PART I

THE CASE FOR STRICT LIABILITY

ONE

Let Us Never Blame a Contract Breaker

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Holmes famously proposed a "no-fault" theory of contract law: A contract is an option to perform or pay, and a "breach" is therefore not a wrongful act but merely triggers the duty to pay liquidated or other damages. This chapter elaborates the Holmesian theory, arguing that fault terminology in contract law, such as "good faith," should be given pragmatic economic interpretations, rather than be conceived of in moral terms. It further argues that contract doctrines should normally be alterable only on the basis of empirical investigations.

I.

My thesis is that concepts of fault or blame, at least when understood in moral terms rather than translated into economic or other practical terms, are not useful addenda to the doctrines of contract law. I have borrowed this thesis from Holmes, who in *The Common Law* (and later in *The Path of the Law*) drew a sharp distinction between tort and contract law, so far as issues of fault or blameworthiness are concerned.[1] In the case of an accident giving rise to a tort suit, he thought the loss should lie where it fell, that is, on the victim, unless the injurer was at fault, that is, negligent, and the victim faultless, that is, not contributorily negligent. He thus disapproved, in general, of strict tort liability. But a complication in his analysis arose from his belief in "objective" standards of liability; negligence was the failure of the average person to take proper care, even if the defendant was below average in his ability to do so.[2]

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[1] O.W. Holmes, Jr., The Common Law 107–10, 299–301 (Boston: Little, Brown, & Co. 1881) [hereinafter Holmes, The Common Law]; O.W. Holmes, Jr., *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897) [hereinafter Holmes, *The Path of the Law*].

[2] Holmes, The Common Law, *supra* note 1, at 108–10.

That belief was not a fatal defect in Holmes's fault-based theory of tort law, however. As Bernard Williams has reminded us, consequences, and not just states of mind, influence our moral judgments. "[I]n the story of one's life there is an authority exercised by what one has done, and not merely by what one has intentionally done."[3] So inability to meet society's expectations concerning care to avoid inflicting injury can, when injury results, be considered a species of fault.

But Holmes was wrong to think that the pockets of strict liability in tort law were inconsistent with a fault-based theory of that law. Strict liability is based on recognition that care is too limited a notion of the duty to avoid doing harm. If you keep a lion in your backyard to ward off intruders and it escapes and mauls someone even though you took every precaution to minimize the risk of escape, there is still the question whether the expected costs of keeping a lion (the risk of injury discounted by the cost of the injury if the risk materializes) exceeded the benefits. To classify an activity as "abnormally dangerous," thus making the applicable tort standard strict liability, is to adjudge those costs to exceed the benefits.

Holmes's theory of contract law is as fault free as his theory of tort law is fault saturated. He thought of contracts as options – when you sign a contract in which you promise a specified performance (supplying a product or providing a service), you buy an option to perform or pay damages.[4] The option feature is particularly pronounced when the contract contains a liquidated damages clause. You are promising that you will either perform or pay the amount specified in the clause. As long as you pay the damages awarded by the court in the promisee's suit for breach of contract, whether they are specified in the clause or computed according to the principles of contract damages, no blame can attach to your failure to perform even if it was deliberate – even if, for example, you did not perform simply because someone offered you more money for the product or service that you had undertaken to supply in the contract and you did not have enough capacity to supply both the promisee and the new, more necessitous customer.[5] You have not *really* broken your promise, because what you promised (though that is not how the contract will have been worded) was either-or: not performance but *either* performance *or* compensation for the cost of nonperformance to the other party to the contract.

[3] Bernard Williams, Shame and Necessity 69 (1993); *see also* Bernard Williams, Moral Luck: Philosophical Papers 1973–1980 20, 28–30 (1981). This is the pre-Socratic Greek theory of blameworthiness.

[4] Holmes, *The Path of the Law*, *supra* note 1, at 462.

[5] *See* Restatement (Second) of Contracts ch. 16, introductory note (1981); *id.* § 309.

The fact that the victim of a breach of contract can sometimes obtain specific performance or some other form of injunctive relief might seem a great embarrassment to Holmes's option theory of contract. But it is not if we bear in mind that injunctive relief is possible only when the remedy at law – that is, damages – is unavailable. For in such a case the contractual undertaking loses its either-or character; instead of a promise of performance or damages, it is a promise of performance or nothing, and that is not a choice the promisee would have agreed to. In contrast, a *general* entitlement to specific performance would, indeed, make contract law fault based. A court would not be willing to command a nonperforming party to perform, on pain of civil and criminal contempt and potentially astronomical fines if he did not, without considering whether he was in some sense "at fault" in not performing – whether, in other words, the costs to him of performing would have exceeded the benefits to the other party. Moreover, a general entitlement to specific performance would thwart some efficient breaches.[6] If *A* breaks his contract with *B* to sell to *C* because *C* will pay more than the harm (which equals damages) to *B* from the breach, the breach increases the social product: *B* is no worse off, and *A* and *C* are both better off. But if *B* is entitled to specific performance, *A* cannot sell to *C* without paying *B* to agree to terminate *A*'s contract with him, creating a bilateral monopoly situation (of which more shortly).

The option theory of contract also implies that liability for the breach of a contract is strict, that is, that the victim of the breach need not prove fault by the contract breaker (another reason why specific performance can't be the standard remedy for breach). The promise is to perform or pay damages, and so if you choose not to perform – even if you are prevented from performing by circumstances beyond your control – you *must* pay damages. It wouldn't make any sense to excuse you just because the cost of performance would exceed the benefits, for that would make the option nugatory.

Another way to understand this point is to note that an option has an insurance component. If you promise me either performance or some compensation in lieu of performance you are insuring me against the consequences of your nonperformance. As Holmes explained with characteristic directness:

> The consequences of a binding promise at common law are not affected by the degree of power which the promisor possesses over the promised event.… In the case of a binding promise that it shall rain to-morrow, the immediate legal effect of what the promisor does is, that he takes the risk of

[6] Ronald J. Scalise Jr., *Why No "Efficient Breach" in the Civil Law?: A Comparative Assessment of the Doctrine of Efficient Breach of Contract*, 55 Am. J. Comp. L. 721, 726–7, 763 (2007).

> the event, within certain defined limits, as between himself and the promisee. He does no more when he promises to deliver a bale of cotton.[7]

You will make such a promise – grant me such an option – if you are the cheaper insurer against the risk of nonperformance. Strict liability for nonperformance reduces transaction costs by optimizing risk bearing (the function performed in the tort setting by formal liability insurance).

The civil law approach to breach of contract is different from the common law approach. Liability is not strict; a party is in breach of his contract only if he "could reasonably have been expected to behave in a different way," that is, only if he was at fault in failing to perform.[8] And the victim's entitlement (to the extent actually honored) under civil law to specific performance discourages efficient breaches.[9] The duty of good faith – the common law version of which can, as we shall see, be explained in nonmoral terms – in civil law expands to include "[b]ad faith bargaining,"[10] which may not have a pragmatic, nonmoral, justification.

The common law and civil law conceptions of contract law may differ because the common law of contracts evolved from the law merchant and the civil law of contracts from canon law.[11] It is apparent which origin is more likely to produce efficient law. There is evidence that common law is, indeed, superior to civil law from the standpoint of promoting commercial activity.[12]

One might object to the common law rule of strict liability for breach of contract that a contracting party, at least if it is a corporation, either will be

[7] Holmes, The Common Law, *supra* note 1, at 299–300.

[8] Jürgen Basedow, *Towards a Universal Doctrine of Breach of Contract: The Impact of the CISG*, 25 Int'l Rev. L. Econ. 487, 496 (2005) ("[T]he fault principle is often considered to be an indispensable part of the law of obligations in civil law countries."); *see also* John Y. Gotanda, *Recovering Lost Profits in International Disputes*, 36 Geo. J. Int'l L. 61, 76 (2004). But the practical significance of the doctrinal differences between common law and civil law contract law has been questioned, as I note later.

[9] Scalise, *supra* note 6, at 726–7.

[10] William Tetley, *Good Faith in Contract: Particularly in the Contracts of Arbitration and Chartering*, 35 J. Mar. L. Com. 561, 568 (2004); *cf.* P.D.V. Marsh, Comparative Contract Law: England, France, Germany 65 (1994).

[11] Joseph M. Perillo, *Essay, UNIDROIT Principles of International Commercial Contracts: The Black Letter Text and a Review*, 63 Fordham L. Rev. 281, 308 n.190 (1994).

[12] *See, e.g.*, Edward L. Glaeser & Andrei Shleifer, *Legal Origins*, 117 Q. J. Econ. 1193, 1220–2 (2002); Paul G. Mahoney, *The Common Law and Economic Growth: Hayek Might Be Right*, 30 J. Legal Stud. 503 (2001); Salvatore Mancuso, *The New African Law: Beyond the Difference Between Common Law and Civil Law*, 14 Ann. Surv. Int'l & Comp. L. 39, 52 (2008); Simeon Djankov et al., *Debt Enforcement Around the World* 24–25 (Eur. Corporate Governance Inst., Finance Working Paper No. 147/2007, 2007), *available at* http://ssrn.com/abstract_id=953000. Yet by not distinguishing between liquidated damages clauses and penalty clauses, the civil law expands freedom of contract, although civil law judges do refuse to enforce "clearly unreasonable" damages clauses. Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses*

risk averse (because its shareholders can eliminate firm-specific risk by holding a diversified portfolio of stocks) or can buy insurance from an insurance company, eliminating the need for an insurance component in its contracts. But even large corporations often buy a great deal of insurance; the reasons have to do with managerial risk aversion (a large part of a manager's wealth may be his firm-specific human capital), tax avoidance, and the deadweight costs of bankruptcy.[13] It is difficult, however, to buy market insurance against the risk of being the victim of a breach of contract, because the risk and its consequences cannot be calculated with the actuarial precision that insurance companies insist on[14]; there is too much heterogeneity among contracts – too much uncertainty about the likelihood and consequences of a breach. The difficulty of insuring against breach of contract has been demonstrated in the current financial crisis by the near collapse of American Insurance Group (saved only by a federal bailout), which through credit default swaps and other devices had offered default insurance on a large scale.

Probing deeper, we can see that strict liability for breach of contract, too, is a sensible default provision, which allows the parties to specify excuses for failure to perform, such as *force majeure*. There are also default excuse provisions, such as impossibility and frustration, but the justification is economic rather than moral; they allocate risk as the parties could be expected to have done had they negotiated over the issue.[15]

Then, too, determination of fault would necessarily be based on matters outside the contract itself, whereas it is highly desirable, in order to minimize the expense and uncertainty of litigation, that most breach-of-contract cases be decided by a simple comparison (made without a trial or even pretrial discovery) of the language of the contract with the fact of nonperformance.

Eric Posner pointed out in his contribution to this volume that negligence can be discussed in nonfault terms, such as the antiseptic terms of the Hand formula, and thus could be proposed as a rival to strict liability in contract law without entry into the morality thicket. But if I am right that contracts contain an important element of insurance, and that strict liability for nonperformance also facilitates contract negotiation and minimizes uncertainty, strict liability is a more efficient regime for contract cases than negligence would be.

in Contracts, 43 Am. J. Comp. L. 427, 442 (1995); *accord id*. at 441; Lucia Ostoni, translation, *Italian Rejection of Punitive Damages in a U.S. Judgment*, 24 J. L. & Com. 245, 261 (2005).

13 *See* Richard A. Posner, Economic Analysis of Law 471 (7th ed. 2007).

14 *Cf.* Alfred W. Cortese, Jr. & Kathleen L. Blaner, *The Anti-Competitive Impact of U.S. Product Liability Laws: Are Foreign Businesses Beating Us at Our Own Game?*, 9 J. L. & Com. 167, 182 (1989).

15 *See, e.g.*, Posner, *supra* note 13, at 96–7.

Strict liability for breach of contract is not logically inconsistent with treating *willful* breaches differently from involuntary ones, as by awarding punitive damages for the former but not the latter. But contract law does not do that, and for good reasons. For what exactly is a "willful" breach? In the usual case of breach of contract, the cost of performance to the defendant would exceed the benefit to the plaintiff. The cost might be or might include an opportunity cost, as in my example in which the defendant discovered that he could sell his product to a third party at a higher price than the contract price. An opportunity cost is a real cost. To deem a breach motivated by a desire to avoid such a cost "willful," and impose punitive damages or order-specific performance, would encourage inefficient conduct – providing a product or service to a party (the contract promisee) who valued it less than someone else did.

Of course, the three parties involved might bargain their way out of the situation. But the bargaining would be costly because of the bilateral monopoly setting. The promisor could get out of the contract only by negotiating with the promisee, and the promisee could extract concessions from the promisor only by negotiating with him. Each party would be pushing to maximize his share of the surplus value that the breach would enable, and such a negotiation is costly and may fail. If it fails, the surplus is lost, and that is a social and not merely a private cost.

There is an element of perversity, moreover, in arguing that efficient breaches, being deliberate rather than compelled, should be discouraged. Efficient breaches are efficient. Involuntary breaches are often inefficient: The promisor miscalculated his ability to comply with the contractual terms to which he had agreed. I am not suggesting that he should be "punished"; but if fault were taken seriously in contract law, he, like a negligent injurer sued in tort, would be thought at fault whereas a party that committed an efficient breach and thus increases the social product would not be.

The common law rule, consistent with the "no-fault" theory of contract that I am defending as a sound positive as well as normative theory, is that punitive damages are not recoverable in breach-of-contract cases.[16] The major judge-made exception[17] is for breaches by liability insurance companies of their contractual duty to defend.[18] Insureds, especially when they are individuals rather than firms (e.g., a driver who has injured someone in

[16] Restatement (Second) of Contracts § 355 (1981).

[17] Consumer protection statutes, such as the Fair Debt Collection Practices Act, frequently provide for the award of statutory damages, which are similar to punitive damages. *See, e.g.*, 15 U.S.C. § 1692k (2006).

[18] *See, e.g.*, 2 Allan D. Windt, Insurance Claims & Disputes: Representation of Companies And Insureds § 9:26 (5th ed., 2007).

an automobile accident), often lack the knowledge or resources required to obtain competent counsel. This may doom their defense to a tort suit and even result in a judgment that takes liability for the injury inflicted on the tort plaintiff out of the coverage of the insurance policy altogether. Yet proof of damages in a suit against the insurance company for breach of its duty to defend may be impossible, or at least very difficult, because it would require a comparison of the performance of the insured's lawyer with the hypothetical performance of the hypothetical lawyer whom the insurance company would have retained or paid for had it acknowledged its duty to defend. And it would require a determination whether, even if a good lawyer would still have lost the case, at least the court would not have made findings that vitiated the company's duty to indemnify.

The award of restitution in contract cases might be thought inconsistent with the no-fault theory of contract that I am advocating. Restitution is normally awarded when the law wants to deter the defendant's conduct rather than just make him internalize its costs. In a copyright case, for example, the infringer may be a more efficient exploiter of the copyrighted work than the copyright owner, but if so, limiting the latter to compensatory damages would create a regime of compulsory licensing. Anyone who thought himself the more efficient producer could infringe with impunity, treating the damages that he would owe the copyright owner as a licensing fee. Restitution of the infringer's profits, by making the infringement worthless to him, forces the would-be infringer to negotiate with the copyright owner, thus preserving the property rights regime of copyright law.

To award restitution in contract cases, however – other than in cases of rescission, where the object is to return the parties to their precontractual position, which may require one of the parties to give up a benefit it received from the other (perhaps because of a mistake, a common ground for rescission), or in extraordinary situations in which for one reason or another compensatory damages would not compensate the victim of the breach – would create a property right in the enforcement of a contract; and that would give rise to the bilateral monopoly problem discussed earlier. The promisor who had a superior opportunity to that enabled by the contract could not avail himself of it (more precisely, could obtain no profit from seizing the opportunity) without a negotiation with the promisee. The problem is less acute in copyright cases, where there are often multiple potential infringers, who if prevented from keeping profits from infringement will instead compete to obtain a license from the copyright owner.

Consistent with the economics of the situation, the traditional rule was that restitution was indeed not available simply to give the victim of a breach of contract a choice between his loss and the other party's gain. The traditional rule is under pressure, but it is too soon to determine whether it will give way; there is very little case law on the question.[19]

Professors Thel and Siegelman, in their contributions to this volume, discuss what is in substance, though not in name, restitution as a remedy for breach of contract: the award of windfall damages to middlemen.[20] Suppose *A*, a farmer, agrees to sell seeds to *B*, a seed wholesaler, for $100, and *B* agrees to resell the seeds to *C*, a nursery, for $150. Before delivery is due, the price of seeds doubles, and *A* breaks his contract with *B* and sells the seeds to *D* for the new market price of $200. If *B* is able to cover, and honor his contract with *C*, he will incur a loss that he can charge to *A*. But suppose *B*'s contract with *C* contains a clause that allows *B* to terminate the contract without liability. *B* does so, renegotiates the contract, and sells the seeds to *C* at a price that yields *B* the same profit as the original contract would have done. *B* has incurred no loss as a result of *A*'s breach, yet most courts would deem him entitled to obtain damages from *A* equal to the difference between the market price ($200) and the price in his contract with *A* ($100). In effect, he receives *A*'s profit from the breach.

But this result is sound, because the breach has not produced an efficiency gain; *A* is selling at the market price rather than to someone who values the seeds more than *B* does. And *B*'s inability to sell to his buyer, *C*, at the agreed-upon price may damage his business relationship with *C* (and perhaps with other customers as well).[21] Moreover, if the market price of seeds had fallen, *B* would have incurred an uncompensated loss by reason of having had to buy them from *A* at the higher contract price, which would limit *B*'s ability to resell at a profit. Thus, what seem "windfall" damages to *B* are really just the outcome of an agreed risk sharing. The expectation of a "windfall" compensates *B* for the possibility that he will have to confer a "windfall" on *A*, depending on which direction the market price moves in.[22]

Thel and Siegelman suggest another case in which restitution may be an efficient remedy for breach of contract.[23] A building contract specifies a particular brand of pipe; the builder deliberately substitutes another brand, which is just as good but cheaper, and so the builder saves money and yet the

[19] See the illuminating discussion in Andrew Kull, *Disgorgement for Breach, the "Restitution Interest," and the Restatement of Contracts*, 79 Tex. L. Rev. 2021 (2001).

[20] Steve Thel & Peter Siegelman, *Wilfulness vs. Expectation: A Promisor-Based Defense of Wilful Breach Doctrine*, this volume, at 164.5.

[21] *Id.*, citing Victor Goldberg, Framing Contract Law 225 (2006).

[22] *Cf.* Tongish v. Thomas, 840 P.2d 471, 476 (Kan. 1992).

[23] Thel & Siegelman, *supra* note 20, at 169. The case is a variant of *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921), but there the substitution was inadvertent, and the court said that all

buyer is no worse off. This looks like the efficient result, and one wonders therefore why the builder's conduct should be deemed a breach, let alone a willful one requiring a sanction even though the "victim" of the breach has incurred no loss. (Whether it should be deemed a breach with zero damages or not a breach at all is of little consequence.) But as Thel and Siegelman explain, the fact that the contract specified a particular brand may have been intended to curtail the builder's discretion out of concern that any deliberate substitution might well be inferior yet that this might be difficult to prove. Another possibility is that the buyer wanted that brand for some idiosyncratic reason, which a court could not value. In both situations, restitution of the builder's profit from the substitution might be justified.[24]

I say "might" rather than "would" be justified because it can be argued that building contracts are understood by the parties to give the builder leeway to make substitutions in response to changes in the price and availability of the various components[25] and that the buyer is compensated for the builder's freedom by the lower price that the builder will charge in exchange for obtaining such flexibility. The specifications in the contract still are legally enforceable, so that the buyer has a remedy against a substitution that whether or not approved by the architect (and there may not be an architect) reduces the value of the property. But if there is no reduction in value, no damages can be obtained.

My argument thus far may be criticized on the ground that compensatory damages for breach of contract are often inadequate to deter inefficient breaches. That is a common ground for wanting to carve out a class of "willful" breaches and punish them in some fashion, for example, by ordering restitution of the contract breaker's profits.[26] But if a supposedly compensatory remedy is not compensatory, then alter the remedy. Yet is that really necessary? The parties are free to specify in advance (within reasonable limits) the amount of damages to which the victim of a breach will be entitled.

I hope I will not be misunderstood to be arguing that there is never wrongful conduct in the negotiation or performance of contracts. I wrote an opinion recently that presented an interesting example of such conduct.[27] Here is a simplified version. *A* and *B* make a written contract. Later, *A* sues *B* claiming

the plaintiff would be entitled to was the reduction in the value of his property as a result of the substitution – which was probably zero.

[24] *See* Richard A. Posner, Law and Legal Theory in England and America 55–58 (1996).

[25] *See* Richard A. Posner, Cardozo: A Study in Reputation 106 (1990); Todd D. Rakoff, *Implied Terms: Of 'Default Rules' and 'Situation Sense,' in* Good Faith and Fault in Contract Law 191, 209 (Jack Beatson & Daniel Friedmann, eds., 1995).

[26] *See, e.g.*, George M. Cohen, *The Fault Lines in Contract Damages*, 80 Va. L. Rev. 1225 (1994).

[27] Extra Equipamentos e Exportação Ltda. v. Case Corp., 541 F.3d 719, 722–26 (7th Cir. 2008).