Efficient Breach Theory in the Law of Contract: An Analysis

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I: INTRODUCTION

The law of contract concerns the legally binding agreements that people make and the rights and duties that arise as a consequence. The precise nature of these rights and obligations has been the subject of much inquiry and investigation. In particular, what is the “cash value” of a contractual right? What is one obliged to do?

One traditional view of the nature of contractual rights is expressed in the maxim *pacta sunt servanda* which means “promises must be observed”. This view is that if you contract to do something then you are obliged to actually do that thing. A contrary view was expressed by Oliver Wendell Holmes in 1897 when he wrote: “The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else.”

This famous statement led Remington to write: “The law has come to regard the obligation to perform a contract as being generally equivalent to an option to perform or pay damages. Holmes saw the matter this way more than one hundred years ago.” Faced with this notion of contractual obligation as nothing more than an option to perform or pay damages, economists have analysed the law of contract to determine optimal economic behaviour — that which leads to the maximisation of resources in society. This has led to the development of the theory of efficient breach.

Part II of this article will outline this theory and its underlying assumptions about the nature of the law of contract. Part III will assess

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* The author gratefully acknowledges the assistance and encouragement of Tim Dare and Rick Bigwood of the University of Auckland Faculty of Law in preparing this article.
1 Holmes, “The Path of the Law” (1897) 10 Harv L Rev 457, 462.
the descriptive adequacy of the theory and address the question of whether it provides an accurate explanation of the present law of contract. Part IV will assess the prescriptive adequacy of the theory to consider whether the theory of efficient breach should be part of the law of contract.

II: THE THEORY OF EFFICIENT BREACH

The theory of efficient breach is part of the law-and-economics school of thought. This school maintains that the law’s objective ought to be the production and distribution of resources in the most efficient manner possible. This is important because there is scarcity of resources in society. In order to utilise resources efficiently, goods should move to their most highly valued uses. Such uses are gauged by the subjective preferences of economic actors, demonstrated by what each actor is prepared to pay for a resource. In the economics of exchange, an economically efficient bargain is defined as one that “results in a gain in ‘economic efficiency’ by moving the exchanged assets to higher valued uses”.

There are two standards commonly used to measure efficiency. The first is called Kaldor-Hicks efficiency. A situation is Kaldor-Hicks efficient if and only if the net gain from a course of action exceeds the net loss. Efficiency here refers to “the relationship between the aggregate benefits of a situation and the aggregate costs of the situation”. The second standard of efficiency is called Pareto-efficiency. A situation is Pareto-efficient or optimal when no one can be made better off without making someone else worse off. A situation is Pareto-superior to another when at least one person in that situation is better off than he or she would be in the first situation and no one is worse off. A situation is Pareto-incomparable when some people are better off and some people are worse off. The theory of efficient breach can be fashioned to reflect either of these two standards of efficiency. This article will focus on the theory that satisfies the more stringent test of Pareto-efficiency.

So what then does the theory of efficient breach say? Richard Posner, one of the original proponents of the theory, states:

In some cases a party would be tempted to breach his contract simply because his profit from breach would exceed his expected profit from completion of the contract. If his profit would also exceed the expected profit to the other party from completion of the contract, and if damages are limited to the loss of expected profit, there will be an incentive to commit a breach. There should be. The opportunity cost of completion to the breaching party is the profit that he would make from a breach, and if it is greater than his profit from the completion, then completion will involve a loss to him.

Consider the following example. A manufacturer of bolts (A) contracts with B to supply 1000 bolts for a total price of $500. B is expecting to on-sell the bolts in the near future for $700, making a profit of $200. A then gets an offer from C to purchase 1000 bolts for $2000. A cannot meet C’s demand without breaching his contract with B, for he only has 1000 bolts to sell at the present time. If damages are limited to compensating B for his loss of expected profit ($200) then by breaching the contract with B, A stands to make a profit of $1300 (the $1500 extra which C is willing to pay minus the $200 in damages payable to B). The theory of efficient breach states that in this situation A should act efficiently and maximise societal wealth by breaching the contract with B and pursuing the contract with C. The idea is that the situation where A breaches the contract with B is Pareto-superior to the situation where he does not breach. A is better off and B is in the same position he would have been in had the contract been performed.7 One person is better off and no one is worse off. The breach therefore creates a more efficient distribution of resources. But is this how the law of contract operates? Should it operate like this?

III: DESCRIPTIVE ADEQUACtY

This part of the article will examine the assertion that the theory of efficient breach explains the way that contract law currently operates. There are three main elements to this assertion. The first is the idea that contractual obligation involves a lawful option to perform or pay damages in lieu of performance. The second is that the default remedy for breach of contract is an award of damages. The third is that when damages are awarded for breach of contract the non-breaching party

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7 It should be noted at this point that the theory of efficient breach views expectation damages as being adequate fully to compensate all loss which B has suffered as a result of A’s breach of contract. Whether this assumption is correct shall be considered in Part IV of this article.
suffers no loss because it is placed in the same position it would have been in had the contract been performed. Analysing the descriptive adequacy of the theory of efficient breach involves asking whether these three elements of the theory are accurate descriptions of what actually happens in the operation of contract law. It will be seen that there are many aspects of contract law that contradict these descriptions.

The attitude of Commonwealth courts to the theory will also be examined in order to determine the extent to which the theory of efficient breach really is a part of the law of contract.

1. Contractual Obligation Involves a Lawful Option to Perform or Pay Damages in Lieu

At first blush this appears to be the case. Holmes wrote that “[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it – and nothing else”.8 Posner has stated: “Even if the breach is deliberate, it is not necessarily blameworthy.”9 Under any contract, either party appears to have the power to breach the contract, with the only consequence being liability to the non-breaching party for its expectation losses. This suggests that contractual obligation does constitute a lawful option to either perform the contract or breach it and pay damages.

On closer analysis, however, one finds aspects of the law of contract that are inconsistent with this view of a lawful option to breach a contract. An official comment to the United States Uniform Commercial Code provides a first clue. It states that “the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit”.10

(a) Punitive Damages

The absence of punitive damages as a remedy for breach of contract has been cited as evidence that contractual obligation involves a lawful option to perform or breach and pay damages. Peter Linzer writes that:

8 Holmes, supra note 1.
9 Patton v Mid-Continent Sys 841 F 2d 742, 750 (7th Cir, 1988) per Posner J.
[W]hile it would be possible to restrain [the breaching party] by ... imposing punitive damages or penalties on him ... the law does not do this ... Thus, despite our concern for holding parties to their word, at least in the conventional market situation ... law, economics, and arguably common sense all condone the deliberate and wilful breach.

This statement of the law is no longer correct in New Zealand. In TAK & Co v AEL Corporation Ltd\textsuperscript{12} the defendant substituted non-pedigree animals for the pedigree animals it were under contract to supply and issued false pedigree documents. The conduct of the breaching party was held to be outrageous and punitive damages were awarded. There have been similar developments in Canada\textsuperscript{13} and the United States.\textsuperscript{14} Thus, it is now possible to be punished for deliberately breaching a contract. With the law relating to punitive damages changing in this way, the efficient breach theory description of contractual obligation as involving a lawful option to perform or breach becomes less certain.

(b) Pre-Existing Duties and Sufficiency of Consideration

A valid contract depends on there being sufficient consideration from each party to the contract. There is no sufficient consideration if all that the promisor does is perform, or promise to perform, an obligation already imposed upon him by a previous contract with the promisee.\textsuperscript{15} This rule rests on the implicit assertion that a contractual obligation involves a duty to perform, rather than a lawful option to perform or breach and pay damages, for if the promisor did enjoy the “right” to breach, he or she could have surrendered it as valid consideration in a subsequent contract.

Doubt was cast on this rule in the English Court of Appeal case of Williams v Roffey Bros & Nicholls (Contractors) Ltd.\textsuperscript{16} In that case, the plaintiff was building a block of flats for the defendant. Upon discovering that the contract price was too low, the parties agreed on an additional payment to the plaintiff for completing the work, which the plaintiff was already bound to do. The Court found adequate consideration in the “factual” or “pragmatic” benefit to the defendant

\textsuperscript{12} (1995) 5 NZBLC 103,887.
\textsuperscript{15} Stilk v Myrick (1809) 2 Camp 317.
promisor of securing its commercial position and held that the second agreement was binding. Purchas LJ said:\(^\text{17}\)

There was, however, no obligation added to the contractual duties imposed upon the plaintiff under the original contract. Prima facie this would appear to be a classic \textit{Stilk v Myrick} case. It was however, open to the plaintiff to be in deliberate breach of the contract in order to ‘cut his losses’ commercially. In normal circumstances the suggestion that a contracting party can rely upon his own breach to establish consideration is distinctly unattractive.

Nevertheless, the Court allowed the plaintiff to do precisely that. This decision seems to support the efficient breach theory idea of the nature of contractual obligation. Friedmann suggests, however, that this change in the rules of consideration is not because the promisor is entitled to break the contract but rather because the doctrine of consideration is itself unsatisfactory.\(^\text{18}\)

\textbf{(c) Economic Duress}

While forbearance from breaching a contract may now constitute valid consideration, a threat to breach a contract can amount to duress. A contract formed as a result of duress is voidable. Lord Scarman in \textit{Universe Tankships Inc of Monrovia v International Transport Workers' Federation} stated the two-stage test for duress as: “(1) pressure amounting to compulsion of the will of the victim; and (2) the illegitimacy of the pressure exerted”.\(^\text{19}\) Bigwood writes that “a breach or proposed breach of contract, employed by [one party] in support of a demand for modification of the same, is \textit{invariably} ‘illegitimate’ for the purposes of the ‘pressure’ arm of the two-staged duress inquiry, for doubtless it is to commit a legal ‘wrong’”\(^\text{20}\).

If contractual obligation really involved a lawful option to perform the contract or breach it and pay damages then it would not be unlawful to threaten to breach it.

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\(^{17}\) Ibid 23.

\(^{18}\) Friedmann, supra note 14, 19 n 63.

\(^{19}\) [1983] 1 AC 366, 400.

(d) Disgorgement

Historically, the plaintiff in an action for breach of contract could recover only his loss, not the defendant's gain from the breach. However, the law in this regard is changing and there is movement to allow disgorgement of the breaching party's profits from the breach. In Attorney-General v Blake the English Court of Appeal considered the possibility of disgorgement for profits arising from a breach of the duty of confidentiality in an employment contract. Lord Woolf MR said that "the law is now sufficiently mature to recognise a restitutionary claim for profits made in breach of contract in appropriate circumstances." Such appropriate circumstances would include where the defendant fails to provide the full extent of the services he has contracted to provide and for which he has charged the plaintiff, and where the defendant has obtained his profit by doing the very thing he contracted not to do. Disgorgement was not eventually granted for other reasons. Whether this trend will be followed is yet to be determined. Nonetheless, if disgorgement is an available remedy for breach of contract in certain circumstances, then it is difficult to see how contractual obligation involves a lawful option to perform or pay damages in lieu of performance. If it were lawful to breach the contract, then presumably one would be allowed to keep the profits gained from the 'lawful' act.

(e) Tort of Interference with Contractual Relations

It is a tort to interfere in the performance of a contract of which one is aware or ought to be aware. Thus, for example, it is unlawful knowingly to induce someone to breach his or her contract with someone else to come and work for you. As Friedmann points out, "[t]here is a marked incongruity between the 'right' to break a contract theory and the tort of interference with contractual relations: why should a person be liable for inducing another to exercise his right?" The tort of interference with contractual relations protects the promisee's right to performance of the contract. It is inconsistent with the efficient breach

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21 Surrey County Council v Bredero Homes Ltd [1993] 1 WLR 1361.
23 Ibid 457.
24 Ibid 458.
26 Lumley v Gye (1853) 118 ER 749.
27 Friedmann, supra note 14, 20.
theory view that it is lawful to elect to breach a contract and pay damages rather than perform it.

Overall, it can be seen that there are aspects of the present law of contract that rebut the proposition that contractual obligation consists of a lawful option to perform or pay damages in lieu.

2. The Default Remedy for Breach of Contract is an Award of Damages

Efficient breach theory derives its assertion that it adequately describes the way that contract law operates in part from the fact that an award of damages is the default remedy for a breach of contract. Only if damages would be inadequate will any other remedy, such as specific performance, be awarded. The damages remedy enables the breaching party to satisfy the non-breaching party’s needs without actually performing the contract.

The claim is that this rule is in place because a routine availability of specific performance would compel promisors who wanted to breach to bribe the promisee to release them from their obligations. Posner writes that this would introduce “an additional step, with additional transaction costs — and high ones, because it would be a bilateral-monopoly negotiation”.28 Thus, efficiency is reduced.

It is important to note that the theory is thus confined to contracts where the subject-matter of the contract is fungible. “Damages can be used ... for only one category of losses: to replace fungible goods or routine services in an orderly market.”29 Where the subject-matter is unique, and damages would be inadequate, specific performance will be granted.30 The fact the default remedy for breach of contract is an award of damages shows that there is a legal presumption that most things which are the subject-matter of contracts are fungible. Rendleman writes: “Our materialistic society considers money an acceptable substitute for most recognized interests.”31 However, the fact that the law is sparing to compel performance of a promise does not necessarily mean that the law aims to encourage efficient breaches. There are other possible explanations for the rule, such as the invasiveness of an order of specific performance. It is a serious thing for the law to compel a person to do an

30 Sky Petroleum Ltd v VIP Petroleum Ltd [1974] 1 All ER 954.
act because to do so limits personal autonomy, one of the main values the law of contract seeks to promote. Another reason for awarding damages instead of specific performance is that the former is an easier remedy to enforce.

Moreover, there is doubt as to the continued existence of the default rule of damages. Laycock argues that the United States legal system does not view damages as hierarchically superior and that courts will find damages adequate only when there is some identifiable reason to deny specific relief in a particular case.\(^{32}\) Having surveyed over 1400 cases he found that the plaintiff typically obtains the remedy she seeks, concluding that to continue to regard damages as a remedy hierarchically superior to specific performance is misinformed. He writes:\(^{33}\)

> Our existing conceptual categories are historical rather than functional. They are left over from a time when law and equity were administered in separate courts, or even from a time when each legal remedy was administered under a separate writ .... In a radically changed judicial system, these rules have become obstacles to decision instead of guides. The courts have generally manipulated such rules to achieve just and functional results, but the formal rules, the vocabulary, and the conceptual categories have become dysfunctional.

This notion that the common law remedy of damages has primacy over equitable remedies, such as specific performance and injunctions, has also been questioned in New Zealand in a number of recent decisions.\(^{34}\) In *Butler v Countrywide Finance Ltd*,\(^{35}\) Hammond J referred to these developments and suggested that in deciding which remedy to grant the Court must engage in a context-specific evaluation of which remedy would be most appropriate in a given case. This evaluation involves considering a number of factors, including the economic efficiency of each remedy in the context of the case, the moral view to be attached to each of the interests at stake, the effect of each remedy on third parties, and the practicability of enforcement.\(^{36}\) Todd suggests that New Zealand courts will increasingly tend to favour this open remedial system. He writes that “[t]he bias in favour of damages is founded

\(^{32}\) Laycock, supra note 29, 5.
\(^{33}\) Ibid 7.
\(^{34}\) *Van Camp Chocolates Ltd v Aulsebrooks Ltd* [1984] 1 NZLR 354 (CA); *Day v Mead* [1987] 2 NZLR 443 (CA); and *Newmans Tours Ltd v Ranier Investments Ltd* [1992] 2 NZLR 68, 96 (HC), cited in Burrows, Finn and Todd, supra note 13, 790.
\(^{35}\) [1993] 3 NZLR 623 (HC). See infra note 60 and accompanying text for further discussion on this case.
\(^{36}\) Ibid 632-633.
simply on matters of history and the relationship between common law and equity and nowadays is not easy to justify". 37

The uncertainty as to whether damages are still the default remedy for breach of contract and the fact that there may be other explanations for this rule besides economic efficiency undermine the proposition that efficient breach theory accurately describes the way the law of contract operates.

3. That Damages Place the Non-breaching Party to the Position He or She Would Have Been in Had the Contract Been Performed

The theory of efficient breach, using the concept of Pareto-efficiency, relies on the idea that someone is better off and no one is worse off in an efficient breach situation than in the non-breach situation. This ties in with the formula for damages for breach of contract which is that the court should aim to put the non-breaching party in the position it would have been in had the breach not occurred. 38 The theory asserts that an award of damages is sufficient to compensate the non-breaching party adequately for its losses and put it in the position it would have been in had the contract been performed, and that by awarding damages the law is encouraging efficient breaches.

This, however, is not the case. An award of expectation damages does not truly put the non-breaching party in the position it would have been in had the contract been performed. There are a number of reasons for this.

First, there are limitations on the losses which may be recovered from the breaching party, such as the requirements of foreseeability and certainty. These limitations mean that real and sometimes enormous losses, such as loss of unforeseen business opportunities or loss of speculative profits, are not compensated. The foreseeability limitation, introduced in Hadley v Baxendale, 39 can be explained in various ways, ranging from the economic idea that it allocates risk in the most efficient manner 40 to the idea that it eases the task of the courts and lawyers in reaching predictable results. 41 Perillo states that: 42

37 Burrows, Finn and Todd, supra note 13, 791.
38 Anglia Television Ltd v Reed [1972] 1 QB 60 (CA).
39 (1854) 9 Exch 341.
None of [these ideas] involves the thought that any kind of breach is encouraged by the law. Instead, they focus on the protection of the promise breaker from the unforeseen consequences of his or her breach and also on the institutional goal of easing the task of administering justice.

Similar arguments apply with regard to the limitation that damages must be proved with reasonable certainty before they are recoverable. Speculative losses such as how much profit would have been made had a movie been completed are non-compensable. This rule is not attributable to the law encouraging efficient breaches. Perillo cites the fact that courts are prone to relax the standard of certainty required in cases where the breach is wilful as authority for this proposition.

Another way in which damages do not truly put the non-breaching party in the position she would have been in had the contract been performed is that damages rarely fully compensate the non-breaching party for her real legal costs, court costs, and other transaction costs such as information costs.

Similarly, the non-breaching party is rarely fully compensated for her loss of interest on the sum awarded which she would have earned had the contract not been breached. Awards of pre-judgment interest are discretionary, only simple interest can be awarded, not compound interest, and interest cannot be awarded in default judgment proceedings. Awards of post-judgment interest are fixed at a prescribed rate that does not take into account changes in standard interest rates. The New Zealand Law Commission has reported that the current law relating to awards of interest on money sums does not realistically compensate the non-breaching party for the loss it has suffered and has recommended that Parliament enact an Interest on Money Claims Act which, among other things, would make awards of interest mandatory and prescribe a more realistic rate of interest. The law has not been changed yet.

Mental stress caused by the breach of contract is another loss that the non-breaching may suffer but not be compensated for. The frustration,
anger, disappointment and mental distress of the non-breaching party are not recognised as proper elements of damages in a breach of contract action unless the contract was specifically intended to prevent loss of that sort.\textsuperscript{49} They are strictly not recoverable in ordinary commercial contracts.\textsuperscript{50} However, even where the contract is purely commercial there is potential for some sort of mental stress on the part of the non-breaching party. This injury is not compensated by an award of damages.

Another important consideration is that the objective value of performance determined by the court may not be the same as the subjective value to the non-breaching party. Efficient breach theory assumes that there is an objectively determinable value of every resource at which the owner will always be prepared to sell. But this overlooks the idiosyncratic values of real humans as opposed to rational economic actors. The performance of the contract may have a personal value to the non-breaching party for which an objectively determined award of damages will not be adequate compensation.

Therefore, the current rules of damages do not put the non-breaching party in same position he would have been had the breach not occurred. The non-breaching party is typically under-compensated. The only way to ensure that the non-breaching party is no worse off in the breach situation is to grant specific performance as the remedy for breach of contract. This is the most accurate method because it gives the promisee the precise outcome promised and expected.\textsuperscript{51} This view undermines a key element of efficient breach theory as a descriptive account of contract law. This is because the rules of damages are relied upon to show that it is possible to place the non-breaching party in a position where it is no worse off in the breach situation than in the non-breach situation, and that therefore it is Pareto-efficient to breach the contract. When the non-breaching party is typically under-compensated, the breach outcome is not Pareto-superior to the non-breach outcome, but is in fact Pareto-incomparable. One party is better off and the other is worse off. It is not possible to say that the breach is efficient.

\textsuperscript{49} Bloxham v Robinson (1996) 7 TCLR 122 (CA).
\textsuperscript{50} Clark Boyce v Mouat [1992] 2 NZLR 559 (CA).
4. Attitude of Commonwealth Courts to Efficient Breach Theory

An analysis of the attitudes of Commonwealth courts to the theory of efficient breach is an important part of assessing the theory’s descriptive adequacy.

In *South Wales Miners’ Federation v Glamorgan Coal Company Ltd* the plaintiff coal company sued the Miners’ Federation for interfering in the contracts of employment between the miners and the coal company. Lord Lindley, in considering the legality or illegality of a breach of contract, stated:  

Any party to a contract can break it if he chooses; but in point of law he is not entitled to break it even on offering to pay damages. If he wants to entitle himself to do that he must stipulate for an option to that effect. Non-lawyers are apt to think that everything is lawful which is not criminally punishable; but this is an entire misconception. A breach of contract would not be actionable if nothing legally wrong was involved in the breach.

Since the “option” notion of contractual rights underpins the theory of efficient breach, this statement also amounts to a rejection of the theory of efficient breach. This statement of the law was approved by Isaacs J in the High Court of Australia in *Goldsbrough Mort & Co Ltd v Quinn.*

An even clearer rejection of the efficient breach theory notion of contractual rights is found in the English Court of Appeal case of *George Mitchell (Chesterhall) Ltd v Finney Lock Seeds Ltd.* In that case the plaintiff contracted to purchase cabbage seeds from the defendant. The seeds supplied were defective, resulting in thousands of pounds of loss to the plaintiffs. The Court had to determine whether the exemption clause on the back of the invoice from the defendant was binding. In canvassing the relevant principles of contract law, Oliver LJ said that “the purpose of a contract is performance and not the grant of an option to pay damages”. Again, this view is inconsistent with the theory of efficient breach.

The comments by Purchas LJ in the English Court of Appeal in *Williams v Roffey Bros & Nicholls (Contractors) Ltd* reveal a view of

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52 [1905] AC 239 (HL).
53 Ibid 253.
54 (1910) 10 CLR 674, 691 (HCA).
56 Ibid.
contractual rights which is more conducive to efficient breach theory. His Lordship said: "It was, however, open to the plaintiff to be in deliberate breach of the contract in order to 'cut his losses' commercially." 57 He went on to say, however, that "[i]n normal circumstances the suggestion that a contracting party can rely upon his own breach to establish consideration is distinctly unattractive". 58 While this comment seems to embrace the Holmesian notion of contractual rights it may be that Friedmann is correct when he argues that dissatisfaction with the doctrine of consideration underpins this type of case, rather than the idea that a promisor is entitled to break the contract. 59

More recently, economic efficiency and efficient breach have been discussed in the High Court of New Zealand in Butler v Countrywide Finance. 60 Hammond J, in exercising his discretion whether to award specific performance under sections 52 and 53 of the Sale of Goods Act 1908 for a sale of chattels agreement, considered that the economic efficiency of the remedy was one of nine relevant factors in deciding which remedy to grant. 61 His Honour compared the morality contention against efficient breach 62 with Posner’s extreme view that the only moral value is wealth maximisation. 63 He was sensitive to the role that efficiency plays in contracting and its value to society. He concluded, however, that wealth maximisation is not the only pursuit of contract law and acknowledged the importance of morality in the law, stating: 64

Promises (thankfully) hold a central position in the law of contract and the sales law (as a specialised branch of contract). The economic viewpoint, which could severely restrict specific performance as a remedy, does not represent the present law anywhere, nor should it.

Having reviewed the attitude of Commonwealth courts to efficient breach theory, it is fair to conclude that: 65

[T]he impact of the notion of ‘efficient breach’ must not be overstated. While it may be generally true that the law will not compel the defendant to

57 Supra note 17.
58 Ibid.
59 Friedmann, supra note 14, 19 n 63.
60 Supra note 35.
61 Ibid 632.
62 See infra text, pages 758-759 for discussion of the morality contention.
63 Posner, “Utilitarianism, Economics, and Legal Theory” (1979) 8 J Legal Stud 103 [“Utilitarianism”].
64 Supra note 35, 635.
perform, it is far from clear that Anglo-New Zealand law has ever fully embraced the Holmesian notion of a contractual duty as being either to perform or to pay damages.

Overall, efficient breach theory does not provide an explanation of the law of contract as it now stands. It is descriptively inadequate. There are many aspects of the law of contract that are not able to be explained by efficient breach theory or are inconsistent with the theory to the point that they contradict it. This is not surprising. It is unlikely, given the ad hoc way that contract law has developed and evolved in the common law, that any one theory of contract could adequately describe the way the law operates. Roberto Unger, a critical legal studies theorist, objects to the idea that all of the law can be explained in terms of a single underlying theory. He writes:

[I]t would be strange if the results of a coherent, richly developed normative theory were to coincide with a major portion of any extended branch of law. The many conflicts of interest and vision that lawmaking involves, fought out by countless minds and wills working at cross purposes, would have to be the vehicle of an immanent moral rationality whose message could be articulated by a single cohesive theory. The dominant legal theories in fact undertake this daring and implausible sanctification of the actual.

This view is echoed by Hillman when he writes: "[d]espite its many dimensions, contract law is a credible, if not flawless, reflection of the values of the surrounding society. A highly abstract unitary theory illuminates contract law, but it cannot explain the entire sphere."

IV: PRESCRIPTIVE ADEQUACY

Having found that efficient breach theory does not adequately describe the way in which the law of contract operates at present, it can now be asked whether the theory nevertheless describes the way that contract law should operate.

Efficient breach theory states that we should breach contracts when it would bring about a Pareto-superior outcome. When someone is made better off and no one is worse off then a net social gain results. More utility is derived from the same resources. Allowing parties to breach in order to take advantage of better economic opportunities also boosts

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economic activity in general. The gains received from the efficient breach situation are reinvested in society, increasing production and decreasing the price of goods and services and, ultimately, resulting in greater societal welfare. This is an attractive notion. In the perfect efficient breach scenario, each party to the contract is satisfied.

There are, however, a number of countervailing reasons why efficient breach theory does not provide an adequate prescription for the law of contract.

1. Transaction Costs

One reason why efficient breach theory does not provide an adequate prescription for the law of contract is that its calculations of efficiency are flawed. In practice there are additional costs to consider which affect whether the breach is truly efficient.

Under an efficient breach theory model of contractual behaviour, parties will breach the contract and then engage in litigation to compensate the non-breaching party for its loss. This, argues Posner, is more efficient than compelling specific performance because if specific performance were compelled, the breaching party would be forced to negotiate a release from the contract with the other party. This decreases efficiency because, to repeat Posner’s point, it introduces “an additional step, with additional transaction costs — and high ones, because it would be a bilateral-monopoly negotiation”. 68 But there are a number of transaction costs involved in a purported efficient breach situation that must also be taken into account. These include the costs to the non-breaching party of losses that are not compensable by an award of damages, such as mental distress and losses that, although significant, were not sufficiently foreseeable or certain. 69 Next there are the transaction costs which result from the fact that in reality the economic marketplace does not operate instantly and without friction. Thus, costs of planning involved with the new opportunity and the costs of delay, inertia and uncertainty must also be taken into account. 70 Further transaction costs are administrative: under an efficient breach model of contractual behaviour there will be an increase in litigation as more people breach and more people have to instigate court proceedings in order to recover their losses. This will “open the floodgates” to a deluge

69 Perillo, supra note 10, 1099.
of breach of contract claims which could be avoided if parties were forced to negotiate with each other rather than breach. It is expensive for the State to maintain a court system to process cases. These costs must be taken into account. Furthermore, the resources of our justice system are limited and already stretched. Accepting efficient breach theory could lead to other meritorious claims not getting to court. This is another transaction cost.

Even more transaction costs result from the fact that efficient breach theory encourages parties to “breach first, talk afterwards”. This results in relational costs such as loss of reputation and loss of future business opportunities. Epstein writes: “When breaches of this sort take place within the organized trades, the opportunist is drummed out of the business as unreliable for any future dealings.” This cost is not so high when specific performance is the known remedy for a breach of contract, because then the parties talk before the breach and co-operate to negotiate a variation of the contract.

In the real world, it makes a great deal of difference whether a breach occurs, or is even threatened, or whether negotiations are viewed as leading towards mutually beneficial allocations of the increased productivity offered by the new opportunity. “[T]he microeconomic model fails to take into account the difference between negotiating over what is viewed as an allocation of losses, and what is viewed as the allocation of potential gains”.

In addition to these relational costs, there are the increased costs of talking after a breach, compared with talking before a breach. These are the transaction costs involved in litigation, including legal costs, court costs and information costs. Macneil states that:

‘[T]alking after a breach’ may be one of the more expensive forms of conversations to be found, involving, as it so often does, engaging high-priced lawyers, and gambits like starting litigation, engaging in discovery, and even trying and appealing cases.

Although having specific performance as the default remedy for a breach of contract may involve the costs referred to by Posner, it can also involve negative transaction costs. The rule encourages behaviour, such as talking and sharing information, which can actually reduce costs. For

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71 Macneil, ibid 968.
73 Macneil, supra note 70, 959.
74 Perillo, supra note 10, 1099; and Macneil, ibid 969.
75 Macneil, ibid 968-969.
example, such co-operation fosters good business relationships that will lead to greater future economic activity and reduce the future costs of establishing the trustworthiness of the other party. In addition, talking enables the parties to assess the true costs to each party of a breach, better enabling them to decide whether varying or terminating the contract would in fact result in a net gain and be efficient. Macneil writes:76

That bias [of efficient breach theory] is in favour of individual, uncooperative behaviour as opposed to behaviour requiring the co-operation of the parties .... That model postulates individuals acting as if the relations in which those individuals exist have no effect on their behaviour. A model assuming away relations slips with the greatest of ease at any stage into favoring uncooperative and — ironically enough — highly inefficient behaviour.

By failing to take these transaction costs into account, efficient breach theory's calculations of efficiency are unrealistic. This undermines the theory's boasted advantage, which rests in the idea that transaction costs are reduced by removing the need of the promisor to negotiate a release from the promisee. It is even possible that a law of contract which had specific performance as the default rule would in fact promote efficiency better than a law based on efficient breach theory.

2. Freedom of Contract and the Liberal Conception of Contract

Another reason why efficient breach theory should not be incorporated into the law of contract is that it imposes on parties conditions relating to the performance of the contract to which they themselves did not agree. The efficient breach theory notion that a contractual obligation involves a lawful option to perform or pay damages in lieu does not reflect what parties typically agree to. When parties sign a contract to do something, they sign it expecting performance of the contract to be certain, not contingent on the later unilateral decisions of each party whether to perform or pay damages. If the parties had intended this contingency they could have granted a right to terminate the contract subject to payment of damages or made other provision in the contract for the rights of each party in the event of a

76 Ibid.
breach. As Lord Lindley stated in _South Wales Miners’ Federation v Glamorgan Coal Company Ltd_:77

Any party to a contract can break it if he chooses; but in point of law he is not entitled to break it even on offering to pay damages. If he wants to entitle himself to do that he must stipulate for an option to that effect.

It is contrary to the fundamental notion of contract as involving voluntarily assumed obligations to imply into the contract a lawful option to perform or pay damages in lieu of performance when it is not clear that this is what the parties intended.

Furthermore, accepting efficient breach theory into the law of contract would mean that it would be necessary to inquire into the substance of every contract to determine the existence and extent of contractual obligation. This is done by reference to the concept of economic efficiency. In deciding whether to enforce a contract the court will examine the substance of the given contract and assess whether upholding it would be economically efficient. If it could be breached efficiently, then the breach will be regarded as lawful and laudable. The primary obligations of the contract to perform will not be enforced and only a secondary obligation to compensate will be recognised. Because efficient breach theory requires this inquiry into the actual substance of the contract rather than the procedural form, it is an externalist and content-dependent theory of contract. It applies a normative standard independent of the parties’ agreement (economic efficiency) to the substance of each contract to determine contractual obligation. This is inconsistent with the liberal conception of contract and the principle of freedom of contract. By applying this external standard the court does not adequately respect the intention of the parties involved and their freedom to determine their own obligations. As expressed by Sir George Jessel MR:79

[I]f there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and their contracts entered into freely and voluntarily shall be held sacred and shall be enforced by Courts of Justice.

77 Supra note 52, 253.
78 Here “enforce” means to hold the parties to their original agreement and decree specific performance.
To understand why this is a flaw in efficient breach theory it is necessary to examine the rationale behind the liberal conception of contract. This conception of contract is linked to the political and moral philosophy of liberal individualism. In modern society there is a plurality of conceptions of the good among citizens. As Dare writes, “[p]luralism and reasonable disagreement are ineliminable features of the political landscape in modern constitutional democracies”. The philosophy of liberal individualism is an answer to the challenge of finding a way that “there may exist over time a stable and just society among free and equal citizens profoundly divided by reasonable though incompatible religious, philosophical and moral doctrines”. It prescribes a political organisation of the State which is committed to neutrality as between conceptions of the good and which aims to maximise the liberty of its citizens as much as possible without infringing the equal liberty of other citizens. The law of contract facilitates this aim by allowing citizens to determine their own legal obligations. In this way it can maximise individual liberty and permit citizens to pursue their own interests in a way which is consistent with the liberty of others. It allows for a pluralist and peaceful society. This primacy of individual liberty entails that courts do not impose an external standard in deciding whether to uphold contracts. If the parties to the contract made a voluntary agreement then this should be upheld, regardless of its consistency with external standards which may not be shared by the parties. Efficient breach theory is inconsistent with the liberal conception of contract and is therefore prescriptively inadequate.

3. Law and Morality

An additional reason why efficient breach theory is not prescriptively adequate is that it fails to address the moral reasons for performing contracts. The theory assumes that there is nothing immoral about deliberate breaches of contractual promises. Posner writes:

Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his

80 Dare, Legal Ethics Notes, unpublished teaching materials, University of Auckland (2000) 38.
82 Rawls’ Basic Liberties principle states that “each person is to have an equal right to the most extensive basic liberty compatible with a similar liberty for others” – Rawls, A Theory of Justice (1972) 60 ("Theory of Justice").
83 Patton v Mid-Continent Sys, supra note 9, 750 per Posner J.
promise, provided he make good the promisee's actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn't want to bring about such a result.

Posner has also argued that the *only* moral value is wealth maximisation. This idea is inconsistent with the moral principle of adhering to promises expressed in the maxim *pacta sunt servanda*. The institution of promise is linked with concepts of personal honour, integrity, morality and justice. For example, Rawls, in *A Theory of Justice*, writes that "[t]he obligation to keep a promise is a consequence of the principle of fairness". One reason to believe that there is a moral obligation to perform contractual promises is that there is a moral obligation to perform non-contractual promises. It is commonly perceived as immoral to make promises in everyday life that one then deliberately breaks. Since "contract is a credible, if not flawless reflection of the values of the surrounding society", we can say that the law reflects this moral value too. Contractual promises are promises which the law regards as sufficiently important, for one reason or another (such as the fact that consideration has been given for the promise), that the obligation to perform them should be not merely moral but also legal. On this view, the moral obligation to perform the contract subsists alongside the legal obligation. Efficient breach theory is thus prescriptively inadequate because the behaviour it prescribes is immoral.

4. The Social and Economic Function of Contract

The institution of contract performs the essential social function of enabling us to trust and rely upon each other, facilitating progress and productivity in society. Knowing that the other person has assumed a legal obligation to do what he says means that we can rely on him and plan, without fear that he may change his mind and leave us in a compromised position. Hobbes recognised this function of contract in *Leviathan*. When man is in a state of nature there are no laws which

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84 Posner, supra note 63.
86 Hillman, supra note 67.
87 It is important to note that an argument that efficient breach theory fails because it prescribes immoral behaviour is inconsistent with the liberal conception of contract because it uses an external standard (morality) in evaluating the theory. The morality argument against efficient breach theory therefore stands separate from the liberal conception of contract argument.
govern him. Natural self-interest and scarcity of resources will inevitably lead to perpetual warfare.\textsuperscript{89}

Whatsoever thereafter is consequent to a time of War, where every man is Enemy to every man; the same is consequent to the time, wherein men live without other security, that what their own strength, and their own invention shall furnish them withall. In such condition, there is no place for Industry; because the fruit thereof is uncertain: and consequently no Culture of the Earth; no Navigation, nor use of the commodities that may be imported by Sea; no commodious building; no Instruments of moving, and removing such things as require much force; no Knowledge of the face of the Earth; no account of Time; no Arts; no Letters; no Society; and which is worst of all, continual fear, and danger of violent death; And the life of man, solitary, poor, nasty, brutish, and short.

Only by entering into contracts whereby men make promises enforceable by a higher authority can peace and progress result, for “Covenants, without the Sword, are but Words, and of no strength to secure a man at all”.\textsuperscript{90} When a contract is formed, the parties may go about their business secure in the knowledge the law protects them from any wrongdoing by the other party. This concept illustrates how trust and reciprocity is essential to civil society. President Harry S Truman, in response to an interviewer’s question about honouring contracts, said: “it has always seemed to me that unless you can trust a man and he can trust you, why, everything breaks down .... [T]rust is absolutely fundamental in every possible kind of relationship.”\textsuperscript{91} While the incorporation of efficient breach theory into contract law in the modern commercial-industrial context is unlikely to result in Hobbes’ state of war, it would have other deleterious effects on productivity and progress. Parties would be less willing to enter into mutually beneficial contracts if they could not rely on the contract to guarantee performance. For example, if certain goods are essential to the running of A’s business and she cannot rely on a contract with B to guarantee the supply of those goods, then A may turn to other more costly and less efficient means, such as becoming a self-supplier or vertically integrating with her supplier.\textsuperscript{92} The result is inefficiency, wasted resources and diminished economic activity and productivity overall. As has been seen, damages in lieu of performance are not the same as actual performance: “A contract is no equivalent of

\textsuperscript{89} Ibid, Part I, Ch 13.
\textsuperscript{90} Ibid, Part II, Ch 17.
\textsuperscript{92} Friedmann, supra note 14, 7.
performance; rights are a poor substitute for goods.” 93 Fuller also writes: 94

The economics of exchange is, in contract, based in two fixed points: property and contract. While it permits interested calculation to reign everywhere else, such calculation is excluded when the question is fidelity to contract or respect for property. Without a self-sacrificing deference towards these institutions, a regime of exchange would lose its anchorage and no one would occupy a sufficiently stable position to know what he had to offer or what he could count on receiving from another.

Thus, an efficient breach scheme would make impossible the trust and reliance inherent in contract law. The theory overlooks the broader social and economic role that contract law plays as an institution that enforces promises. As such, it is prescriptively inadequate.

5. There is More to Law than Economics

The presupposition of efficient breach theory is that the legal system is merely an adjunct to the economic system. The discussion so far, however, shows that the current law of contract serves many ends besides economic efficiency. This is a criticism that applies to the law-and-economics school of thought generally. Although Posner may claim that the only moral value is wealth maximisation, 95 this is an extreme view that does not accurately reflect the full range of aims of the law. The law reflects societal notions of the moral institution of promise, it enables trust, reliance and planning, and it enables us to live together peacefully while still respecting personal autonomy. Perillo writes: 96

The law, however, does want to discourage breaches, efficient or otherwise. The law seeks to protect reliance and expectancies, and to preserve peace and tranquility [sic]. Breaches – even efficient breaches – tend not only to disappoint expectations, but also to precipitate private disputes. The legal system knows what economic science does not know: damages and other legal remedies are substitutes for private warfare.

96 Perillo, supra note 10, 1092-1093.
The law-and-economics theory of efficient breach fails to reflect these concerns and so should not be accepted as part of the law of contract.

V: CONCLUSION

The theory of efficient breach is both a descriptive account of how the law of contract currently operates and a prescriptive account of how it should operate. It is submitted that both of these accounts are inadequate.

As a descriptive account it rests on three main assertions about contract law. The first assertion is that contractual obligation involves a lawful option to perform or pay damages in lieu of performance. This assertion is contradicted by the fact that punitive damages may now be awarded for breach of contract, that a threat to breach a contract can amount to economic duress, that disgorgement of profits from a breach of contract may be granted to the non-breaching party, and that it is a tort to induce another to not perform a contract. The second assertion of efficient breach theory is that the default remedy for breach of contract is an award of damages and that this is designed to facilitate efficient breaches. The problem with this assertion is that there are other explanations for the rule, such as the law’s reluctance to limit personal autonomy by decreeing specific performance and the relative ease of enforcing damages orders. Furthermore, it is no longer clear that damages are the default remedy for breach of contract in New Zealand. The third assertion of efficient breach theory is that when damages are awarded for breach of contract the non-breaching party suffers no loss because he is placed in the position he would have been in had the contract been performed. This assertion is false because it overlooks the fact that much of the non-breaching party’s loss is irrecoverable due to the current rules of damages. Thus, there is no compensation for non-foreseeable or uncertain losses, full legal and court costs, lost interest, and mental stress. In addition, the objectively determined value of performance under the contract may not be the same as the non-breaching party’s subjective value of it. The conclusion that efficient breach theory does not provide an adequate explanation of the way in which the law of contract currently operates is supported by the fact that Commonwealth courts have largely rejected the theory. This descriptive inadequacy is not surprising, given the ad hoc way in which contract law has developed and evolved in the common law.
Efficient breach theory as a prescriptive account for contract law is attractive in that it promises more efficient use of resources, boosted economic activity and greater societal welfare overall. Ultimately, however, the theory is prescriptively inadequate. There are four main reasons for this conclusion. First, its calculations of efficiency are flawed because, while recognizing the transaction costs involved in a scenario where performance is compelled, they do not take into account the transaction costs involved in a breach scenario. Secondly, efficient breach theory is prescriptively inadequate because it is inconsistent with the principle of freedom of contract and the liberal conception of contract. It imposes on contractual parties an “option” notion of contractual rights that they themselves may not have agreed to, and evaluates their contracts by reference to an external normative standard (efficiency) which they may not share. Thirdly, if one accepts that there is a moral obligation to do as one promises then efficient breach theory is prescriptively inadequate because it endorses the immoral act of breaking a promise when a better opportunity presents itself. The fourth and, it is submitted, most important prescriptive failure of efficient breach theory is that it is inconsistent with the social and economic function of the institution of contract. The social and economic function is that it allows for the presence of trust and reliance without risk in transactions and thus creates an efficient and effective system of exchange in our society. Much of the progress and achievement of our modern society would not have occurred but for the trust and reliance made possible by the law of contract. Efficient breach theory seeks to undermine this because it makes performance of a contract contingent upon the unilateral decision of either party not to breach and makes this decision lawful. The law of contract should not embrace the theory of efficient breach because “unless you can trust a man, and he can trust you, why, everything breaks down”.  

97 President Harry S Truman, quoted in Miller, supra note 91.