

Remedies for Breach of Contract: Expectation, Reliance, Restitution, Disgorgement, and Restoration of the Contractual Equivalence

Eyal Zamir

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Introduction

Conceptualizations and classifications are crucial for understanding and analysis of any phenomenon, including legal ones. Concepts and categories shape the way we think about anything, including legal doctrines and judicial decisions. Once a certain classification takes root in our minds, however, it can dominate our thinking and thus preclude us from seeing the entire, complex picture.

For nearly seventy years, our thinking about contract remedies has been dominated by Lon Fuller and William Perdue's classification of the "interests" protected by monetary (and other) remedies for breach of contract: Expectation, Reliance, and Restitution. In recent years, several scholars have severely criticized this threefold classification. The critique refers to the conceptual classification itself; the descriptive claim that courts regularly award damages that are aimed at protecting the reliance interest (even if they do not declare that that is what they are doing); and to the normative claim that the reliance interest is more worthy of protection than the expectation interest. Avery Katz pointed out that Fuller and Perdue's tripartite classification is incomplete, and proposed to complete it by adding a fourth interest. Richard Craswell and Eric Andersen suggested to abandon Fuller and Perdue's classification altogether and replace it with alternative ones. Despite all the criticism and new proposals, Fuller and Perdue's analytical framework has maintained its dominance in contract law doctrine and theory, and continues to provide us with a common vocabulary for discussing the goals of contract remedies.

Fuller and Perdue's ingenious conceptualization has clarified the complex picture of contract remedies, yet has simultaneously obstructed our view to some of the picture's elements. Thus, for example, in *Fast v. Southern Offshore Yachts*, a buyer was granted specific performance of a seller's obligation to deliver the sale object, and as an ancillary monetary relief recovered interest on 90% of the purchase price that he had already paid. Discussing this monetary award, Edward Yorio notes that it "seems to violate the underlying principles of equitable accounting", i.e., duplicating as nearly as possible the situation that would exist but for the breach. Clayton Gillette and Steven Walt made a similar observation regarding Article 50 of the United Nations Convention on Contracts for the International Sale of Goods. This Article allows the buyer to proportionally reduce the contract price as a remedy for nonconformity of the goods. After thoroughly analyzing this provision, they conclude: "Because we lack a good justification of Article 50's price reduction, we find it puzzling". Finally, Dan Dobbs opens his comments on the rule that, in some circumstances but not in others, the injured party is entitled to recover restitution in excess of expectancy, by labeling it "doubly strange".

Do these remedies truly "violate the underlying principles" of contract remedies? Are they "puzzling" and "strange"? They are if one thinks in terms of the conventional classification, because they do not conform to any of the three familiar interests (nor to the fourth interest identified by Katz). These remedies are less puzzling once we realize that there is a fifth interest. The first objective of this Article is to demystify this

puzzlement by identifying yet another goal of contract remedies, heretofore overlooked; namely, *restoration of the contractual equivalence* (RCE). In awarding RCE remedies, courts and legislatures do not aim to place the injured party in the position that she would have been in had the contract been performed or had she never made the contract, nor do they aim to put the breaching party in any of these two positions. Rather, courts and legislatures strive to put the injured party in a position similar to the one she would have occupied had the parties made (and performed) a contract in which their obligations were adjusted to the actual performance by the breaching party, while maintaining the contractual equivalence in terms of the agreed value of performance, the chronological relation between their obligations, etc. I shall argue that RCE is the only – or at the very least, the most – coherent explanation for the remedies awarded in the aforementioned examples, as well as for remedies courts and legislatures award in numerous other cases.

The rich theoretical scholarship on contract remedies does not limit itself to defining and refining the interests (that is, the principles and goals) underlying remedy rules, such as expectation, reliance, and restitution. It also analyzes and compares the different interests from the point of view of various normative theories, such as economic efficiency, the will theory of contract, and corrective and distributive justice. In addition to demonstrating that courts and legislatures actually award RCE remedies in some cases, this Article explores the normative justifications for RCE as an additional interest protected by contract remedies.

While this Article further highlights the incompleteness of the conventional, tripartite classification, in contrast to some other contributions to this body of scholarship, it does not try to undermine Fuller and Perdue's analytical framework nor deny its usefulness in discussing contract remedies. It merely rejects the prevailing notion that the threefold classification (or even the fourfold one proposed by Katz) exhausts the possible and worthwhile goals of contract remedies.

The plan of the Article is as follows. In Part I, I present the notion of RCE against the backdrop of the conventional classification of interests protected by contract remedies. Part II is descriptive and analytical. It demonstrates how various existing doctrines of contract remedies, judicial as well as legislative, are best understood as intended to restore the contractual equivalence rather than protect any of the familiar interests. [...]

Based on the survey of the case law and legislative material in Part II, Part III provides additional observations on RCE remedies, thus complementing its preliminary analytical presentation in Part I. [...]

Part IV is normative. It examines whether the award of RCE remedies falls into line with some of the major foundational objectives of contract law, as reflected in contract law theory. It first examines two deontological theories that focus on the relations between the breacher and the injured party: the will theory of contract (Section IV.B) and corrective justice (Section IV.C). It then moves to consequentialist theories that

concentrate on the effect of legal rules on society as a whole: distributive justice (Section IV.D) and economic efficiency (Section IV.E). [...]

I. Introducing RCE against the Background of the Conventional Interests

Before surveying judicial and legislative awards of RCE remedies in Part II, this Part flashes out the concept of RCE. To that end, it seems useful to first summarily describe Fuller and Perdue's analytical framework. As ordinarily conceived, the *expectation interest* focuses on the injured party, and is forward-looking in the sense that it aims at putting her in the same (monetary) position that she would have been in had the contract been fully performed. It aims at letting her have the benefit of the bargain. The *reliance interest* also focuses on the injured party, but is backward-looking in the sense that it strives to put her in the position that she would have been in had she not made the contract in the first place. It does so by reimbursing her for the loss caused by her reliance on the contract. The *restitution interest*, on the other hand, focuses on the breaching party. It is backward-looking in that it aims to put the breaching party in a position similar to the one she would have been in had no contract been made. Forcing the party in breach to return any benefits she obtained from the injured party attains this goal. The following table highlights the basic characteristics of the three interests:

	Injured Party	Party in Breach
Backward looking	Reliance	Restitution
Forward looking	Expectation	

This table also exposes the incomplete nature of Fuller and Perdue's analytical framework, which disregards the possibility of remedies designed to put the breaching party in the position she would have been in had she performed the contract. This goal is typically achieved by disgorging the breaching party of any benefit she gained by breaching the contract, even if such benefit was not directly drawn from anything she received from the injured party. Katz dubs this fourth interest "liquidated specific performance", but a more suitable label seems to be "disgorgement", or the *disgorgement interest*. While disgorgement remedies are not ordinarily available to the injured party under American contract law, they have been awarded in some cases, are awarded in other legal systems, and have attracted growing scholarly attention in recent years.

In theory (though not in practice), all four interests represent "end cases", or an "all-or-nothing" approach. Fully realizing of the expectation interest, for example, requires putting the injured party in the position that she would have been in had the other party

performed all of her obligations, that is, had the injured party obtained the full benefit of the bargain. Similarly, full realization of the disgorgement interest mandates that the breaching party be put in the position she would have occupied had she performed all of her obligations, thereby depriving her of any profit made by breaching the contract. Sometimes, however, the injured party may prefer – or the legal system may compel her to suffice herself with – a remedy that would not aim at fully undoing the outcomes of the contract (reliance, restitution) or the outcomes of the breach (expectation, disgorgement), but rather let her adjust her own obligations to the actual performance by the breaching party. Such adjustment would put the injured party in a position similar to the one she would have been in had the parties made a different contract than the one they actually did: a contract in which the balance between their respective obligations is similar to the balance drawn by the contract they actually did, but in which the obligations of both of them are adjusted to the actual performance of the breaching party. A central reason (though not the only one) for preferring such a remedy would obviously be that it gives the injured party a higher reward than she could get through other available remedies, protecting other interests. Thus, to use a simple example, the chronological equivalence between the parties' obligations is attained when, in response to one party's delayed performance, the corresponding obligations of the other party are concurrently suspended. The suspended performance does not give the injured party the full benefit of the bargain, and it certainly does not put her in the position she would have been in had she made no contract at all. It puts her in a position similar to the one she would have been in had she made a contract in which performance by both parties would be postponed. Likewise, when a seller delivers three out of five similar goods and then repudiates, payment of 60% of the agreed price coupled with cancellation of the repudiated part of the contract restores the contractual equivalence. Often, restoration of the contractual equivalence requires more sophisticated responses to the breach, as illustrated in Part II below.

Beyond the seemingly simple hierarchy among the three conventional interests, there are in fact intricate interrelations between them. Similar complex relations exist between RCE and any of the other interests as well. A simple example can illustrate some of these relationships, and a further account is provided below in Parts II and III. Consider a sale contract in which the agreed price – \$1,200,000 – accurately reflects the market price of the (indivisible) sale object at the time of contracting. By the time of delivery, market price of the same object falls to \$1,000,000 (and stays at this level from then on). After taking delivery and paying the price, the buyer finds out that the object is seriously and incurably defective. The defect reduces the object's (objective and subjective) value by 25%. Assume further that for some reason, the buyer is either not interested, not entitled, or missed the opportunity, to cancel the entire contract. Lastly, for the sake of simplicity, assume that the buyer suffers no consequential or incidental losses as a result of the breach.

In this case, the buyer's *expectation interest* equals \$250,000. Adding this sum to the current value of the defective object (\$750,000) would put her in the monetary position she would have been in had she received a conforming object whose current market value is \$1,000,000. Had the buyer been interested in and entitled to canceling the entire contract, her *restitution interest* would equal \$1,200,000 – the full purchase price paid to the seller (that is, if she returns the defective object to the seller; otherwise it would be \$450,000: \$1,200,000 minus \$750,000). In such a case, her *reliance interest* would have been somewhat higher, including – in addition to the prepaid purchase price – the costs involved in drafting, executing, and canceling the contract (and possibly also compensation for forgone opportunities). A *RCE remedy* would give the buyer 25% of the contract price (\$1,200,000), i.e. \$300,000. Reducing 25% of the agreed price for a defect diminishing the goods' value by 25% maintains the contractual equivalence. Thus, assuming the buyer is either not interested in, or not entitled to, canceling the contract, RCE remedy provides her, under these circumstances, with an award exceeding her expectation interest (\$250,000). The same would be true had the market value been \$1,000,000 all along and the contract price was \$1,200,000. This is because a remedy aiming at restoring the contractual equivalence would still be calculated according to the contract price (25% of \$1,200,000 = \$300,000), while expectation damages for the decreased value of the object would still be based on its current market value, i.e. 25% of \$1,000,000. This outcome would be reversed were the contract price lower than the object's market value at the date according to which expectation damages are calculated. If, for example, the market price of the object had increased from \$1,200,000 to \$1,500,000, expectation damages for the direct loss resulting from the defect would be \$375,000 (25% of \$1,500,000), while a RCE remedy would still be \$300,000.

Before examining actual legal doctrines aiming at restoring the contractual equivalence, I would like to clarify the meaning of “equivalence”. The term “equivalence” (or its interchangeable synonym “balance”) as used in this Article refers to the equivalence drawn by the parties. In this Article I take no position regarding the important question of whether a minimal objective or market-based equivalence between the exchanged considerations is, or should be, a pre-condition for the enforceability of contracts. The equivalence referred to is the one the parties agreed upon, whether it corresponds to or deviates substantially from any objective or market-based valuation of the exchanged considerations.

Following the general introduction of the notion of RCE, we may now turn to legal doctrines that actually aim at restoring the contractual equivalence.

II. Legal Doctrines

This Part surveys some of the instances in which courts and legislatures grant remedies aiming at restoring the contractual equivalence. The relative prevalence of such remedies is remarkable, considering that RCE is neither explicitly mentioned in any of the canons

of American contract law (e.g., the Restatement on Contracts (First and Second), the Uniform Commercial Code, the contract treatises of Williston, Corbin, and Farnsworth), nor in other sources. The following survey focuses on two aspects of contractual equivalence: the equivalence between the exchanged objects, and the chronological equivalence between the parties' performances. While in these cases restoration of the contractual equivalence benefits the nonbreacher, I shall also note cases in which courts restore the contractual equivalence for the benefit of the breaching party.

A. Restoration of the Equivalence Broken by Partial or Defective Performance

1. Damages for Vendor's Breach in Land Sales and Price Abatement Ancillary to Specific Performance

When it turns out that a parcel of land is smaller than it should have been under a sale contract, or that the seller cannot convey the full title she undertook to convey, the buyer may sue for damages for breach of covenant or warranty. One way to calculate the damages would be according to the difference between the current value of the nonconforming land and its value had it conformed to the contract, thus protecting the buyer's expectation interest. Often, however, courts resort to a different method of calculation, namely, allowing the buyer to reduce the agreed-upon price at the same proportion as the value of the land decreased due to the seller's breach. Such calculation is straightforward when the size of the parcel is smaller than the agreed size, there are no considerable gaps between the value of different parts of the parcel, and the deficiency is not large enough to significantly alter the potential use or enjoyment of the land. In such cases, the agreed price may simply be reduced at the same proportion as the actual size of the land bears to the agreed size. In other cases, such simple calculation is inappropriate, because there is no direct correlation between the decrease in acreage or the deficiency in title to the land and the decrease in its value. Yet, even in those instances, courts and legislatures do sometimes resort to the proportional method of calculation by allowing the buyer to reduce the price at the same proportion as the market value of the deficient land bears to the market value of the conforming land.

A similar monetary relief may accompany an award of specific performance. [...]

Just like damages for breach of covenant or warranty in land sales, calculated as a proportional price reduction, proportional abatement ancillary to specific performance restores the contractual equivalence.

2. Rent Abatement for Breach of Warranty of Habitability and other Obligations

In recent decades, tenants' rights and remedies have steadily expanded. This expansion has particularly benefited residential tenants, but also to some extent

commercial ones. A major development was the introduction of a warranty of habitability. The implied warranty of habitability is a mandatory obligation, imposed first by the courts and then by state legislatures, on landlords of residential units. It imposes a contractual obligation on the landlord to comply with the requirements of the relevant Housing Codes and keep the premises suitable for habitation in terms of safety, sanitation, etc.

One of the remedies available to tenants for breach of the warranty of habitability (and at times, for other breaches as well) is rent abatement. It is calculated according to a proportional formula, sometimes called “percentage reduction in use” or “proportional diminution in value”. According to this formula, the agreed-upon rent is reduced in the same proportion as the apartment’s market rent decreased due to its nonconformity with the Housing Code or general standards of suitability for use. This formula was adopted in section 11.1 of the Restatement (Second) on Property, Landlord and Tenant, where rent abatement is a remedy available for a broad variety of breaches. Similar rules may be found in State legislation. Even if the tenant has paid the full rent, rent abatement is available in an action for the reimbursement of the excess payment.

The proportional formula, dating back to the 19th century, is but one of several methods courts use for calculating rent abatement. Interestingly, this method overcomes an unusual difficulty courts have faced in cases where the agreed-upon rental fee reflects the poor condition of the apartment. In such cases, the difference between the market rent of the defective unit and the market rent of the same unit had it met the statutory requirements – the normal measure of expectation damages for nonconformity of a leased property – equals, or even exceeds the agreed rent. This would mean that the tenant could use the apartment for no rent at all, or even for a negative rental fee! Suppose the market rent of an apartment, had it met the requirements of the relevant Housing Code, would be \$500. The market rent of the same apartment given its poor condition is \$200, and the agreed rent is \$250. In this case, the sum necessary to put the tenant in a monetary position similar to the one she would have occupied had the Code’s requirements been met is \$300 (\$500 minus \$200). However, if one subtracts this sum from the agreed-upon rent, every month the defaulting *landlord* should pay the *tenant* \$50 (\$250 minus \$300)! The proportional formula avoids this strange result by reducing the rent at the same proportion the market rent of the apartment decreased due to its nonconformity. In the above example, the tenant is entitled to a reduction of the agreed rent (\$250) by 60% (300/500), that is, a reduction of \$150 of the monthly rent.

As the Restatement’s comments explain, the aim of the proportional measure of abatement is “to preserve [the parties’] original bargain in so far as possible”.

3. Price Reduction under the CISG

The United Nations Convention on Contracts for the International Sale of Goods (CISG) was approved in a diplomatic conference held in Vienna in 1980, and became

effective to international sales contracts entered between American parties and foreign parties in 1989. Articles 45-52 of the Convention deal with the buyer's remedies for the seller's breach. One remedy available to the buyer for delivery of nonconforming goods is price reduction under Article 50. This Article provides:

If the goods do not conform with the contract and whether or not the price has already been paid, the buyer may reduce the price in the same proportion as the value that the goods actually delivered had at the time of delivery bears to the value that conforming goods would have had at that time [...].

If the seller delivers only part of the goods or if only part of them are nonconforming, the buyer is entitled to price reduction in respect of the part which is missing or which does not conform (Art. 51(1)). Reduction of the price is an alternative remedy to rejection of the goods, remedying the nonconformity by the seller, and damages for the decrease in the goods' value due to their nonconformity. Price reduction does not, however, preclude the buyer's right to damages for consequential and incidental losses, beyond the mere decrease in the goods' value.

As formulated in the CISG following the Civil Law tradition, the amount of price reduction is calculated according to a proportional formula. The buyer is entitled to reduce the price in the same proportion as the value of the goods decreased due to their nonconformity. As demonstrated in Part I above, this formula may result in a monetary relief lower than, equal to, or higher than expectation damages for the decrease in the market value of the goods. Price reduction under the CISG does not put the buyer in the position she would have occupied had she received conforming goods, nor does it protect her reliance or restitution interests. Rather, it puts her in as good a position as she would have been in had she contracted for goods of the same quality, quantity and description as the ones she actually received, and the price would have been set accordingly. Price reduction restores the contractual balance.

The remedy of price reduction dates back to the Roman *actio quanti minoris*, and is one of the two standard remedies for hidden defects in the sale object in many Civil Law systems. It is therefore well known to Civil Law jurists. While close examination reveals that American courts and legislatures also use the proportional formula in various contexts (as noted earlier), price reduction is not a standard remedy for breach of warranty under the Uniform Commercial Code, nor is it thought of as a standard remedy for breach of contract outside of the UCC (possibly because it does not fit neatly into the conventional expectation/reliance/restitution classification). Thus, its inclusion in the CISG – a convention drafted by both Civil Law and Anglo-American jurists – resulted in some confusion. Lawyers unfamiliar with the remedy sometimes confused it with the buyer's right to set off damages for nonconformity against the contract price. To avoid this confusion, Art. 50 stresses that the buyer is entitled to price reduction “whether or not the price has already been paid”.

A central reason for why price reduction has been a useful remedy in Civil Law systems is that, contrary to damages for breach of contract, the buyer is entitled to price reduction in these systems even in the absence of any fault on the part of the seller. The seller is expected to compensate the buyer for not getting the benefit of the bargain only if the breach resulted from the seller's fault. In contrast to this tradition, under the CISG the buyer is entitled to expectation damages in the absence of fault on the seller's part. This difference somewhat diminishes the practical importance of price reduction under the CISG. A correlation between the seller's fault and the buyer's remedies is found, however, in the CISG as well. According to CISG Art. 79, the buyer is not entitled to damages (but is still entitled to price reduction) if the breach was due to supervening circumstances she could not have been reasonably expected to anticipate, nor to avoid or overcome. It seems that in both Civil Law systems and under the CISG, maintaining the contractual balance is thus conceived as more fundamental a goal than protecting the buyer's expectation interest.

4. Monetary Restitution for Non-Monetary Performance in Divisible Contracts

[...]

B. Restoration of the Chronological Equivalence

The contractual equivalence not only consists of the objects the parties exchange (goods, services, money, etc.), but also of the timing of performance. Usually, the sooner the promisee gets an object, the higher its value to her. Assuming each party values what she is entitled to get more than what she is parting with, and that performance by each party is conditional on the counter-performance, the chronological relations between the parties' obligations also provide built-in incentives to perform. The contractual equivalence may thus be broken not only by partial or defective performance, but also by a delayed one. In such cases, the injured party may be interested in restoring the broken chronological equivalence. She is in fact entitled to such restoration, as demonstrated below.

1. Suspension of Performance Due to Other Party's Failure to Render Performance

[...]

Although not ordinarily classified as such, the right to withhold performance until counter-performance is carried out or at least rendered or assured is a very important self-help remedy for breach of contract. Without resorting to the slow and costly court system, it provides a powerful incentive to perform by depriving the actual or prospective breacher of the benefits that she expects to get from the bargain. By suspending her performance, the nonbreacher also avoids the burden of extending credit to the other party (or financing her beyond the period envisaged by the parties, in the case of

prospective breach), and possibly mitigates her losses. Often, the non-breaching party will suffice herself with this remedy.

[...]

[T]he likely outcome of suspension is that both parties perform the contract; the agreed chronological relation between the parties' obligations is maintained; yet, performance by both parties is postponed.

2. Interest on Price Paid as a Remedy for Seller's Delay

When a seller (or any other obligor) performs her obligations after the agreed time (either voluntarily, or pursuant to a court order of specific performance), the buyer (or any other obligee) is ordinarily entitled to a monetary relief for this delay. Such a relief may be damages calculated according to the partial loss of the benefit of the bargain (ordinarily the lost use and enjoyment of the property during the time of delay), thus protecting her expectation interest. Alternatively, to put the parties in as good a position as they would have been in had the contract been performed on time, courts awarding specific performance often grant *equitable accounting*. Typically, in contracts for the sale of real property, the buyer is entitled to the gross rental value of the property during the period of delay minus the expenses the seller incurred in managing the property, and the seller is entitled to interest on the unpaid purchase price for the same period. The underlying principle of equitable accounting is said to be restitution: each party is compelled to part with the gains she made, or could have made, during the delay.

At times, the interest on the unpaid purchase price is higher than the net rental value or profits made from the property during the period of delay. Under such circumstances, equitable accounting would presumably result in the buyer having to pay the breaching seller the difference between the interest and the net rental value of the land. This is not the rule, however. Reasoning that the defaulting party should not profit from her delay, courts have denied her of the right to such an accounting. By waiving her entitlement to the rental value of the property, the innocent buyer denies the breacher's right to the interest on the unpaid purchase price. At least in theory, the outcome is that the injured party is made better off as a result of the breach (compared to her position had the contract been performed on time). This outcome is not astonishing, as it sometimes happens that one party's breach actually benefits the other party. By denying equitable accounting in such circumstances, the law lets the buyer keep the benefits she received from the seller's breach.

More intriguing are the less common cases in which the non-breaching buyer has paid the purchase price prior to, or in spite of, the seller's breach. In such cases, courts sometimes award the buyer interest on the purchase price she paid on time, for the duration of the delayed performance. Thus, in *Fast v. Southern Offshore Yachts*, the buyer of a customized yacht paid 90% of the agreed price on time (20% at the time of

contracting and 70% upon arrival of the yacht at a United States port of entry – the remaining 10% being due upon delivery), but for various reasons delivery of the yacht was not executed. The buyer brought suit for specific performance and for statutory interest on the sums of money he paid, from the agreed date of delivery until actual delivery. The court granted the buyer specific performance and such “incidental damages” as requested. Similar relief was granted in *Worrall v. Munn*. In this case, the rental value of land bought for clay mining was extremely low because it was hardly usable for any other purpose. Measure of damages for the very long delay in transferring the land was thus held to be the interest on the purchase money.

Clearly, in cases like *Fast* and *Worrall*, the court neither aims at putting the innocent buyer in the position she would have occupied had the contract been performed on time (the buyer would not have gained interest on the money had the contract been duly performed), nor at restoring the breacher to its pre-contract position (the interest does not necessarily reflect the breacher’s enrichment at the expense of the injured party). It places the injured party in a monetary situation akin to the one she would have been in had she made a contract similar to the one she actually made, but in which the dates of performance by both parties were deferred. In such a contract, the buyer would have earned interest on the money while the seller enjoyed the net rental value of the property until the deferred date of performance. Depending on the rate of market interest and market rental value of the property, damages measured by interest on the prepaid price may be similar to, higher than, or lower than expectation damages for the direct loss caused by the delay. At any rate, granting interest on the money paid by the buyer for the period of the delayed delivery monetarily restores the contract chronological equivalence.

C. RCE in Favor of the Breaching Party

While restoration of the contractual equivalence typically benefits the injured party, at times it benefits the party in breach. Before listing instances of this outcome, it should be reminded that such an effect is not unique to RCE. For example, when following a cancellation of a contract both parties are obliged to give back what they received from each other, such mutual restitution operates for the benefit of the breaching party as well. Two illustrations of restoration of the contractual equivalence in favor of the breaching party would be recovery by workers and contractors for part performance and payment for excessive quantity the seller delivered.

1. Recovery by Workers and Contractors for Part Performance

Where a contract calls for performance that requires a period of time (e.g., a worker’s obligation to do the work or a contractor’s obligation to construct a building), in exchange for a momentary performance (e.g., the employer’s and owner’s obligation to pay the remuneration), the default rule is that the latter obligation is due only after completion of the former and is conditional upon its completion. This rule may bring

about harsh results when a worker or a contractor performs a substantial part of her obligations and then quits before completing the job. Strict application of the rule would allow the employer/owner to enjoy the work already done without paying for it. One way to mitigate this harsh outcome is to award the breaching party a right to a proportional part of the agreed remuneration, at least in cases where the contract remuneration can be apportioned to corresponding parts of the worker's or contractor's performance. The entitlement to a proportional part of the agreed remuneration does not detract from the right of the injured party (the owner, the employer) to damages for the losses caused by the breach. It does, however, maintain the contractual equivalence with respect to the completed part.

2. Delivery of Excessive Quantity

Article 52(2) of the United Nations Convention on Contracts for the International Sale of Goods (CISG) provides as follows:

If the seller delivers quantity of goods greater than that provided for in the contract, the buyer may take delivery or refuse to take delivery of the excess quantity. If the buyer takes delivery of all or part of the excess quantity, he must pay for it at the contract rate.

A similar rule is implied by the cumulative effect of UCC §§ 2-606 and 2-607(1). Arguably, by sending a larger quantity the seller makes an implied offer to modify the original contract, and the buyer accepts this offer by taking delivery of the excess quantity. Be that as it may, by obliging the buyer to pay for the excess quantity at the contract rate (rather than at current market price or not at all), this rule directly restores the contractual equivalence to the benefit of the seller, who (at least technically) breached the contract by deviating from the agreed quantity.

III. General Observations on RCE Remedies

[...]

A. Comparison of RCE and other Goals of Contract Remedies

At this point, we can more clearly see the relations between RCE and the more conventional goals of contract remedies. RCE is not similar to any of the conventional interests, but it has significant correlations with each one of them.

Starting from the noticeable comparability of the remedy of price reduction and the outcome of restitution following partial cancellation of a divisible contract, RCE and protection of the *restitution interest* sometimes bring about identical results. When available, both kinds of remedies may give the injured party a relief exceeding her expectation interest. However, while restitution aims at undoing the outcomes of the contract, RCE remedies seek to restore the contractual balance struck by the parties. RCE

remedies do not focus on the breacher's unjust enrichment, although (as in the case of remedies directed at any other goal) they may actually prevent it. To illustrate the difference between RCE and restitution, assume that a buyer has paid the price on time, while delivery of the sale object is delayed for one year. RCE damages would allow the buyer to claim the amount of interest that she could have received on the price money had she postponed payment for one year. Restitution of the seller's enrichment may be calculated according to the interest the seller earned (or could have earned) on the price money during the same period. Since the rate of interest each party could have reasonably received on the same amount of money need not be identical (and assuming calculation is based on the parties' specific characteristics, rather than on general standards), there may be a difference between RCE damages calculated according to the buyer's interest, and restitution calculated according to the seller's.

RCE also shares a common feature with the *reliance interest*. A typical element of reliance on a contract is forgoing alternative uses of one's resources. Thus, buying raw materials from one supplier, generally means that a factory forgoes the opportunity to buy similar materials from other suppliers. Proving lost profits from alternative bargains, their foreseeability and the existence of causal connection may be rather difficult, and thus the status of the entitlement to reliance damages based on lost profits from alternative contracts is uncertain. Nevertheless, putting the injured party in the position she would have occupied had she made an alternative contract is analytically part of the reliance interest. Now, one way to describe RCE remedies is to say that they put the injured party in a monetary position similar to the one she would have occupied had she made an alternative contract – a contract for the lease of property of inferior quality, for the supply of smaller quantity of goods (or a smaller parcel of land), or for acquiring the object at a later date. While in this sense RCE resembles reliance, in other respects the two are sharply different. In protecting the reliance interest, the goal is to put the injured party in as good a position as she would have been in had she not entered the present contract. Contrarily, RCE remedies are directly based on the present contract, and on the parties' agreement underlying it. One implication of this difference is that, while it makes perfect sense to protect one's reliance interest in cases where the contracting process was flawed by duress, for example, it would not make sense to endorse RCE in such circumstances, because RCE presupposes the validity of the contractual equivalence.

Like the *expectation* and *disgorgement interests*, RCE is closely linked to the parties' actual agreement. The equivalence protected is the one the parties assented to. When a contract is perfectly performed by both parties, all three 'interests' – expectation, disgorgement, and RCE – are fully realized. In such a case, both parties get the benefit of their bargain (even if this "benefit" is actually a loss); none of them gets any benefit from pursuing alternative courses of action; and the contractual equivalence is fully maintained. However, once the contract is breached, protecting each of these interests may yield considerably different results. Under different circumstances each of these three interests may yield the largest reward to the innocent party (and, of course, the three

may coincide). Schematically, whenever the object's market price at the time according to which expectation damages are calculated is lower than the contract price, and whenever postponing performance would be more advantageous to the innocent party than performing at the agreed time – RCE gives the injured party a relief larger than expectation. Indeed, under such circumstances, not only RCE but also the restitution and reliance interests are likely to exceed expectation, and to an even greater extent. Yet, there is a fundamental difference between awarding reliance or restitution remedies and awarding RCE remedies. While the former arguably disregard the parties' agreement, RCE builds on it. One could say that a contracting party has not only a legitimate expectation, based on the contract, to the benefit of the bargain, but also to the agreed-upon balance between the parties' undertakings. Parenthetically, this understanding of RCE bears on the availability of RCE damages under the prevailing rules of contract damages. A powerful argument against reliance damages as a remedy for breach of contract (except when instrumentally used as a minimal approximation of expectation), is the lack of *causal connection* between the breach and the loss. When reliance exceeds expectation, the injured party's loss is not a result of the breach, but rather a result of the poor bargain she made. Contrarily, when the innocent party sues for RCE relief, the broken equivalence is a direct result of the breach, and thus merits compensation. Thus, unlike restitution and reliance, restoration of the contractual equivalence in a meaningful sense effectuates the parties' will.

The relative magnitude of RCE and disgorgement depends both on the profitability of the contract for the innocent party (as seen above) and on the profits made, or losses saved, by the breaching party through the breach. Often, when RCE exceeds expectation, it also exceeds disgorgement, and vice versa. Disgorgement (i.e., the profits made or losses saved by the breaching party through the breach) is particularly large when the breaching party has made a losing contract and tries to cut down her losses by breaking the contract. RCE is particularly large when the injured party has made a losing contract. These generalizations assume that when one party stands to lose from a contract, the other stands to gain. Of course, it may be that both parties stand to lose from executing the contract, in which case comparison between RCE (and reliance and restitution) and disgorgement may depend on who is about to lose more.

B. Election among Remedies

Although heavily concealed behind a myriad of specific doctrines, rules, exceptions, and conflicting precedents, the general principle of contract remedies is that the injured party is entitled to choose among the different remedies available to her and resort to more than one remedy, as long as they are not inconsistent. The injured party may even shift from one remedy to another as long as the other party has not materially changed her position in reliance on the injured party's manifestation of choice of a certain remedy. This general principle should apply (and usually does apply) to the election between, and the accumulation of, RCE and other remedies. Hence the injured party is ordinarily

entitled to the higher between the RCE and expectation measures of relief. Some RCE doctrines, like abatement of the purchase price ancillary to partial specific performance, are invariably accompanied by another remedy. Other RCE remedies, such as suspension of one's performance in response to the other party's delay, or suing for the interest on the price paid for the duration of the seller's delay, do not preclude the injured party's right to damages for consequential damages. The same applies to proportional price reduction for nonconformity under the CISG, and to proportional rent abatement. The injured party is not, however, entitled to proportional price reduction coupled with damages for the decrease in the object's value, because this would be a double relief for the same harm. Similarly, the buyer is not entitled to interest on the price paid for the duration of the seller's delay together with the rental value of the object during this period.

There are also exceptions to the principles of election and accumulation of remedies. [...]

C. RCE – A Goal or Principle, Not a Rule

The last observation regarding RCE has to do with its relative indeterminacy. For example, suppose that under a sale contract concluded on 1.1.04 the buyer commits to pay the price in 13 equal installments, starting on the contracting day and ending on 1.1.05 – the day in which delivery of the sale object is due. The buyer duly pays all installments, but delivery is delayed for one year. As indicated in Section II.B.2 above, while expectation damages for this delay are based on the net rental value of the object, RCE damages are calculated according to the interest the buyer would have earned on the purchase price had the payments been postponed accordingly. Yet, there are different ways to monetarily restore the chronological equivalence in such a case. One possibility would be to calculate interest on the assumption that all installments would have been postponed by one year (i.e. starting on 1.1.05 instead of 1.1.04). Another possibility is to spread the 13 installments along two years instead of one, from 1.1.04 (the contracting date) to 1.1.06 (the actual delivery date). These two alternatives may yield different outcomes at times of fluctuating interest. The court may also have to consider whether to award interest according to the statutory rate or to let the buyer prove that she could have attained a higher rate. Moreover, one may contend that none of the above ways of calculation actually restores the contractual equivalence, because rescheduling the performance may have plausibly affected other aspects of the transaction as well. Analogous questions and contentions may be raised with respect to other RCE remedies.

While I do not deny this flexibility of RCE remedies, I submit that in this respect there is no difference between RCE and other goals of contract remedies. The latitude courts have in setting the criteria and calculating expectation damages is certainly not smaller. Restitution may similarly be attained in different manners, and the reliance interest is notorious for having multiple meanings. Like expectation, reliance, restitution, and

disgorgement, RCE is a principle, not a rule. In fact, since calculation of RCE remedies often refers to the contract price or to a standard measure such as statutory interest, it is less prone to manipulation than other goals of contract remedies.

Characterizing RCE as a principle or a goal implies that there may be considerable differences between different RCE remedies. In fact, the remedies surveyed above in Part II vary in many respects. While most of them are monetary, some are not; while most of them benefit the injured party, some favor the party in breach; some are more akin to one of the familiar interests than others; and so forth. Just as under certain circumstances, any of the familiar interests may equal any of the other interests and may instrumentally serve as an approximation thereof, so does RCE sometimes equal other interests and may serve as an approximation thereof (and the other interests may approximate RCE).

These interrelations explain the various attempts to interpret and rationalize particular RCE remedies on the basis of familiar interests. But as the above analysis demonstrated, these explanations have been problematic, partial and forced. The notion of RCE provides a more unified and coherent account of a relatively wide range of remedy doctrines. It presents rules and rulings that otherwise seem puzzling or awkward as resting on a sound analytical basis. Despite their differences, all RCE remedies share a fundamental similarity. They all aim at restoring the contractual equivalence, rather than at any of the three (or four) conventional interests.

IV. Normative Analysis

A. General

In the preceding Parts I claimed that analytically, RCE is an independent goal of contract remedies, and that courts and legislatures actually award remedies directed at restoring the contractual equivalence. This Part addresses the normative question of whether RCE is a worthwhile goal of contract remedies. Within contract law theory there is a longstanding debate as to whether the organizing principle and central goal of remedies for breach of contract should be protection of the expectation interest, or rather protection of the reliance interest. This debate, rooted in the fundamental questions of contract law theory, lies beyond the scope of this Article. The present discussion follows the prevailing (doctrinal and normative) conception that the basic goal of contract remedies is to protect the injured party's expectation interest. It further assumes that damages may legitimately be calculated according to the reliance interest whenever such calculation is used as a minimal approximation of the expectation interest, but not when the breaching party establishes that reliance exceeds expectation. I shall argue that, whether RCE provides the injured party with a relief equal to, smaller than, or larger than her expectation interest, RCE is justified by – or at least compatible with – the major normative theories of contract law. Finally, following the general principle concerning election of remedies, it is assumed that the injured party is free to choose between RCE and other types of remedies, and whenever appropriate, to combine RCE remedies with

other remedies. Thus, I do not try to justify RCE as a *substitute* for expectation (or for any other interest), but rather as an additional interest or goal of contract remedies.

This Part examines the justification for restoration of the contractual equivalence from the perspectives of a liberal theory of contracts (the will theory), corrective justice, distributive justice, and economic efficiency. This Part does not discuss the philosophical underpinnings of any of these normative perspectives, nor does it weigh their relative merit. Thus, I shall mostly disregard the extensive debates concerning the attractiveness and moral plausibility of these theories and their application to contract law. Similarly, I shall not discuss in detail the important arguments purporting to show that some of these theories have no bearing on the choice between different contract remedies or measures of relief. Rather, I shall examine the desirability of RCE remedies according to each theory on its own terms. By demonstrating that RCE is justified by – or at least compatible with – various normative theories, I seek to persuade adherents of different normative perspectives of its attractiveness.

B. The Will Theory

The will theory of contract stems from the liberal notion that every human being is an autonomous moral agent, obliged to keep her promises because she freely undertook them. By forcing a person to keep her promises, we respect her as an autonomous, rational entity, and promote the trust created by her promise. The moral obligation to keep a promise and the legal obligation to keep a contractual promise do not rest, according to this theory, on any utilitarian or other consequentialist theory, but rather on its intrinsic moral force.

Arguably, the will theory of contract requires that expectation damages be the standard remedy for breach. In the words of Charles Fried:

If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance. In contract doctrine this proposition appears as the expectation measure of damages for breach. The expectation standard gives the victim of a breach no more or less than he would have had had there been no breach. ... [T]o the extent that contract is grounded in promise, it seems natural to measure relief by the expectation, that is, by the promise itself.

Two attacks were launched against this proposition. The first attack, led by Richard Craswell, maintains that respect for individual autonomy indeed requires that people be allowed to commit themselves to legally binding promises; yet it gives no reason to prefer expectation damages over any other conceivable remedy, including for instance reliance damages. This argument proves too much. While the will theory of contract does not necessarily entail expectation damages as the standard remedy for breach, there is a

significant linkage between this theory and remedies for breach of contract. Specifically, if a breach of contract is regarded as intrinsically, morally wrong, than, other things being equal, one should prefer remedies providing the promisor with a stronger incentive to keep her promise. One should opt for remedies that more clearly express the inherent moral virtue of keeping one's promise and condemnation for its breach.

This brings us to the second attack on Fried's endorsement of expectation damages. Several scholars pointed out that the will theory might justify remedies that deter people from breaching contracts more effectively than expectation damages do. These may include specific performance, reliance damages exceeding the expectation interest, disgorgement, and punitive damages. This cogent argument paves the way to justifying RCE according to the will theory.

RCE may be justified by the will theory for two cumulative reasons. First, like the aforementioned remedies, RCE reinforces the notion that contractual promises should be kept. It does so by awarding the innocent party a relief that is potentially greater than her expectation interest, thereby increasing the deterrence against contract breaches. Second and more importantly, contrary to other remedies that may attain this result (e.g., reliance damages exceeding the expectation interest, punitive damages, and disgorgement), RCE remedies more directly and concretely reflect the parties' actual agreement, as embodied in their contract. The criterion for calculating RCE remedies is not external to the contract, but rather based on it. The criterion for calculation is the value that the parties attributed to the exchanged objects, the agreed chronological relations between their corresponding obligations, and so forth. For this reason, even if RCE remedies are viewed as "reformation of the original contract" or "modification" thereof, they do not adversely affect the parties' autonomy. The breaching party is the one who, by her breach, deviated from the agreement. She cannot persuasively object to adjusting the counter-performance to her own actual performance when this adjustment is based on the originally agreed upon equivalence. As for the innocent party – she is the one opting for a RCE remedy, preferring it to remedies aimed at other goals.

A counter-argument might be that RCE remedies cannot be based on the parties' *actual* consent. The parties envisaged a full, conforming, and timely performance. They did not envision a partial, nonconforming, or belated performance coupled with corresponding adjustment of the injured party's obligations. Thus – the counter-argument proceeds – the most one can claim is that RCE rests on a *hypothetical* agreement, not on the parties' actual will. Indeed, while contracts sometimes explicitly adopt the RCE measure of relief, my aim is to justify its availability, at least as a default rule, in cases where they do not. If accepted, however, this counter-argument applies to any contract remedy and indeed to any contract default rule, thus denying the possibility of justifying any contract remedy on the basis of the will theory (as Craswell and others contend). To the extent that the will theory can meaningfully evaluate contract remedies – which I believe it can to some extent – RCE is a commendable goal of contract remedies. It is a commendable goal, first, because it closely follows the *agreed upon* equivalence (in

which sense it is comparable with the expectation measure); and second, because the nonbreacher's option to resort to RCE remedies provides a powerful incentive to keep one's promises (often stronger than the expectation measure).

Alternatively (that is, if one insists that no remedy rule or principle can be derived from the will theory), the above discussion indicates that RCE may be justified as resting on an ex ante hypothetical agreement. Reasonable parties may well agree, for example, that partial performance by one of them will result in correspondingly partial counter-performance, or that any delay in performance by one of them will entitle the other party to similarly delay her counter-performance. This alternative justification seems applicable also to the instances in which RCE benefits the breaching party, like obliging the buyer to pay for excessive quantity and allowing workers and contractors to recover for part performance.

Lastly, when crafting remedies for breach of contract, an additional concern from the point of view of a liberal theory aiming at enhancing people's autonomy is to refrain from excessive sanctions. A remedy is excessive if it unnecessarily curtails the breaching party's freedom (as is arguably the case with specific performance, at least in some circumstances), or is disproportionate to the costs and benefits that are at stake in the contract itself. RCE remedies are clearly proportionate to the contract and to the potential outcomes of its breach and are not intrusive at all.

C. Corrective Justice

1. General

The basic idea underlying corrective justice is that people have a duty to remedy wrongful losses they inflict on others. Unlike distributive justice, dealing with the allocation of entitlements among members of society, corrective justice narrowly focuses on the interaction between two people. As stated by Aristotle, corrective justice requires that the balance breached by the wrongful enrichment of one person at the expense of another's loss be restored.

Fuller and Perdue argued that from a corrective justice point of view, the restitution interest is the most worthy of protection, the reliance interest comes second, and the expectation interest comes only third. According to their argument, protection of the restitution interest is justified twice as much as the reliance interest, because restitution at the same time compensates the innocent party for her loss and deprives the breaching party of her unjust profit, while protecting the reliance interest attains the first goal only. They further claimed that protection of the expectation interest exceeds the sphere of corrective justice altogether, because it does not aim at restoring the breached equivalence, but rather at placing the innocent party in a position better than the one she would have been in had she not made the contract.

Fuller and Perdue assume that the balance that needs to be restored is the one existed prior to the conclusion of the contract. If, however, one refers to the parties' position had the contract been fully performed as the relevant benchmark, than corrective justice would be realized to a fuller extent by protecting the injured party's expectation interest. [...]

The ease with which both reliance and expectation interests may be justified on the basis of the notion of corrective justice arguably demonstrates the inherent weakness of corrective justice as a justificatory theory. Concepts of corrective and distributive justice are basically formal and structural concepts, rather than substantive principles of justice. [...]

2. Looking at Both Sides of the Equation

Having realized the limits of corrective justice, one may nevertheless connect between RCE and the Aristotelian concept. The common feature of expectation and reliance damages is that both strive to rectify the injury caused to the innocent party, regardless of the existence or absence of actual enrichment by the breaching party following the breach. Similarly, restitution and disgorgement, aimed at depriving the breaching party of her unjust enrichment, disregard the existence or absence of actual loss to the innocent party. In contrast, in the case of RCE there is a closer correlation (although not necessarily an identity) between the injured party's loss and the breacher's gain.

[...]

3. RCE as an Alternative to Expectation

RCE remedies may seem desirable from a corrective justice perspective for a much more practical reason. Sometimes, the injured party resorts to a RCE remedy not because it would get her a reward exceeding her expectation interest, but rather because there are insurmountable or very considerable obstacles to protecting her expectation interest at all. Thus, for example, whereas courts grant damages for belated delivery of the sale object on the basis of the interest the price paid would have yielded during the delay period, they often do so because it is impossible or very difficult to figure out the net rental value of the object during that period. At the same time, it may be quite easy to find out the statutory or market interest the buyer could have received on the money she paid on time. The point here is not that the RCE remedy is higher or lower than the expectation interest. Rather, it is that in the absence of RCE the injured party would not have been compensated at all. Suspension of the nonbreacher's performance in response to an actual or expected breach bypasses in an even more straightforward manner any difficulty in establishing the injured party's expectation interest. Similarly, when a seller delivers 60% of the agreed quantity of customized goods, it is much easier to reduce 40% of the

contract price than to determine the missing goods' current market price. The same is true with regard to price abatement in real property transactions.

Arguably, in such cases, RCE is instrumentally used to protect the innocent party's expectation interest, just as reliance expenses are sometimes used as a minimal approximation of expectation. This counter-argument should be rejected for two interrelated reasons. First, contrary to reliance damages, RCE remedies are compatible with effectuating the parties' will, and the break of the contractual equivalence is sensibly a result of the breach. Therefore, RCE remedies are available even when they manifestly exceed the expectation interest. Second and more fundamentally, restoration of the contractual equivalence is a different goal than putting the nonbreacher in the position she would have occupied had the contract been fully performed. The fact that under certain circumstances protecting the expectation interest is unattainable does not imply that RCE remedies are used in such circumstances to protect expectation. It means, however, that RCE remedies are doubly important as a means of corrective justice in such circumstances.

D. Distributive Justice

Awarding the injured party RCE remedies may have distributive consequences that are worth exploring. The following analysis assumes that it is morally right to aspire to a fairer distribution of wealth and power in society; that redistribution of resources is a legitimate role of the state; and that contract law is a legitimate and appropriate vehicle for enhancing distributive justice. These assertions are highly debatable, yet but these debates remain beyond the scope of this Article.

The distributive outcomes of RCE remedies are not unequivocal. Indeed, when the innocent party is weaker or poorer than the party in breach, extending the scope of remedies available to her may bring about desirable distributive outcomes. Thus, for example, the availability of such remedies to residential tenants suing for breach of the warranty of habitability, as well as to other consumers, may seem desirable. However, it is not clear that the breaching party is typically stronger or richer than the innocent one. Whenever the innocent party is stronger or richer, extending the scope of her remedial rights may further strengthen and enrich her. In fact, given the considerable costs involved in filing a lawsuit, it may well be that courts are more accessible to the rich and the strong. If this is so, then RCE remedies may arguably have undesirable distributive effects (though, some RCE remedies – such as suspension of performance and reduction of price when the price has not been paid yet – are self-help remedies not entailing a lawsuit).

A possible reaction to this concern may be that RCE remedies should be available only to injured parties who are typically weaker and poorer. However, this constraint is not part of existing doctrines of RCE remedies, and it is very doubtful that it should be. A more persuasive reaction would be that increasing the expected gains from a lawsuit (by

awarding RCE remedies exceeding expectation remedies) would encourage the weak and the poor to sue.

There are however additional reasons to believe that, more often than not, RCE remedies benefit the weaker party. One situation in which RCE remedies are particularly advantageous is when the agreed price exceeds the goods' or services' market price. In the cases of proportional price abatement, rent abatement, and price reduction under the CISG, this is because unlike expectation damages, RCE remedies are measured by reference to the contract price. The fact that a party agreed to pay more than the market price may indicate that she had an inferior bargaining power, was less informed, or was a less sophisticated bargainer. Even if the difference between the agreed price and the market price at the time of breach results from subsequent decrease in the object's market price, this may indicate that the injured party was less sophisticated than the breacher. Another category of situations in which RCE remedies are especially advantageous are those where establishing the facts necessary to obtain expectation damages is difficult or expensive. Allowing the injured party to sue for proportional rent abatement or for proportional price abatement without having to prove the net rental value or current market value of the property is a significant advantage for poor and unsophisticated plaintiffs.

Even if these (admittedly tentative) generalizations are accepted, there is still a more fundamental argument against viewing RCE as a redistributive means. Analyzing the distributive effects of contract remedies, one should examine not only their effect on the parties following the breach, but also their effect on future contracts. In principle, extending the scope of remedies available to the promisee (including remedies that may put her in a better position than she would have been in had the contract been fully performed) increases the potential costs of the bargain to the promisor. When the promisor is a firm, it may try to pass on these costs to its customers. Whether the promisor fully or partially succeeds in passing on these costs, the distributive outcomes of RCE remedies – as between the supplier and the customer and among the customers themselves – depend on various factors, including the relative risk-aversion of the different customers and the firm, the existence of market substitutes for the product or service, and the distribution of the risk of breach for which remedies have been expanded. These distributive outcomes are hard to predict.

These competing considerations make it difficult to reach any definite conclusion regarding the distributional outcomes of RCE remedies. Nonetheless, a review of the judicial awards of RCE remedies seems to not only remove the fear of negative distributional effects (to the limited extent that one can deduce this from reading court judgments), but also to indicate that sometimes they have positive distributive effects. A conspicuous example is the case of the breaching employee who quits her job before the end of the contract period. In that instance, RCE assists the breacher, who is probably the weaker and poorer of the two parties, by entitling her to remuneration for the work she had already done. The proportional formula used to calculate damages for breach of the

warranty of habitability is also part of an (admittedly controversial) redistributive legal scheme; and the procedural and evidential advantages of some of the RCE remedies are significant too.

Finally, as against these (relatively modest) positive distributional effects of RCE remedies, one may contend that most of these effects are indirect, unsystematic, and ad hoc; and that if one seriously seeks to attain redistribution through contract remedies, it should be done in a more systematic and direct manner. A possible response to this contention would be that, given the heated debate regarding the appropriateness of redistribution through contract rules, the indirect and covert nature of these distributive effects may actually be an advantage.

E. Economic Efficiency

1. General

Normative economics is a consequential moral theory attributing equal weight to the well-being of every person. It evaluates acts and rules according to their effect on aggregate social welfare. According to the prevailing (Kaldor-Hicks) criterion, a rule is efficient if the sum of benefits it generates is greater than the sum of its costs, that is – if it maximizes social utility. The outcomes of a legal rule are examined first and foremost by their influence on the behavior of the people to whom the rule applies.

[...]

From an economic point of view, remedies for breach of contract are primarily evaluated according to the incentives they create for the parties at different stages of the contractual process: prior to and at the time of contracting (e.g., the decision to enter into a contract, with whom, and under what conditions; how much information to gather before contracting and what information to share with the other party); after contracting (for the promisor: how much effort and what precautions to take to ensure performance; for the promisee: to what extent to rely on the contract and whether to get ready for its potential breach); at the performance stage (whether to perform or to breach), and even later (what measures to take to mitigate the loss in case of breach; whether to sue for the breach, etc.). In any of these stages and with regard to both parties, economic analysis endorses rules creating incentives for behavior that would maximize aggregate social utility (which, in the absence of externalities, means maximization of the joint contractual surplus). However, different remedy rules generate different (and countervailing) incentives for the parties in different stages of the contractual process and under different circumstances. Consequently, the efficient rules should either generate the most efficient incentives overall, or be tailored for specific types of transactions. The possibilities of ex ante contracting around remedy rules, and of post-contracting renegotiation between the parties, as well as the parties' relative risk-aversion and the cumulative effect of non-legal sanctions, further complicate the picture. Not surprisingly, one could find efficiency

arguments supporting almost any conceivable remedy rule. Viewing the payment of damages as an embedded option to terminate the contract subject to the payment of a “termination fee”, an argument was even made for rules that in “thin-market” contracts would encourage parties to agree explicitly on the measure of damages by making specific performance the default remedy, and in the case of consumers’ breaches – by setting the default remedy at zero damages.

Focusing on the performance of the contract and the promisor’s precautions, the common point of departure of economic analysis is that remedy rules should urge the promisor to perform and take precautions to avoid breach as long as performance and such precautions are efficient, and to breach and avoid such precautions if breach is efficient. This is the well-known efficient breach theory. A perfect protection of the promisee’s expectation interest through damages supposedly creates an optimal incentive in that sense. Full expectation damages make the promisee indifferent between performance and breach while at the same time make the promisor (and society at large) better off. Expectation damages are necessary because they force the breaching party to internalize the costs her breach is inflicting on the nonbreacher.

2. Overcoming Undercompensation, Underenforcement, and Uncertainty

The endorsement of expectation damages by the efficient breach theory is however problematic because it unrealistically assumes perfect compensation, perfect enforcement, and certainty of rules and rulings. Once these assumptions are relaxed, the advantages of RCE remedies become clear. This Section addresses several difficulties characterizing the award of expectation damages and demonstrates how RCE remedies may overcome these difficulties. It starts with the problem of *undercompensation* due to gaps between subjective and objective valuations of entitlements. Then, drawing on arguments made earlier in the contexts of corrective and distributive justice, it argues that RCE may also mitigate the problem of *underenforcement*. The prospect of receiving larger rewards through RCE remedies makes them potentially superior in coping with undercompensation and underenforcement. RCE remedies may contribute to the enhancement of *certainty* even if they do not yield greater rewards. Finally, I shall argue that RCE remedies sometimes provide direct incentives to perform, thus circumventing to some extent the problems of undercompensation, underenforcement, and uncertainty characterizing expectation damages.

Subjective Value. Contrary to the assumption of the efficient breach theory, the injured party is hardly ever indifferent between getting the contractual performance and receiving expectation damages. Typically, expectation damages do not fully protect the expectation interest of the injured party. This is due to the difficulties of establishing the loss with sufficient certainty, the foreseeability requirement, the mitigation of loss rule, the reluctance to award emotional distress damages, the limited or no recovery of legal costs, and so forth. While each of these limitations on the availability of damages may

have its own economic justification, they nevertheless undermine the efficiency of expectation damages. Due to these limitations, expectation damages are likely to create suboptimal incentives for performance. Inasmuch as RCE remedies help solving the problem of undercompensation, they are likely to enhance efficiency. The first reason why RCE remedies may indeed contribute in this respect has to do with the problem of subjective valuation.

A well-known difficulty in protecting the expectation interest is due to the possible gap between the objective, market value of entitlements and their subjective value for the innocent party. It is commonly assumed that from an economic point of view, the yardstick for determining the value of an entitlement for any person is the sum that person is willing to pay for it – namely, the subjective value of the entitlement to her. Thus, if the benefit to the breacher from the breach is smaller than the subjective value of performance to the innocent party (and there are no readily available substitutes on the market), breach would be inefficient. However, when calculating damages, it is obviously difficult to trust the assertion of the injured party regarding the subjective value she attributes to performance, because she has a clear incentive to exaggerate. For this reason, damages are usually calculated according to the objective value of entitlements. Such calculation yields suboptimal incentive to perform. This difficulty is primarily acute in contracts referring to singular goods or services (as opposed to standard ones), ordered or purchased for self use, and in particular for personal, household or family use (as opposed to commercial ones). These are the contracts in which the difference between subjective and objective value may be particularly large. Now, what differentiates RCE remedies from expectation damages is that RCE remedies are much more closely related to the subjective value of performance to the promisee.

Take, for example, the remedies of price abatement ancillary to specific performance and proportional price reduction. Suppose the market price of the object at all relevant times is \$100,000, yet the agreed price is \$120,000. Suppose further that a deficiency in the land's acreage or a defect in the goods diminishes its value by 25%. In this case, expectation damages for the direct loss would be \$25,000 (the difference between current market value of the conforming object and current market value of the nonconforming one), while proportional reduction would provide the buyer with \$30,000 (25% of \$120,000). The fact that the buyer was willing to pay a price exceeding the object's market value indicates that her subjective loss due to the decrease in the object's value is at least \$30,000. True, one may resort to this argument in an attempt to receive expectation damages higher than the decrease in the object's market value. But the abatement and price reduction remedies bring about this result in a much more direct and immediate fashion.

The same is true where, as a remedy for delayed delivery of real property (or any other object), the buyer recovers market interest on the prepaid purchase money for the duration of the delay. In pure monetary terms, whenever market interest rates are higher than rental rates (measured as a percentage of the leased property's value), the buyer

would have done better investing the purchase money in an interest-yielding financial investment and renting a property similar to the one she contracted to buy. Even under such circumstances, however, people often prefer to live in their own homes rather than renting. Presumably, they do so because they derive additional, non-monetary benefits from living in their own home above and beyond the saving of rent payments. When a buyer claims damages for belated delivery not in accordance with the net rental value of the property (expectation), but according to the interest the price money would have yielded had she suspended payments (RCE), the latter is probably higher than the former. Making the contract in the first place indicates that in fact the subjective value the buyer attributed to having the property during the delay period exceeded not only its market rent, but also the even higher market interest rate at the same time. Once again, the RCE remedy better compensates the non-breaching party for her subjective loss, without relying on her ex post, highly suspected testimony.

Underenforcement. The argument that the expectation measure of damages yields optimal incentive to perform unrealistically assumes that there is a 100% probability that the breacher will compensate the injured party for her losses. Inasmuch as this probability decreases, so do the expected damages paid by the breaching party and her incentive to perform, thus resulting in inefficient breaches (although risk aversion of the breacher may mitigate this effect). We noticed that sometimes the data necessary to establish the expectation interest (e.g., rental value or current market value of customized goods or real property) is more difficult to collect and prove than the data necessary to calculate RCE remedies (e.g., statutory or market interest, the quantity of missing goods, contract price). Facilitating the enforcement of the injured party's rights, RCE remedies may efficiently mitigate the problem of underenforcement. Similarly, increasing the expected payoffs to the injured party (who may choose between expectation and RCE remedies) somewhat rectifies the distortion caused by the reluctance of the weak and the poor to protect their contractual rights, thereby increasing the probability of enforcement.

Uncertainty. Some law and economics scholars, notably in recent years Alan Schwartz and Robert Scott, have claimed that the norms applying to contracts between sophisticated, commercial parties should be as concrete, predictable and certain as possible. Vague standards fail to provide the parties with ex ante guidance and create ex post moral hazard, especially in cases of asymmetric information. Since adjudication is costly, courts should resolve contract disputes using narrow evidentiary base, rather than a broad one. These claims have focused on legislative default rules and judicial interpretation, but their implications are broader.

While this self-proclaimed formalism is contestable, it provides some support for RCE remedies whenever their calculation is based on easily verifiable data, like the contract price, the quantity of supplied goods, and statutory or market interest. From an efficiency point of view, the relative predictability and certainty of remedies is an important advantage even if more certainty is achieved at the price of some deviation (downward or upward) from a supposedly ideal measure of damages that is less predictable, more

susceptible to manipulation, and costly to determine. This is true from both the parties' perspectives and from the institutional point of view of the courts system.

Direct Incentives. Sometimes RCE remedies create direct efficient incentives. Thus, the right to suspend performance in response to actual or expected non-performance by the other party (discussed in Section II.B.1 above) ordinarily prompts the other party to perform, knowing that her performance (or assurance of future performance) is a condition to receiving the counter-performance. Since contracting parties usually value the counter-performance higher than their own performance (otherwise the contract would not be profitable), this is ordinarily a significant incentive. Interestingly, suspension of one's performance seems efficient also in adapting the promisee's reliance expenditures to the promisor's actual or expected non-performance. When the innocent party suspends her performance in response to an actual or expected non-performance by the other party, she at least partially bypasses the problems of undercompensation, underenforcement, and uncertainty characterizing monetary damages.

3. Counter-Arguments and Responses

As against these arguments, one may submit at least two counter-arguments. First, some of the arguments presented in support of RCE remedies do not equally apply to all situations in which such remedies are available, or do not apply to all of the remedies. Thus, RCE remedies are available even where there is no considerable gap between the objective and subjective valuations of the promisee's entitlement, and where the fear of underenforcement of the injured party's remedial rights is not particularly significant. Likewise, the promisee's right to suspend her performance for fear of future non-performance by the promisor is phrased in vague standards of reasonableness, thus not necessarily enhancing certainty and predictability. Admittedly, the scope and import of the efficiency arguments analyzed above vary among different RCE remedies and different situations in which these remedies are available.

A second and more fundamental counter-argument is that most of the above arguments provide reasons to use RCE remedies instrumentally to protect the 'true' expectation interest, rather than justifications for RCE as an independent goal of contract remedies (just as a reliance measure is sometimes used as a minimal approximation for expectation). If it is assumed that expectation is the most efficient measure (at least in terms of incentive for performance and for taking precautions), RCE remedies may miss this goal and result in overcompensation. This is because, contrary to the use of reliance as a minimal approximation for expectation, RCE remedies are available even when they exceed the innocent party's expectation interest. Overcompensation is undesirable not only because it ex post prompts the promisor to perform when breach would be more efficient, but also because it ex ante prompts her to demand a higher price for her performance (due to the risk of being exposed to greater liability for breach), thus discouraging otherwise efficient contracts. Generally, if the assumption is that efficiency

calls for exact protection of the expectation interest, then arguably one should seek more adequate ways to protect this interest, rather than award RCE remedies.

This objection would have been decisive had there been ways to attain exact protection of the expectation interest. However, not only such ways are practically non-existent, they are not even theoretically desirable. Putting the nonbreacher at exactly the same position she would have occupied had the contract been performed would mean that such requirements as foreseeability and mitigation of loss – which serve important efficiency goals – would have to be relinquished. It is doubtful that other measures could more successfully handle the real problems of undercompensation, underenforcement and uncertainty.

At the end of the day, RCE remedies seem to enhance efficiency, but this conclusion is neither conclusive nor unequivocal. It should be stressed that the question under discussion is not whether to replace expectation remedies with RCE ones. In most cases, the question is whether to allow the injured party to choose between the two. This option is significant when there are considerable obstacles to effectively protecting the injured party's expectation interest, and in losing contracts. Since the scope of these cases is relatively limited, and since considering the effect of RCE remedies in such cases *ex ante* requires a rather sophisticated planning capacity, one may doubt that the availability of RCE remedies significantly influences people's decision to enter contracts and under what circumstances. Given the limitations of human imagination and capacity for analysis and planning, the benefit of taking this consideration into account at the contracting stage is probably smaller than its cost. For this reason, despite the fact that RCE remedies are ordinarily default rules, one would rarely expect the parties to contract around them. RCE remedies have a larger effect on people's decisions and behavior at the performance stage. To the extent that the decisions regarding precautions and performance are affected by legal rules, the availability of RCE remedies influences these decisions whenever the difference between them and other remedies is not trivial. Given the typical inability of expectation damages to effectively protect the expectation interest, the limited availability of specific performance, and almost no availability of disgorgement remedies, RCE may well be an efficient means to prompt efficient performance, especially in those cases where its implementation requires data that is simpler to attain and establish in court proceedings. At the same time, when RCE remedies are likely to exceed the full expectation interest of the injured party, they are likely to discourage efficient breaches.

These conclusions may be rephrased in the language of *ex ante* allocation of risks. Realizing that expectation damages do not adequately deter against inefficient breaches and being aware of the boundaries of specific performance, rational parties may well agree to grant the promisee an option to get RCE remedies in addition to other remedies.

4. The Efficiency of RCE Favoring the Breaching Party

The case for the efficiency of RCE doctrines favoring the breaching party is straightforward. Recall that these doctrines disallow the injured party – the employer whose employee stopped working before the end of the agreed term, the owner whose contractor failed to complete the project, the buyer who received excessive quantity of goods, etc. – to enjoy the breacher’s performance without paying for it. The prospect of such an enjoyment would distort incentives on both sides. It would discourage even extremely efficient breaches by contractors and employees; and would prompt owners and employers to strategically and opportunistically provoke a default by the contractor or employee. In the case of delivery of an excessive quantity of goods, it would mean that the buyer may retain the goods even if she values them below, and even far below, their value to the seller. Restoring the contractual equivalence in favor of the breaching party is therefore clearly efficient.

F. Summary

One of the major debates in contract law theory concerns the question of what should be the primary goal of contract remedies and the organizing principle of contract law in general: the expectation interest or the reliance interest. As seen in Section III.A above, RCE combines features of both reliance and expectation. On the one hand, RCE remedies strive to put the injured party in the position she would have occupied had she made a different contract, in which the agreed upon counter-performance would have been the one actually rendered by the breaching party. On the other hand, RCE remedies do not disregard the contractual agreement, because it is the parties’ agreed equivalence that these remedies strive to restore. Since RCE is to a certain extent a hybrid carrying genes of reliance as well as expectation, its justifications are related to the conventional justifications for each of these interests. This section summarizes the main conclusions of the above normative analysis and connects them to additional theoretical perspectives on contract law.

According to the will theory, RCE remedies are justifiable even if they put the nonbreacher in a better position than the one she would have been in had the contract been fully performed, because they reinforce the moral-legal principle that contractual promises should be kept. Compared to other remedies that potentially exceed the expectation interest, (e.g., punitive damages and disgorgement), RCE better coheres with the will theory of contract because it relies on the equivalence agreed upon by the parties. RCE remedies may also be related to the notion that the central goal of contract law is to realize the parties’ reasonable expectation. Arguably, even in a losing contract, restoration of the contractual equivalence does not provide the innocent party with a remedy exceeding her reasonable contractual expectations.

RCE is fully compatible with corrective justice principles, because it reinstates the balance broken by the breach of contract. Remedies aiming at this goal compensate the injured party for her loss, and at the same time deprive the breaching party of the benefit

gained through the breach. While remedies aiming at other goals may attain this result as a by-product of their focus on compensating the injured party (expectation, reliance) or depriving the breaching party of her wrongful gains (restitution, disgorgement), RCE remedies purposefully aim at restoring the equivalence. RCE remedies are a particularly important means to attaining corrective justice goals when there are considerable (or even insurmountable) obstacles to protecting other goals of contract remedies, such as expectation.

The picture is less clear with regard to the distributive effects of RCE remedies, but to the extent that RCE remedies have such predictable effects, they seem to be desirable. One may plausibly conjecture that extending the injured party's remedies would encourage the poor to protect their rights by filing lawsuits, and that this effect would be particularly significant in those cases where establishing the facts necessary to get expectation damages is particularly burdensome, while establishing the data necessary for RCE remedies is significantly easier. There are also reasons to believe that weak and unsophisticated parties are more likely to agree to pay for goods and services above their objective, market value. These are the cases in which the proportional formula grants the injured party a larger relief.

The efficiency effects of RCE remedies are likewise inconclusive yet seem to be positive overall. A major cause for this indefiniteness is that, while economic analysis exposes the incentives created by any measure of damages (or any other remedy) for the parties' behavior at different stages of the contractual process, it falls short of concluding which remedy yields the most efficient incentives overall. Since it is hardly likely that the availability of RCE remedies would significantly affect the pre-contracting decisions of the parties, one should focus on the post-contracting incentives for the promisor's precautions and performance. In this respect, standard economic analysis advocates expectation damages as the most efficient remedy because it encourages efficient breaches and discourages non-efficient ones. Whenever ordinary damages are in fact unlikely to put the nonbreacher in a position similar to the one she would have occupied absent the breach, RCE remedies may assist in attaining this goal. They do so by better coping with the gap between subjective valuation and the market value of entitlements, and by encouraging the enforcement of contractual rights. The relative simplicity of calculating some of the RCE remedies and the limited data necessary to that end also serve the goal of certainty. Finally, some RCE remedies provide direct incentives to perform. One has to concede, however, that these effects are not equally relevant to all situations in which RCE remedies are available, and that RCE remedies may (at least in theory) result in inefficient overdeterrence. RCE doctrines benefiting the breaching party are more obviously efficient, primarily because they discourage strategic and opportunistic behavior by the promisee.

One more theory of contracts and contract law deserves to be mentioned here, if only briefly. Notwithstanding their fundamental differences, the will theory of contract and standard economic analysis share some notions about contracts. They both tend to view

contracts as discrete transactions allocating rights and risks between autonomous, rational people, each interested in pursuing her own interests. Competing perceptions view “the contractual relationship (even in commercial settings) ... not only as a locus of competition or an instrument for the allocation of risks and the production of wealth, but also as a zone of mutual cooperation and confidence, dependence and vulnerability”. Such social and relational conceptions underscore values of trust, fairness, good faith, taking into account the interests of the other party, and loyalty to joint objectives.

While these latter conceptions (much like the other perspectives discussed in this Part) may seem too vague to generate specific goals of contract remedies, they nevertheless appear to support the notion of RCE. This is because RCE remedies often express a greater commitment (compared with ordinary expectation damages) to the notion that contracts should be performed (even at the expense of efficiency). At the same time, RCE doctrines sometimes prevent the injured party from harshly and unfairly taking advantage of the other party’s breach. The redistributive effects of RCE remedies also fall into line with social conceptions of contract law.

Conclusion

[...]