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THE RELATIONAL CONSTITUTION OF REMEDY: CO-OPERATION AS THE IMPLICIT SECOND PRINCIPLE OF REMEDIES FOR BREACH OF CONTRACT

David Campbell†

> Error is viewed . . . not as an extraneous and misdirected or misdirecting accident, but as an essential part of the process under consideration—its importance . . . being fully comparable to that of the factor which is normally considered, the intended and correct logical structure.
>
> John von Neumann[1]

I. INTRODUCTION

I am of the opinion that the main reason the relational theory of contract has encountered such resistance from mainstream thinking on the law of contract thought is that it has been interpreted as a very paternalistic theory opposed to freedom of contract, one which has no or very little place for competition.[2] As I have argued elsewhere, this

† Department of Law, University of Durham, UK. In addition to the version given at the conference on which this Symposium is based, earlier versions of this paper have been given to the Department of Law, University of Leeds, March 2001; to the Annual Meeting of the Law and Society Association, Central European University, Budapest, Hungary, July 2001; to the School of Law, University of Bristol, November 2002; to a BCL Seminar, Faculty of Law, University of Oxford, May 2004; and to the Osgoode Hall Law School, Canada, September 2004. Throughout this paper I continually draw on previous work with Hugh Collins, Roger Halson, and Donald Harris.

1. J. von Neumann, *Probabilistic Logics and the Synthesis of Reliable Organisms from Unreliable Components*, *in* AUTOMATA STUDIES 43 (C.E. Shannon & J. McCarthy, eds. 1956).

2. *See, e.g.*, Gunther Teubner, *Contracting Worlds: The Many Autonomies of Private Law*, 9 SOC. & LEGAL STUD. 399, 404–05 (2000). In criticism, see David Campbell, *The Limits of Concept Formation in Legal Science*, 9 SOC. & LEGAL STUD. 439, 445 (2000).

certainly was not Ian Macneil's intention,[3] and, drawing on his work, the relational theory can readily be restated in such a way as to give competition a central place in it.[4] Nevertheless, that the relational theory is associated with general paternalism is undeniable,[5] and in this paper I hope to call this association further into question by giving a general defence of breach of contract from the relational perspective. In a sense I intend to go rather further than in my previous attempts to bring competition into the relational theory, for on this occasion I do intend to argue that, in important ways, Macneil's own views (on breach) are open to radical criticism, as are those of the other principal contributor to the relational theory, Stewart Macaulay.

As I trust will be fully acknowledged in this paper, the defence of breach I will put forward is very substantially indebted to the important contributions to our understanding of the remedies for breach which a number of writers sympathetic to the relational perspective, notably Charles Goetz, Alan Schwartz, and Robert Scott, have made, and continue to make. Nevertheless, the predominant attitude taken towards breach by writers with such sympathies, including Macaulay and Macneil themselves, is that breach represents an amoral or immoral failure by the breaching party to respect, not only the obligations which contracts themselves impose, but, more importantly, those on which contracting rests. It therefore would seem that breach must generally be disapproved from the relational perspective.

I will argue that such disapproval is a mistake. Far from it being the function of the law of contract to (so far as possible) prevent breach, the function of that law is to make breach possible, although on terms which the law regulates. This function is so central to the efficient working of the market economy that, in an important sense, there is very little point in passing moral judgement upon it. So long as one is committed to the market economy, one must allow contract to perform this function; and we are all now, of course, committed to that economy. The point I wish to stress, however, is that this is *not* an instance of having to sacrifice what is "moral" to what is economically "efficient." I will argue that the expectation principle allows breach to work in an efficient way only by giving the parties a strong incentive to co-operate in dealing with the errors the defendant has made when

3. David Campbell, *Ian Macneil and the Relational Theory of Contract*, *in* THE RELATIONAL THEORY OF CONTRACT: SELECTED WORKS OF IAN MACNEIL 3, 20–7 (David Campbell ed. 2001).

4. *See, e.g.*, David Campbell, *The Relational Constitution of the Discrete Contract*, in CONTRACT AND ECONOMIC ORGANISATION: SOCIO-LEGAL INITIATIVES 40, 40–66 (David Campbell & Peter Vincent-Jones eds., 1996).

5. Kennedy's rightly very influential gloss on particularly the work of Macaulay seems to have played a large part in this, though Kennedy's views are much more nuanced than the title of his paper would seem to have led many who have cited it to believe: Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, with Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 563–658 (1982).

agreeing the terms of the contract; the manifestation of those errors in increasing costs of performance being the reason the good faith defendant wishes to breach.[6] In order to emphasise the way I am hoping to change the view taken of the expectation principle in the relational theory, I will put my argument in the following way. Whilst protection of the claimant's[7] expectation is the first principle of remedies for breach of contract, co-operation in keeping the defendant's costs of furnishing that protection as low as possible is the second principle. One cannot explain the basic structure of the law of remedies using only the first principle. I hope to show one can explain that structure using both principles, which together reveal the co-operative nature of breach.

Whereas the principle of protecting the claimant's expectation is, of course, so well known as to be trite law (until recent developments in the law of restitution in particular have called it into question in England and Wales), the second principle is, to say the least, obscure. Though it is my basic claim that the specific legal rules constituting the second principle do already exist, the principle is not merely not recognised but is denied by those who understand breach as amoral or immoral, and this failure of recognition may be taken to extremes of antagonism in the attitudes and conduct of the parties (and their advisers) to strenuously contested commercial litigation. It is not the least ambitious of my aims that I intend my argument to have the clear implication for those parties that they should eschew this antagonism, which fails to represent, not merely their counterparts', but their own best interest, were they adequately self-conscious of it.

II. THE CRITIQUE OF BREACH

There is a very surprising degree of agreement in the attitudes taken towards breach by most proponents of the relational theory and in the classical theory of contract to which the relational theory is normally thoroughly opposed. It had seemed that the proper attitude to take to classical law's belief in *pacta sunt servanda* was to regard it as one of the charmingly antiquated tropes which were indicative of that law's obsolescence, but in a way which it was no longer worth challenging in detail.[8] Any edifice resting on foundations of this highly ornamental but wholly dysfunctional sort cannot be repaired, but has to be entirely replaced. It certainly was the case that, whilst the rela-

6. I entirely ignore the problems posed by the bad faith defendant.

7. An unfortunate consequence of the overall successful review of civil procedure conducted by Lord Woolf in the 1990s is that the perfectly well-understood term "plaintiff" has been replaced by "claimant" in the new civil procedure rules for England and Wales.

8. The outlines of all that needed to be said were indicated in J.H. Gebhardt, *Pacta sunt servanda*, 10 MOD. L. REV. 159, 159–61 (1947).

tional theory recognised this,[9] the mainstream thinking remained forlornly mired in the past.[10] Nevertheless, one had thought that, at least among those capable of taking a sophisticated interest in the issues, if not all those who passed as being learned in contract law, the drastic shortcomings of the classical law were acknowledged.

One has been a little startled, then, to see strenuous attempts being made to claim that there is "wide acceptance of the phrase '*pacta sunt servanda*'"[11] as a central aspect of the recent attempt to revive formalism of a decidedly Langdellian sort,[12] and to stress a basic "performance interest" in contract:

> The essence of contract is performance. Contracts are made in order to be performed. This is usually the one and only ground for their formation . . . This interest in getting the promised performance . . . the performance interest . . . is the only pure contractual interest [and] is protected by specific remedies, which aim at granting the innocent party the very performance promised to him, and by substitutional remedies.[13]

The argument for the performance interest mutually reinforces the argument for wider use of the restitutionary remedies of partial or total disgorgement following breach of simple contract that in recent times has enjoyed considerable influence in England and Wales,[14] for the effect of this wider use of restitution must be to deter breach to a much greater extent than damages quantified in the normal way.

The reason the performance interest and restitutionary arguments are made, but also the great difficulty they face, is—it is unarguable that the existing remedies for breach of contract do not seek to protect a performance interest in this way; quite the contrary in fact.[15] The positive law of remedies shows, as Farnsworth famously put it, "a marked solicitude for men who do not keep their promises."[16] Exem-

9. *See* Ian R. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589, 597–610 (1974); Ian R. Macneil, *Contracts: Adjustment of Long-term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U. L. REV. 854, 899–905 (1978).

10. *See* David Campbell, *The Undeath of Contract: A Study in the Degeneration of a Research Programme*, 22 H.K. L.J. 20, 20–21 (1992).

11. Brian Coote, *Contract Damages, Ruxley, and the Performance Interest*, 56 CAMBRIDGE L.J. 537, 542 (1997).

12. *See generally* ERNEST J. WEINRIB, THE IDEA OF PRIVATE LAW (1995).

13. Daniel Friedmann, *The Performance Interest in Contract Damages*, 111 LAW Q. REV. 628, 629 (1995).

14. *See, e.g.*, Peter Birks, *Restitutionary damages for breach of contract;* Snepp *and the fusion of law and equity*, 1987 LLOYD'S MAR. & COM. L.Q. 421 (1987) and Peter Birks, *Profits of Breach of Contract*, 109 LAW Q. REV. 518, 518–21 (1993).

15. In what follows I shall concentrate on the law of England and Wales. The law of the United States and of other common law jurisdictions is not different in principle, and indeed a great deal of our understanding of the law of England and Wales is based on analyses of the United States' position.

16. E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1216 (1970).

plary damages are not normally available in contract, unless the parties clearly have contracted with the express intention that they should be and then the basis of those damages is purported compensation of the claimant's non-pecuniary loss rather than the explicit punishment of the defendant or the deterrence of breach.[17] Ignoring the special case of debt,[18] literal enforcement is an exceptional remedy available only when normal damages are shown to be inadequate, and even then it may be denied if the cost it imposes on the defendant is found to be out of reasonable proportion to the benefit it will convey on the claimant.[19] The quantification of damages on the basis of compensation of lost expectation, subject to limits of causation and net of mitigation, tends to keep those damages as low as possible, consistent with protection of the claimant's expectation thus quantified.[20] A number of relatively minor doctrines are to the same effect.[21]

In sum, our thinking about remedies remains dominated by Fuller and Purdue's[22] very robust, if not, as we will see, entirely coherent explanation of that law as aiming at the protection of (net) expectation rather than the enforcement of primary performance. Broad acceptance of this explanation shows the claim that the essence of contract is performance to be contradicted by the fact that the existing law of remedies unarguably is based not on literal enforcement, but on shifting from primary obligations to the secondary obligation to provide a remedy[23] and that remedy will only exceptionally be literal enforcement of the primary obligation. It is unarguable that this shift usually gives the defendant an incentive (which must be balanced against counter-incentives) to breach.

It is for this very reason that those advocating the performance interest regard the system described by Fuller and Purdue as fundamentally inadequate and in need of reform, the basic argument being that "[t]he expectation interest is simply an inappropriate term describing the performance interest."[24] Not only the academic literature, but in the important cases where the wider use of non-compensatory damages is currently being developed in England and Wales are replete with outraged claims that the expectation principle permits important injustices to occur. In the leading case, *A.G. v. Blake (Jonathan Cape*

17. DONALD HARRIS ET AL., REMEDIES IN CONTRACT AND TORT 579–608 (2nd ed. 2002).

18. *Id.* at 158–66.

19. *Id.* at 153–226.

20. *Id.* at 3–24, 73–130.

21. *See, e.g., id.* at 75–76 (referring to the "minimum obligation rule").

22. L.L. Fuller & William R. Perdue Jr., *The Reliance Interest in Contract Damages: 1*, (1936) 46 YALE L.J. 52, 52–96; L.L. Fuller & William R. Perdue Jr., *The Reliance Interest in Contract Damages: 2*, (1936) 46 YALE L.J. 373, 373–420 (1936).

23. *See* HARRIS ET AL., *supra* note 17, at 7.

24. Friedmann, *supra* note 13, at 632.

Ltd. Third Party),[25] which the Court of Appeal has claimed "mark[ed] a new start in this area,"[26] it was observed that:

> If the court is unable to award restitutionary damages for breach of contract, then the law of contract is seriously defective. It means that in many situations the plaintiff is deprived of any effective remedy for breach of contract, because of a failure to attach a value to the plaintiff's legitimate interest in having the contract duly performed.[27]

The Court of Appeal and a majority of the House of Lords in *Blake* accordingly have made it possible that restitutionary damages, up to and including total disgorgement of the profits of breach, might be sought in simple contract cases.[28]

This criticism of the expectation principle is so very overdone as to be quite misleading, and the alternative which is proposed, of giving much greater weight to literal enforcement or to (particularly restitutionary) damages which amount to much the same thing, is far inferior to limited literal enforcement and damages based on the protection of (net) expectation. I have argued this on numerous previous occasions[29] and, in briefly recapitulating my argument here, I will concentrate upon the outraged moralistic tone of current criticism of the expectation principle. This follows not from thinking that the expectation principle is ill-suited to prevent breach, which it is, but from taking it for granted that it should seek to prevent it, which it should not. Were the current law of remedies properly understood, it would not attract criticism of this sort.

The most moralistically agonised criticism which has been lodged against the expectation principle is that it allows "efficient breach." When economically rational parties enter into a contract, analytically they do so in the belief that this commitment of their resources will maximise their utilities over the time of performance. Of course, as their rationality is bounded, there inevitably will be a risk that they are wrong, and one way in which they may be wrong is that they may have failed to identify a superior maximising opportunity available during that time. Upon learning of a sufficiently superior opportunity,

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25. [1997] EWCA Civ. 3008.

26. Experience Hendrix L.L.C. v. P.P.X. Enter. Inc., [2003] EWCA Civ. 323 para. 16.

27. *Blake*, [1997] EWCA at para. 35.

28. HARRIS ET AL., *supra* note 17, at 262–68; David Campbell & Donald Harris, *In Defence of Breach: A Critique of Restitution and the Performance Interest*, 22 LEGAL STUD. 208, 217–21 (2002) (discussing the crucial point of the relationship of *Blake* to "efficient breach"); D. Campbell, *The Treatment of Teacher v Calder in AG v Blake*, 65 MOD. L. REV. 256 (2002). Developments subsequent to *Blake* are described in David Campbell & Philip Wylie, *Ain't No Telling (Which Circumstances Are Exceptional)*, 2003 CAMBRIDGE L.J. 605, 605–30.

29. See generally the references given in the previous note and David Campbell, *Hamlet without the Prince: How Leng and Leong Use Restitution to Extinguish Equity*, 2003 J. BUS. L. 131, 131–41.

the defendant will have a rational incentive to breach and recommit his resources to the exploitation of that opportunity. So long as he adequately compensates the claimant, it will be efficient to allow him to do so. The net result will be identical for the claimant and superior for the defendant.

As the costs to the defendant of breaching the original contract are his lost expectation (and wasted reliance) on that contract *and* his liability for the claimant's lost expectation and wasted reliance, efficient breach is possible only because the expectation principle normally minimise that liability. Were the performance interest protected by normal literal enforcement or (restitutionary) damages to the same effect, the defendant's incentive to breach would be lowered to the extent that he will be required to disgorge the profit he would make. If literal enforcement were certain to be carried out (*e.g.*, were the defendant to be forbidden to pay the claimant to relax an order of specific performance), or were the total disgorgement damages logically required by restitution certain to be imposed, the defendant would have no incentive to breach at all, and no efficient breach would be possible. That such breach is possible under the expectation principle is the strongest possible indication to the proponents of the performance interest that that principle is inadequate.[30] The outrage is even more pronounced when the claimant's damages are nominal because he suffers no loss on compensatory principles, or suffers a loss which is not thought to justify the cost to the defendant of remedying it. It is here that the performance interest thinking has made its greatest progress so far in England and Wales, for it is now usually the case that, when breach of a restrictive covenant in a sale of land would lead to only nominal damages quantified according to the expectation principle, the claimant will be able to obtain damages which require the defendant to partially disgorge the profits of his breach.[31]

Though, to my knowledge, the term efficient breach was coined in 1977,[32] and the first formal statement of the concept was made as recently as 1970,[33] the idea of an efficient breach which allows the defendant to maximise his utilities is traceable to Holmes' famous observation that: "[T]he only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised event does not come to pass. [The law of contract] leaves

30. Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 1–24 (1989).

31. The leading case is *Wrotham Park Estate Co. Ltd. v Parkside Homes Ltd.* [1974] 1 W.L.R. 798.

32. Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558–77 (1977).

33. Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 273–92 (1970).

[the promisor] free to break his contract if he chooses."[34] This observation smacks of the cynicism of Holmes's "bad man,"[35] and so is anathema to those classical lawyers and modern Langdellian formalists who regard breach as a wrong. But it is also seen this way by most contributors to the relational theory.[36] Both Macaulay, in the shining decency of his general attitude to the legitimate use of the law,[37] and Macneil, in his more formal accounts of contract's normative foundations,[38] have placed an explicit morality at the heart of contract, to which the attitude of the bad man seems repugnant. It is no surprise, then, that both have launched extremely hard-hitting attacks on efficient breach. I have discussed these elsewhere,[39] so want here only to distinguish two lines taken by these attacks. The first line turns on showing that breaches can take place under the guise of efficient breach which are not efficient at all, because the claimant is not, in fact, adequately compensated,[40] and with this line I have no basic disagreement. I do, however, disagree with a second line taken by the relational criticism of efficient breach, which is to claim that the amorality of the defendant's conduct is reprehensible even when the claimant is compensated, and, in fact, that in the moral world of contract, good faith parties just do not behave in this way. In a very important passage, Macneil claims that:

> In the real world of commerce, opportunities for gain through 'efficient breach' of transactions in goods other than true futures deals are so rare as to be almost non-existent. There simply are not many chances for deliberate breaches of this kind, and general propositions about remedies based on them tell singularly little about effi-

34. O.W. HOLMES JR., THE COMMON LAW 301 (1881). I formed my views on these matters before I read Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 FORDHAM L. REV. 1085, 1085–106 (2000), and although I have benefited greatly from this excellent paper, though I am afraid my views on Holmes and on efficient breach remain quite opposed to those of Professor Perillo.

35. O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897).

36. *See* Ian R. Macneil, *A Primer of Contract Planning*, 48 S. CAL. L. REV. 627, 692 (1975). *See also* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1696 (1976).

37. Everything Macaulay has written on the subject demonstrates this quality, but I particularly refer the reader to the captivating account of an "organic transaction" in Stewart Macaulay, *Organic Transactions: Contract, Frank Lloyd Wright and the Johnson Building*, 1996 WIS. L. REV. 75, 75–122.

38. Ian R. Macneil, *Values in Contract: Internal and External*, 78 NW. U. L. REV. 340, 346–66 (1983).

39. David Campbell, *Breach and Penalty as Contractual Norm and Contractual Anomie*, 2001 WIS. L. REV. 681, 687–91. I have used some paragraphs of this discussion in the current paper.

40. *See* Stewart Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465, 469–70; Ian R. Macneil, *Essays on the Nature of Contract*, 10 N.C. CENT. L.J. 159, 183–84 (1979); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 947–49 (1982); Ian R. Macneil, *Contract Remedies: A Need for a Better Efficiency Analysis*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 6, 14 (1988).

> ciency in the real world. What does happen in the world of contracts—often in clear violation of legal rules of contract remedies—is that people get themselves into trouble in an incredible variety of ways, both ingenious and disingenuous, and are unable or at the very least think themselves unable to perform. Their position *at that time* comes much closer to impossibility and serious impracticability than it does to deliberate breach, even when they led themselves into the morass.[41]

III. THE TWO RULES IN *ROBINSON V. HARMAN*

This attitude to efficient breach, shared across the range of contractual scholarship, including by many of the leading proponents of the relational theory, is mistaken. The mistake involves unduly concentrating on efficient breach, rather than on breach itself. For the very considerable attention which efficient breach has received is in marked contrast to the, from the perspective which is being advanced here, opposite form of breach, though this form is far more important; indeed determining the correct policy towards it is the most important issue in the law of contract remedies. The purpose of what has been called efficient breach is to allow the defendant to maximise a gain. But far more important than this maximising breach is the breach which has the purpose of minimising loss.[42] This is, indeed, the typical case of breach, though not generally recognised as such.

When the defendant undertakes a primary contractual obligation, he does so in the belief that performance of that obligation will cost a certain amount. As we have noted, that this belief inevitably will be based on bounded rationality at the time of the agreement means that a risk always attends a contractual undertaking. One risk is the efficient breach risk that, even if the original contract goes as planned, a better contract could have been made. In other cases, however, the risk that the original contract does not go as planned becomes manifested in a rise of the costs the defendant incurs in performing. Any rise in the cost of complete performance above the defendant's original estimate will reduce the defendant's expected profit margin, and thus the defendant's own expectation interest, and beyond a certain point the rise will extinguish that margin completely (leaving the defendant in a "break-even" contract, where receipts equal costs), or make the margin negative (leaving the defendant in a "losing contract," where receipts are lower than costs). The enormous variation in the empirical circumstances which give rise to these outcomes—unanticipated shortage of raw materials, destruction of premises by

41. Ian R. Macneil, *Contract Remedies: A Need for a Better Efficiency Analysis*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 6, 15 (1988).

42. *Cf.* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 254–55 (4th ed. 2004) (noting the distinction between the "fortunate" and the "unfortunate" contingency).

fire, etc.—should not obscure the fact that (the terms not being in dispute) it is always a rise in the cost of performance that gives the good faith defendant an incentive to breach.

At zero transaction costs, in a world where each party was fully informed about all the circumstances, including relevant future events, and negotiation was costless, the parties would draw up a completely contingent contract that exhaustively specified all the parties' rights and obligations in every possible situation, and provided a set of procedures and remedies to deal with every conceivable aspect of nonperformance. But, of course, finding all the relevant information and fully negotiating terms to incorporate it into the contract incurs positive transaction costs, and contracts cannot be the completely contingent products of perfect rationality. The state of the world (including its potential for change) will not exist as the parties believed at the time of the contract, for their knowledge of that state, and their ability to calculate the consequences of what they do know will be limited, as is their ability to negotiate, and it is this limitation that leads to risk.

In all contracts, there is an allocation of risks to the parties. This allocation takes place within certain limits to the extent that any defendant can be required to absorb risk. There is a fundamental limit to the extent that the defendant could be obliged to perform even when his costs are rising which is set by the possibility of his becoming bankrupt or going into liquidation. There is a lower limit set by the possibility of the contract being discharged for common mistake or frustration,[43] though this is almost otiose because it is so rarely granted. In the great majority of cases, however, a more relevant limit is set and the general possibility of breach *created*, by the quantification of damages according to the expectation principle. When the costs of performance exceed the costs of breach, the defendant has a rational incentive to breach. Because, as we have seen, the costs of breach are the defendant's *and* the claimant's lost expectation and wasted reliance, the costs of breach can be lower than the costs of performance only if damages are normally quantified on a compensatory basis and there is an incentive to mitigate so that the claimant is compensated only for lost net profit; or, to put it the other way around, only if literal enforcement is an exceptional remedy. The fact remains that the remedies system is like this and results in the most important sensible course of action for the claimant after breach is normally to take commercial cover by finding a substitute and being compensated for his net loss, if any. Exceptions to the basic position must be considered when cover is inadequate to protect the claimant's expectation.

If the damages system works in the sense that damages actually are adequate, the claimant should be indifferent whether the defendant

43. These are the analogues to commercial impracticability in the law of England and Wales.

pays damages or performs. The issue should be whether the defendant be made to perform or to pay compensatory damages when *both* protect the claimant's expectation; and, if the defendant decides that breach is a less costly way of doing this than performance, the defendant should be allowed to breach. To compel the defendant to perform will protect the claimant's expectation, but *ex hypothesi*, damages will do this more cheaply than literal enforcement. As no benefit will be conferred by making the defendant protect the claimant's expectation by the more expensive method of literal enforcement, the defendant should be allowed to elect the cheaper method.

Nor is this a matter of being unilaterally generous to the defendant. As rational pricing requires the parties to include the cost of potential liability for breach, the claimant will benefit from a lower price because mitigation lessens the cost of liability. I would hazard the hypothesis that it is competition over this aspect of contracting that has made contracts which minimise liability the norm and this is reflected in the expectation principle being the default rule of remedies. To do otherwise than adopt what Goetz and Scott have called this "principle of joint-cost minimisation"[44] of loss would be to impose pointless waste on the parties which they themselves normally avoid.

When one wishes to understand and properly evaluate the contract remedies system, it is absolutely vital to appreciate that, in complete contradiction of what has always been claimed for *pacta sunt servanda* and is now being claimed for its modern statement as the performance interest, it does not necessarily matter to commercial parties whether the primary obligation is performed or enforced. The institution of contract is the general form of regulation of economic exchange, but, in a most important sense, the legal institution is not what is essential. It is the economic exchange, and particularly the surplus that the parties intend to realise through their exchange, that is essential. The actual performance of the contract is incidental to obtaining the surplus, indeed it is a cost of obtaining that surplus and an understanding of contract remedies that turns on seeing expectation of surplus is what matters, not actual performance of the obligation. In a contract that is performed, expectation is protected by performance. In a contract that is breached in good faith, something has happened to make performance more costly, and though the overriding goal remains protection of the claimant's expectation, this should, in order to avoid waste, be done as cheaply as possible and alternatives to performance

44. Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 972–73 (1983). Schwartz's interesting advocacy of wider use of specific performance is readily reconcilable with this stance, for it does not envisage actual literal enforcement being the result of his suggestion but believes, generally wrongly in my view, that post-breach negotiations will be improved if that suggestion is adopted. Alan Schwartz, *The Case for Specific Performance*, 89 YALE L. J. 271, 271–307 (1979). *See also* Timothy J. Muris, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053, 1053–69.

should be considered. Both the law of contract's general recourse to compensatory damages rather than literal enforcement and its mitigating principles of quantification of damages can be explained only on this basis. In sum, we might say that the fundamental goal of the law of contract is to put the claimant in the position he would have been in had the contract been performed (that is, to protect the claimant's expectation), *but by the means which imposes least cost on the defendant.* As it has been put by Andersen: "[R]emedies for breach of contract . . . attempt to accommodate two competing goals . . . (1) securing to the injured party the benefit of the bargain, (2) without imposing unnecessary costs on the breaching party."[45]

In the law of England and Wales, "the rule in *Robinson* v. *Harman*" states what has come to be known as the "first principle" of contract damages: "where a party sustains a loss by reason of breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed."[46] By stressing that the aim is to put the claimant where he *would* have been had the contract been performed, the rule in *Robinson v. Harman* makes protection of future expectation the basis of compensatory damages. In *Robinson v. Harman* itself, a defendant who had failed to convey a lease was liable not merely for the claimant's wasted expenses (in modern terms, reliance loss), but also for the extra cost of leasing a similar property from a third party (in modern terms, expectation loss). In one important respect, *Robinson v. Harman* expanded the defendant's liability, which was argued to extend only to reliance loss, but it did so in the way sympathetic to the defendant with which we are now familiar. The expectation loss was calculated as the difference in the rent of the third party's property minus the contracted rent, (*i.e.*, in modern terms, market damages) when, to labour the point, the claimant mitigates by securing a substitute.

I submit that the full significance of *Robinson v. Harman* lies in its articulation of *two* principles of contract damages: protection of the claimant's expectation, with protection in such a way as to minimise the defendant's expense. If the protection of the claimant's expectation were the only aim of the system of remedies, it would be impossible to say why, for example, that system requires mitigation by the claimant rather than simply allowing the claimant to let his consequential losses mount up, for either would protect the claimant's expectation. The same could be said of all the choices of remedies that

45. Eric G. Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299, 306 (1988). One might say that the first compensation principle of damages is supplemented by a second efficiency principle in the instance of the common law's combination of compensation and efficiency discussed in Cooter's seminal article: Robert Cooter, *Unity in Tort, Contract and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 1–51 (1985).

46. [1848] 1 Ex. 850, 855.

flesh out the preference for compensation over literal enforcement. To obtain a basic explanation of the system of remedies, one must see that *Robinson v. Harman* itself expresses the two rules set out by Andersen, and together these rules articulate the co-operative project of joint cost minimisation within a contractual framework. The immediate distinctness of the parties to a contract is recognised in the first rule in *Robinson v. Harman*, indicating a general privilege of the claimant's over the defendant's interests (whereas in a firm a breakdown, plans corollary to a breach could be met by revision of those plans which was prepared to alter the plans of all production units within the firm regardless of which unit was responsible for the breakdown). The ultimate co-operation of those parties, both within the instant contract and in the economy over time, is recognised by the second rule. It is the shortcoming of the contemporary Langdellian formalist insistence upon the performance interest that it does not even see the existence of this second rule (except as defects in the system of remedies), and it is the shortcoming of relational theory that it does not see that the second rule, though giving an incentive to breach, is basically co-operative.

IV. WHY PARTIES BREACH CONTRACTS

To explain why these *two* rules have been developed, and in particular why the second compliments the first, one has to understand why contracts are breached. At considerable risk of exposing myself to ridicule, I have prefaced this paper with a quote from one of John von Neumann's papers which have proved to be the foundations of modern computing, which I attempted to read when trying to come to terms with game theory. Much of it is incomprehensible to me, but insofar as I understand the matter, one of von Neumann's contributions to the conceptualisation of computing problems was to recognise that error can not be eliminated,[47] and the goal of eliminating error from calculation is illusory. One should first be aware of this, and so not put excessive faith in one's results, and then try to manage the inevitable failure. In computing, von Neumann's basic strategy was to duplicate the calculation on various computers (or parts of computers) and work from some samples of the multiple results.

Without wishing to put any weight on what is intended purely as a heuristic device, I submit that an analogue to this happens in the market economies. It is obvious that in those economies, composed of countless numbers of exchanges of varying degrees of complexity, dealing with those inevitably occurring contracts in which one party finds his costs during performance growing in an unanticipated way

47. The mechanical reliability of the computing machines available to von Neumanm was considerably poorer than that of contemporary computers, but the basic point still holds.

(telling him he made a mistake, in the lay sense, by agreeing this contract) is a major problem. The mechanism for handling this problem is central to the efficiency of the market economy.[48] The fundamental mechanism is adjustment of obligations by the parties without recourse to legal action, but this is encouraged by limiting the extent to which performance can legally be insisted upon in the way we have seen. It is breach that is most important in setting this limit; more so than insolvency, which nevertheless itself has a crucial role, and certainly more so than discharge for common mistake and frustration, which, as I have said, are almost redundant because they are so rarely granted. Breach allows flexibility into the system of exchanges, allowing parties relief from unanticipatedly expensive obligations when further performance would merely be wasteful as the claimant can be compensated in damages. In this sense, *a major function of the law of contract is to allow breach*, but on the right occasions and on the right terms; in essence, on terms which encourage claimants to cover in the knowledge that the defendant will compensate lost net expectation. This is to say, properly regulated breach, which does involve adequate compensation, is normative contractual action.

All this, of course, assumes that it normally is possible to take cover, but for commercial parties this normally is possible because the market economies are characterised by the ready availability of goods in competitive supply, including a margin of excess capacity which allows a buyer faced with breach to take cover. This margin functions *inter alia* as the space in which inevitable misallocations of resources through contract are adjusted through breach, or adjustment by the parties which makes it unnecessary for the party experiencing difficulty to breach. Much economic theory viewing "excess capacity" in the economy as a sign of malaise simply fails to take onboard this vital function of such capacity in making the taking of cover widely possible.[49] This mistake is greatly exaggerated by legal theories of the performance interest, which simply have no inkling of the economic

48. A comparison with the extreme rigidities characteristic of the centrally-planned command economies is useful. In such economies, an analogue to specific performance played the major role as a remedy for failure to comply with obligations under the plan because satisfaction of the plan was the goal of economic action. *See* Bernard Grossfeld, *Money Sanctions for Breach of Contract in a Communist Economy*, 72 YALE L. J. 1326, 1326–46 (1963). *See generally* Wang Liming, *Specific Performance in Chinese Contract Law: An East-West Comparison*, 1 ASIA-PAC. L. REV. 18 (1992). Of course, as much as in any system, obligations were entered into under imperfect information and with limited computational power, and so their performance was subject to unexpected rises in costs. Though a whole legion of semi-illicit devices for modifying the plan would seem to have arisen (bribes to those who held scarce goods, lying about plan fulfilment, etc.), the absence of a general possibility of an analogue to breach to deal with these rises would appear to have caused an inflexibility which was a major weakness of these economies. *See, e.g.*, J. NOS KORNAI, THE SOCIALIST SYSTEM 131–60 (1992).

49. JOHN MAURICE CLARK, COMPETITION AS A DYNAMIC PROCESS 81 (1961).

difficulties that in their pursuit of general literal enforcement, would require the terms of agreement so often to be right as to eliminate or greatly reduce the necessity of breach.

The point of relevance to us is that cover is both efficient and co-operative in a way that undercuts the typical opposition of these qualities. In circumstances when the claimant can be compensated in damages, cover obviously is efficient, for insisting upon anything else would satisfy the claimant's expectation at a higher cost to the defendant than the cost of the cover, and what would be the point of that? The breach is efficient in this case because it minimises *the defendant's* loss. But this efficiency emerges only because the claimant co-operates by taking cover. Allowing the defendant to breach and placing the burden of mitigation on the claimant enlists the claimant's co-operation in dealing with the defendant's problems, one aspect of this co-operation is it makes legal action unnecessary in cases where compensation is adequate. In this way, the "efficient breach" that leads to cover in order to minimise the claimant's and the defendant's loss is, I suggest, the fundamental provision giving an incentive to co-operation in contract.

V. CO-OPERATION ACROSS THE SPECTRUM OF CONTRACTS

If my suggestion is accepted, much of the empirical evidence, such as we have it, about contracting, as opposed to the law of contract, becomes more readily reconcilable with that law. If the most detailed formulation of the relational theory is due to Macneil, the arguments that have made the necessity for an alternative theory to the classical law are largely due to Macaulay, whose finding of "non-use"[50] made the classical law seem so irrelevant that, as we all know, when Gilmore proclaimed its death, he named Macaulay the executioner.[51] The essential import of Macaulay's conception of non-use is that the actual conduct of business, and particularly the resolution of disputes, does not rely on formal legal provisions so much as informal, non-legal understandings.[52] But in the typical business situation where failure to deliver a satisfactory generic good is accompanied by a ready market in that good, then non-use is exactly what one would expect, not because of defiance of the legal rules, but because those rules prescribe the taking of commercial cover rather than pursuit of a legal remedy in the sense of a remedy that actively involves lawyers. Equally, other apparently lenient responses to breaches, such as allowing repair or (rescheduling) redelivery when complete rejection

50. Stewart Macaulay, *The Use and Non-use of Contracts in the Manufacturing Industry*, 9 PRACTICAL LAWYER 13 (1963).

51. GRANT GILMORE, THE DEATH OF CONTRACT 113 n.1 (Ronald K. L. Collins ed., 2d ed. 1995).

52. Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 56 (1963).

was possible, might be explained as sensible responses to the limited extent to which the claimant, even if he or she pursued the formal remedy, would actually find that it took her or him any closer to literal enforcement of the defendant's primary obligations.

I hope to have at least plausibly advanced the hypothesis that, properly understood, parties to relatively simple contracts relying on standard remedies based on the expectation principle, those contracts that Macneil would call discrete,[53] typically have recourse to the "remedy" of what I have elsewhere called "forebearance"[54] when faced with a breach, because the remedies point them in this direction.[55] There can be nothing so certain as that this is not properly understood by the parties, which is an unsurprising state of affairs when the position is not properly understood by most of the parties' advisers; but forebearance is, I submit, the normal case. Revising our understanding here will require not only a readjustment of our view of the substantive law, but, even more, a readjustment of our view of the practical use of that law. For Macneil surely is right, in the quotation given above, to cast doubt on the number of cases of deliberate breach. But, I submit,[56] "deliberateness" in this respect need not indicate bad faith. Rather, even on current understandings, it could indicate a good faith party being aware of his *decision* to breach, rather than divesting responsibility by believing that further performance is "impossible." "Even if . . . breach is deliberate, it is not necessarily blameworthy,"[57] for the deliberateness may just follow from clarity of thought. I would go further and say that, on the understanding I am seeking to put forward, deliberateness should indicate consciousness of seeking co-operation from the potential claimant.

As Macaulay has led the way in telling us,[58] the vast majority of disputes are settled by direct negotiations between the parties in which compromises are reached in the light of all the factors they consider relevant. The efficiency and legitimacy of breach, the value of a continuing relationship or of possible future business or, more widely, of a commercial reputation, as opposed to the one-shot value of pur-

53. Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a "Rich Classificatory Apparatus"*, 75 Nw. U. L. REV. 1018, 1025–37 (1981).

54. HARRIS ET AL., *supra* note 17, at 27–40.

55. Though my account greatly differs from that of Macaulay, which worries me, and is, as I have said, critical of parts of his work, which worries me even more, I have gained great help from his analysis of the "compromises" which are integral to Fuller's conception of the practical quantification of the reliance interest. Stewart Macaulay, *The Reliance Interest and the World Outside the Law Schools' Doors*, 1991 WIS. L. REV. 247, 282–87.

56. *See also* HARRIS ET AL., *supra* note 17, at 19.

57. Patton v Mid-Continent Sys. Inc., 841 F.2d. 742, 750 (7th Cir. 1988).

58. Stewart Macauley, *Elegant Models, Empirical Pictures and the Complexities of Contract*, 11 LAW & SOC'Y REV. 507 (1977); Steward Macaulay, *An Empirical View of Contract*, 1985 WIS. L. REV. 465.

suing litigation most ruthlessly, must all be weighed.[59] As I have said, in previous work I have described the potential claimant who, after breach, does not seek a formal remedy as "forebearing" from seeking a remedy. I have used this term to try to indicate that her or his decision not to seek the remedy does not take the form of self-conscious co-operation but of forebearance from seeking what, to the extent they believe in *pacta sunt servanda*, they must believe is an ability to compel the defendant to perform. This is a giving up of what the potential claimant perceives, however incorrectly, to be a right, for pragmatic reasons. For though the overwhelming weight of evidence is that disputes will be settled out of court by compromise, the present understanding of remedies encourages a "vindication of rights" mentality in the conduct of litigation.[60] The most aggravated form this takes, now deplored and intended to be corrected by recent reforms of civil procedure in England and Wales, is the tendency of commercial litigation to:

> degenerate into an environment in which the . . . process is too often seen as a battlefield where no rules apply. In this environment, questions of expense, delay, compromise and fairness may have only a low priority. The consequence is that expense is often excessive, disproportionate and unpredictable; and delay is frequently unreasonable.[61]

To this I would add that an otherwise valuable business relationship subjected to the strains of the "resolution" of a dispute in this way is unlikely to survive that resolution, which would appear to be a very substantial and largely unjustifiable cost which civil litigation imposes on business.

Businesses can, and perforce do, avoid these costs by eschewing litigation conducted in this way, but the vindication mentality casts its pall over post-breach negotiations where reference to the contract takes the form of exchanges of surrenders of adversarially asserted claims. The only general present corrective to this seems to be the advice one imagines is given very commonly indeed, that the law in practice falls short of the law in books (in which the client would get his supposed full deserts), a very unsatisfactory position indeed.[62] Self-consciousness of the co-operative element of contract is a necessary condition for improving the basic quality of advice in this regard. Parties who are aware that the expectation principle encourages co-

59. *See, e.g.*, James Shanteau & Paul Harrison, *The Perceived Strength of an Implied Contract: Can It Resist Financial Temptation*?, 49 ORGANISATIONAL BEHAV. & HUM. DECISION PROCESSES 1, 2–8 (1991).

60. HUGH COLLINS, REGULATING CONTRACTS 350–55 (1999).

61. Lord Harry Woolf, *Civil Justice in the United Kingdom*, 45 AM. J. COMP. L. 709, 710 (1997).

62. *See generally* IMMANUAL KANT, *On the Common Saying: That May Be Correct in Theory But It Is Of No Use In Practice*, *in* PRACTICAL PHILOSOPHY 273, 273–309 (1996).

operation would not have to learn this by the expensive pursuit of vindication through litigation which is almost always frustrated by settlement, is the unsatisfactory way in which the ubiquity of compromise between good faith parties is currently made known to those parties.

I do not for a moment want to deny that the expectation principle (or at least Fuller and Perdue's statement of it) is in need of reform, not merely at its edges but in some more fundamental ways. But I do think that its basic thrust is correct, and what has misled not only business parties but also classical and (some) relational scholars is that they think primary obligations *should* be performed, when it is always questionable whether they should. Self-consciousness of this would allow the displacement of the always frustrated taste for litigation based in the vindication of rights mentality to be replaced by a taste for settlement based in an acknowledgement that the adequate form of self-interest always acknowledges a role for co-operation.

I have developed these remarks by focusing upon contracts at the discrete end of Macneil's spectrum of contracts. Towards the other end, where are located contracts that I believe it is best to call "complex,"[63] there is a much more developed awareness of the necessity of co-operation between the parties. Indeed, the existence of this awareness was a major stimulus to Macaulay's and Macneil's development of the relational theory. As the complexity of projects increases, it becomes increasingly difficult to specify contractual obligations at the time of agreement, and provision for explicit co-operation in the modification of broadly defined obligations must be made. This places obvious stress on the classical doctrines of agreement and sanctity, and it is the point where they have fractured.

In previous work, I have analysed the necessary shift to a perspective of *conscious* joint maximisation in the agreement and performance of complex contracts,[64] and I flatter myself that this work has played some part in establishing the necessity of explicit co-operation in complex contracting. Hoping here to stress the absolute centrality of co-operation in all contracts, there is one aspect of the analysis I have previously made of co-operation in complex contracts that I should now like to revise. In this analysis, that I believe in this respect perfectly captured the tenor of relational contract thinking at the time, the emphasis was on the flexibility in how the parties regarded their obligations, and the contract itself almost dropped out of view. Modifications apparently unconstrained by, or in direct defiance of, explicit contractual provisions were shown to be a commonplace of business contracting, and were regarded positively as showing up the weakness of the classical law of contract, as indeed they did. But if the crucial issue was the existence of a region of non-use governed by non-con-

63. Campbell, *supra* note 3, at 15–20.

64. David Campbell & Donald Harris, *Flexibility in Long-Term Contractual Relationships: The Role of Co-operation*, 20 J.L. & Soc. 166 (1993).

tractual relations, it became hard to see why commercial parties to complex contracts bothered with contracts at all. When, having established the existence of the region of non-use, Macaulay later sought to give formal remedies any place in this region, his principal example was their use only as a fallback when relations collapse in unusual circumstances such as "major shocks to the world economic system."[65] To single out Macaulay in this way is most unfair,[66] for, as I hope I have made clear, he certainly, at least as much as any other contributor, has set the paradigm for basic research in contract over the last forty years, certainly including the research that has produced this paper. But it is for just this reason that I think it important to refer to limits in even his analysis.

The mistake is, I now believe, to confuse contracts agreed on the basis of the parties' (and their advisers') inadequate classical understandings of contract with "formal contract" as such, and especially with formal contract as it might be reformed were parties able (to receive adequate advice and therefore) to contract free of the classical illusions of *pacta sunt servanda* and their contemporary exhumation as the performance interest. In complex contracts, the contractual documents were agreed in order to signal the existence of an ultimately legally enforceable agreement (and hopefully to plan at least some of the details of performance and what would be done in the likely or inevitable event of difficulties arising with that performance).[67] But, in certain circumstances, that were common enough given the gulf between the classical contract and at all complex "economic deals" made within at all complex "business relationships,"[68] the contract could substantially hinder the productive resolution of disputes, and so was, in regard of these circumstances, ignored. The important difference, to which Macaulay has obliged us to pay attention, was between the "real" and the "paper" deals.[69]

But, of course, the contract remained, and even if not taken out the draw where the parties left it, it could exercise an influence on the way the parties dealt with disputes, and whether complex relational contracts could ever represent really non-contractual relations is, it is submitted, highly questionable.[70] Even in functioning complex contracts, the classical remedies remain as possible threats and the parties' rela-

65. Macaulay, *supra* note 40, at 472.

66. Especially in the light of Macauley, *An Empirical View of Contract*, *supra* note 40.

67. Macneil, *supra* note 36, at 629–701.

68. COLLINS, *supra* note 59, at 129–32.

69. Stewart Macaulay, *The Real and the Paper Deal: Empirical Pictures of Relationships, Complexity, and the Urge for Transparent Simple Rules, in* IMPLICIT DIMENSIONS OF CONTRACT 3, 51–102 (David Campbell et al. eds., 2003).

70. EDWIN M. SCHUR, LAW AND SOCIETY: A SOCIOLOGICAL VIEW 130–31 (1968). This is quoted in H. Beale & T. Dugdale, *Contracts Between Businessmen: Planning and the Use of Contractual Remedies*, 2 BRITISH J. LAW & SOC'Y 45 (1975), still the leading British paper reproducing Macaulay's analysis, which strives to emphasize the

tions are conducted with these threats in the background, a background that influences events in the foreground. The classical remedies may never be invoked, but they may have a most important influence on the actions of the parties, for their existence, and the possibility that they may be invoked, radiates an influence[71] on the nature of any settlement and on any continuing relation.[72] To the extent that they in this way encourage the vindication mentality, the formal remedies remain to pose a problem. To improve the contribution of the law to business,[73] it would appear to be necessary, from the point of view of the substantive law, to in future design remedies that more facilitate and less hinder the making of the necessary (and therefore legitimate) modifications of obligations in relational contracts.[74]

VI. Co-operation and The New Formalism

It is here that the recent development of a "new formalism" intended to be part of the relational theory by contributors extremely sympathetic to that theory, notably Schwartz and Scott, seems to me to offer a great deal.[75] This is by no means the Langdellian formalism that lies behind the performance interest, but an "instrumental" argument that basing adjudication on a "literalist" approach to relatively clear, formal rules around which competent parties can then bargain to achieve specific outcomes, will be superior to trying to determine those outcomes directly, for the courts cannot really know what the intentions of the parties are in complex contracts. The basic impulse

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ways in which it does not amount to evidence of completely non-contractual relations. I am grateful to Hugh Beale for instructive conversations on this point.

71. Marc Galanter, *The Radiating Effects of Courts*, *in* Empirical Theories About Courts 117, 121–24 (Keith O. Boylum & Lynn Mather eds., 1983).

72. *See* Carrie Menkel-Meadow, *Toward Another View of Legal Negotiation: The Structure of Problem Solving*, 31 UCLA L. Rev. 754, 783–94 (1984).

73. *See* Ronald J. Gilson, *Value Creation By Business Lawyers: Legal Skills and Asset Pricing*, 94 Yale L.J. 239, 249–55 (1984). *See also* Ronald J. Gilson & Robert H. Mnookin, *Symposium on Business Lawyering and Value Creation for Clients*, 74 Or. L. Rev. 1, 7–14 (1995).

74. And this, indeed, is what is happening in the drafting of the new standard forms of construction and engineering contracts in the U.K. *E.g.*, The Institution of Civil Engineers, The Engineering And Construction Contract 3 (2d ed. 1995) (noting the first "core" clause of the contract provides that: "The *Employer*, the *Contractor*, the *Project Manager* and the *Supervisor* shall act as stated in this contract and in a spirit of mutual trust and co-operation").

75. *See* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Contracts and Judicial Strategies*, 21 J. Legal Stud. 271, 271–318 (1992); Robert E. Scott, *The Case for Formalism in Relational Contracts*, 94 Nw. U. L. Rev. 847, 847–76 (2000); Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 Colum. L. Rev. 1641 (2003); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541 (2003). Without detracting from the value of the important papers of Schwartz and Scott, I am of the opinion that John Kidwell made the fundamental point almost twenty years ago at a previous Wisconsin Law School contracts conference: John Kidwell, *A Caveat*, 1985 Wis. L. Rev. 615, 615–22.

behind the new formalism is a belief that, if they stick to the provision of a relatively simple framework of formal rules around which competent commercial parties can negotiate, the courts will be sticking to what they do best:

> The common law interpretive methodology is grounded on the implicit assumption that courts function well when they operate within tightly constrained, formal modes of analysis. Courts will perform poorly, on the other hand, where they attempt . . . actively [to regulate] complex economic activity.[76]

To the extent that courts have tried to do the latter, they "crowd out"[77] the typically superior efforts of the parties themselves, either because the law explicitly supplants the parties' own decisions or because the willingness of the courts to intervene creates an incentive to seek rents rather than properly negotiate. We currently get the proper spheres of the competence of the courts and of the parties to complex contracts wrong:

> Formalist modes of interpretation are justified because, and only because, they offer the best prospect for maximising the value of contractual relationships, given the empirical conditions that seem to prevail . . . the case for formalism in relational contract turns on the relative implausibility of the empirical conditions necessary for activist [adjudication]: competent courts and incompetent parties. The evidence from the cases adjudicating contract disputes . . . is that the more likely empirical condition is competent parties and incompetent courts.[78]

The lesson we should draw from this is that:

> A normative theory of contract law that takes party sovereignty seriously shows that much of the expansion of contract law over the last fifty years has been ill-advised. Contract law today is composed of a few default rules, many default standards, and a number of mandatory rules. Most of the mandatory rules should be repealed or reduced to defaults, and most of the defaults should vanish from the law. Advocating freedom of contract for firms is uncontroversial. Taking freedom of contract seriously, however, would radically truncate current contract law. A law merchant appropriate to our time would be a merchants' law; and for merchants, the less publicly supplied law the better.[79]

76. Scott, *The Case for Formalism in Relational Contracts*, *supra* note 74, at 875–76.

77. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, *supra* note 74, at 1645.

78. Scott, *The Case for Formalism in Relational Contracts*, *supra* note 74, at 875.

79. Schwartz & Scott, *supra* note 74, at 619.

Though I believe that the crowding out problem is not nearly as great as they seem to allege,[80] I agree with the argument against intervention made by Schwartz and Scott. I would, however, like to make two further points. First, the thrust of Schwartz's and Scott's argument is that courts are reducing the value of complex contractual relationships to competent commercial parties by intervening when they should not. I myself am as much concerned about the costs and consequences of committing the valuable and scarce public resource of court time to the assistance of competent commercial parties in this way. I see no compelling reason why the courts should, even if they could, provide an extensive negotiation and dispute resolution service in this way to business parties who really should provide for these expenses themselves, either by planning for dispute avoidance or dispute resolution, or by integrating the formerly separate stages of the production process, or by not undertaking this form of production if the transaction costs of doing so are prohibitive.

Second, and more important in this context, the paternalistic impulse undercuts the relational theory in two ways. It leads to inappropriate interventions in the dealings of competent commercial parties, as the new formalists argue; and, I would add, by tarring potentially appropriate paternalist interventions in the dealings of relatively incompetent parties such as consumers with the same brush, it undermines the case for even these interventions. For, of course, along the spectrum of contracts, different degrees of state involvement are necessary to produce optimum outcomes, and terms that not merely cannot but should not be provided by the state in contracts between competent parties must be provided in contracts when one of the parties is relatively incompetent. The, as it were, vicarious co-operation between the parties supplied by the paternalist intervention of the state is as obvious in these latter cases as is the co-operation of competent parties to complex contracts adopting "non-contractual relations." I would say that an important source of misunderstanding amongst those committed to the relational theory is that they often have different contracts in mind when arguing about the appropriate role for the state. For contracts between competent commercial parties, the state's role should be kept to a minimum, and the state certainly should eschew paternalist intervention. The resultant contract will, nevertheless, be relational in the most important sense that it will be based on co-operation, because co-operation is the essential product of the relations of good faith parties.[81]

80. *See generally* Stewart Macaulay, *Freedom from Contract: Solutions in Search of a Problem?*, 2004 WIS. L. REV. 777–820 and William C. Whitford, *Relational Contracts and the New Formalism*, 2004 WIS. L. REV. 631–43.

81. Macneil, *supra* note 53, at 1034 (stating "similarity of interests may be produced by external forces such as sovereign law. But . . . solidarity may and does arise internally in relations").

VII. Efficient Breach Revisited in the Light of Relational Theory

One can anticipate that, certainly in England and Wales, the new formalist argument will run up against the critique of efficient (maximising) breach that has so galvanised the performance interest argument. I want to deal with this now. As I have said, I should not wish to be thought as arguing that the expectation principle works perfectly well. In this specific context, I would not wish to deny that the defendant's keeping the profits of efficient breach, to the disgust of the claimant *surprised* to see these profits arise, would be unsatisfactory. That the claimant may respond by refusing to deal with the defendant in the future, and that the defendant may suffer loss of reputation in the eyes of third parties, are important "non-legal" sanctions[82] which may well push the defendant's calculation of "resultant wealth" beyond the horizon of the specific contract which he may consider breaching, and so reduce the likelihood of breach.[83] But let us allow that these sanctions do not alter the basic point, which is that there are shortcomings to the expectation principle (and additional shortcomings in Fuller and Perdue's statement of it).

I should make explicit my implicit belief that the expectation principle (incorporating the second principle of co-operation) seems to me to be the best conceivable system of remedies, a belief that is entailed in my belief that the market is the best conceivable system for the allocation of economic goods. But, to put the point the other way around, just as one would have to be obtuse in the extreme to deny the shortcomings of the market, one would have to be similarly obtuse to deny the shortcomings of the expectation principle. The nature of these shortcomings may be seen in its founding statement in Fuller and Purdue's three interests analysis. Let us ignore the problems which have beset the relationship between expectation and reliance, and turn to those which beset the relationship of expectation and restitution. It is central to the argument of this paper that these problems are very serious, for we have seen that general restitutionary damages would be an important way of giving greater protection to the performance interest, and so would be ultimately antithetic to the expectation principle. But even if one tries to keep restitution within "quasi-contractual" limits as a supplement to expectation, this must ultimately prove to be theoretically unsatisfactory, because even to have the two different, indeed, as I say, ultimately antithetic, principles simultaneously at work means that the problem always exists of deciding when each principle should be invoked, and a proper solution of this will logically require a third overarching principle which

82. *See* David Charny, *Non-legal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 373, 408–25 (1990).

83. Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615, 616 (1981).

subsumes both of the original principles of expectation and restitution. It is highly arguable that Fuller and Perdue's analysis is ultimately unsatisfactory for just this reason. However, I believe this problem can be solved within the framework of Fuller and Purdue's analysis, but I am not in a position to offer my solution, which is in no fit state to be publicly presented at the moment. In this situation, I must acknowledge these grave problems and say something about what can be done about them now, in advance of their proper resolution, for their existence obviously undermines the case I am making for the expectation principle.

In addition to the problem which might be caused by efficient (maximising) breach, let us also acknowledge that, what is typically much more unsatisfactory than merely not sharing in a gain, the way the expectation principle works through the rules on literal enforcement certainly can leave the claimant with an outright uncompensated loss. When cover is not possible, then consequential losses may be incurred, and if these losses are of an idiosyncratic nature that makes them uncertain and remote, the claimant will be attracted to literal enforcement. The claimant may be unable to show damages to be inadequate, but he nevertheless is left (partially) uncompensated by them. It is to avoid this sort of problem that commercial claimants often seek literal enforcement when damages should, in theory, be adequate to satisfy their commercial interest, but they fear that damages as actually quantified will leave them with an uncompensated idiosyncratic loss.[84] Even then, the analogues to the mitigation rules in the law governing the award of the various forms of literal enforcement keep the defendant's costs as low as possible under these more difficult circumstances and will even deny literal enforcement if it is thought too costly to the defendant.[85]

I have discussed these problems, and the responses that have been made to them, at length elsewhere.[86] I believe co-operation is the key to the management of these problems, but not the *ex post* co-operation we have already discussed, but co-operation *ex ante* the agreement, co-operation in negotiations. Let us imagine that two commercial parties wish to commit themselves to a complex relationship in which, in general terms, it is foreseen that: (1) circumstances may arise in which the defendant will gain windfall profits if he or she breaches; and/or (2) the claimant will suffer an idiosyncratic loss if the defendant breaches and literal enforcement is denied. The common response to (2) is, of course, to plan for dispute resolution by, to take

84. An illustrative case is *Behnke v. Bede Shipping Co. Ltd.*, [1927] 43 T.L.R. 170 (discussed in HARRIS ET AL., *supra* note 17, at 172–73).

85. The leading case is *Co-Op. Ins. Soc'y Ltd. v. Argyll Stores (Holdings) Ltd.* [1997] 1 W.L.R. 898, (discussed in HARRIS ET AL., *supra* note 17, at 225–26).

86. *See* HARRIS ET AL., *supra* note 17, at 262–68; Campbell & Harris, *supra* note 28, at 212–15.

the clearest case, agreeing to bespoke remedies that supplant the normal expectation principles. Reflection on this makes it clear that the same tactic is available in respect of (1). Bespoken remedies, perhaps specifying restitutionary disgorgement in terms, may be agreed to cover (1) as well as (2), for the expectation principle is not, of course, in general mandatory, but is a default rule out of which the parties can contract. Ignoring the various, often really quite indefensible, rules relating the ousting of the default rules by competent commercial parties,[87] we can say that the solution to the problems we have acknowledged, of windfall profits and uncompensated losses, lie in the hands of the claimant prior to agreement, for he or she can require a clause giving the remedy he or she wants during negotiations.

Of course, one must be clear what one means by "solution" in this respect. That circumstances arise which are not adequately foreseen by the parties will not change just because they have made general provision for them in the contract, but it should be recalled that it is the basic argument of this paper that bounded rationality is ineluctable, and the persistence of these inadequately foreseen circumstances can hardly be held against that argument. The point is how well the parties, aware of the inevitable possibility of breach, deal with these circumstances, if they arise, by negotiation before they arise. They could agree not to oust the default rules, and so leave the possibility of windfall gains with the defendant and of uncompensated loss with the claimant. They could agree to oust the default rules and replace them with some form of bespoke clause that in some way apportions any gains and losses which might arise, or even tries to completely reverse the allocation of risk under the default rules. Whatever they do will not eliminate the problems that lead to breach, but will allocate the risks it causes to the parties in the way they agree, and this, I submit, is the best possible thing that can possibly be done to deal with risks that can not be eliminated.

When actually faced with the eventuation of the unforeseen circumstance, the parties could, of course, decide to revise their agreed solution, in pursuit of a gain assessed over a longer period than that of the instant contract. But let us ignore this particular possibility of co-operation, which the relational theory has thoroughly analysed. My argument is that, by requiring it to be made explicit that the parties intention is to deal with these problems by ousting the default rule, the remedies system forces the parties co-operatively to negotiate a solution to these problems. But, of course, this way of handling the problem requires that the parties have some general inkling of the possibility that it will arise, and this requires them to realise that breach can occur and that the default rules will in all likelihood not seek to prevent it; just the opposite understanding, in fact, to that en-

87. HARRIS ET AL., *supra* note 17, at 133–50.

couraged by belief in *pacta sunt servanda* and the performance interest. Such a belief can be maintained only by denial of the ineluctability of breach and that, therefore, "[s]ocial efficiency . . . requires [parties] to restrain [their] reliance in light of the . . . probability of breach."[88] It then requires that the parties effectively negotiate the allocation of risk and, I submit, they are more likely to be able to do this if they take a co-operative attitude than if they attempt to secure all possibility of gain to themselves and to impose all possibility of loss on the counterpart. Beyond a certain point of complexity, negotiation costs will be so large as to make the agreement impossible and the exchange will have to be abandoned, or require the parties to integrate in order to allow the "exchange" to take place within the hierarchical structure of the firm. But even when the parties remain distinct, they will have to adopt a co-operative attitude if they are to have any hope of reaching a serviceable agreement about these complicated matters, for the more one seeks to get everything, the more chance there is one gets nothing (or nothing but trouble).

VIII. CONCLUSION

In this paper I have argued that breach, and the remedies system which makes it possible, can be adequately explained only as a fundamentally co-operative legal institution. Grasping this has proven difficult for all theories of the law of contract, including even the relational. The ultimate necessity of co-operation has mainly been visited on the law of contract by the ubiquity of settlement and by non-use. Nevertheless, I hope to have shown that the relational theory can accommodate the co-operative explanation of breach; something which is entirely beyond the classical law and its revival in the form of the performance interest.

And, of course, we should not be surprised by this. It is now quite evident that the relational theory can deal with complex contracts far better than the classical law. It should also be recognised that it is similarly superior in respect of discrete contracts and competition. For underlying the entire spectrum wherein these forms of contract lie is the fundamental necessity of co-operation in exchange to which Macaulay and Macneil have drawn our attention. The superiority of the relational theory over the classical law lies in the way that it is built upon recognition of co-operation (from which competition within legitimate parameters can be coherently derived), whereas co-operation can appear only as an overwhelming set of disturbing counter-examples to the individualism of the classical law.

88. Cooter, *supra* note 45, at 13.