2d 113, 115 (Colo. 1995) (en banc).

143. *See* PALMER, *supra* note 76, at 378-79; PERILLO, *supra* note 137, § 15.6, at 607 (referring to the rule as an "anomaly").

144. *See supra* notes 54-57 and accompanying text.

145. Indeed, restitution may require the breaching party to pay more than either the promisee's expectation or the amount the promisee's performance enriched the promisor. The promisee recovers the value of performance tendered even if the promisor did not benefit therefrom. *See* PERILLO, *supra* note 137, § 15.4. The Restatement indicates that when the amount it would have cost the breaching promisor to obtain the promisees' performance

advantage of a more profitable opportunity, the promisee who elects restitution is entitled to recover only those benefits that her own performance conferred on the promisor, which may amount to less than full disgorgement.[146]

C. Innocent Breach—When Promisors Can Keep the Expenses They Avoid by Breach

In a wide variety of circumstances, the doctrines discussed in Parts II.A-B put breaching promisors in the position they would have been in had they performed instead of breaching. Promisors sometimes gain from breach, however, simply by avoiding an expense of performance—for example, by failing to produce a widget. Although courts almost always require breaching promisors to surrender their profits, they only sometimes require them to share with promisees the expenses they save by breach.[147] This category of "expenses saved by breach" is the major exception to the availability of disgorgement, and on first glance it is quite puzzling. After all, expenses avoided by breach are in some sense just the flip side of profits earned by breach, so one might expect that both should be addressed by the same remedial devices.[148]

On closer examination, however, the loss avoided/profits earned situations *do* differ in an important respect. Virtually all breaches that involve sales to a third party are deliberate—it is hard to

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elsewhere is greater than the amount by which the performance increased the promisor's wealth, the promisee is typically entitled to the higher amount. RESTATEMENT (SECOND) OF CONTRACTS § 371 cmt. b.

146. RESTATEMENT (SECOND) OF CONTRACTS § 370 cmt. a.

147. Promisee expectation damages will sometimes exceed the avoided cost of performance, in which case the award of such damages effectively requires surrender of expenses saved by breach, and the prospect of paying such damages gives promisors a substantial incentive to perform. Often, however, the cost of performance exceeds the value of performance to the promisee, which means that the expenses saved by breach will exceed expectation damages. In such situations, the profit from breach is not captured by expectation, and a remedial regime limited to expectation damages will permit profitable breaches.

148. *Cf.* Securities Exchange Act § 21A(a)(2), 15 U.S.C. § 78u-1(a)(2) (2006) (providing for penalty for illegal insider trading based on profits gained or losses avoided); Farnsworth, *supra* note 21, at 1382-83 ("Here, as in the case of the widget resold, I have realized a gain that is not offset by your expectation damages."). Indeed, if our contract with you prevents us from taking a more profitable opportunity to sell to someone else, this would seem to be an opportunity cost that is every bit as real as the loss we suffer if we have to incur added expenses in order to perform.

imagine how we could sell someone else the widget we promised you without knowing what we were doing. Some breaches that save expenses are of this form as well—the promisor sees a way to cut corners and takes advantage of it, hoping the promisee will not notice or will not insist on promisor expectation.[149] But other expense-saving breaches are inadvertent, such as the mistaken substitution of Cohoes for Reading pipe in *Jacob & Youngs, Inc. v. Kent*,[150] or the savings that result when a promisor fails to deliver goods because his factory has accidentally burned down and he does not rebuild it in time to perform. The law *does* tend to treat like cases alike: deliberate breaches, whether to earn higher revenues *or* to save expenses, are remedied by promisor expectation; accidental breaches that save expenses typically result in only a promisee expectation remedy.[151]

We have already discussed one set of cases in which breaching promisors are required to surrender the money they save by breaching: the cases in which a seller breaches a contract to sell goods to a middleman (who in turn has a contract to resell the goods at a markup) and then goes on to sell the goods at a higher price to a third party.[152] In these cases, the promisor's gain consists of an expense avoided, in that he could have performed by buying product in the market and delivering it to the middleman; this avoided expense is precisely what the contract-market differential requires

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149. The middleman cases discussed above, *supra* note 59 and accompanying text, are examples in which the court applied the contract-market formula to compel disgorgement. Another famous example is *New Orleans v. Firemen's Charitable Ass'n*, 9 So. 486, 486 (La. 1891), in which the city contracted with a private association to provide firefighting services. The contract expressly required staffing at a level of 124 firefighters, but the association only used 70, saving $25,920 in labor costs. *Id.* at 487. Despite the reduced labor force, however, the association was apparently able to put out fires successfully, and the city could show no actual losses it suffered as a result of the association's failure to maintain adequate staffing. *Id.* at 488. On our theory, this case should have resulted in a disgorgement remedy. It did not—but it has been widely criticized for failing to do so. *See, e.g.*, Eisenberg, *supra* note 29, at 593 & n.89.

150. 129 N.E. 889 (N.Y. 1921).

151. Eisenberg, *supra* note 29, at 592-97, discusses many of these issues. He insightfully points out that the cost of correction measure effectively accomplishes disgorgement of the promisor's savings from breach. *Id.* at 596-97. But, as is conventional, he sees the cost of correction measure merely as a way to protect the promisee's subjective expectation of full performance. *Id.* at 594. He does not discuss the distinction between willful and accidental breaches, *id.* at 592-97, which is crucial to explaining the cases.

152. *See supra* note 59 and accompanying text.

the breaching promisor to surrender. In contrast, courts consistently refuse to award the contract-market differential in middleman cases in which the promisor breaches not to sell to a third party but because the goods are destroyed. In these cases the middleman is limited to his expected markup,[153] and thus the breaching promisor may keep the expense he avoids by breach.

A more common situation in which expenses saved by breach exceed promisee expectation arises when the cost of providing perfect performance exceeds its value. *Jacob & Youngs, Inc. v. Kent*[154] and *Peevyhouse v. Garland Coal Mining Co.*[155] are the famous examples. Courts typically award one of two remedies in these cases—either the diminution in value attendant to the breach or the cost of correction. Although the cost of correction can be thought of as protecting the promisee/buyer's expectation interest, it almost always exceeds the value that perfect performance has for the promisee, even if the promisee places idiosyncratic value on performance. Even when the promisee specially values performance —as in the case of a contract to provide a roof of a specified color—only rarely will she have received *no* benefit at all from the defective performance that was actually tendered, that is, a roof of the wrong color.[156] On the other hand, the cost of correction exactly accomplishes promisor expectation: it is just equal to the amount the promisor saves by not providing perfect performance.

In almost all cases in which the cost of correcting performance greatly exceeds the value of performance and the promisee cannot prove some idiosyncratic value in performance, the promisee is

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153. *See* H-W-H Cattle Co. v. Schroeder, 767 F.2d 437, 438 (8th Cir. 1985); Nobs Chemical, USA, Inc. v. Koppers Co., 616 F.2d 212, 214 (5th Cir. 1980); Internatio, Inc. v. M.S. Taimyr, 602 F.2d 49, 50-51 (2d Cir. 1979); Allied Canners & Packers, Inc. v. Victor Packing Co., 209 Cal. Rptr. 60, 66 (Ct. App. 1984). These cases have been widely criticized. *See, e.g.*, GOLDBERG, *supra* note 59, at 227-28; Alan Schwartz & Robert E. Scott, *Market Damages, Efficient Contracting, and the Economic Waste Fallacy*, 108 COLUM. L. REV. 1610, 1614 (2008); Robert E. Scott, *The Case for Market Damages: Revisiting the Lost Profits Puzzle*, 57 U. CHI. L. REV. 1155, 1200 (1990); *see also* FARNSWORTH, *supra* note 49, § 12.12, at 785-86; Simon, *supra* note 49, at 89. We take no position on whether contract-market remedies ought to be available in this situation. Our position is simply that, as it is, the availability of the remedy turns on the willfulness of the breach. *See* Thel & Siegelman, *supra* note 6, at 1520.

154. *Jacob & Youngs*, 129 N.E. at 889.

155. *Peevyhouse*, 382 P.2d 109 (Okla. 1962).

156. *See* O.W. Grun Roofing & Constr. Co. v. Cope, 529 S.W.2d 258, 263 (Tex. Civ. App. 1975).

limited to recovering the value of performance.[157] One can argue about whether this result protects promisee expectation, but it clearly does not accomplish disgorgement. Even when the difference between the value of correction and its cost is great, however, courts sometimes award the cost of correction, that is, disgorgement, on the ground that the breach was willful.[158]

The issue of willfulness is something of an embarrassment for contract law. A breaching promisor's state of mind would seem of little relevance in computing a promisee's expectation, and willfulness is largely irrelevant under received contract doctrines. Nevertheless, a promisor who saves costs by breaching willfully is much more likely to be required to surrender his savings, by paying the cost of correcting his breach, than one who saves expenses by an accidental breach.[159] In this context, we suggest that the concept of willfulness is largely epiphenomenal, indicating that a promisor's actions are contrary to what the contract expressly or implicitly required.[160] A promisor is not likely to sell to another buyer or substitute a cheaper input by accident, and if a promisor takes either of these actions, it is likely that he did so in a way that undermines the interests the contract was formed to promote and protect. Accidental breaches that merely *happen* to save money, as when the factory burns down and is not rebuilt in time, are not in

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157. In an important recent article, Alan Schwartz and Robert E. Scott argue that the cost of completion should be the default rule in these cases, even when the breach was accidental. Schwartz & Scott, *supra* note 153, at 1657-58. We take no position on that question, but, fortunately for us, they also undertook to find "What Courts Actually Do." *Id.* at 1624. They found that courts award the cost of correction when there is insufficient evidence of disproportion between that cost and the value of performance or when the buyer established idiosyncratic value in performance. *See id.* at 1624-29 (summarizing). These cases represent expectation damages in the conventional taxonomy. *See id.* On the other hand, when the cost of performance greatly exceeds the market value of completion and the promisee cannot show idiosyncratic value, recovery is almost always limited to the value of performance. *See id.*

158. *See* Thel & Siegelman, *supra* note 6, at 1525-26.

159. *See* Kangas v. Trust, 441 N.E.2d 1271, 1275-76 (Ill. App. Ct. 1982); City Sch. Dist. v. McLane Constr. Co., 445 N.Y.S.2d 258, 260 (App. Div. 1981); *cf.* H.P. Droher & Sons v. Toushin, 85 N.W.2d 273, 280-81 (Minn. 1957) (emphasizing good faith); George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225, 1232 (1994); Robert A. Hillman, *Contract Lore*, 27 J. CORP. L. 505, 509 (2002) ("[T]he degree of willfulness of a contractor's breach helps courts determine whether to grant expectancy damages measured by the cost of repair or the diminution in value caused by the breach, the latter often a smaller measure."); Marschall, *supra* note 6, at 734; Thel & Siegelman, *supra* note 6, at 1520.

160. *See* Kull, *supra* note 20, at 2050.

derogation of the contract, in the sense that the parties did not—and probably would not—allocate these savings to the promisee.

In sum, although the available remedy *seems* to turn on whether the gain from breach takes the form of a profit made as opposed to a loss avoided, this is incorrect. Instead, promisor expectation is available whenever the breach represents a choice by an opportunistic promisor that the promisee would not have made if he controlled both sides of the transaction. That includes all cases of sales to another buyer at a higher price and all deliberate attempts to cut corners on performance, but does not include accidental breaches.

III. EXPLAINING PROMISOR EXPECTATION

We have argued that contract law usually puts breaching promisors in the position they would have been in had they performed, even when doing so overcompensates promisee expectations. This finding runs against the received wisdom that promisors are free to breach so long as they pay their promisees' expectation.[161] Indeed, the fact that the law so often accomplishes promisor expectation may have been underestimated precisely because the promisor expectation remedy does not fit well with the conventional wisdom that contract remedies are supposed to compensate promisees rather than punish breaching promisors.[162] Moreover, given the powerful arguments in favor of protecting promisees' expectations, it may seem that requiring breaching promisors to surrender profits that exceed promisee expectation could serve no good purpose. We think the central role of promisor expectation in contract law will seem less jarring if we can identify the purposes it serves. We undertake to identify those purposes in this Part.

The widespread availability of disgorgement in contract law is obscure in part because the law does protect promisees' expectation interests. When a promisee's expectation exceeds the promisor's gains from breach, the promisee is entitled to her expectation, subject to the limitations of the certainty requirement and the rule

161. *See supra* text accompanying notes 16-18.

162. This proposition is often attributed to Holmes, but it is not what Holmes thought or said. *See* Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1085-91 (2000).

of *Hadley v. Baxendale*.[163] Powerful efficiency considerations justify the promisee expectation remedy,[164] and we agree that parties would bargain for perfect expectation damages if they could.

Moreover, people who break promises often expect to profit by doing so, and surely many of them are successful. Disappointed promisees often choose not to litigate, those who do may not succeed, and even successful plaintiffs may not always recover all of their promisor's gains. Still, the various legal doctrines discussed in Parts II.A-B are well-established, and together they do accomplish disgorgement across a wide spectrum of contract breaches.

A unified promisor expectation principle is also hard to comprehend, because it is difficult to reconcile with the conventional explanation of contract remedies. At least since the publication of Fuller and Perdue's article, contract remedies have been explained in terms of promisee interests; and, once again, we agree that the ideal contract remedy would be some version of promisee expectation.[165] Remedies that accomplish promisor expectation, however, are best explained by reference to the interests of other contract players, particularly courts and promisors. The explanation we offer here is not intended to show that the law ought to *require* breaching promisors to surrender their profits. Indeed, it is difficult to make a strong case for a binding or uniform rule of disgorgement, if for no reason other than that promisees in bargained-for promises must pay for the remedies they get, and parties to such contracts are largely free to opt out of disgorgement as a default remedy.[166] Nonetheless, the promisor expectation remedy is central to contract law and furthers compelling goals of contracting parties.

The obvious justification for requiring breaching promisors to surrender their gains is probably one based on justice or fairness.[167]

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163. (1854) 156 Eng. Rep. 145, 151 (Ex.); *see* RESTATEMENT (SECOND) OF CONTRACTS §§ 347, 351-52 (1981).

164. For a cogent explanation of the optimality of expectation damages, when calculated properly so as to leave the promisee indifferent between performance and breach plus damages, see STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 342-50 (2004); or, for a more technical exposition, see Shavell, *supra* note 7, at 472, 485-87.

165. *See supra* text accompanying notes 14-15.

166. *See* U.C.C. § 1-102(3) (2002); *infra* discussion accompanying notes 170-75.

167. For an analysis of disgorgement in a corrective justice context, see Weinrib, *supra* note 20, at 70-84, who concludes that disgorgement is not compatible with corrective justice because it does not aim to correct the wrong done to, or harm suffered by, the party injured by breach.

It is usually wrong to break a promise, and perhaps when promises are important enough to be enforced at all, the law should right the wrong of breaking them by requiring promise-breakers to give up their profits.[168] On the other hand, when they enter contracts, parties have to pay for the remedies they will get upon breach; and inasmuch as they enter contracts to accomplish their expectations, they should prefer the cheaper remedy of promisee expectation to the presumptively more expensive one of promisor expectation.[169] In any event, so long as any appreciable number of promisees would prefer to be limited to their expectation, the protection of promisee interests cannot justify a *mandatory* remedy of promisor expectation. When promisees have different interests, it can quite plausibly be argued that the law should provide only a default set of remedies for use when parties do not choose their own. So viewed, the content of those remedies, and the manner in which contracting parties must manifest their intention to opt out of them,[170] will be the product of a sometimes complicated and counterintuitive process, rather than flowing from some simple judgment of what the remedies ought to be.

It is not clear to us that the law should make people keep their promises, and we will leave the issue of whether fairness requires that breaching promisors surrender their profits to those who are more adept at answering such questions. Nevertheless, the possibility of promisee choice that complicates the normative question will invariably color our view of what the law actually is. Contracting parties have substantial latitude in deciding whether to subject themselves to the various elements of the promisor expectation

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168. *See* FRIED, *supra* note 2, at 14-17; Shiffrin, *supra* note 3, at 749-53 (arguing that contract law should hew more closely to the morality of promising).

169. *See* Schwartz, *supra* note 43, at 372-83; *see also* SHAVELL, *supra* note 164, at 342-45 (providing a lucid analysis of why this is so). Shavell's answer turns on the role of damages as substitutes for a complete, state-contingent contract. *Id.* at 342-45. In such a contract, there would never be a breach, because performance would either be required or excused in all possible circumstances. Parties to a complete contract will excuse performance, and lower the contract price, whenever the cost of performance is larger than its value to the promisee, and will require performance whenever the reverse is true. Perfect expectation damages—when the promisor pays the difference between promisee's value of performance and what was actually received—produce exactly the same result as the complete contract—performance occurs when and only when its value to the promisee exceeds its cost to the promisor—without having to contract expressly for each possible contingency.

170. On such "altering rules," see Ian Ayres, *Menus Matter*, 73 U. CHI. L. REV. 3, 6 (2006).

regime described above.[171] They can structure their relationship as a fiduciary one, or agree that their obligations will be specifically enforced,[172] in which case promisor expectation will follow. Alternatively, contracting parties can stipulate exclusive liquidated damages,[173] provide for alternate performance,[174] agree that specific performance will not be available,[175] or structure their relationship so that it will not be a fiduciary one,[176] in which case promisor expectation will not occur. It would be odd if contract law *required* disgorgement as a remedy, even when the parties agreed that it would not be available. However, the regime described above can be explained, if not justified, as furthering the reasonable expectations of contracting parties and reflecting the deal that bargaining parties would typically choose for themselves.

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171. Fiduciaries may not be able to contract around the exclusive benefit rule, and thus disgorgement, but fiduciaries may be able to realize, and keep, a profit by obtaining consent to an action that would otherwise constitute a breach of the duty of loyalty. *See* Brudney, *supra* note 99, at 605.

172. The traditional view is that parties cannot contract for specific performance, because, among other things, it is an equitable remedy available at the court's discretion, and parties cannot order equity courts to do anything. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 359 cmt. a (1981). These concerns have largely been superseded by modern courts' willingness to enforce contractual language calling for specific performance. *See* YORIO, *supra* note 48, § 19.3. That trend is codified in section 2-716(1) of the revised U.C.C., which states in part that "[i]n a contract other than a consumer contract, specific performance may be decreed if the parties have agreed to that remedy." U.C.C. § 2-716(1) (2002). Comment b points out that this means that parties can "bind themselves to specific performance even where it would not otherwise be available." *Id.* cmt. b. In the domain of intellectual property licensing, U.C.C. "Article 2B provides that the parties can contract for specific performance of any obligation, including a personal service obligation, *see* U.C.C. § 2B-711(a)(1) (Draft, Aug. 1, 1998), provided that it will not create an administrative burden for the court." Mark A. Lemley, *The Law and Policy of Intellectual Property Licensing*, 87 CAL. L. REV. 111, 135 n.103 (1999).

173. Of course, damages can be stipulated only up to 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." RESTATEMENT (SECOND) OF CONTRACTS § 356(1). Low liquidated damages, however, are not subject to special scrutiny, and if a contract clearly provides that liquidated damages are exclusive, then specific performance will not be available. *See, e.g.*, McGee v. Damstra, 431 N.W.2d 375, 379-80 (Iowa 1988).

174. *See* RESTATEMENT (SECOND) OF CONTRACTS § 361 cmt. b & illus. 2.

175. *See* Iron Eagle Dev., L.L.C. v. Quality Design Sys., Inc., 65 P.3d 509, 514 (Idaho 2003) (holding that equitable relief is not available when a contract precludes it); Westmoreland Coal Co. v. Entech, Inc., 794 N.E.2d 667, 671 (N.Y. 2003); *see also* YORIO, *supra* note 48, § 20.1, at 454 ("[C]ourts usually uphold contractual restrictions on specific relief.").

176. *See* Farnsworth, *supra* note 21, at 1359 n.77.

A. Promisor Expectation as a Simple Remedy

The simplest, and perhaps most important, reason that courts apply the various rules described above is that they are good for courts; they minimize the administrative costs of enforcing contracts.[177] To award actual promisee expectation, a court has to decide what would have happened—in what position the promisee would have been—if the promisor had performed. This is often hard to do.[178] What profits would the piano owner have earned if the EPE had honored their contract? How much better-off, if at all, would the CIA and the United States have been had Snepp kept his word?[179] What would you have done with the widget?

These are virtually unanswerable counterfactual questions. To the extent courts want to be right, or at least want to avoid being second-guessed, they will seek to avoid them. These questions are also expensive to answer, correctly or not, and anyway, the parties are better situated to answer them. It is an insight of Guido Calabresi and Douglas Melamed that if the parties can answer these questions, the State should not.[180] In every contract case presented to them, courts know that the parties knew what was at stake, and courts may best force the parties to answer the question, or at least settle their disputes, by refusing to intervene.[181] Indeed, by regularly giving promisor expectation as a remedy, courts surely prevent some breaches from occurring in the first place.[182]

Disgorgement remedies are easy to administer because objectively verifiable evidence of what the breaching promisor actually earned

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177. *See* Calabresi & Melamed, *supra* note 71, at 1093 ("Perhaps the simplest reason for a particular entitlement is to minimize the administrative costs of enforcement.").

178. *See* COOTER & ULEN, *supra* note 105, at 183 ("Counterfactual values are difficult to compute."); *id.* at 245 ("Some economists think that the problem of valuation by courts is so severe that contract law should adopt specific performance more widely as a remedy.").

179. In *Snepp*, the Court recognized that the United States could not have proved compensatory damages. Snepp v. United States, 444 U.S. 507, 514 n.10 (1980) (per curiam); *cf.* Chi. Coliseum Club v. Dempsey, 265 Ill. App. 542, 549-50 (App. Ct. 1932); RESTATEMENT (SECOND) OF CONTRACTS § 352 (noting that uncertainty limits damages).

180. *See* Calabresi & Melamed, *supra* note 71, at 1106-10.

181. *See* Ayres & Gertner, *supra* note 87, at 95-100 (suggesting that remedies that deliberately do not fit the plaintiff's harm from breach—"penalty defaults"—may encourage agreement among parties).

182. *See* Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 J. LEGAL STUD. 503, 512-23 (2008).

from his breach is almost always available. Moreover, as long as courts compute remedies on the basis of objective evidence, litigating parties can accurately predict what a court will order. Accordingly, informational asymmetries are much less likely to derail settlement in a disgorgement regime than in a regime of hypothetical promisee expectation because the promisee's subjective value is private information, known only to her.

The contract-market remedy and specific performance are both commonly justified on the ground that courts can award them without subjective and individuated inquiry into what the promisee would have done had the promisor performed.[183] The judicial commitment to easily administrable remedies is also evident in the disposition of courts to deny any remedy to promisees who cannot present easily verifiable evidence relevant to their remedies, even when it is clear that they have been injured. The most famous rule to this effect is the one that requires promisees to prove damages with certainty,[184] so that even under the objective contract-market price rule, a promisee who cannot prove market price loses.[185]

Although Calabresi and Melamed did not discuss contract law at any length, their famous distinction between property rules and liability rules has been a touchstone for analysis of remedies for forty years.[186] It is conventional shorthand to refer to specific performance as the contract remedy that is on the property rule side of this taxonomy, and to think of monetary remedies as liability rules; and much of the literature treating contract remedies within Calabresi and Melamed's framework is focused on the choice between specific performance and monetary remedies, typically

183. Just as Fuller and Perdue, *supra* note 14, at 62, suggested that we "encourage reliance ... [by] dispens[ing] with its proof," here, too, we protect expectation not by trying to figure out what subjective value a promisee would have attached to performance, but by dispensing with such proof altogether, and thereby forcing the promisor to relinquish his gains from breach.

184. RESTATEMENT (SECOND) OF CONTRACTS § 352 (stating that no recovery is available for losses "beyond an amount that the evidence permits to be established with reasonable certainty").

185. WHITE & SUMMERS, *supra* note 53, § 6-4, at 219-20. The same judicial preference for objectively determinable remedies also explains the reluctance to order disgorgement of expenses avoided by breach: the amount saved by *not* rebuilding a burned-down factory is very difficult to determine.

186. *See* James E. Krier & Stewart J. Schwab, The Cathedral *at Twenty-Five: Citations and Impressions*, 106 YALE L.J. 2121, 2130 (1997).

promisee expectation.[187] Nevertheless, the promisee's right to insist upon disgorgement, whether accomplished through specific performance or sufficiently large monetary awards,[188] is best viewed as a property rule protecting the promisee's entitlement to performance. Under a property rule, the promisor cannot gain by withholding performance unless the promisee releases him; so, to paraphrase Calabresi and Melamed, the promisor who wishes to take the entitlement to performance from the promisee must buy it from her in a voluntary transaction at a price that reflects the value she places on his performance.[189] If the promisor does breach, he will not be let off with paying an "objectively determined value" for the performance, as under a liability rule, but will instead be required to forfeit all of his gains.[190]

A substantial part of the enterprise of Calabresi and Melamed, and of those who have followed them, was to determine whether rights should be protected by property or liability rules. Briefly and quite loosely put, Calabresi and Melamed argue that when the costs of transferring a right are low, that right should be protected by a

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187. *See, e.g.*, Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027, 1031 (1995) (describing remedies at law as a liability rule, and equitable relief as a property rule); Kronman, *supra* note 136, at 352 (describing money damages as a liability rule, and specific performance as a property rule). When someone may take a right "if he is willing to pay an objectively determined value for it, an entitlement is protected by a liability rule." Calabresi & Melamed, *supra* note 71, at 1092. Calabresi and Melamed also identify inalienable rights, which may not be transferred even between willing buyers and sellers. *Id.* at 1092-93. Inalienable rights have not figured as prominently as property and liability rules in discussion of conventional contract remedies, but they are obviously implicated in the rules against specific enforcement of service contracts and the award of negative injunctions and penalty damages.

188. Lawyers sometimes think of property rules as identical to injunctive relief. But the distinction between property rules and liability rules does not track the difference between damages and equitable remedies. Damages can provide property rule protection for promisees, as long as the level of damages is high enough so as to make it unprofitable for the promisor to breach without obtaining the promisee's consent. Jail time for breaching promisors could also work.

189. "An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller." Calabresi & Melamed, *supra* note 71, at 1092; *see also* Kronman, *supra* note 136, at 352 (noting the existence of a property right if "the owner of the right is in a position to force the would-be taker to negotiate a voluntary transfer").

190. Calabresi & Melamed, *supra* note 71, at 1092; *cf. id.* at 1092, 1125 (suggesting liability rules approximate owner values).

property rule.[191] On that simple story, contractual rights look like the ideal candidate for property rule protection, because when breach time comes, there are only two parties involved, and they know each other.[192] That story is apparently too simple, though, and commentators influenced by Calabresi and Melamed continue to disagree about whether promisees ought to be protected by property rules.[193] If nothing else has become clear with time, it is at least true that the efficiency implications of the rules used to protect promisee interests are quite complicated.[194] The issue is not going to be sorted out here, and perhaps the answer depends on the particular contract at issue.

B. Promisor Expectation as a Promisor Bonding Mechanism

Even if the rules discussed in Part II are good for courts, we have to explain why contracting parties do not act to avoid disgorgement remedies. As noted above, promisees pay for their remedies, and all that a party wants from a contract is her expectation. Inasmuch as promisees do not desire supracompensatory remedies,[195] we have to explain why so many contracting parties opt into, or fail to opt out of, rules that lead to promisor expectation remedies that exceed promisee expectation.

The answer lies in the fact that promisee expectation remedies as actually administered are systematically and unavoidably *under*-compensatory.[196] If promisees cannot count on their expectations being satisfied, promisors will suffer, because promisees will insist on a reduced contract price in the shadow of the undercompensatory remedies that they will receive in the event of breach. Promisors thus are keenly interested in assuring promisees that they will not

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191. *Id.* at 1106-10.

192. *See* Kronman, *supra* note 136, at 353; *cf.* Ayres & Talley, *supra* note 187, at 1032 (relating the common wisdom on property rules for low-transaction settings).

193. *Compare* COOTER & ULEN, *supra* note 105, at 93 ("It is easier to bargain when legal rights are simple and clear than when they are complicated and uncertain."), *with* Ayres & Talley, *supra* note 187, at 1032 (arguing that liability rules promote efficient trade).

194. *See, e.g.*, Ayres & Talley, *supra* note 187, at 1098-1103.

195. Thus, we agree with Anthony Kronman that the promisee would prefer damages for fungible goods available in the market *if* damages were compensatory. *See also* Schwartz, *supra* note 38, at 280.

196. *See infra* note 198 and accompanying text.

interfere with the latter's expectations, for by doing so they will get higher prices ex ante.

Disgorgement remedies are thus best understood as a promisor bonding device. By subjecting himself to promisor expectation, the promisor gives valuable assurance to the promisee—for which he is presumably compensated—and suffers no risk of penalty: he will never be worse off than he would have been if he had performed.[197] This assurance is valuable to receive and cheap to provide because promisors are only insuring against their own willful conduct.

The fact that actual contract remedies are undercompensatory is uncontroversial.[198] Disappointed promisees are not fully compensated even when they are successful in court, if only because a disappointed promisee must pay legal fees and prove her expectation with certainty.[199] Moreover, the doctrine of *Hadley v. Baxendale* deprives promisees of some of their actual damages, even when they can prove them, and there are important reasons to limit damages in this way. Finally, although we generally assume that a promisee will at least know if the promisor breaches, this is not always so. Surely many potential cases similar to *Jacob & Youngs* were never decided because the homeowner never discovered the wrong pipes buried in her walls.[200] Faithless fiduciaries can be expected to hide their behavior, and even beneficiaries who devote substantial resources to monitoring cannot expect to be compensated fully.

1. The Example of Fiduciary Duties

The constructive trust remedy for breach of fiduciary duty may be the rule with which the law most clearly and self-consciously

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197. Shavell explains that a complete state-contingent contract would never be breached. SHAVELL, *supra* note 164, at 342-43. Such a contract would always simply excuse performance when performance was inefficient and require it when it was efficient, with damages for breach high enough to insure that this always occurred. *Id.* Thus, damages would never actually be paid because promisors would always either perform or be excused from having to do so. *Id.*

198. *See* Melvin A. Eisenberg, *Actual and Virtual Specific Performance*, 93 CAL. L. REV. 975, 989-96 (2005); Schwartz, *supra* note 38, at 278-98; Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439, 451 (2006).

199. WHITE & SUMMERS, *supra* note 53, § 6-6, at 232. Unless otherwise provided in the contract, the costs of bringing suit to defend one's rights are also excluded from an award of "lost profits."

200. *See* Jacob & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921).

requires the surrender of profits from breach, even when it exceeds promisee expectation.[201] Because even extremely damaging fiduciary breaches may go undiscovered,[202] parties to fiduciary relationships seeking to protect beneficiaries might agree to employ supracompensatory remedies to adjust for the low probability of a fiduciary breach coming to light. However, although compensation might be accomplished by multiplying expectation to account for the likelihood of discovery of breach, the breaching fiduciary's profits are not at all likely to work out to compensation, even on an aggregate basis, inasmuch as gains from breach of the duty of loyalty bear no direct relationship to the harm caused by such breaches.

A superior explanation of the promisor expectation rules in fiduciary duty cases can be grounded in the theory of agency costs. As Robert Clark put it, the rule that fiduciaries are not entitled to any profit except that expressly agreed upon with the beneficiaries is "designed to help deter abuse of managerial discretion. (Or as the economist would say, they aim to reduce agency costs.)"[203]

A fiduciary relationship separates management of the enterprise from the benefits of the enterprise, and thus the fiduciary is not likely to manage the enterprise as efficiently or profitably as he would if he were to keep all the profits. The parties recognize this when they create the relationship, and arrange their affairs and the manager/fiduciary's compensation in the way they think will best lead the manager to run the enterprise in the way an owner would. Thus, the compensation arrangements that the parties reach when they create the relationship do not simply reflect their determination of how much the manager should get; they reflect a structure that will maximize the total return of the enterprise.

A manager who takes an extra benefit creates two problems. His taking may be at the beneficiaries' expense, but also, and perhaps more importantly, a manager looking for personal benefits has an incentive to manage the enterprise in a way that will differ from the

201. *See supra* Part II.B.1.

202. *See* Clark, *supra* note 106, at 78-79.

203. *Id.* at 77; *see also* Snepp v. United States, 444 U.S. 507, 514 (1979) (per curiam) (characterizing disgorgement remedy as the only reliable deterrent to breach); *id.* at 515-16 (stating that constructive trust "is tailored to deter"); Farnsworth, *supra* note 21, at 1358 ("[T]he law of fiduciary relations, unlike that of contractual relations, is distinctively concerned with deterrence and ethical standards.").

way the parties desired when they decided how the manager would be compensated.[204] Thus, extra-contractual profits change the manager's incentives and may change the way the enterprise is conducted. The way to get the enterprise to be run as if it were being run by an owner is to settle at the start on one residual claimant for all of the enterprise's profits. That way, the manager will have no incentive to manage the enterprise so as to increases his share of the profits at the expense of the owner, and thus he will not be distracted by self-interest from pursuing the maximization of the enterprise's profit.

Managers who steal do not create value or merely shift it; they destroy it. Thus, ex ante, principal and agent alike have an interest in reducing agency costs—indeed to the extent agency costs are foreseeable, the agent bears them. The prospective agent wants to assure his principal that he will not steal, but will manage their enterprise as he if were the owner of the whole thing.[205] The exclusive benefit rule is a bonding device—by requiring the agent to surrender and account for all gains from breach, it deprives the agent of any incentive to pursue his own interest and, thus, of an incentive not to run the enterprise as an owner would.[206] As such, the exclusive benefit rule serves the interest of the fiduciary/agent by assuring the beneficiary/principal that the fiduciary will have every incentive to do what he should.

2. Bonding in Ordinary Contractual Settings

The same analysis applies to ordinary contracts. The promisor wants to assure the promisee that she will get her expectation, and thus the promisor benefits by successfully committing himself to

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204. *See generally supra* Part II.B.1.

205. *See* Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. L. 5, 10 (1996).

206. The exclusive benefit rule also has the advantage of being nonpenal, inasmuch as it simply puts the agent in the situation he would have been in had he done what he promised. However, in the context of fiduciary duties, in which breach may not be discovered, this may prevent the rule from creating a perfect bond. To the extent that a fiduciary who is discovered to have breached the duty of loyalty will only have to give up his profits, the exclusive benefit rule presents the fiduciary with a case of heads he wins, tails the game does not count. The absence of private law penalties, *see* Clark, *supra* note 106, at 78-79, may be ameliorated by the availability of criminal sanctions for fiduciary breaches that also constitute crimes.

delivering that expectation. In our undercompensatory damage regime, however, he cannot credibly commit to doing so. Both sides know that in the event of breach, the injured promisee will recover less than her true expectation. By subjecting himself to promisor expectation, however, the promisor nonetheless assures the promisee that he will not intentionally breach, and by doing so the promisor reaps a benefit in the form of a higher contract price.[207] Indeed, a promisor who refuses to consent to disgorgement signals to his promisee that performance is at risk.

Bonding also explains both the law's failure to require disgorgement of losses avoided by breach and the curious doctrine of willful breach. Promisors will often want to bind themselves not to breach on purpose, and inasmuch as promisors can easily avoid willful breaches by simply performing, promisees will not have to pay much for that bond. Promisees might sometimes want insurance against negligent breaches, of course. But that insurance will typically be much more expensive because it requires promisors to undertake careful monitoring or to invest in extensive precautions. Thus, insurance against negligent breach, which would take the form of disgorgement of even the promisor's *inadvertently* avoided losses, will rarely be worthwhile. Moreover, when an expense-saving breach *is* likely to harm the promisee, the promisor almost always has ample incentive not to breach, for example, by allowing his crops to die or his factory to burn. Conversely, when an expense-saving breach is not likely to be harmful, as with, for example, the accidental use of a different but functionally identical brand of pipe, the promisee has no reason to pay the promisor to take excessive caution, which will achieve no good end.[208]

Some promisees will so value performance that they will be willing to pay for disgorgement even in the case of negligent breach.

207. The Appendix, *infra*, offers a simple algebraic demonstration of how promisor expectation can realize efficiency gains when compared to an undercompensatory promisee expectation remedy.

208. If *Jacob & Youngs* had come out the other way, contractors would demand astronomically high prices for building mansions in order to compensate for the risk that an inadvertent but trivial mistake would saddle them with substantial damages. *See* 129 N.E. 889 (N.Y. 1921). Homeowners would presumably find it in their interests to shed such "protection," because if they did not, they would in effect be purchasing insurance against an event—such as the substitution of a functionally identical brand of pipe—that simply did not matter to them. *See* Thel & Siegelman, *supra* note 6, at 1526-27.

Inasmuch as such promisees are likely atypical, disgorgement of costs avoided by negligent breach should be an exceptional remedy that is available only when the promisee demands it at the time of contract by identifying her exceptional interest. This approach, which mirrors the law,[209] allows the promisor to secure compensation for taking extraordinary precautions and assures that promisors will not take such precautions except when justified by the benefit they provide for promisees. This justification mirrors the one that Ian Ayres and Robert Gertner offer for the *Hadley* rule,[210] of course, but, as noted above, when a promisee recovers because she has put the promisor on notice of the idiosyncratic value she places on performance, the remedy she gets is promisor expectation (the cost of completion), not promisee expectation (the value of completion).[211]

It is often illuminating to think of contracts problems from the perspective of a single owner of the subject of the contract or of the project it contemplates. This perspective reveals the value of the promisor expectation remedy by showing that although not all contracts should be performed, promisor expectation—and not promisee expectation—is the best way to ensure that contracts are breached only when they should be. Consider once again Farnsworth's widget hypothetical,[212] but now suppose that you own the widget from the start. Although the market value of the widget is $100, you think you can use it to earn $110. You would then be justified in spending up to $10 to realize that value, and you might well proceed to do so. If before you were done, however, you found a better use for the widget, or someone else who had a better use came along and offered $125, you would presumably abandon your project, or sell the widget. Abandoning the project when a better use arises is what

209. *See* Hadley v. Baxendale, (1845) 156 Eng. Rep. 145 (Ex.); *supra* text accompanying notes 161-62.

210. *See* Ayres & Gertner, *supra* note 87, at 101-02.

211. This also accords with the administrative simplicity rationale for promisor expectation. *See supra* Part III.A. The cost of completion is ascertainable, but the value of completion is not. Moreover, in cases of recognized idiosyncratic value, courts almost always award the market value of completion rather than attempt to determine idiosyncratic value. *See* O.W. Grun Roofing & Constr. Co. v. Cope, 529 S.W.2d 258, 261 (Tex. App. 1975); Thel & Siegelman, *supra* note 6, at 1540 n.44.

212. *See supra* Part II.A.

a single owner would do, and presumably reflects the best use of the widget.

Now, suppose that, as in Farnsworth's hypothetical, before we deliver the widget to you, we learn that we can get $125 for it. If you still value the widget at $110, you should be happy with $10; and if you get your $10, everyone should be happy. But existing promisee expectation rules do not fully protect your expectation—even if your expectation is $10, you are not likely to get it, given the certainty and *Hadley* doctrines.[213] And if it is not clear what remedy will be awarded at the end of litigation, we may waste the $15 surplus in wasteful bargaining and litigation. Moreover, at the time of breach, there is usually no way for us to know that you in fact value the widget at $110. Accordingly, if all we have to do is pay you what a court determines is your expectation, your true expectation may go unprotected, and we may even breach when you actually value the widget more than the third party does.

Promisor expectation remedies solve these problems. You are best situated to determine how much you value the widget, and you get to decide whether we will sell the widget to the third party. From an ex ante perspective, we are better-off as well. When we agreed to sell you the widget, we did not expect the third party to come along.[214] Moreover, we were compensated up front for effectively promising not to sell if a third party did emerge. By agreeing not to profit from breach—by subjecting ourselves to promisor expectation rules—we assured that the "pie" that constitutes our transaction was as big as it could be, and we presumably got a bigger slice for doing so.

Because contracts are arrangements about an unknowable future, however, events may transpire in a way that indicates that the parties should abandon their planned contractual arrangements. The parties to a widget contract enter it with their own plans and expectations, but, like a single owner of the widget, both are better-off if they can be sure that the widget will ultimately be used toward its most profitable end—that is, the way a single owner would use it. Thus they would agree, at the time they entered their contract,

213. *See supra* note 163 and accompanying text.

214. If we had, we could have reserved the right to sell to another, or would have contractually limited damages.

that if some better use came along for the widget, then the plan should be abandoned and the widget put to that other use. They might argue about how they would split the gain they would receive from the new use, but they would agree from the start that the promisee's plan would be abandoned for the new use; and they would arrange to split that gain, perhaps by allocating the benefit between them and adjusting the purchase price. Herein lies the insight behind the theory of efficient breach.

The problem with a contract, however, and the way that a contract differs from the single-owner benchmark, is that, although the promisor will decide whether to breach and interfere with the project by selling to a third party, for example, so long as legal remedies are not fully compensatory, the promisee will bear part or all of the cost of breach; so in making the decision whether to breach, the promisor may not act like a single owner of the widget who fully internalizes all of the costs of breach.[215] For example, if promisors can breach with impunity, we will sell the widget to anyone who will offer more than $100 for it, even if you in fact value it much more. To be sure, if you really do value the widget more than the third party, you may buy it from the third party or pay us a bonus not to sell it to someone else. This would, however, entail an additional transaction that would be wasteful,[216] and strategic posturing might prevent us from reaching an agreement even if you do in fact value the widget more than anyone else.[217]

One way to make sure that the promisor abandons the originally contemplated use only for an alternative use with a higher value is to insist that the promisor compensate the promisee for the value of

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215. Put another way, "[a] rule that allows anyone to take actions without bearing their full costs is unsound." Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573, 583 (1998). It is telling that in his study of cases involving tortious interference with contract, Fred McChesney found that in almost none did either the breaching promisor or the interfering third party offer to compensate the disappointed promisee at all. *See* Fred S. McChesney, *Tortious Interference with Contract Versus "Efficient" Breach: Theory and Empirical Evidence*, 28 J. LEGAL STUD. 131, 177 (1999) ("[I]n most cases, neither breaching Promisor nor breaching Inducer is in fact offering to compensate Promisee."). Robert Clark's criticism of Frank Easterbrook and Dan Fischel over the question of whether managers take corporate opportunities only when they can exploit them better than their firms, and whether the managers and firms ever settle up, echoes the argument in the text in the context of fiduciary relationships. *See* Clark, *supra* note 106, at 69-70.

216. *See* POSNER, *supra* note 1, at 120; Kronman, *supra* note 136, at 353 n.12.

217. *See generally* Ayres & Gertner, *supra* note 87.

her use.[218] If the promisor was obligated to compensate the promisee for the value she placed on the widget, that is, pay full promisee expectation damages,[219] the promisor would act like a single owner and breach only when an alternative use with a higher value presented itself. So long as court-awarded expectation damages are less than actual promisee expectation, however, there is a risk that the promisor will breach inefficiently—that is, when the promisee values performance more than anyone else does.[220]

Unless the promisee's value can be computed exactly, the only way to ensure that the contract is abandoned *only* for more valuable or efficient uses, and is abandoned for *all* such uses, is to entrust the abandonment decision to a person who gets the full value of the widget, regardless of how it is used.[221] Promisor expectation remedies do this by making the promisee the marginal claimant who bears the full costs and benefits of the abandonment decision. The promisee gets all the profits, however the subject of the contract is eventually employed. If a better use comes along, the promisee will be happy to abandon her plans and consent to the breach—she will get all the profit from the better use. On the other hand, she will not agree to abandon her plans for an alternative use unless that use is in fact more valuable than hers. By placing the full benefit of the widget in the promisee, the promisor expectation rules effectively create a single owner, who will have the incentive to maximize the value of the widget.[222] This presumably leads to the best use of

218. *See* POSNER, *supra* note 1, at 121.

219. The appropriate remedy must cover actual expectation, even if that expectation includes damages that were not foreseeable by the promisor at the time the contract was entered. Yet the *Hadley* rule that bars recovery of unforeseeable damages is well established and serves important ends. *See* Hadley v. Baxendale, (1854) 156 Eng. Rep. 145 (Ex.). So long as expectation damages are limited by *Hadley*, they cannot serve to deter inefficient breaches. Promisor expectation, on the other hand, does not undercut the information-forcing value of *Hadley*. The amount of promisor expectation is not dependent on the promisee's actions, and the promisee cannot be confident, at the time of contracting, that receiving her promisor's profits in the event of breach will compensate her for her special value in performance.

220. Conversely, if awarded expectation *exceeds* actual expectation, the promisor will have an incentive to perform inefficiently and forgo more efficient uses.

221. Even if promisee expectation could be calculated exactly, it would be costly to do so. This cost would have to be justified if such damages are to be the mechanism for assuring that contracts are breached if, and only if, breach is efficient. As discussed above, promisor expectation remedies may be cheaper to administer than a promisee expectation regime. *See supra* Part III.A.

222. An alternative single-owner proxy would entitle the promisor to all the benefits of the

resources, and is in any event in the collective best interests of the promisee and promisor, who would thus adopt promisor expectation remedies ex ante.

The obvious objection to allowing the promisee to decide whether to insist upon performance is that she may refuse to abandon the contract when it is efficient to do so. The risk of such refusal will be borne by both parties ex ante, and if the risk is deemed too high, the contracting parties can, if they choose, simply opt out of promisor expectation in the first place. The efficiency-producing attributes of disgorgement, however, will often outweigh the costs of inefficiency produced by strategic bargaining over breach. Those costs, such as they are, are simply a consequence of the fact that the promisor expectation regime gives the promisee a property right, and property rights are generally regarded as best suited to promote the best use of resources when transaction costs are low, as they are between parties who are already in a contract.[223]

Disgorgement remedies do reduce the promisor's incentive to search for alternative, more profitable uses of his performance once the contract is made. Of course, this problem may be fully offset by

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widget by dispensing with promisee remedies entirely. Doing so would substantially undermine the value of contracting, of course.

223. It is noteworthy that before a contract is made, each party has a property right in its own performance—in Farnsworth's widget hypothetical, we start with a property right in the widget and you in your cash. By almost all accounts this is good, inasmuch as otherwise, instead of bargaining, one of us would take the other's property and just pay damages later. But see Ayres & Talley, *supra* note 187, who argue that liability rules can achieve efficiency gains when there is asymmetric information. After performance, we also have property rule protection, but to something else—you to the widget, we to the cash. Without disgorgement, during the time our contract is executory, and only during that time, our rights vis-à-vis each other are not protected by property rules, but only by a set of interacting property and liability rules.

Why should that be? Liability rules during the executory period have serious costs, and the only obvious justification for using liability rules during the executory period, and only during that period, is that transaction costs are likely to be higher—that is, bargaining is more likely to fail—during the executory period than before or after. Yet there is no reason to expect this always, or even usually, to be the case. This is not to say that bargaining will always succeed during the executory period; it is just that bargaining can also fail before and after contract, and the factors likely to cause bargaining to fail during the executory period are present before contract and after performance as well. If those reasons do not justify abandoning property rights before and after contract, the case for a liability rule in contract damages depends on showing that the contract creates new impediments to bargain and that those impediments create a greater cost than the cost created by the liability rule itself. That case has not been made.

creating an equal incentive in the promisee to search for such uses. Moreover, if the promisor does discover a more profitable use of which the promisee is not aware, he can sell that use to the promisee. That sale will entail transaction costs, but there is no reason to think they even approach the costs imposed by a regime of flawed promisee expectation.

Promisors may not demand much, if any, compensation for agreeing to give their promisees the value of subsequently arising uses for performance, since they may be able to capture part of this value later.[224] If the promisor learns of a higher-value use before he performs, he will be able credibly to threaten to perform—even inefficiently—unless he is given a share of the profits from that alternative use.[225] Consider Farnsworth's widget hypothetical yet again,[226] this time under a disgorgement regime. If, after entering the contract, we learn that someone else is willing to pay $160 for the widget, we will ask you to release us from our obligation in exchange for paying you your expectation, or offer to reveal our buyer's identity if you will give us part of the excess of $160 over the value you place on the widget. You will realize that, if you refuse our request, we will just deliver the widget to you—we will have no reason not to, given that we cannot gain from breach—in which case you will not get the excess either. If you in fact value the widget less than $160, you will not be able to get any part of the excess value from the third party unless you give us part; so you will have every reason to negotiate a waiver, and the widget will still go to the highest value.[227] Moreover, when we enter the contract, we will

224. To the extent an expectation rule allocates the value of subsequently arising higher-value uses to the promisor, under an expectation regime the promisor would pay for that value in the contract, whereas the promisee will have to pay for that value if she gets it under a promisor expectation rule. Even if promisors are more likely to know of the possibility that higher-value uses may arise, there is no reason to think that they value those uses more than promisees. Thus, if the whole story of promisor expectation was the allocation of the right to receive the gains of subsequently arising better uses, the choice between expectation and disgorgement would be one of distributing the value of such uses, and of no particular efficiency concern. Given that promisor expectation rules also protect the promisee's interest in expectation, prevent inefficient breaches, and increase the value of the contract, however, efficiency concerns would seem to favor such rules.

225. *See* Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45, 46 (1999).

226. *See supra* Part II.A.

227. Presumably, the promisor will get only part of the excess value, whereas under an

recognize that this is how things will work out if we subsequently find a higher-value use. Accordingly, we retain some of our incentive to find other high-value uses, and when we enter the contract we will not demand to be compensated for surrendering our right to part of the profits from a higher-value use for performance that we may subsequently discover, since we will be able to get that profit later.

To be sure, promisees will have to pay something for the right to disgorgement remedies—a promisee who gets that remedy will presumably pay a higher price than one who does not, although when parties exchange reciprocal promises, the amounts they demand will tend to offset each other. We do not claim that, at the time of contracting, promisees place a greater value than promisors on the right to the gains from more profitable uses that may subsequently arise. If the allocation of that right simply reflected its distribution between promisor and promisee, there would be no particular reason for the law to adopt a default rule that assigns it to the promisee. The allocation of that right, however, actually shapes post-contract behavior. Assigning the promisee the right to gains from breach assures, better than any alternative short of unobtainable perfect promisee expectation, that the contract will be breached only when it is efficient to do so, and thus maximizes the value of the contract. It does so because the promisee—who suffers from the breach—will get to decide whether to pursue the alternative performance, and to assure that it is pursued only if it in fact creates value in excess of the loss from breach.

In any event, inasmuch as the parties can opt out of the promisor expectation regime if they choose, for example, with exclusive liquidated damage or alternative performance clauses, a promisor who in fact values the prospect of the gain from breach more than the promisee can buy that right when the contract is created. Of course, the promisor who seeks this right at the time of contract will, by doing so, alert the promisee to his strong sense that alternative better uses may subsequently arise. This disclosure is all to the good, however, because it will lead the promisee to reduce

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expectation regime he would get all of it. He would, however, have to pay for the right to all of the excess value under an expectation regime, so there is no reason to expect that people would be less likely to make promises or that the contracting process would be more expensive under a promisor expectation regime than under a promisee expectation rule.

her reliance on performance to reflect the fact that her intended project may not in fact be the best use of that performance.[228]

CONCLUSION

Across a wide variety of contexts, breaching promisors are in fact required to give up the profits they earn from breach. That this is so has escaped the notice of courts and commentators, and, if we have accomplished nothing else, we hope to have demonstrated the importance—indeed, the near ubiquity—of promisor expectation remedies.

Our positive theory of promisor expectation rules that put breaching promisors in the position they would have been in had they performed avoids the intellectual pitfalls that have plagued previous academic analysis of this topic, locating its rationale *not* in an attempt to compensate injured promisees, but rather to serve promisor interests by allowing promisors to make credible commitments to perform that would not otherwise be possible. In this sense, promisor expectation is a kind of antiremedy: the best remedy for breach is to prevent the breach in the first place, and promisor expectation does just that when performance is appropriate.

228. On the incentive to disclose privately held information, see Ayres & Gertner, *supra* note 87, at 94. If the disgorgement remedy for breaches of fiduciary duties of loyalty is mandatory, and thus one that the promisee cannot waive at the time of contract, it may be either because divided loyalty is particularly unlikely to lead to the best use of trust assets, because principals are particularly unlikely to understand the consequences of their waiver, because of collective action problems, or because cognitive limitations are particularly pronounced when entering long-term relationships. *See* Brudney, *supra* note 99, at 625 n.79; Clark, *supra* note 106, at 56-71; Epstein, *supra* note 205, at 12.

APPENDIX: A COMPARISON OF UNDERCOMPENSATORY-EXPECTATION AND DISGORGEMENT RULES

Here we develop a simple algebraic example that provides an intuition for why parties might prefer a promisor expectation remedy to an undercompensatory promisee expectation remedy. We take it as given that *perfect* promisee expectation damages are in fact optimal, at least insofar as the breach decision is concerned (as established by Steven Shavell)[229]; they replicate the behavior that would occur under an optimal complete contract that precisely spells out each party's obligation in every possible state of the world. More particularly, perfect promisee expectation damages induce breach when, and only when, the promisor's cost of performance is higher than the value the promisee attaches to that performance. This generates the largest possible contractual surplus for the parties, which they can then divide as they see fit, via the contract price.

As is widely recognized, however, *actual* contract damages are systematically less than perfect expectation, for a variety of reasons described in the text.[230] Thus, even though both parties would prefer perfect promisee expectation damages to any other remedy, such a remedy is not in fact available. That actual damages are inherently too low has two effects. First, it means that promisors will sometimes find it in their interests to breach, even when their cost of performance is less than the value the promisee attaches to that performance. Promisors thus have no credible way of committing themselves to perform when performance is optimal but when it will be cheaper for them to breach and pay undercompensatory damages instead. Second, whenever breaches do occur, including efficient ones, the promisee will be undercompensated. In the face of these problems, promisees will find the contract less attractive to them than they would otherwise, and will be willing to pay less than they would under a true expectation remedy. A better remedy would result in a larger contractual surplus, leaving room for *both* a higher price to the promisor and a better outcome, that is, more frequent performance, to the promisee.

229. This example is derived from SHAVELL, *supra* note 164, at 342-50.
230. *See supra* Part II.A.

What might that remedy look like? Here we contrast *perfect* expectation damages with "discounted" or "α-Expectation" (where $0 < \alpha < 1$) and with disgorgement. Under some circumstances, we show, promisor expectation is second-best optimal. We ignore the default nature of contractual remedies, at least initially, and assume that parties must live with whatever remedy the law provides.

Assume that v, the value of performance to the promisee, is fixed at 110. At the time of contracting, the promisor's cost of performance, c, is a random variable, distributed uniformly between 80 and 120.[231] We assume that the contract price, k, is paid up front, before costs are realized and performance occurs.[232] The promisee's expectation at the time of contracting is thus $v - k$.

If performance always occurs—that is, if there is no possibility of breach—then the contract generates an expected surplus (to be divided among the two parties) of $v - E(c) = 110 - (120+80)/2 = 10$. As we will see, however, the parties can do better than this by eliminating performance when it costs more than it is worth.

Under perfect expectation damages, the promisor receives the contract price, k, and either performs at cost c, or owes damages of $d = -(v - k)$ if it breaches. The promisor will breach whenever it is cheaper to do so than to perform. That in turn means that it will perform whenever $k - c > -(v - k)$, or $c < v$, and will breach otherwise. Thus performance will take place whenever $c < 110$.[233]

When performance occurs, the expected contractual surplus under this arrangement is easy to calculate. Because c is uniformly distributed between 80 and 120, it follows that the probability that c will lie in the range in which the promisor finds it worthwhile to perform is PR(Performance) = (110 - 80)/(120 - 80) = 0.75.

231. We can think of this as a contract to provide a widget at zero marginal cost, with c representing the bid of an alternative user for the widget, and hence the opportunity cost of performing the initial contract.

232. As we will see, the contract price is irrelevant for this analysis, because the promisor first receives—and then must "repay"—the contract price, so that it nets out of any calculation of whether to breach or to perform.

233. Notice that perfect expectation damages induce performance when, and only when, it is efficient to perform; whenever the cost of performance is greater than the value the promisee places on performance, breach will occur.

Given that performance *does* occur, it will on average cost (110 + 80)/2 = 95, yielding an expected surplus, conditional on performance, of S = E(Surplus | Performance) = (110 - 95) = 15.

There is a 75 percent chance of performance, which will be worth, on average, 15 when it occurs, so the *expected* surplus is 0.75 x 15 = 11.25 under perfect expectation damages.

This example shows that the ability to breach when performance is inefficient adds value to the contract: an "always perform" contract is only worth 10, but an "efficient performance" contract is worth 11.25, precisely because it eliminates those contexts in which costs are high and performance is not worthwhile.

Now imagine that actual expectation damages as awarded by a court are systematically less than perfect, by a factor $0 < \alpha < 1$. Suppose $\alpha = 0.9$. The promisor will now choose to perform whenever $k - c > -(\alpha v - k)$, which implies that performance occurs whenever $c > \alpha v$, or whenever costs are less than 0.9 x 110 = 99. The expected surplus, *given performance*, is now, by the same logic above, 20.5.[234] The probability of performance is (99-80)/(120-80) = 0.475, which is considerably smaller than under expectation damages. Hence, the expected surplus is now 9.738 (i.e., 0.475 x 20.5), a loss of about 13.4 percent versus perfect expectation. The loss occurs because, under α-Expectation, breach occurs more often than it should: when costs are between 99 and 110, potentially profitable opportunities to perform end up being foregone because the promisor chooses to pay damages rather than perform.

Finally, consider a promisor expectation rule, under which promisors have to give up all the profits or savings they earn from breach. Gains from performance are still $k - c$, but damages are now identical to $c - k$: if costs are larger than 110, the promisor must still perform, or else pay damages equal to the savings it incurs by failing to do so. Hence, performance will *always* occur, regardless of what the cost turns out to be. That means that expected surplus, given performance, is

234. Performance occurs whenever costs are between 80 and 99, and the uniform distribution implies that expected cost, given that cost is in this range is (99+80)/2 = 89.5. That means that the expected *surplus*, given performance, is: 110 - 89.5 = 20.5. Note that this is actually larger than under expectation damages because the promisor now breaches for some small—but positive—values of the surplus; eliminating these small values raises the average of the surpluses that occur when performance *does* take place.

S = [(110 - 80)/(120 - 80)] x [110 - (110+80)/2] + [(120-110)/(120-80)] x [110 - (110+120)/2] = 0.75 x 15 + 0.25 x (-5) = 11.25 - 1.25 = 10.

Note that the promisor expectation surplus is 1.25, or about 11 percent, less than the surplus under the optimal contract, 11.25, using perfect expectation damages. But it is *larger* than the surplus under α-Expectation damages by about 0.26, or 2.6 percent.

These simple examples lead us to the following conclusions:

(a) Perfect expectation damages maximize the surplus available to both parties by inducing breach when, and only when, the cost of performance is larger than its value to the promisee.

(b) Insufficiently compensatory expectation damages induce inefficient breaches in some situations in which performance is more valuable to the promisee than its cost to the promisor, but damages are less costly to the promisor than performance is. Promisees are also hurt, because whenever breach occurs—whether efficient or not—they are undercompensated for their losses.

(c) A promisor expectation rule is also sub-optimal in that it induces performance even when the cost is greater than the value of the performance.

(d) A direct comparison between promisor expectation and imperfect expectation, however, reveals that the former may dominate. Whether it does depends on two obvious factors.

The first factor is the extent to which actual damages fall short of perfectly compensatory expectation. This is measured by the parameter α, and the smaller α is, the more attractive the parties will find the promisor expectation remedy, because smaller α means lower damages, which lead to more inefficient breaches that are in both parties' interests to prevent.

The second factor that bears on the desirability of promisor expectation is the domain of the promisor's costs. Suppose costs were uniformly distributed on the interval (80, 200), instead of (80, 120). In that case, performance would be inefficient (200 - 110)/(200 - 80) = 75 percent of the time; so a rule that always required performance would trade large and highly probable losses—whenever costs were between 200 and 110—for small and unlikely gains—whenever costs were between 80 and 110. Promisor expectation is obviously less attractive relative to α-Expectation in this setting.[235]

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235. Of course, it is possible to improve on a pure promisor expectation regime. For

We have assumed thus far that the parties cannot renegotiate the contract in the shadow of the damage formula, once costs become known. Suppose, however, that such renegotiation is possible. In the α-Expectation case, this would mean that the promisee could offer to pay the promisor an additional fee to perform whenever the promisor would find it advantageous to breach an efficient contract. For example, suppose that the cost of performance turns out to be 100. The promisor could breach and net $-0.9 \times (110 - k) = k - 99$, or perform and net $k - 100$. For any value of k, breaching dominates, even though there is a surplus to be realized by performance, because it is worth more to the promisee than it costs the promisor to produce.

But if the promisee can step up her offer, performance will once again be worthwhile to the promisor. For instance, the buyer in this situation might make the seller an offer of an additional 2. In that case, performance earns $k + 2 - 100 = k - 98$, but breach earns $k - 99$, and now performance is the better choice for the promisor/seller as well as the promisee.

Of course, renegotiation is also possible when inefficient performance is required under a promisor expectation rule. Suppose c is equal to 115, so performance is *in*efficient, and the contract price is 105. If the promisor performs, he loses $105 - 115 = -10$ and the promisee gains $110 - 105 = 5$. He obtains the same result if he breaches and is subject to promisor expectation. But suppose the promisor offers to return the contract price plus 7 if he is excused from having to perform. Now the promisor has avoided performance that costs 10 (net), and is down only 7 instead. The promisee does not get performance (worth 5) but has made 7 for agreeing to cancel the contract. Both parties are thus better-off than they would be if performance had occurred.

This example illustrates the idea that renegotiation can eliminate inefficient outcomes that come up under any damage formula, correcting inappropriate decisions to breach *or* to perform. Is there any difference between the bargaining that would occur in these two

example, we could imagine a kind of "tailored" rule, in which very bad news would free the promisor from having to give up the savings it realized by breaching. This starts to look a bit like an impossibility or frustration defense; it also captures those cases in which the promisor inadvertently breaches in order to save very substantial sums, as, for example, when the factory burns down and could be rebuilt in time to perform, but only at vast expense.

renegotiations? There might be: when the promisee has to induce the promisor to perform, all she needs to know in order to figure out how much to offer is the cost of performance, which is likely to be objective and easily verifiable. By contrast, when the promisor has to make an offer to be excused from performance, he has to know the promisee's subjective valuation of the widget, which will often be very difficult to observe. The issue, unfortunately, turns not just on which party has private information but on which party makes the offer. In cases in which the informed party makes an offer, we have a signaling game; in cases in which the uninformed party makes the offer, we have a screening game. In general, the equilibria will not be the same; and it is obviously not clear ex ante who will make and who will receive the offer in either instance.