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Donald Harris, David Campbell and Roger Halson
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Section 1
Remedies for unfulfilled contractual undertakings

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1 Introduction: the function and structure of remedies for failure to perform a contractual obligation

Introduction

This section of this book considers 'remedies' in the sense of the courses of action open to a claimant, C, who wishes to take some step to cope with the consequences of the defendant, D's, (threatened) failure to perform his contractual obligation. These steps are all legal in the sense of not involving any illegality, but a distinction must be drawn between 'legal' remedies which ultimately rely on the judgment of the court and 'self-help' remedies which do not. Our use of the term 'remedies' will include self-help by C, or action taken by non-judicial agencies, or C's seeking an out-of-court compromise with D. C may have guarded against the risk of D's breach by seeing that the contract included a clause dealing with the consequences of a breach. If C was prudent and capable of doing so, he may have got D to agree to a remedy which did not require any judicial action. C may also have taken out his own insurance protection against the risk of D's failure to perform, but since this is not a remedy directly against D, it is not considered here.

One possible action open to C following D's failure to perform is, of course, forebearing to do anything, or at least forebearing to seek to pursue a remedy as it has just been defined.[1] Though forebearance therefore is, in a sense, tangential to the subject matter of this book, it is a course of action following non-performance that practical experience and empirical studies of contractual action have shown to have great importance. Forebearance will, then, be discussed as such in chapter 2 and will be in the background of all our discussion of contractual remedies.

1 WLF Felstiner, 'Avoidance As Dispute Processing: An Elaboration' (1975) 9 Law and Society Review 695.

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Since this is a book on remedies, in this section it is almost always assumed that C can prove the existence of an enforceable contract.[2] That according to the rules of the substantive law of liability the contract was initially valid and that D has breached it are almost always never directly at issue in this section. These assumptions do not apply to the discussion of two exceptional remedies for a failure to perform with a lawful excuse, which are therefore not treated as a breach: discharge for common mistake and frustration. In the discussion of even these remedies, however, the relevant facts and rules about the initial validity of the contract or its subsequent discharge are also assumed. Generally, then, this section is concerned not with determining liability for a failure to perform but with the choice between the various remedies potentially available to C after the failure to perform, and with fashioning the remedy to meet the particular situation.

When C is faced with a breach of contract committed by D, he could, as a layperson, expect the law to provide a number of possible remedies. The first thing which, it would seem from the experience of first-year teaching, occurs to a layperson is to ask the court to compel D to do exactly what he promised, if he still is able to do so (although there might well be some delay after the time when D originally promised to do it). But even when C still wants actual performance, he may no longer want performance by D. He may no longer trust an unwilling but coerced D to produce performance of the expected standard, and so would prefer to be able to choose a third person to do exactly what D had promised. C would then wish to ask the court to compel D to pay for any extra cost involved in obtaining this 'third party' or 'substitute' performance. In this section, these two possible remedies will, following the now common (if loose) usage, be referred to as the 'literal enforcement' of the contract, and will be discussed in Part 3. The third possible remedy which C might seek is an order by the court compelling D to pay a sum of money to 'make up' or 'compensate' for the loss of the benefit which C had expected to receive if both parties had fully performed their obligations under the contract. C may also seek money from D to compensate him for consequential losses and expenses arising from D's breach. These 'compensatory' damages will be discussed in Part 2. Damages quantified on an other than compensatory basis, to make D disgorge any benefit he may have gained by not performing or to punish him for breach, will be discussed in Part 4 on 'restitution' and chapter 30 on exemplary damages. In sum, this section of this book will examine how the law has responded to the layperson's desire for these different remedies.

2 This assumption does not apply to the discussion of misrepresentation in pp 553-560 below.

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The law leaves the initiative to C. It does not compel him to take any action at all, and certainly does not compel him to seek any remedy from the court. But if he does resort to legal action, the law usually allows him to choose the remedy he wants.[3] The award of compensatory damages is by far the most important remedy,[4] and C's claim to it is not subject to the exercise of any discretion by the court. (There are, of course, rules about how such a claim can properly be framed.) However, the special remedies of enforcement of D's performance are subject to such a discretion, and the award of third party performance damages are subject to limits analogous to that discretion; but they both are granted only if C asks for them. If, however, the court does not grant either form of literal enforcement, C may fall back on the usual remedy of damages for his loss in not getting the benefit of performance.

The function of the law of contract

Though it is not appropriate in a textbook treatment to spend a great deal of time discussing the economic, legal and social theory of the law of remedies for failure to perform a contractual obligation, some brief statement of the theory which underlies that treatment is needed in the interests of clarity. All such treatments are informed by a theoretical position, whether this is recognised or not, and the lack of self-consciousness which follows from a failure to recognise this can lead only to confusion.

This section of this book deals with capitalist economies in which the principal mechanism for the allocation of economic goods is regular, proportional exchange motivated by the desire of the parties to the exchange to maximise their wealth, wealth being the amount of satisfaction or utility afforded by the economic goods to which the parties have some form of title.[5] The parties exchange goods or services for money, each in the belief that by so doing he will realise a surplus utility.[6] At the time of agreement, each party commits his existing resources, representing a certain utility, to the exchange and expects that, after performance of the exchange, he will obtain a resource which represents an increased utility over that with which he began. The sale of goods which have cost £1m to make for a price of £1.1m is the most clear example of the capitalist exchange, in which proportional exchange and surplus, in the form of a

3 See see p 83 below.
4 Claims in debt and for recovery of monies paid, which are the most common proceedings, are examined in ch 11 and see pp 232-235 below. Both are largely (but not entirely) congruent with a compensatory damages claim.
5 M Weber, *Economy and Society* (1968) ch 2.
6 HH Gossen, *The Laws of Human Relations* (1983) ch 7.

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net money profit, are obvious. In what remains the leading contribution to the analysis of contractual remedies, that of Fuller and Perdue,[7] the surplus realised at the completion of performance, or rather the expectation of that surplus which arises at the time of the agreement, is called 'the expectation interest'. The institution of contract is the general form of regulation of economic exchange,[8] but, in a most important sense, the legal contract is not what is essential to the exchange. It is the economic exchange, and particularly the surplus, that is essential. The actual performance of the contract is incidental to the obtaining of the surplus, indeed it is a cost of obtaining that surplus, and an understanding of contract remedies turns on seeing that 'expectation' is what fundamentally matters, not 'performance'.[9]

Fuller and Perdue called the sum of resource which a party commits to the contract in reliance on the other party's promise of performance 'the reliance interest'. In the above example (assuming that D breaches after the goods were put in a deliverable state), the reliance interest is the cost of the production of the goods. It is obvious that in some circumstances a combination of the expectation and the reliance interests may be needed properly to protect the expectation interest. For example, when, as has just been said, goods have been put in a deliverable state, full protection of the expectation interest would require compensation of lost net profit (expectation) and lost production costs (reliance).[10] If the breach took place before any work had been done (and no resale was possible), a bare expectation award would sufficiently compensate. These matters will be dealt with at much greater length in Part 2 below.

One can contemplate economic exchange without contract, and there would appear to be widespread evidence of this in pre-capitalist economies[11] and, less certainly and perhaps not fully understood,[12] exceptional examples of this within overall capitalist economies.[13] However, the law of contract has proven to be a necessary institutional

7 LL Fuller and WR Perdue Jr, 'The Reliance Interest in Contract Damages' (1936) 46 Yale Law Journal 52 and 373. This is widely regarded as the most important article on contract law: R Birmingham, 'Notes on the Reliance Interest' (1985) 60 Washington Law Review 217.

8 H Collins, *Regulating Contracts* (1999) ch 6.

9 For an argument quite to the contrary see D Friedman, 'The Performance Interest in Contract Damages' (1995) 111 Law Quarterly Review 628, which is discussed in ch 17 below.

10 It is possible to quantify lost expectation using a 'costs avoided' figure in a way which allows one to work with a gross, rather than a net, profits figure, but this is, it is submitted, less theoretically clear and this method will not be used here.

11 B Malinowski, *Crime and Custom in Savage Society* (1962) chs 2-5, 8-9.

12 As it is argued at pp 33-38 below, these cases are examples not of 'non-contractual' relations but of bargaining in the shadow of the law.

13 Eg F Pyke et al (eds), *Industrial Districts and Inter-firm Co-operation in Italy* (1990).

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support for the capitalist economies based on generalised exchange, by providing the security to C of being able ultimately to obtain a legally enforceable remedy against D when D breaches by failing to perform without a lawful excuse. The law of contract provides a framework within which parties can, if they wish, turn their voluntary agreement into a binding arrangement subject to external sanction. Although market forces would often induce performance, a third-party enforcement mechanism (such as a court) would be needed to deal with the recalcitrant promisor even in the case of an otherwise perfectly well functioning contract. Even if the parties had made an 'ideal' contract, there would be problems in deciding disputed questions of fact, in settling a disputed question of interpretation, and in compelling an unwilling party to pay the penalties for breach laid down in the contract. The law thus enables the parties to make arrangements which are ultimately much more reliable than those which depend exclusively on sanctions within their own control. (However, the latter sanctions are still important: this book places weight on 'self-help' remedies for breach of contract.)

The relationship of the exchange and the contract is realised in the distinction, central to the law of contractual relationships, between 'primary' and 'secondary' obligations.[14] The primary obligations are the parties' obligations under the exchange. In the above example, the seller's obligation is to deliver the goods[15] and the buyer's is to pay £1.1m. Each party's secondary obligation under the contract is to provide a remedy for a failure to perform (part or all of) his primary obligation. This secondary obligation is created at the time of agreement of the contract, but it is latent until breach, when C gains the right to seek it. The remedy may completely take the place of D's original performance, or may be combined with some residual part of it after breach. In the exceptional case where the remedy sought is compulsion of D's original performance, the primary and secondary obligations apparently merge, though we shall see that there is a very significant practical difference between a performance which D renders voluntarily in the expectation of profit and one which he renders under the compulsion of the court.[16]

The reason(s) for breach

The obvious question raised by this analysis of contract in terms of primary and secondary obligations is why D breaches? If we know that contract

14 The *Hong Kong Fir Shipping Case* [1962] 2 QB 26 at 64 and *Photo Productions Ltd v Securicor Transport Ltd* [1980] AC 827 at 848.
15 There probably also will be obligations that the goods are of the right quantity and of satisfactory quality, etc.
16 See pp 187-193 below.

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works by providing the threat of remedy, we have to ask why that is needed if we are to assess how well contract works. One obvious and indisputably correct answer to the question why D breaches which has already been implied is that D may act in bad faith. By virtue of having entered into a contract with C, D may be placed in a position where he may make a gain by not performing. If, in the example above, the buyer pays for the goods in advance of delivery, the seller will obviously have an incentive not to deliver the goods, for by avoiding the costs of delivery, he will be able to treat all of the payment as a profit, instead of being confined to the net profit that he would realise after delivery. (The prudential as well as moral reasons why the seller should not do this are obvious.) One may, indeed, dispense with 'exchange' at all and just steal. It is obvious that the very same individualistic orientation towards the maximisation of wealth that can lead to productive exchange can also lead to actions that undermine an exchange economy, such as violent expropriation, duress, fraud, etc.[17] The law of contract, and even more other bodies of law including the criminal law, would appear to have a vital role in providing a framework of 'peacefulness'[18] which keeps the maximisation impulse within parameters which mean that it broadly works towards productive exchange.[19] As Macneil has put it in the most thorough treatment of the issue by a contract scholar:

> [C]ontract between totally isolated, utility-maximising individuals is not contract, but war … contractual solidarity – the social solidarity making exchange work … at a minimum holds the parties together so that they will not kill and steal in preference to exchanging. [This is a matter of the] external god providing social stability, enforcement of promises, and other basic requirements. Within these rigid confines, the parties are free to maximise their individual utilities to their hearts' content.[20]

This role of the 'external god' may be traced back to Hobbes[1] and it is a vital part of the social contract as the political foundation on which the capitalist economies have been built.[2] The consequences of attempting

17 VI Pareto, *Manual of Political Economy* (1970) p 341: 'the efforts of men are utilised in two different ways: they are directed to the production … of economic goods, or else to the appropriation of goods produced by others'.
18 L von Mises, *Socialism* (1981) p 36.
19 EA Cannan, 'Review of NG Pierson, *Principles of Economics*' (1913) 23 Economic Review 331, p 333: 'the working of self-interest is generally beneficent … because human institutions are arranged so as to compel self-interest to work in directions in which it will be beneficent'.
20 IR Macneil, *The New Social Contract* (1980) pp 1, 14.
1 T Hobbes, *Leviathan* (1968) p 196.
2 CB Macpherson, *The Political Theory of Possessive Individualism* (1963).

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to encourage 'economic' action in the absence of the moral and political constraints which are the indispensable but often, highly mistakenly, taken for granted institutional framework of capitalism, have very sadly been visited on the former COMECON economies, the 'liberalisation' of which has led to widespread or even general gangsterism.[3] However, it is the argument of this section of this book that, *in the 'high trust'*[4] *established capitalist economies*, it is possible to treat as relatively marginal those cases in which D is motivated by bad faith, and in the majority of cases, those cases which it is most important to understand in order to grasp the function and structure of the law of remedies, breach of contract should be seen as a rational economic choice. In the established capitalist economies, the remedies for breach of contract, it will be argued, both essentially are and should be designed to regulate, and thereby facilitate, that choice.

The way in which this facilitation takes place is that there is a general preference for the award of compensatory damages rather than literal enforcement.[5] Either form of literal enforcement, whether D or a third party performs, is likely to cost (a great deal) more than the cost of D's original performance. For reasons which will be set out fully in Part 2, compensatory damages, however, can cost less than literal performance and perhaps even less than original performance. The crucial point which arises from this which it is necessary to grasp to understand remedies is that these cost differentials mean that D may choose voluntarily to breach for an economically rational reason. Put bluntly, D will breach when he believes that breach will, by a significant margin, more greatly maximise his resultant wealth than performance. This is the only reason there can be for breach on the basis of rational self-interest. As the law of contract is a legal institution for the facilitation of economic exchange, and as such exchange is at its heart motivated precisely by parties' wishes to maximise their wealth, much overtly moralistic criticism of breach as a dishonourable failure to keep one's promises is contradictory, or rather beside the point.[6] (Of course, this does not apply to gratuitous promises which are, precisely, non-contractual.)[7] This is even more the case when,

3 D Campbell, 'Breach and Penalty as Contractual Norm and Contractual Anomie' [2001] Wisconsin Law Review 68. The situation in Russia is described in S Hedlund, *Russia's Market Economy: A Bad Case of Predatory Capitalism* (1999) and S Menshikov, *Catastrophe or Catharsis?* (1990).

4 F Fukuyama, *Trust* (1995) Pt 3.

5 C is given a very strong incentive indeed – instructively, this incentive is commonly called a duty – to follow this general preference by the causation and mitigation rules which govern the quantification of compensatory damages: see chs 6-7 below.

6 PS Atiyah, *Promises, Morals and the Law* (1981) ch 6.

7 MA Eisenberg, 'The World of Contract and the World of Gift' (1997) 85 California Law Review 821.

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as we will see, breach performs a central, legitimate function in the market economies and, indeed, significantly contributes to such efficiency as those economies possess. If one's understanding of contract takes it that obligations should always be performed and that the courts play the principal role in this enforcement, then the actual picture of contract revealed by empirical studies – of ubiquity of breach and absolute rarity of court enforcement of primary obligations (indeed, of court action at all)[8] – is simply hopelessly bewildering. However, it is the shortcomings of that understanding of contract that produces the bewilderment, rather than it being the case that the actions of the contracting parties lack rationality. When properly understood, non-performance is perfectly rational.[9] The position taken in this book is that the function of the law of remedies for breach of contract is not to 'enforce' (primary obligations under) contracts but to regulate the occasions of breach; that is to say, to provide a framework which will allow breach in wealth maximising circumstances.

Of course, were there no rules regulating the terms and occasions of breach, then the law of contract would have no function. One must bear in mind that breach analytically is not just walking away from a contract (though this does in practice occur when C's damages are nominal). It is, as it were, walking away, but on terms, those terms essentially being the compensation of C based on protection of his expectation interest. In order that the underlying trust in the market economy be preserved, C should have his lost expectation compensated by D's payment of damages, and the law of contract has this compensation as its principal function.[10] This is the first rule of contractual remedies, the famous rule in *Robinson v Harman*, that a remedy should aim to put C in the position he would have been in had the contract been performed.[11] In any consideration of contractual remedies, then, the necessity of compensating C is never an issue, though how and how far this goal is realised is. With this in mind, let us examine what, analytically, are the only two reasons which there can be for breach according to rational self-interest. These are the maximisation of gain and the minimisation of loss through breach. In what immediately follows it will be argued that the function of the law of contract is best understood not as the general prevention of breach but as the regulation of the terms on which breach may legitimately be made.

8 See ch 2 below.
9 Collins, *Regulating Contracts*, above p 6, n 8, ch 6.
10 GH Treitel, *Law of Contract* (10th edn, 1999) p 7. Though it is too complex an argument to pursue here, by attempting to give certainty to compensation liability through the rules of causation, remoteness and mitigation, the damages rules allow D to fix the price of its goods accurately, for the cost of (inevitable occasional) failure should be part of the price of the good: see ch 6 below.
11 (1848) 1 Exch 850 at 855. See further ch 5 below.

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Breach in order to maximise gain: the concept of efficient breach

A powerful incentive to breach a contract arises where D expects to make a net profit from the opportunities created by his proposed breach. Although the courts are often concerned to see that C, the non-breaching party, is not better off as a result of the breach – the remedy for the breach should not be more valuable to him than performance would have been – they do not usually accept the converse. There is, in fact, a good economic case for so-called 'efficient' breach of contract based on the view that society should allow D not to perform whenever the breach will leave him better off after fully compensating C. An important reason for C's choosing, after breach, to seek money rather than compulsion of D's promised performance is that he may want to be completely free in deciding how to use that money. C may not even want to use the money to buy a substitute performance from a third person because, in the light of some new circumstances, he may have found a better opportunity, a new use for the money. Similarly, if D had not yet completed performance on his side, he would often wish to be released from that obligation so that he could redeploy to other uses the resources he would have devoted to the contract, eg his own time and labour. This freedom might be especially valuable to D because, since the contract was made, a more profitable opportunity might have opened up. It is claimed that society as a whole will benefit if D can deploy his resources to a more profitable use which will leave him with a net profit or surplus after he has paid damages to compensate C.[12]

The efficiency of allowing breach in this sort of case can best be appreciated by taking a contractual-type problem and transforming it into a similar problem within a single firm which is subject to an overall decision-making body (the central management). Instead of a contract between two strangers, suppose a similar arrangement between two branches of the same firm. How would the central management deal with a change in circumstances which affected the profitability of the arrangement? They would ask themselves the question whether, in the light of all the information *then* available, the firm as a whole would be better off by continuing the arrangement or by stopping it (viz which alternative would maximise profits overall or minimise losses overall?). Since the relevant circumstances may change over time, an arrangement

12 RA Posner, *Economic Analysis of Law* (5th edn 1998) p 133. The case most often cited in support of efficient breach of this profit maximising sort is not, on its facts, clear authority for this principle: *Teacher v Calder* 1897 SC 661. However, in that case it was firmly stated that C cannot recover from D the profits D made from his breach of contract but can recover only for his own (C's) losses: ibid at 672-673; affirmed on this point [1899] AC 451 at 467-468 (HL(Sc)).

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