CHAPITRE 3 – LE DROIT DES CONTRATS

I – INTRODUCTION

La notion de contrat n'est *ni arrêtée, ni uniforme*.

En droit français, on conçoit mal l'existence d'un contrat sans un *échange du consentement*, bien que l'article 1108 du code civil n'exige que « *de celui de la partie qui s'oblige* ».

On peut distinguer trois grandes conceptions des contrats.

Dans la pensée *juridique continentale*, l'accord de volonté est l'élément moteur du contrat. Sans cet accord le contrat n'existe pas, peut-être est-il inconcevable ? Le contrat naît et ne peut naître que de la rencontre des volontés. A suivre cette conception, le contrat est une aventure spirituelle. La science juridique « civiliste » rend ici un hommage appuyé à la liberté individuelle et à l'autonomie du sujet.

Selon une *seconde conception, nord-américaine*, le contrat est avant tout une *promesse juridiquement obligatoire*. C'est par exemple, la définition retenue par le *Restatement* (*second*) *of contracts*, œuvre censé refléter fidèlement le droit américain.

« *A contract is a promise or a set of promise for the breach of which the law gives a remedy, or the performance of which the law in some way recognize as a duty* ».

Deux éléments se dégagent de cette définition. En premier lieu, le contrat est une *promesse*. Il s'ensuit que le contrat s'inscrit par définition dans le temps. Qu'est-ce que c'est en effet qu'une promesse si ce n'est le report dans le temps de l'exécution d'un engagement. Selon cette définition, l'échange instantané (celui qui s'exécute en même temps qu'il est conclu) n'est pas un contrat.

Ici la distinction est très nette avec la conception fondée sur *l'accord de contrat*. Reste que *toute promesse n'est pas un contrat*. Pour cela il faut, en second lieu que la promesse *soit juridiquement obligatoire*. La reconnaissance du caractère juridiquement obligatoire de la promesse découle soit de l'accomplissement d'une forme plus générale de ce que le créancier offre quelque chose de valeur en échange de la promesse dont il bénéficie (une *consideration*). Soulignant l'importance de cette dernière exigence, certains ont défendu une troisième conception du contrat

Selon cette *troisième conception du contrat*, *qualifiée de plus réaliste,* le contrat est moins un accord ou une promesse qu'un échange économique. Sans échange ou plutôt sans *bargain* il n'existerait pas de contrat. Telle est la signification profonde de la *consideration*. Ceci expliquerait qu'en *Common Law*, les actes à titre gracieux soient exclus de la qualification de contrats à la différence de conception « *volontariste* », a cet égard, plus compréhensive.

En l'état actuel des choses **on relève plus souvent l'opposition entre les traditions civilistes et de *Common Law*,** observation parfois complétée par une **opposition idéologique fondée sur le prétendu caractère commercial du droit anglo-américain des contrats.**

Toutefois, même en *Common Law* **tous les contrats ne sont pas des *bargains*.** Certains **contrats tirent leur force obligatoire de l'accomplissement d'une *formalité*** ; d'autres **de la confiance** légitimement accordée à la promesse.

Les quatre principes fondant le droit des contrats

Premier principe

Pour les économistes, le droit des contrats doit faciliter la coopération en transformant un jeu non coopératif en un jeu coopératif.

Les contrats vont réduire l'incertitude.

Second principe

Le droit des contrats doit favoriser une «symétrisation» efficiente de l'information durant la négociation du contrat.

Le Droit des contrats i.e. ce qui apparait dans le code civil comme le droit des obligations, constitue l'ensemble des règles de Droit qui organisent les relations contractuelles entre les individus et leur créent des obligations)

Donc les relations de contrat forcent à symétriser les informations, contrat est un instrument qui permet d'éviter la sélection adverse

Le droit des contrats *va forcer à révéler* ce que vous savez sur le produit.

Troisième principe

La troisième fonction du droit des contrats est de sécuriser un niveau d'incitation optimal à l'exécution du contrat.

Ne pas effectuer le contrat nous amène à une situation sous efficiente. Contrat bien libellé : la non exécution coute plus cher que le bénéfice de la non exécution. Il faut une sanction qui incite à l'exécution du contrat, mais

pas une sanction disproportionnée, qui mènerait à une situation sous optimale.

Il faut que la non exécution des contrats soit «sanctionnée» par des dommages. Lorsque les dommages sont parfait (optimaux), le coût de la non exécution est égal au bénéfice de l'exécution.

Quatrième principe

Le droit des contrats doit être conçu de telle sorte que les parties atteignent un niveau de confiance réciproque optimal.

Un droit des contrats correctement rédigé doit inciter les individus à ajuster leur confiance au niveau optimal.

La théorie de l'efficience suggère que la confiance doit augmenter tant que *la probabilité de réalisation du contrat multiplié par l'augmentation du gain est supérieure au coût incrémental*. Du point de vue de l'économiste, il est illogique de considérer que celui qui l'émet doive payer les dommages si il ne tient pas sa promesse.

II – INFORMATION ET CONTRAT

Quel **que soit la conception du contrat retenue**, on constate que dans chaque droit, un **équilibre** est recherché entre **la liberté contractuelle**, d'un côté, et la **justice contractuelle**, de l'autre**.**

1 – Echange volontaire et contrat

Les règles du jeu de l'échange volontaire reposent sur un principe simple : celui *de l'autonomie de la volonté*.

Au plan politique, la liberté contractuelle incite tout à chacun à défendre ses intérêts personnels, ce qui dans une vision libérale, est un comportement conforme à l'intérêt général.

Au **plan économique**, la liberté contractuelle encourage *l'esprit d'initiative* et facilite les échanges.

Enfin, d'un point de vue de **technique juridique**, la liberté contractuelle est une réponse aux limites d'un *législateur incapable d'anticiper e*t de fixer le contenu de l'ensemble des contrats encadrant les rapports humains.

L'exercice de la liberté contractuelle a toujours été **borné par le souci d'imposer un** *minimum de justice dans le contrat*.

Les moyens techniques pour satisfaire la justice **varient d'un droit à l'autre.** D'une part, **de nombreuses lois** (y compris dans les droits de

Common Law) ont été adoptées afin de **protéger la partie présumée la plus faible.**

Ces dispositions, généralement impératives, réglementent le contenu du contrat (par exemple, en imposant, la reproduction de clauses légales, en fixant des seuils de validité pour les salaires et le taux d'intérêts ou en prohibant les clauses abusives) et en encadrent le comportement des parties, en les incitant à coopérer, à tenir compte des avis d'autrui (par exemple à travers le devoir d'information e de conseil).

Il en résulte un éclatement du droit des contrats, c'est à dire un *déclin de ce que les juristes français appellent le droit commun au profit des contrats spéciaux* (contrat de travail, contrat de bail, contrat d'assurance, etc.).

2 - L'incomplétude des contrats

Le contrat, est avant tout un « **réducteur », fut-il imparfait, de l'incertitude inhérente à la transaction**.

Dans un modèle « principal-agent » un principal cherche **à mettre au point un contrat** qui sera **bon pour lui** et **acceptable pour l'agent** en tentant *d'anticiper les problèmes*.

Ces problèmes, rappelons-le, viennent en partie du fait que le principal (rédacteur du contrat) **possède une information imparfaite** sur les caractéristiques de l'agent (**sélection adverse et du problème de risque moral**).

Mais il y a sans **doute d'autres sources d'incertitude** auxquelles le modèle principal-agent ne prête guère attention. On peut dire que le modèle principal-agent **s'intéresse à l'incertitude qui a une source** *interne ou stratégique*.

L'évolution de l'environnement économique des contractants constitue une autre source majeure d'incertitude.

Dans la mesure où le principal et l'agent auront su anticiper toutes les éventualités qui peuvent se présenter durant la vie du contrat, on dira que le **contrat est complet**. **Nous n'avons jusque-là envisagé que des contrats complets** où, quelques soit la tournure que prennent les choses, *le contrat précise les obligations et droits de chacun et ces obligations sont réalistes*.

Un contrat complet prévoit donc toutes les contingences.

Supposons par exemple que vous invitiez des amis à une grande fête (peut-être votre mariage) et que vous passiez contrat avec un traiteur. Si le contrat est complet il prendra en compte les différentes évolutions possibles de la

météo : s'il fait beau nous serons dans le jardin, s'il pleut ou qu'il fait du vent nous avons une solution de repli. **Un contrat sera incomplet s'il ne prévoit pas les obligations des parties dans le cas où le buffet ne peut être dressé[24].**

Pour dire la même chose différemment[25] : puisque le modèle principal-agent analyse la formation du contrat *à travers la perception du rédacteur du contrat*, il est donc **naturellement centré sur le contrat complet**. Le principal choisit le meilleur contrat après avoir dressé l'inventaire, *qu'il pense complet*, des situations possibles[26].

Mais le principal n'étant pas omniscient, il est fort possible que ce contrat se révèle, à l'expérience, être incomplet.

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[24] Supposons que vous deviez passer un contrat avec une personne dont vous savez qu'elle peut être très douée (auquel cas elle aura une forte productivité) ou peu douée. Le contrat doit spécifier des objectifs de production (et donc un certain niveau d'effort) pour cette personne. Il y a bien un double problème de sélection adverse et de risque moral. Pour inciter la personne douée à vous révéler ses capacités réelles (c'est-à-dire, pour résoudre le problème de la sélection adverse), vous pouvez être conduit à lui fixer des objectifs qui ne correspondent pas au maximum de production d'une personne douée, ceci pour éviter que la personne douée ne se fasse passer pour une personne peu productive afin de se voir fixer des objectifs facilement réalisables.

[25] Notre analyse du « market for lemons » participait bien de cette logique. L'acheteur de la voiture d'occasion ne connaît pas la qualité de la voiture, mais il sait qu'elle peut être de bonne ou mauvaise qualité (et l'autre sait qu'il sait). De même, l'employeur ne connaît pas l'effort que mettra en oeuvre l'employé, mais il sait que celui-ci sera fort ou faible (et l'autre sait qu'il sait). L'une des parties à la négociation ne sait pas quelles sont les possibilités offertes par ailleurs à l'autre partie, mais elle connaît son prix de réservation, c'est-à-dire, le minimum qui doit être offert pour que l'autre accepte (et l'autre sait qu'elle sait...). L'analyse économique des contrats se ramène ainsi à la recherche du meilleur contrat—le contrat « optimal »—dans un contexte d'asymétries informationnelles correctement cernées par les parties, ou d'incertitude exogène là encore correctement « probabilisée » par tous. On peut évidemment s'interroger sur les raisons qui ont conduit les économistes à réduire de la sorte leur champ d'analyse. Nous pensons que cela est dû essentiellement au souci de conserver les outils d'analyse « traditionnels », et en particulier le concept d'équilibre qui ne tolère pas un univers ouvert, une incertitude « authentique ».

[26] Le modèle principal-agent est donc utile pour conseiller le principal, mais pas nécessairement pour réfléchir à une règle contractuelle universelle. D'une certaine façon, l'économie des contrats présentée jusqu'ici est plus utile à une réflexion sur la technique contractuelle qu'à une réflexion sur le droit des contrats.

L'incomplétude du contrat est évidemment une source potentielle de conflit entre les parties. C'est donc une situation typique pour le juriste !

Ainsi que le notent Hart et Moore, « *un rapide coup d'œil aux conflits juridiques passés suffit pour s'apercevoir que la plupart des disputes contractuelles qui arrivent devant les cours concernent des questions d'incomplétude* ».

III- REMEDIES FOR BREACH

The law should only enforce contracts that were formed voluntarily and, hence, promise a mutual benefit.

Contracts that **appear mutually beneficial at the time of formation, however, may not be when the date of performance arrives**.

The reason is the **occurrence of some unforeseen contingency** that reduces the value or raises the cost of performance for one of the parties.

If the contract is **judged to be enforceable-that is, if the party seeking to avoid performance fails to convince the court that the contract was invalidly formed-then the court must decide on a remedy**.

Designing an **efficient remedy for the breach of enforceable contracts** is the subject of this chapter.

We begin the analysis by arguing that breach of contract is efficient in those cases where **the cost of performance tums out to exceed the benefit of performance.**

An **efficient remedy for breach should give contractors an incentive to breach only in those circumstances**.

In addition, **we will examine the incentives breach remedies create for parties to make investments in preparation for performance**.

These **reliance investments are desirable because they enhance the value of performance,** but they are often nonsalvageable in the event of breach. Thus, **we examine the role of breach remedies ·in preventing contractors from overrelying on performance**.

Finally, we consider the role of breach remedies in assigning the risk of breach in an optimal way.

1 -The efficient breach hypothesis

We will begin with several examples of efficient breach.

The general setting concerns a contract between a buyer and a seller for the

production and delivery of some good.

Let **V** be the value of the good to the buyer and let **C** be the variable cost of production for the seller. (We will assume that the seller bas zero fixed costs.)

Example 1: Uncertainty over Production Costs.

Suppose that the seller's cost of production is uncertain at the time the contract is made, due, for example, to uncertainty over energy, labour, or material costs.

When the value of C is realized, the seller must decide whether to go ahead with production of the good. The efficient rule is to produce the good if $C < V$ but to breach the contract if $C > V$.

Breach is efficient in the latter case because the cost of resources needed to complete production is greater than the value of performance.

Thus, production would entail a net loss of C - V.

Example 2: Uncertainty over the Value of Performance to the Buyer. In this case, suppose that the value of performance to the buyer is uncertain.

For example, a factory orders a machine that it may not need if the demand for its product falls. Although the uncertainty is over V rather than C in this example, the condition for efficient breach (and the rationale) is the same as in example 1: that **is, it is efficient to breach if $V < C$, and it is efficient to perform if $V > C$.**

Example 3: Uncertainty About Offers from Alternative Buyers. Suppose that the seller has completed production of the good (given that $V > C$), but before he can deliver it to the original buyer, a **second buyer arrives and offers a higher price**. In this case, efficiency dictates that the good should end up with the buyer who values it most Thus, **if V' is the valuation of the second buyer, then it is efficient for the seller to breach the original contract and sell to the second buyer if $V' > V$.**

In general, the **breaching party will not base her decision on efficiency**, but **rather on how it affects her private return**, in the same way that injurers made their care decisions based on **private rather than social costs**.

The **role of breach remedies, like tort damages, will therefore be to align the interests of the breaching party with those of society**.

The next section shows how this is done.

2. Money Damages and Efficient Breach

Consider a **contract for the construction of a house**.

Let the value of the house to **the buyer be V**, which is known, but suppose that the seller's actual cost of production is uncertain at the time the contract is made.

For example, suppose the he is unsure how costly it will be to dig the foundation. However, be expects his costs to be less than the **contract price P,** which is less than the buyer's valuation. Thus, both parties expect to enjoy a positive gain from the contract.

Suppose further that in preparation for performance of the contract, the buyer made a **reliance investment of R**.

For example, suppose that **she hired a moving company to deliver her furniture on a certain date**. The reason for making the investment is to **enhance the value of performance** in the event that the contract is completed (thus, **V depends on R** in away that will be made explicit below), but the cost is that the investment will be lost if the contract is breached (for example, a **non-refundable deposit paid to the moving company will be lost, or the furniture will have to be stored**).

We say **that the investment of R is nonsalvageable**.

The fact **that the buyer invests R** be/ore the seller makes his breach decision is therefore crucial; if she could wait, she would clearly only spend R in the performance state.

In many cases, however, waiting will not be possible or desirable. For purposes of the current analysis, **we treat R as a fixed expenditure**. Below, we examine the **optimal choice of R by the buyer**.

Finally, **let D be the court-imposed damage payment that the seller must pay to the buyer in the event of breach.**

Efficient Breach

Our goal will be to determine the **value of D that induces the seller to breach efficiently.**

Table 1 summarizes the payoffs to the buyer, the seller, and the joint (social) payoffs breach states and I the performance.

Before proceeding, **recall that the (social) condition for efficient breach in this example is**

$$C > V, \tag{1}$$

or that the **cost of performance exceeds the value of performance**. Note that the reliance investment is irrelevant for this condition because it is a sunk cost at the time production costs are realized.

Table 1 - Breach of contract example

State	Buyer's return	Seller's return	Joint return
Performance	V-R-P	P-C	V-R-C
Breach	D-R	-D	-R

To see this, note from column three of the table that **the joint return from breach exceeds the joint return from performance if:**

-R > V - R - C.

The R's cancel, leaving C > V.

Now consider the **actual breach decision by the seller.**

It is clear from column two of the table that, once production costs are realized.

The seller (private) will breach if -D > P - C, or if

C >P + D. (2)

The left-hand side of this condition is the **benefit of breach-the savings in production costs.**

The right-hand side is the cost of breach-the foregone price plus damages. **The seller will breach when the benefit exceeds the cost.**

Remember **that our objective is to give the seller an incentive to breach only when it is efficient. Thus, we want the seller's private breach condition in (2) to coincide with the social condition in (1)**. This will be true if the right-hand sides of the two conditions are equal, or if

D = V - P, (3)

which says that damages should equal the difference between the buyer's valuation and the price (known as the buyer's surplus).This damage measure was derived with the specific goal of inducing efficient breach.

3 - Breach and remedies

Efficient Breach under expectation damages

The next question is how it relates to actual remedies employed by courts in breach of contract cases.

By far the most popular measure of damages is **expectation damages (intérêt positif)**, which is defined to be an amount of money that leaves the

promise (the victim of breach- in this case the buyer) as well off as if the contract had been performed. T

hat is, it leaves the **promise indifferent between breach and performance**.

We can thus calculate this measure from Table 1 **by equating the two rows in the buyer's column and solving for D.**

The result is **D = V - P,** which is identical to the measure in (3)

Thus, **expectation damages gives sellers exactly the right incentives for efficient breach.**

This conclusion should not be surprising.

Because expectation damages fully compensates the buyer for her losses as a result of breach, the seller is forced to internalize those losses and therefore mak.es the socially correct breach decision.

Non-Efficient Breach under reliance damages

Another measure of damages occasionally used by courts is **reliance damages(Intérêt négatif)**, defined to be **an amount of money that leaves promisees as well off as if the contract had never been made**.

Like expectation damages, this measure is meant to fully compensate victims of breach, except that **the reference point is their precontract status** rather than their post performance status.

Since the returns in Table 1 **are measured as net gains, the buyer's precontract status is zero profit.** Thus, **equating the buyer's return in the breach state to zero yields D = R.**

Reliance damages (**intérêt négatif**) thus reimburse the buyer for her **nonsalvageable reliance expenditures**.

What are the seller's incentives for breach under the reliance measure?

Substituting D = R into (2) yields the breach condition:

C >P + R. (4)

The seller will therefore breach **too often if P + R < V and too little if P + R > V.**

But note that **V - R -P > 0 in order for the buyer to receive a positive return from performance of the contract** (see the first row in the buyer's column).

Thus, P + R < V and the seller breaches too often under reliance damages.

Efficient Breach under zero damages rule

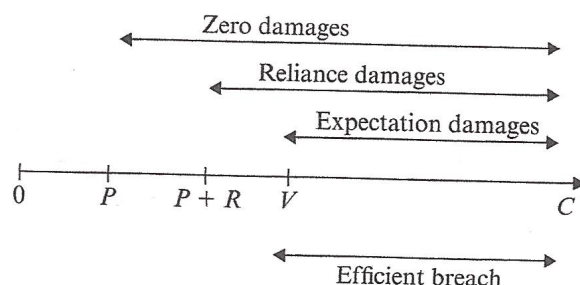Finally, we consider the seller's incentives for breach under **zero damages** (D =0).

Under this measure**, the seller will breach whenever C > P**, or whenever be incurs a loss from performance.

Since breach will occur even more frequently **under zero damages** than **under reliance damages** (given R >0), **breach must also be excessive in this case.**

Figure 1 summarizes our conclusions regarding breach by showing the ranges of production costs over which breach occurs under the various damage measures compared to the efficient range.

Comparison on of the rules

Figure 1. Ranges where breach occurs under various damage measures

IV - INCENTIVES FOR EFFICIENT RELIANCE

We now extend the model to allow the buyer to choose the level of reliance.

In order to do this, **we need to be explicit about the relationship between the reliance choice, R, and the buyer's value of performance, V**.

As noted above**, reliance investments are made prior to the contract to enhance the buyer's value of performance**.

Thus, **we suppose that V is increasing in R but at a decreasing rate, reflecting the usual assumption of diminishing returns. Figure 2 shows V(R) graphically**.

1 – Socially optimal investment in reliance

If performance of the contract were certain, then the **socially efficient level of reliance would maximize the net value of performance**. **That is, R would be chosen to**

Maximize P(R) - R. (5)

Let **R* be the solution to this problem**.

Optimal reliance in a world of perfect information: When q=1

In Figure 2, R* **occurs at the point where the vertical distance between the V(R) and R curves is greatest**. (This is also the point where the slopes of the two curves are equal.)
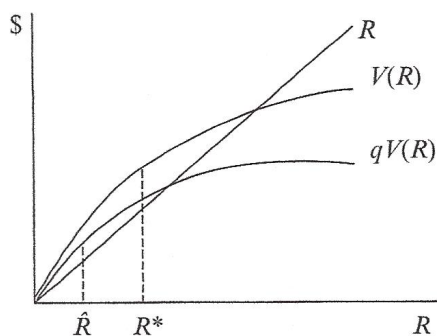
Optimal reliance in a world of imperfect information: When q≠1

Performance of the contract is not certain **if the seller's costs turn out to be high.**

To capture this in the simplest way, suppose **that the seller will realize either high costs** (Ch) or **low costs** (Ct), where Ch>Ct> and that performance is only efficient when costs are low.

Further, suppose that when the contract is made, both parties know that the probability of low costs is q. Thus, the probability of efficient breach is 1 - q.

Figure 1 Efficient reliance when performance is certain (R*) when it is uncertain (R chapeau)

What is **the buyer's optimal reliance given this uncertainty over performance?**

Return to Table 1. The final column shows the joint return from the

contract in the performance and breach states **(where now V should be viewed as a function of R**).

Weighting the first line by q, **the probability of performance, and the second line by 1 - q, the probability of breach, yields the expected joint (social) value of the contract:**

q[V(R) – Cl] -R = qV(R) - qCl-R (6)

The efficient level of reliance, denoted R, maximizes this expected value. It is important to note that the -**qCL term in this expression does not affect R** since it is just an additive constant.

Thus, **R also maximizes the expression qV(R) - R.** This outcome is shown in Figure 2.

Note that R < R*, reflecting the fact that the buyer should invest less when performance is uncertain in order to reduce the loss in the breach state (given the nonsalvageability of R). Indeed, it should be clear from the graph that as the probability of performance decreases (i.e., as q falls), so should R.

So far we have derived the efficient level of buyer reliance in a world of uncertain performance.

2 – Private optimal investment in reliance

The next step is to consider the buyer's actual choice of reliance.

Under expectation damage

In order to do this, **we need to reintroduce the damage remedy**.

Since our **hope is to induce the buyer to invest in the efficient level of reliance while retaining incentives for efficient breach, we begin with the expectation damage remedy.**

In the current version of the model, **this measure of expectation damage is given by D =V(R) -P.**

Note that the **buyer's damages in the event of breach therefore depend on her choice of reliance because, as she invests more reliance, her loss in the event of breach increases**.

As we showed above, the seller will make **the efficient breach decision under expectation damages**.

Thus, **the buyer expects the seller to breach when costs are high, and to perform when costs are low**.

From Table 1, we c therefore calculate the buyer's expected return to be

$$q[V(R) - R - P] + (1 - q)(D - R). \tag{7}$$

Substituting $D = V(R) - P$ in to this expression yields

$$q[V(R) - R - P] + (1 - q)[V(R) - R - P] = V(R) - R - P. \tag{8}$$

Note that the level of reliance that maximizes this expression is R*, the efficient level of reliance when performance is certain.

Thus, expectation damages causes the buyer to overinvest in reliance. Intuitively, **expectation damages fully insures the buyer against the risk of breach**; hence, **she behaves as if performance were certain**.

In other words, expectation damages creates a moral hazard problem for the buyer.

Under negligence-type

We could similarly try to define a negligence-type rule for breach of contract that sets a threshold for efficient reliance.

Such a rule, for example, **would require sellers to pay full damages for breach if the buyer invested in the efficient level of reliance and no damages if the buyer overrelied**.

In equilibrium, buyers would invest in efficient reliance in order to ensure compensation in the breach state, and sellers would breach efficiently because they expected to pay full compensation.

Fortunately, there is a **doctrine in contract law that addresses the problem of overreliance**. We will refer to it as the **Hadley v. Baxendale rule** after the case in which it was first proposed.

V – POSTIVE DOCTRINE OF OVERRELIANCE

The facts of this case are easily stated.

The plaintiffs operated a mill that was forced to shut down when the crankshaft broke. Because the design of the shaft was specific to the plaintiffs' mill, they needed to ship the broken one back to the manufacturer to serve as a pattern for construction of a new one. Accordingly, they hired the defendant, a carrier company, to transport the shaft. The defendant promised delivery to the manufacturer the following day, but delivery was "delayed by some neglect " which caused the mill to be shut down for several days. The plaintiffs sued for the lost profits resulting from the delay. The defendants

In deciding this case, the court stated the following general rule:

"Were two parties have made a contract which one of them broken, the dam- ages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract as the probable result of the breach of it."

The implication of this rule is that damages for breach of contract will be limited to a reasonable level. One way to interpret this limitation is-that damages will be limited to the tosses that result from are reasonable (efficient) **level of reliance**.

Formalisation

In terms of our model, expectation damages under the Hadley v. Baxendale rule would therefore be written

$$D = V(\bar{R}) - P. \tag{9}$$

Note that this differs from the unlimited expectation damage measure in (3) in that here, **damages are based on the efficient level of reliance**, whereas **in (3), damages were based on the actual level of reliance**.

The difference **between limited and unlimited expectation damages** is illustrated in Figure 3.

Suppose the **plaintiff invested in reliance of R' > R. Under the unlimited** measure, she would receive the full amount of the difference between V(R') and P, whereas **under the limited measure**, she would receive the smaller amount V(R) - P (shown by the darkened segment in the graph). **Thus, she would not be compensated for the value of reliance in excess of R.**
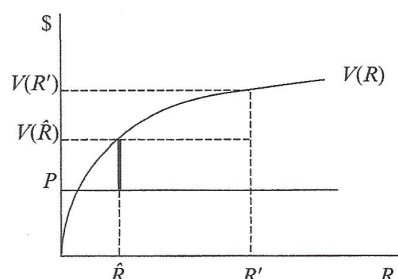
What is the impact of this limitation on the buyer's choice of reliance? Return to the buyer's expected return in (7), but now substitute the damage measure in (9) for D. The resulting expression, after rearranging; is

$$qV(R) - R - P + (1 - q) V(\bar{R}). \tag{10}$$

Note that the final two terms in this expression are constants-that is, they are independent of R. **Thus, the value of R that maximizes (10) is the same** as that which maximizes $qV(R) - \bar{R}$, which is $\bar{R}$, the efficient level of reliance. **Thus, under the limited expectation damage measure, the**

buyer invests in the efficient level of reliance.

Figure 3. Comparison of limited and unlimited expectation damages

Mathematically, **this result arose because the first and last term in (10) cannot be combined to eliminate the q since V(R) is a function where V(R) is a number (a single point of the function V(R)).**

Intuitively, **the buyer has no incentive to invest in reliance beyond** $\bar{R}$ because she will receive zero compensation for any tosses that result. (**In this sense, limited expectation damages is a threshold rule like negligence**.) **The moral hazard problem associated with full compensation is thereby eliminated.**

In some cases, **buyers may have unavoidably high reliance**, perhaps because they underestimated the likelihood of breach, or simply because there is some variation in the value of performance across buyers. (For example, there are high and low V' since the population of buyers: some mills have spare shafts and some don't.)

The court in Hadley v. Baxendale also addressed this possibility **by placing the burden on high-value plaintiffs (those who have a lot to lose from breach) to communicate this information to defendants.** If *they do*, then the damages in the event of breach "would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated."

However, if the *plaintiffs failed to communicate* their higher than nominal value of performance, then the damages would be limited to the "injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract."

In other words, the law limits the ability of promisees to collect so-called consequential damages, defined to be damages that were unforeseeable to the promisor at the time of breach.

From an **economic perspective, limiting damages in this way serves to encourage communication between the parties prior to contracting**. This is desirable because it allows defendants to exercise extra care in those cases where the cost of breach is unusually high.

In sum, the **Hadley v. Baxendale rule serves two important economic** functions in breach of contract cases.

First, when buyers can choose the level of reliance prior to contracting, it **prevents them from overrelying** by limiting the damages to the amount that buyers would lose if they had invested efficiently.

Second, when buyers vary in their valuation of performance, it encourages **those with higher than normal valuations to communicate that fact so sellers can take extra care to avoid breach**. Thus, the court in Hadley held that the mill's lost profits were not recoverable because the mill owner had **not informed** the carrier of his need to shut down for lack of a spare shaft.

VI - CONCLUSION

This chapter began by asking w**hen it is efficient to breach an enforceable contract.**

Although a contract may have promised mutual gains at the time of formation, unforeseen changes **can cause the cost of performance to exceed the value of performance,** in which case breach is the efficient course of action.

The role of the **court in fashioning remedies for contract disputes is to create incentives for the parties to breach only when it is efficient to do so**.

We showed that expectation damages achieves exactly this outcome. **Unlimited expectation damages does not, however, provide efficient incentives for reliance, nor does it necessarily share risks optimally**. We could therefore **discussed alternative remedies aimed** at achieving these goals.

Besides money damages, courts sometimes order specific performance. Typically, **this remedy is limited to contracts involving unique goods** (like land), but economists have argued for its wider use, both to lower the transaction costs of resolving disputes and to protect subjective value.

Court-imposed remedies are costly to employ, so parties often provide their own "self-help" remedies as part of the contract, the most

common being liquidated damages.

This **type of remedy is especially beneficial in long-term or repeated contracts where the parties can develop a reputation for honouring promises**.

Economic theory says that courts should generally enforce such self-imposed remedies since they reflect the parties' efforts to maximize the value of the contract.