

HYPOTHETICAL EFFICIENCY IS NOT GROUNDS FOR BREACH

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The law does not approve of the efficient breach of contract; it merely provides or fails to provide remedies.ⁱ Although there are situations where the law implies contract terms, there is no basis for an implied covenant of efficiency. Hypothetical contracts, purporting to incorporate a release where the cost of performance to the promisor exceeds its value to the promisee, cannot be used to bind people to results, even efficient ones, to which they did not agree.ⁱⁱ Where it is inefficient to demand performance, flexibility should come from the promisee who, having received in trust the power to limit the freedom of the promisor, may not abuse it.

I. INTRODUCTION

Parties contemplating breaching a contract face an intractably difficult situation. They may be legally bound by the terms of their agreement, but—perhaps as a result of a new opportunity or unforeseen circumstance—continued performance is no longer efficient. In such instances, some firms will simply breach, and pay damages. Others will comply with the terms of their contract, or seek to renegotiate. But, in all events, it seems legitimate to ask, if the only penalty the law imposes for breach is the payment of compensatory damages, and the breaching firm pays those damages, is it morally permissible to breach a contract whenever it is efficient to do so? This question, although hotly debated among the leading commentators,ⁱⁱⁱ remains unresolved, and, as a result, business leaders are left without sufficient guidance.

This article rejects efficient breach by showing how the arguments of one of its leading proponents, Steven Shavell,^{iv} fail and, in doing so, lays out a new path for parties to remain in relationship even where considerations of efficiency would call for breach and payment of damages. To be clear, Shavell does not contend that there is no moral obligation to keep promises.^v He would, however, limit that obligation to those instances where the parties' agreement expressly provides for the contingency at issue. He maintains that where a contingency occurs that is not expressly set forth in the contract—but as to which the law would require performance—breach is ethical so long as the cost of performance by the promisor exceeds its value to the promisee, and the promisor pays damages.^{vi}

I begin by explaining why the law cannot be read to favor breach plus the payment of damages even in the more limited situations Shavell identifies, and explore and reject the use of hypothetical contracts as a basis to support efficient breach. I then distinguish the covenant of good faith and other contract terms implied by law from an implied covenant of efficiency, which is what those advocating efficient breach would imply into every contract. I maintain that although economic considerations may provide information that may help business leaders consider normative questions, economics cannot serve as an effective moral compass for business decisions. Instead, business leaders should be guided by the values they use when making normative decisions in their interpersonal relationships, and avoid distancing themselves from such matters by viewing them as involving “just business” decisions.

II. MISPLACED RELIANCE ON THE LAW FOR A MORAL BREACH

A. *Misplaced Reliance on Holmes*

Those advocating the morality of efficient breach frequently begin with an appeal to the law based on the assertion that the law purportedly permits parties to breach contracts if they pay damages.^{vii} Shavell is no different. He opens with an observation, “[t]here is a widely held view that breach of contract is immoral.”^{viii} Whether or not he agrees with that view, he apparently recognizes that to win the day, he must disabuse his readers of the universality of the notion and convince them that there are some circumstances in which breach of contract is morally acceptable. He asserts:

It is manifest that legal systems ordinarily do allow breach—the law usually permits breach if the offending party pays damages—and it is commonplace that breach occurs.^{ix}

He, thereby, implies that so long as the promisee pays damages, breach of contract has the imprimatur of the law.^x However, the law generally does not approve of contract breaches. It merely provides or fails to provide remedies in the event a breach occurs. Shavell continues:

A tension exists between the felt sense that wrong has been done when contracts are broken and the actual operation of the law. This opposition has long been remarked by commentators.^{xi}

The commentator Shavell cites is Holmes, but he does not support Shavell’s argument. As one Holmes scholar observed in a similar context,

The misunderstanding of Holmes has [made it] commonplace to tie the economists’ notion of efficient breach to the towering legal authority of Holmes, who is incorrectly cast as articulating the idea of a *right* to breach a contract.^{xii}

Indeed, a closer reading of the Holmes^{xiii} reveals that he did not say that breach is permissible if the promisor pays damages. Instead, he maintained that law and morality are separate concepts that do not always coincide—and that people need to know the rules that the state will enforce so that they can guide their behavior accordingly. Indeed, “[i]n Holmes’ view, the breach of a contract was as much an offense against the law—a legal wrong—as a tort, not the free choice that the misinterpreters of Holmes believe he advocated.”^{xiv} Of course, Shavell knows that Holmes did not view efficient breach as morally proper,^{xv} and Shavell recognizes that “most sources on contract law and legal commentators who have addressed the issue of the morality of breach have considered it to have a generally unethical dimension.”^{xvi} Nevertheless, he implies that Holmes would support efficient breach.^{xvii}

B. *Weak Contractual Remedies Do Not Justify Efficient Breach*

He further argues that relatively weak contractual remedies and the limited role of specific performance imply that a breaching party who pays damages acts properly.^{xviii} Again, that is not the case. It is true that damages for breach of contract are generally limited to

providing the promisee with the benefit of the bargain.^{xix} But it is an error to imply, as Shavell appears to do, that the limitations on remedies mean that “the law usually permits breach if the offending party pays damages.”^{xx} “The fact that the law often fails to deter efficient breaches hardly means that it seeks to encourage such breaches.”^{xxi}

Contract damages are limited due to the nature of the obligation, and the idea that breaches are not generally viewed as being intentional.^{xxii} With respect to the requirement that damages be foreseeable at the time of contracting to be collectable by a promisee, for example, the rule places limits on “the liability of the breaching party whose breach unintentionally and unknowingly produces disastrous consequences.”^{xxiii} As Holmes recognized, “in most contracts if not in all[,] you have only a limited, and it may be no, power over the event.”^{xxiv} Accordingly, the law does not limit damages so as to encourage parties to breach and pay damages.^{xxv}

Similarly, it is true that the situations in which the law authorizes specific performance are limited.^{xxvi} But concepts of personal liberty and integrity and the impracticality and potential injustice associated with enforcing orders directing people to do things they do not want to do limit the availability of specific performance to those rare instances in which specific performance is feasible and necessary and where compensation cannot substitute for performance and should not be viewed as supporting efficient breach.^{xxvii} Indeed, the availability of damages for anticipatory breach, tortious interference with contract, and specific performance and other equitable remedies, make clear that the “operation of the law”^{xxviii} does not provide a justification for efficient breaches.^{xxix}

Thus, simply because the law does not provide sufficient remedies for breach of contract or for broadly granted specific performance or punitive damages regimens,^{xxx} does not mean that “the law usually permits breach[,]”^{xxxi} nor does the absence of such remedies imply that breach plus the payment of damages is proper under the law.

Of course, the foregoing discussion does not defeat Shavell’s argument. It simply rejects the idea that the law supports it. Because the law can and should generally be viewed as a reflection of morality not the other way around,^{xxxii} the way remains open for Shavell to identify situations where, the law aside, his position can be justified.

C. Hypothetical Contracts Do Not Make Efficient Breach Moral

1. “Hypothetical Complete Contracts”

Shavell’s most creative approach is his reliance upon “hypothetical complete contracts” as a means to argue that it is moral to breach some promises where the promisor pays damages. Shavell begins his discussion of hypothetical contracts with what is not in dispute. He grants that where a contingency occurs that is provided for in the contract, the promisor must perform and the failure to do so is immoral.^{xxxiii} Under such circumstances, and based on philosophical arguments concerning the duty to keep promises, he recognizes that the morality of the seller’s action depends upon the parties’ agreement.^{xxxiv} However, with respect to contracts that do not expressly provide

a rule of decision as to a particular contingency, he argues that proper conduct may be deduced by considering the “hypothetical complete contract,” that the parties would purportedly have entered into had they considered the contingency when they entered into their actual contract.^{xxxv}

To explore the morality of failures to perform under this and other contingencies, Shavell uses an example involving a contract for the removal of snow. In the first permutation of the example, he assumes that a thief steals the promisor’s “snow removal equipment.”^{xxxvi} Shavell begins by recognizing that if the contract expressly requires performance notwithstanding the theft of the seller’s^{xxxvii} equipment, then the failure to perform is morally wrong.^{xxxviii} Similarly, if the contract expressly excuses performance in the event of theft, he admits that the seller’s failure to perform is, of course, not morally wrong.^{xxxix}

Shavell points out, however, that contracts do not always (and generally cannot reasonably) address all possible contingencies.^{xl} To explore the question of whether a breach of such an agreement (what Shavell refers to as an “incomplete agreement”) is ethical, Shavell returns to his snow removal example. But now, the contract requires the seller to clear snow if it is in excess of five inches deep, and the contract is silent as to the contingency of the theft of the seller’s snow removal equipment. Shavell understands such a contract divides the world into two contingencies. If snowfall is less than five inches, performance is not required. If it is, he mistakenly assumes that under the “background, gap-filling law” performance is necessarily required (in the absence of efficiency considerations) notwithstanding that someone stole the seller’s snow removal equipment.^{xli}

Shavell maintains that where—as in the foregoing example—a contingency occurs that the contract purportedly does not expressly address, the morality or immorality of the decision not to perform depends upon what the seller and buyer would have done had they considered the contingency. To ascertain what the seller and buyer would have done, Shavell argues that morality is dictated by the contract that “rational parties” would have entered into had they considered the contingency.^{xlii} He refers to such contracts as “hypothetical complete contracts.” He further maintains that he:

Deduce[d] a very important characteristic of hypothetical complete contracts. Namely, performance will be required in a *contingency if and only if the cost of performance by the seller . . . would be less than the value of performance to the buyer.*^{xliii}

Shavell’s argument is that had the parties contemplated the contingency, they would have agreed (or not agreed) to require performance depending on the relative cost of performance to the seller and value of the service to the buyer. If the seller’s cost is higher than the value of the service to the buyer, Shavell contends that the parties would not have agreed to require performance. Instead, the parties would have agreed that the seller would pay the buyer an amount in excess of the value of the service to him (and an amount less than it would have cost the seller to perform). In such a situation, Shavell asserts that the breach would not be immoral.^{xliv}

2. *Hypothetical Contracts Can’t Create Real Obligations*

Shavell's reliance upon hypothetical contracts does not inform the question of whether breach of contract may be moral because demonstrating that a person would have agreed to X does not show that it is fair to hold the person to X when there was no agreement or when circumstances changed. As Dworkin explained, "a hypothetical contract is not simply a pale form of an actual contract; it is no contract at all."^{xliv}

Where a person actually enters into a contract but miscalculated his "self-interest, the fact that he did contract is a strong reason for the fairness of holding him nevertheless to the bargain."^{xlvi} However, Shavell does not argue that his buyer and seller actually entered into the hypothetical contract. Instead, he maintains that if rational buyers and sellers were in such a position, they would have agreed to certain terms. The argument is a hypothetical one, and "hypothetical contracts do not supply an independent argument for the fairness of enforcing their terms."^{xlvii}

Let's take Shavell's example. You (the seller) might say to me (the buyer), "you would have agreed that no performance was required in the event that my snow equipment was stolen." Indeed, it may well be true that I would have so agreed because I wanted my parking lot cleared and I did not want to lose the chance to get you to do it. I might also concede that I would have agreed to allow you to escape performance in the event that your snow equipment was stolen, but that does not mean that I did in fact agree. "If I had not in fact agreed, the fact that I would have in itself mean[s] nothing."^{xlviii} Accordingly, the assertion that it is fair to deem the buyer to have consented to allow the seller to escape performance because he would have done so if asked at the time of contracting, does not mean that it is fair to hold the buyer to such a position later, particularly under different circumstances, when the seller did not consent.^{xliv}

Dworkin's example is helpful here.

Suppose I did not know the value of my painting on Monday; if you had offered me \$100 for it then I would have accepted. On Tuesday[,] I discovered it was valuable. You cannot argue that it would be fair for the courts to make me sell it to you for \$100 on Wednesday. It may be my good fortune that you did not ask me on Monday, but that does not justify coercion against me later.¹

So, Shavell's argument must stand or fall on its own. The hypothetical contract may be a "device for calling attention to some independent argument for the fairness of the . . . [conclusion, but it cannot] rest on the false premise that a hypothetical contract has some pale binding force."^{li} Tracking Dworkin's argument further, if it can be shown that allowing a seller to escape performance when the costs exceed the value of the performance is in the best interests of everyone (something Shavell does assert) that may be a good argument for the fairness of the rule. However, one must distinguish between what would be fair or in the interests of all parties at the time of contracting and what would be so at times after contracting when the actual occurrence took place. Returning to Shavell's example, the fact that it may have been in the Buyer's interest at the time of contracting to agree that the Seller could escape performance if he were not feeling well, does not mean that that would be in the interests of the Buyer to do so at the time of the snow. The Buyer might want that Seller to get himself out of bed and plow the

parking lot. Again, the fact that the Buyer would have agreed to the contingency at the time of contracting does not, in and of itself, carry the day for the Seller or for Shavell.

What remains unclear, however, is whether Shavell would perform the cost/benefit analysis as of the time of the occurrence or as of the time of contracting. But, either way, the result would not help his argument. If Shavell performs the cost/benefit analysis as of the time of contracting, and there was no such agreement at that time, it would be unfair, for the reasons set forth above, to hold the parties to that calculation. Similarly, if the cost/benefit analysis is performed at the time of the occurrence of the contingency, the Seller and Buyer would have the actual opportunity at the time to conduct such an analysis and renegotiate to form a new contract or reform the old one. If they do not do so, it is an indication that they do not think that such an arrangement would be fair. If they reach a new agreement or agree to reform their contract, the new obligation arises from the reformed or the new agreement, and there is, of course, no reason to consider whether a breach of the original agreement was ethical or to pay damages because that agreement would no longer control.

3. Where Performance Is Excused, Efficient Breach is Unnecessary

Sometimes, performance is required because the unanticipated contingency is of the type that reasonable people would think the seller should deal, and other times it is of the type where performance is impracticable, and, therefore, it is excused. In sales of goods transactions governed by the Uniform Commercial Code (“U.C.C.”) § 2-615, “nonperformance may be excused if performance has been made impracticable by a contingency, the nonoccurrence of which was a basic assumption of the contract.”^{lii} The Restatement (Second) of Contracts similarly provides for the discharge of promises where performance is impracticable:

Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.^{liii}

So, with respect to Shavell’s example, the theft of the promisor’s snow removal equipment, it seems fair to say that the theft was not the fault of the promisor, and that the contract was silent as to the contingency. However, it is not clear from the available facts whether the performance was impracticable due to “extreme and unreasonable difficulty, expense, injury, or loss to one of the parties.”^{liv} Shavell does not identify the particular equipment at issue or whether the promisor could procure similar equipment from another source. “A party is expected to use reasonable efforts to surmount obstacles to performance.”^{lv} If there were no reasonably available alternative source of snow removal equipment, and the promisor could not otherwise arrange to remove the promisee’s snow, the performance may well be deemed to be impracticable. Here it is telling that Shavell refers to “*snow clearing equipment*”^{lvi} and others who have challenged him recast that equipment as a “*snow-shovel*”^{lvii} and the “*clearing of snow*”^{lviii} to “*shoveling*.”^{lix} The difference could be material to the question of whether performance is impracticable.^{lx}

At least one commentator has argued that the “background law” would require performance in the case of Shavell’s example of the theft of “snow clearing equipment” in a contract that merely provides that the “seller shall clear snow”^{lxix} on the grounds that “the doctrine of impossibility [purportedly] does not excuse nonperformance in the case of equipment failure of theft.”^{lxxii} However, the law is not conclusive on the issue because the result hinges, in large measure, on the feasibility of obtaining alternative snow clearing equipment as to which we lack necessary facts. Clearly, it would seem easy for the seller to purchase or borrow a shovel, and, therefore, reasonable to conclude that the theft of the shovel should not absolve her of her duty to perform. However, if the snow clearing equipment were a heavy truck and a plow, and such equipment were required to clear a large parking lot owned by the buyer, it might well be impracticable for the seller to perform, and similarly unreasonable to find her in breach particularly where the truck and plow were unavailable due to the fact that a third-party stole the equipment.

Instead of winning the day for Shavell, however, a defense based on impracticability begs the following question. If the background law would not require performance, why should the promisor be required to pay damages?^{lxxiii} Why would we need the hypothetical contract analysis? By its terms, Shavell’s argument only applies to “incomplete contracts.”^{lxxiv} Where a contingency occurs that is not set forth in the contract with respect to which the law does not require performance, there is no need for Shavell’s analysis. At the other end of the spectrum, when all the promisor would have to do is to purchase or borrow a new shovel, there is no need to question the duty to perform.

It is not always clear, as Shavell suggests, that, “contracts should be viewed through the lens of hypothetical complete contracts, to which there would be a moral obligation to adhere.”^{lxxv} Sometimes, performance is required because the unanticipated contingency is of the type that reasonable people would think the seller should deal, and other times it is of the type as to which performance is impracticable, and, therefore, is excused. In either event, there is no need for resort to a hypothetical contract or economic analysis.

4. *An Efficient Result is Not Necessarily a Just One*

Now, please consider the following, slightly modified, well-known hypothetical scenario.^{lxxvi} Train tracks run through a farmer’s land. Sparks from the train cause a fire, and \$100 in damages to the farmer’s property. Assume also that it would cost \$50 for the railroad to install equipment that would block the sparks from landing on the farmer’s property. It would make no difference in terms of economics whether the farmer entered into a contract to pay \$50 to induce the railroad to install the spark arrester, or for the railroad to pay \$50 to install it.^{lxxvii} However, given that the railroad caused the sparks, the just result would be for the railroad to assume the costs. Efficiency, however, has nothing to say about justice in this example and a similar statement may be made with respect to Shavell’s snow removal examples.

Efficiency considerations do not speak well to the question of whether it is just to find the seller to have acted unethically for failing to remove the buyer’s snow in the “incomplete contract” contexts that Shavell identifies. It may or may not be efficient for the seller and buyer to be deemed to agree that performance should have been required in matters Shavell lists as

among those important to the seller, such as “theft of his snow-clearing equipment, illness of his crew, snow so deep that it makes roads impassable—or to the buyer—unexpected travel out of town over the winter, sale of her home, inheritance of snow clearing equipment.”^{lxviii} But, the conclusion that it may be efficient for the seller to be released from an obligation to perform does not make it right for him to be released.

There must be a source for obligations. If the parties may reasonably be held to have agreed to require performance, then they generally must perform. If the agreement does not provide for such an obligation, then there is no obligation to perform. To this point, I suspect that Shavell would agree. Where we part ways is the finding of an obligation to act or an excuse not to act solely based on considerations of efficiency in the “incomplete contract” situations he describes. That is not to say that parties to contracts—or even legislatures by operation of law—could not include a term that provides that parties to contracts are deemed to have agreed upon the most efficient course where their agreement fails to expressly provide a rule of decision.^{lxix} However, in the absence of such an agreement or rule of law, there is no legal basis to hold the parties to such terms. The obligation, if any, must be found in the expression of the will of the parties. Where it is absent, economic considerations should not be heard to create it.

III. THERE IS NO SUCH THING AS AN “IMPLIED COVENANT OF EFFICIENCY”

Perhaps Shavell is simply arguing for the reading of an implied term into every contract—one that might say that with respect to contingencies not expressly identified, the duty to perform will be determined by whether the cost of performance exceeds its value.

A. *Distinguishing the Covenant of Good Faith From an Implied Covenant of Efficiency*

Such an argument is in some ways akin to the application of the covenant of good faith, which is implied, in most jurisdictions, into every formal contract.^{lxx} As one court explained,

The implied covenant of good faith and fair dealing involves a “cautious enterprise,” inferring contractual terms to handle developments or contractual gaps that the asserting party pleads neither party anticipated.^{lxxi}

That sounds somewhat like Shavell’s hypothetical complete contract. Yet, as that court further explained:

We will only imply contract terms when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby frustrating the fruits of the bargain that the asserting party reasonably expected. When conducting this analysis, we must assess the parties’ reasonable expectations at the time of contracting and not rewrite the contract to appease a party who later wishes to rewrite a contract he now believes to have been a bad deal.^{lxxii}

Shavell may simply be arguing that the reasonable expectation of the parties at the time of contracting can be no other than performance when the cost of performance is less than its

value and no performance when the facts are otherwise. Perhaps Shavell is saying that had his seller and buyer considered the contingency (theft of snow removal equipment) they would have resolved it in the way he indicates and that it would be bad faith to construe the contract any other way. But it is one thing to require good faith in performance of an agreement and quite another to allow a promisor to escape obligations that the agreement implies should exist. Additionally, if the actions at issue rose to the level that they would constitute a breach of the covenant of good faith, the consequence would not be breach plus payment of damages, but rather enforcement of the terms of the contract, and there would be no cause to pay damages. Thus, the implied covenant of good faith acts to protect the parties’ actual agreement, not to allow one party to escape what would otherwise be its obligations under the contract.

In any event, it appears that the covenant of good faith may actually work to preclude a party from recasting an agreement in some of the “incomplete contract” situations Shavell describes where the parties could have, but failed to address the eventual contingency—particularly where they do so to reap an economic advantage. In one case, for example, the Delaware Supreme Court recently considered the claim of two retired shareholders who argued that the company violated the implied covenant of good faith by redeeming stock rights held by the shareholders on the eve of the merger notwithstanding that the company knew that the merger would markedly increase the value of the stock. The Court held that it was not a violation of the implied covenant of good faith for the company to redeem its stock. The Court explained that the shareholders should have anticipated the possibility of such a merger when they entered into their original agreement with the company and provided for it in their agreement. The Court was unwilling to cure the failure to do so notwithstanding that it seemed clear that had the parties considered the contingency prior to contracting that they would have agreed to it.^{lxxiii}

As applied to Shavell’s snow removal example, the seller might argue that had he and the buyer considered the question of whether performance was required if the seller’s snow removal equipment was stolen, they would have included a provision in the contract relieving the seller of the obligation to perform on the grounds that the cost of such performance would exceed its value. However, in the absence of such a provision, the covenant of good faith would not imply such terms. As the Delaware Supreme Court observed, “The policy underpinning the implied duty of good faith and fair dealing does not extend to post contractual rebalancing of the economic benefits flowing to the contracting parties.”^{lxxiv} Indeed, it may constitute bad faith conduct for a party to attempt to seek to escape contract terms so as to obtain a better offer.^{lxxv}

B. Statutorily Implied Terms Don’t Fill the Gap

Alternatively, Shavell might argue that the law should imply a term into contracts that provides that permits a promisor to escape its obligations where the costs of performance exceed its value to the promisee. Such a provision might be viewed as akin to the operation of the Uniform Commercial Code, which implies the following terms consistent with recognized business practices notwithstanding that the parties may not have actually agreed to them.

Omitted Term	Implied Term
Delivery location	Seller’s place of business ^{lxxvi}

Time for shipment	Reasonable time ^{lxxvii}
Time payment is due	Upon receipt of goods ^{lxxviii}

The purpose of implying the foregoing terms under the U.C.C., however, is to prevent a contract from being held to be indeterminate and unenforceable and to protect the parties' reasonable expectations. The purpose is to save the agreement where there is one. Tellingly, the U.C.C. does not fill in a gap where the parties did not agree, such as where the parties did not reach an agreement concerning the quantity of goods to be sold or purchased. The reason is that where the parties do not reach an agreement as to the quantity of goods to be shipped, there is no agreement to enforce.

In Shavell's incomplete contract context, there is an agreement. The question is whether breach of that agreement, with respect to undelineated contingencies is ethical. It is possible that a statute could be enacted that provides that if an undelineated contingency occurs, performance will only be required if the cost of performance is less than its value. But no such statute exists, and if it did, it would be inefficient. It would create a situation in which parties would likely find it necessary to identify and expressly provide for every possible contingency. Ultimately, the question is whether a result under a contract is a just one depends upon the agreement of the parties and their relative bargaining power. As far as the law is concerned, however, the obligation must arise from the agreement or be implied at law. Shavell maintains that contract terms only control—without application of his hypothetical complete contract construct—when they expressly provide a rule for decision with respect to the contingency, but neither the agreement of the parties nor a statute provide a basis for such a rule.

IV. DEFINITIONS OF MORAL BEHAVIOR DO NOT SUPPORT EFFICIENT BREACH

Shavell recognizes that others may disagree with his definition of moral behavior and he seeks to explain why his view is correct. Accordingly, he identifies three criteria that he maintains support his position. For the reasons set forth below, it is not clear that they do.

A. *Promises Are Contracts the State Will Enforce*

Shavell writes that the first criterion “by which a definition [of moral behavior] might be chosen”^{lxxix} is based on how people commonly view breaches of contract. Here, he recognizes again that people generally equate contracting with promising and breach of contract with breaking one's word and moral blame. If breaking one's word is morally wrong, so too is breaking a contract. Shavell, however, objects to the equation of contracts with promises based on the assertion that damages are available for breaches of contracts and not breaches of promise.^{lxxx} He writes: “[w]e do not pause to consider that *contracts are in fact different from promises* made in social intercourse, and that breaking contracts, unlike breaking promises, results in the payment of damages.”^{lxxxii} If, reasons Shavell, promises are different from contracts, then there might be a reason to disassociate the “ethically incorrect aspect” of promise breaking from contract breaking.^{lxxxii}

However, contracts are promises for the violation of which the law provides a remedy.^{lxxxiii} Accordingly, Shavell's argument has trouble getting off the ground. If contracts are enforceable promises, it is not clear that there are meaningful differences between them. Indeed, it is not even clear what type of promise Shavell is seeking to distinguish from contracts-promises for which the law provides a remedy or those that do not. But if the law provides a remedy, the terms (promise and contracting) are identical and the contract should be similarly binding.

Moreover, if the law does not provide a remedy, that would not make the breach of such promises ethical. Statutes of frauds provide good examples of instances in which the law declines to enforce what may be morally binding obligations. Statutes of frauds require certain contracts to be in writing to be enforceable.^{lxxxiv} But the absence of a legal remedy does not make the breach of contracts within the statute of frauds any less immoral, nor does the presence of a remedy absolve the breaching promisor of moral culpability. Consider the following example. If A promised to buy B a house if B would agree to marry A, and B, in fact, married A but A refused to buy the house, the moral character of A's breach of promise would not depend upon whether B can enforce A's promise. B would justifiably feel wronged and the relationship would be damaged regardless of whether B is able to enforce A's promise. Clearly, A's wrongful inducement to marriage seems deserving of moral condemnation without regard to whether the law provides B with a remedy.

The foregoing examples may not be entirely fair to Shavell. He appears to be arguing that the existence of a remedy ameliorates any wrong arising out of a breach of contract because it puts the promisee in as good as or better position than he was in before the contract. Nevertheless, his argument that breaches of promise may be morally different from breaches of contract on the grounds that remedies exist for breaches of contract is not a strong one. The morality of a breach, whether of a promise or a contract, does not depend upon the availability of a remedy. Accordingly, the first of Shavell's criteria for a definition of moral behavior does not support his argument.

B. There is No Obligation to Adhere to a Hypothetical Contract

The second criterion of a definition of moral behavior Shavell offers as supportive of his thesis, is that "contracts should be viewed through the lens of hypothetical complete contracts, to which there would be a moral obligation to adhere."^{lxxxv} As set forth above,^{lxxxvi} hypothetical contracts cannot serve as independent sources of obligations. Simply because I may have been willing to agree to something on Monday, does not mean that it is justifiable to hold me to that position on Friday when I did not so agree.

C. Efficient Breach, Even Limited to the "Incomplete Contract" Context, Would be Inefficient and Contrary to the Expectation of the Parties

Shavell offers a third criterion for a definition of moral behavior that he maintains supports his argument. He explains that a theory of moral behavior is a good one if it "promotes the welfare of contracting parties."^{lxxxvii} Shavell maintains that where performance is only required when the cost is less than the value, both parties are better off than in a system that

requires performance. If the seller breaches, Shavell asserts that it must have been in his interests to do so. And, if the seller pays the buyer expectation damages, he asserts that, “the buyer is not harmed.”^{lxxxviii} Shavell further argues that a system in which a seller can decide to breach and pay damages also allows the seller to offer his services at a lower price because of the possibility of breaching and paying damages.^{lxxxix}

However, as note above, what the parties might have otherwise agreed to at the time of contracting is not relevant to what they are obligated to do at the time of the contingency when they did not so agree. In any event, at the time of the occurrence, there seems to be little need for the hypothetical contract concept because the parties could—at that point—reform their contract or enter into a new one. Assuming parties are acting in good faith, the failure to settle the dispute at the time of the occurrence would likely occur where the promisee believed that the offer of settlement was insufficient to cure the breach.

As Shavell appropriately recognizes, compensation schemes in the United States frequently undercompensate the promisee.^{xc} However, one aspect of undercompensation that he does not discuss is that expectation damages may not repair the harm the breach caused to the level of trust^{xcⁱ} in the business relationship. The promisor is subject to moral blame for the breach of trust, and the promisee is to be on guard for future misdeeds. Thus, the payment of damages in the absence of release or forgiveness by the promisee may not be enough to repair the harm the breaching promisor caused. The act of promising transfers to the promisee the power to release the promisor from her obligations.^{xcⁱⁱ} Once a promise is made, the promisor can try to make it right and can provide compensation, but the power to forgive the breach of trust lies with the promisee.

Moreover, in addition to the inadequacy of damages, there are other practical problems with Shavell’s argument that considerations of efficiency “promote the welfare of contracting parties”^{xcⁱⁱⁱ} as measured by considerations of efficiency. Shavell does not explain how the seller is to establish that his costs will be greater than the amount at which the buyer values the performance. In practice, the seller is likely to simply encounter a situation in which it becomes unprofitable for him to sell the product to the promisee or perform a service at the agreed price. So, he may decide to breach without regard for the value the promisee attributes to his performance.

In reality, breaching parties rarely volunteer to pay their promisees compensatory damages. They ignore requests for payment and demand letters. They force litigation knowing, as Shavell properly recognizes, that contract damages are generally undercompensatory. All too often, breaching parties also force their commercial partners to make their private disputes public and incur attorneys’ fees and other costs of litigation. In order to get money that the promisee is owed, the promisee may have to submit to intrusive discovery practices—exposing the victim of breach to potential harm to its reputation. In short, it can pay to be obstructionist, and it is not clear that breach plus payment of damages offers a realistic way to promote the welfare of the parties.

V. CONCLUSION

Shavell recognizes that people hold strongly to the view that it is immoral to break promises. People who hold that view generally do so on categorical grounds, and no amount of economic reasoning is likely shake them from it. Accordingly, he does not make a global claim that one should be permitted to break a promise or a contract based on considerations of efficiency.^{xciv} Instead, he constructs the concept of the “incomplete contract,” and argues that where a contract is “incomplete,” no performance is required if that performance would be inefficient. But this is a slight of hand to allow for the argument that certain contracts should be deemed less binding than others. Incomplete contracts are not contracts at all, and valid contracts are enforceable.

But Shavell speaks to a nagging problem. What should happen when enforcing a contract by its terms would produce inefficient results? Should parties be held to agreements when the promisor is willing to pay the promisee an amount that would give the promisee the financial equivalent of the benefit of the bargain? Why should the promisee be permitted to insist on performance when the promisor could use his resources more efficiently and produce greater economic benefits for both parties than had he been forced to perform?

I think the answer to these questions lies in the value of promising to human relationships. Most people would not want to live in a society in which people could break their promises—even if it were efficient for them to do so. Categorical imperatives do not yield easily to utilitarian arguments. The power to promise is central to human relationships.^{xcv} Upon promising, the promisor gives over to the promisee control over his right to act contrary to his promised performance. The power to promise, thereby, serves the relationship by allowing the promisee to proceed with her life projects with less worry that the promissory will change his mind.^{xcvi}

Business relationships are human relationships, and the power to promise serves those relationships as well. Sometimes all business people want is predictability and performance. For example, if I need many parts to manufacture a cell phone, I may not care whether a particular part costs \$20 or \$25, but I may care very much if my suppliers could opt-out of the deal if they find a better opportunity. Shavell might argue that the seller who wanted out would have to pay damages to compensate me for my loss. But if every supplier did that, it would be very difficult to operate a business. My business would be transformed from a telephone manufacturing company to a collections agency that makes poor telephones.

Economic concepts are generally justified based on consequentialist moral theories, and it shares many of the same philosophical strengths and weaknesses. Economics may be able to inform the question of efficiency, but it cannot speak to the question of “what decision will increase trust in business relationships?” Matters of contract are not “just business” issues. They involve people making promises to one another. They involve people doing what they say they are going to do because they said they are going to do it. People want to live in a society that operates according to those rules and, such behavior is of value to society.

Then again, there are times when it seems unfair to hold a party to its promise even when that party is not in a position to compensate the promisee for its loss. Consider the waiter who is also an aspiring singer. On Friday, he agrees with his employer to wait tables that Saturday,

which, it turns out, is New Year's Eve. It is the most profitable day of the year for the restaurant and the restaurant owner will have some difficulty finding someone else to work should the waiter fail to appear. On Saturday morning, however, the waiter receives a call from a director of a charity event at Lincoln Center. The waiter learns that he will have an opportunity to sing at Lincoln Center (something the waiter has dreamed of doing his whole life), but for which he will not be paid, and the waiter is otherwise unable to compensate the restaurant for its losses.

Who is to say that the cost of performance by the waiter (working at the restaurant and not appearing at Lincoln Center) is more or less than the amount the restaurant values his work. Value is not always measurable, and it makes little sense to try to weigh incommensurable considerations. The problem is, the waiter agreed to work at the restaurant. The waiter has a valid legal obligation to the restaurant, and what he may or may not have agreed to in a hypothetical contract cannot serve to release him from his actual contract even if it did not mention a singing contingency. So, perhaps the law should bend here.^{xcvii} But if it doesn't, the promisee should consider doing so. Just as it is important for the promisor to do that which is consistent with his honest convictions,^{xcviii} it is necessary that the promisee also act based on what he must understand is a once in a lifetime opportunity for another human being. Accordingly, although the law may not release the waiter—the owner probably should do so—just as she would if a member of his family was in a tragic accident and needed his care.

All this is not to say that economic considerations cannot play any role in informing the outcome of our ethical decisions. It is possible that they would support the waiter in his dream and lead to expanded levels of trust in contractual relationships, but, then again, they may not. But, there seems to be little reason to elevate economics over other values^{xcix} (if you count economics as a value)^c and over other considerations such as trust in determining whether a breach of contract is immoral.

If anything, the legal system . . . should . . . underwrite relationships of trust, of general reciprocity, and penalize breaches of trust. . . In hard times—such as shortages, strikes, price increases [contingencies of the kind at issue in Shavell's incomplete contracts]—parties are expected, within limits, to tolerate shortfalls in performance, lend each other mutual support, and share in losses.^{ci}

Where relationships of trust may be preserved by “tolerating shortfalls in performance,”^{cii} perhaps it is improper to so quickly cry “breach.” Similarly, parties should not look for “efficient” ways to escape meeting the reasonable expectations of their business partners.

In short, considerations of efficiency may help identify the most cost-effective course of conduct, but they should not be used as the primary method for determining whether contract breach is moral or immoral. The guide for behavior in our capacity as business people is not different from that which we apply in our interpersonal relationships. In interpersonal relationships, few of us look to economics as our exclusive moral compass. There seems to be little reason to take a different approach in our business relationships.

*I am grateful for the critical comments of Michael Gerber, Seana Shiffrin, and Alan Strudler. I also extend my thanks to the editors of the West Virginia Law Review for their editorial comments. In October 2013, the West Virginia Law Review will publish this article as part of volume 116.

ⁱ Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 457–462 (1897) (“People want to know under what circumstances and how far they will run the risk of coming against what is so much stronger than themselves. . . . The object of our study, then, is prediction, the prediction of the incidence of the public force through the instrumentality of the courts. . . . A legal duty so called is nothing but a prediction that if a man does or omits certain things he will be made to suffer in this or that way by judgment of the court; and so of a legal right.”); Robert W. Gordon, *Unfreezing Legal Reality: Critical Approaches to Law*, 15 FL. STATE U. L. REV. 195, 213, 214 n. 35 (1987) (“What acts are those which will cause society to come forward with a strong arm?” . . . “The issue is always: what kind of property, what kind of contracting regimes, should a legal system put its force behind? Abstract notions of property and contract, liberty and efficiency, give one literally no help at all in answering these questions.”); *but cf.* ROBERT P. WOLFF, IN DEFENSE OF ANARCHISM 9 (1998) (“Legitimate. . . authority thus concerns the grounds and sources of moral obligation.”).

ⁱⁱ Ronald Dworkin, *The Original Position*, 40 U. CHI. L. REV. 500, 501 (1973).

ⁱⁱⁱ Compare Shavell, *Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts*, 107 MICH. L. REV. 1569 (2009) with Seana Shiffrin, *Could Breach of Contract be Immoral?*, 107 MICH. L. REV. 1551 (2009).

^{iv} Shavell, *supra* note iii.

^v Shavell admits, that “there are well known grounds for finding that individuals have moral obligations to keep. . . . promises [that] . . . provide. . . explicitly for a contingency.” Shavell, *supra* note iii, at 1571. *See also* Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439, 444 (2006) (“[C]ontract is a species of a promise for which there are well-known grounds for finding moral obligations.”).

^{vi} Shavell, *supra* note iii, at 1570–1571.

^{vii} *Id.* at 1569.

^{viii} *Id.*

^{ix} *Id.*

^x *Id.*

^{xi} *Id.*

^{xii} Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1090 (2000).

^{xiii} Shavell, *supra* note iii, at 1569 (citing O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897)).

^{xiv} Perillo, *supra* note xii, at 1087.

^{xv} In a 2006 article, Shavell recognized that Holmes did not approve of efficient breach. Steven Shavell, *Is Breach of Contract Immoral?*, 56 EMORY L.J. 439, 440 n. 5 (2006). However, Shavell placed that admission in a footnote after strongly implying in the text that Holmes would have approved of efficient breach.

^{xvi} Shavell explains mildly that Eisenberg’s view is that “a breach might be immoral.” *Id.* at 456. In reality, Eisenberg largely rejects efficient breach not only because it was not what the parties bargained for, but also because it is not efficient. He wrote, “[t]he theory of efficient breach does nothing to promote efficiency. On the contrary, if widely adopted the theory would promote inefficiency.” Melvin A. Eisenberg, *Actual and Virtual Specific Performance*, 93 CALIF. L. REV. 975, 987 n.18, 1000–1016 (2005).

^{xvii} Shavell, *supra* note iii, at 1569.

^{xviii} *Id.*

^{xix} Perillo, *supra* note xii, at 1094 (“Attorneys’ fees and other transaction costs are generally not part of the recovery, [that] real and sometimes enormous damages are not compensated unless hurdles of foreseeability and certainty are overcome, [and that] damages for mental distress caused by a contractual breach are [generally] not compensable.”).

^{xx} Shavell, *supra* note iii, at 1569.

^{xxi} Perillo, *supra* note xii, at 1095.

^{xxii} *Id.* at 1094–1096 (Perillo details the reasons why damages for breach of contract are limited.).

^{xxiii} *Id.*

^{xxiv} *Id.* at 1089 (quoting 2 HOLMES-POLLOCK LETTERS: THE CORRESPONDENCE OF MR. JUSTICE HOLMES AND SIR FREDERICK POLLOCK 1874–1932, at 200 (Mark DeWolfe Howe ed., 1941)).

^{xxv} Perillo, *supra* note xii, at 1095.

^{xxvi} Shavell, *supra* note iii, at 1569 (noting that “specific performance is an extraordinary remedy.” (internal citation and quotation omitted)).

^{xxvii} Eisenberg, *supra* note xvi, at 987, 1000–1016. *See also* Shiffrin, *supra* note iii, at 1568 (observing that “there may be distinctively legal reasons to reject such remedies given the difficulties of judicial supervision, risks of arbitrary enforcement, and in some cases, the hazards of involuntary servitude.”).

^{xxviii} Shavell, *supra* note iii, at 1569.

^{xxix} Perillo, *supra* note xii, at 1086, 1100.

^{xxx} As one commentator explained:

Parties to a contract create contractual obligations by an exercise of will; unlike the commission of a tortious act, failure to discharge these self-imposed obligations does not inevitably violate objective standards of societal conduct. Since breach of contract usually abuses no external standard of acceptable conduct, contract damages may be thought to have no punitive function.

Timothy Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 219 (1977), available at <http://scholarship.law.wm.edu/facpubs/478>.

^{xxxi} Shavell, *supra* note iii, at 1569.

^{xxxii} Robert W. Gordon, *Unfreezing Legal Reality: Critical Approaches to Law*, 15 FL. STATE U. L. REV. 195 (1987) (Gordon writes about the need to “destroy the seemingly necessary connection between the way our law is and the way it must be.”).

^{xxxiii} See Shavell, *supra* note iii, at 1570.

^{xxxiv} *Id.*

^{xxxv} *Id.* at 1572.

^{xxxvi} *Id.* at 1570–1571.

^{xxxvii} Presumably, to distance his hypothetical situations from “promising,” Shavell uses the term “seller” to refer to the promisor, and “buyer” to refer to the promisee. *Id.* at 1570 n. 9.

^{xxxviii} *Id.*

^{xxxix} *Id.*

^{xl} *Id.* at 1571–1572.

^{xli} Shavell, *supra* note iii, at 1571. Indeed, in *Could Breach of Contract Be Immoral* where Seana Shiffrin challenges Shavell’s argument, she too incorrectly assumes that the law would necessarily require performance under the scenario Shavell described. Shiffrin, *supra* note iii, at 1558.

^{xlii} Shavell, *supra* note iii, at 1572.

^{xliiii} *Id.* (internal citations and quotations omitted, emphasis in original).

^{xliiii} *Id.* Shavell’s snow removal example highlights his argument on this point. If a contingency occurred (one not expressly provided for in the contract) such that it would cost the seller \$300 to remove the snow, and the buyer only valued the removal at \$100, Shavell explains that the seller should breach—without moral culpability—and pay the buyer \$110. If, however, the cost of performance was \$100, and the value to the buyer was \$300, failure to perform would be morally wrong. *Id.* at 1572–1573.

^{xlv} Ronald Dworkin, *The Original Position*, 40 U. CHI. L. REV. 500, 501 (1972).

^{xlvi} *Id.*

^{xlvii} *Id.*

^{xlviii} *Id.* at 502.

^{xlix} *Id.*

^l *Id.*

^{li} *Id.*

^{lii} John Trentacosta, *Commercial Impracticability and Fair Allocation Under U.C.C. 2-615*, MICH. BAR. J. (Nov. 2010), available at <http://www.michbar.org/journal/pdf/pdf4article1767.pdf>.

^{liii} RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

^{liv} *Id.*; Greer Properties, Inc. v. LaSalle Nat’l Bank, 874 F.2d 457 (7th Cir. 1989).

^{lv} RESTATEMENT (SECOND) OF CONTRACTS § 261 cmt. d (1981); see also U.C.C. § 2-205 (2013) (“a performance is impracticable only if it is so in spite of those efforts.”).

^{lvi} Shavell, *supra* note iii, at 1570.

^{lvii} Shiffrin, *supra* note iii, at 1555.

^{lviii} Shavell, *supra* note iii, at 1570.

^{lix} Shiffrin, *supra* note iii, at 1555.

^{lx} Law professors have a knack of selecting scenarios for examinations at the cusp between areas where the law provides and does not provide guidance. The facts offered are often vague enough such that the best score is achieved by the student who notes the ambiguity and describes the manner in which the law would address various possible situations. Shavell’s example, and the way in which Shiffrin interprets it, are subtly different; but the differences matter.

^{lxi} Shiffrin, *supra* note iii, at 1558.

^{lxii} *Id.*

^{lxiii} Shiffrin correctly asks, “If [the buyer and the seller] would have agreed to excuse nonperformance, then why would there be a moral or legal duty to pay damages?” *Id.* at 1556.

^{lxiv} Shavell, *supra* note 3, at 1569–1572.

^{lxv} *Id.* at 1579.

^{lxvi} See generally R.H. Coase, *Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Also see the example provided at *Legal Theory Lexicon: Efficiency, Pareto, and Kaldor-Hicks*, LEGAL THEORY BLOG (Dec. 9, 2012),

<http://lsolum.typepad.com/legaltheory/2012/12/legal-theory-lexicon-efficiency-pareto-and-kaldor-hicks.html>.

^{lxvii} *Id.*

^{lxviii} Shavell, *supra* note iii, at 1571.

^{lxix} Similarly, Shiffrin observed that parties could “make an explicit agreement that one party will either perform or pay.” Shiffrin, *supra* note iii, at 1562.

^{lxx} See, e.g., *Greer Properties, Inc. v. LaSalle Nat’l Bank*, 874 F.2d 457 (7th Cir. 1989).

^{lxxi} *Nemec v. Shrader*, 991 A.2d 1125 (Del. 2010) (internal citations omitted).

^{lxxii} *Id.* at 1126.

^{lxxiii} *Id.* at 1128.

^{lxxiv} *Id.*

^{lxxv} See Eisenberg, *supra* note xvi, at 987, 1009–1010 (Discussing the decision of the court in *LaSalle Nat’l Bank*, 874 F.2d 457 (7th Cir. 1989)).

^{lxxvi} U.C.C. § 2-308.

^{lxxvii} U.C.C. § 2-309.

^{lxxviii} U.C.C. § 2-310.

^{lxxix} Shavell, *supra* note iii, at 1579.

^{lxxx} *Id.*

^{lxxxi} *Id.* at 1579 (emphasis added).

^{lxxxii} *Id.*

^{lxxxiii} Shiffrin, *supra* note iii, at 1551 n. 3 (citing, *inter alia*, RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981)).

^{lxxxiv} See, e.g., U.C.C. § 2-201 and Mich. Comp. Laws § 566.132 (2013).

^{lxxxv} Shavell, *supra* note iii, at 1579.

^{lxxxvi} See discussion *supra* Part II.B.2.

^{lxxxvii} Shavell, *supra* note iii, at 1579–1580.

^{lxxxviii} *Id.* at 1580.

^{lxxxix} *Id.*

^{xc} *Id.* at 1575 (“First, courts are reluctant to credit hard-to-measure components of loss as damages. Hence, lost profits and idiosyncratic losses due to breach are likely to be inadequately compensated or neglected. Second, courts are inclined to limit damages to those that could have been reasonably foreseen at the time the contract was made. Third, damages tend not to reflect the considerable delays that victims of breach may suffer. Fourth, legal costs are not compensated.”).

^{xci} See generally Gordon, *supra* note i, at 208 (“The legal system. . . should therefore underwrite relationships of trust, of general reciprocity, and penalize breaches of trust—especially in situations where the relationship is not likely to be a continuing one, so that the sanction of refusing future dealings is unavailable.”).

^{xcii} Seana Shiffrin, *Promising, Intimate Relationships, and Conventionalism*, 117 THE PHILOSOPHICAL REV. 481 (2008).

^{xciii} Shavell, *supra* note iii, at 1579–1580.

^{xciv} He does seek to distinguish promises from contracts; however, for the reasons discussed above (see discussion *supra* Part II.A), I don’t think he succeeds in doing that.

^{xcv} Shiffrin, *supra* note xcii.

^{xcvi} *Id.* at 514–516, 521.

^{xcvii} Just as ethics may not seem important to Holmes’ question, what is it that the state will use its power to enforce. Ethics need not concern itself with the practical problems the law must address in determining how to deal with contract breaches. It need only opine as to when such breaches are immoral even if the law would not enforce or release them. While it is true that in general the law should conform to ethical principles, there may be practical reasons why they occasionally may not conform to one another.

^{xcviii} Bernard Williams may hold part of the answer:

Because our moral relation to the world is partly given by . . . [our individual moral] feelings, and by a sense of what we can or cannot ‘live with’, to come to regard those feelings from a purely utilitarian point of view, that is to say, as happenings outside one’s moral self, it to lose a sense of one’s moral identity; to lose, in the most literal way, one’s integrity.

Bernard Williams, *Consequentialism and Integrity*, in CONSEQUENTIALISM AND ITS CRITICS 38 (Samuel Scheffler ed., 1988).

^{xcix} Robert C. Solomon, *Corporate Roles, Personal Virtues: An Aristotelian Approach to Business Ethics*, 2 BUS. ETHICS. Q. 317

(1992).

^c Ronald Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980).

^{ci} Gordon, *supra* note i, at 208.

^{cii} *Id.*