International Review of Law and Economics 35 (2013) 13–25

Contents lists available at SciVerse ScienceDirect

International Review of Law and Economics

The effect of time on default remedies for breach of contract

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ARTICLE INFO

Article history:
Received 23 March 2011
Received in revised form
25 November 2012
Accepted 27 November 2012

JEL classification:
K12

Keywords:
Contract law
Breach of contract
Default remedies
Expectation damages
Specific performance
Punitive damages
Renegotiation costs
Discount factor
Prejudgment interest

ABSTRACT

Among default remedies for breach of contract, expectation damages are believed superior to property rules such as specific performance since they allow the promisor to breach inefficient contracts when renegotiation is economically infeasible. We examine whether the promisor's ability to accurately determine when to breach is maintained when taking into account the value of time that distinguishes between immediate performance and paying damages in court. We show that if prejudgment interest does not equal the promisor's subjective value from time (e.g. if the court uses the promisee's interest rate to fully compensate him), the promisor's breach decision will be distorted. When renegotiation *is* feasible this problem of excessive breach is mitigated, however asymmetric information about discount factors can lead to a renegotiation process that is *doomed to fail*. Punitive damages behave similarly. Specific performance without ancillary monetary awards always creates a pie for division between the parties. Ancillary awards for delay are unlikely to change this, but ancillary awards for partial breach make specific performance behave more like expectation damages, although to a lesser degree.

> "Now Aesop was not much of a finance major, because he said something like 'A bird in the hand is worth two in the bush'. But he doesn't say when. Interest rates – the cost of borrowing – are the price of 'when'. They are to finance as gravity is to physics. As interest rates vary, the value of all financial assets – houses, stocks, bonds – changes, as if the price of birds had fluctuated. *And that's why sometimes a bird in the hand is better than two birds in the bush and sometimes two in the bush are better than one in the hand*." (Attributed to Warren Buffett, Sun Valley, Idaho, July 1999 in Alice Schroeder, *The Snowball: Warren Buffett and the Business of Life*, p. 16.)

1. Introduction

The standard analysis of remedies for breach of contract shows that their importance grows with the cost of renegotiation. Consider a situation in which circumstances change and a party to a contract finds himself in a situation in which he loses from carrying out the contract, and thus prefers to breach. If it is possible for the party to costlessly renegotiate with his contractual partner, the parties can resolve the dispute by agreement, and continue to carry out efficient contracts and terminate inefficient ones. This is believed true independent of the default remedy (Hermalin, Katz, Craswell, Polinsky, & Shavell, 2007, p. 99), which may affect the division of surplus that results from the renegotiation process, but not the outcome of the process.

In general, however, renegotiation is not costless, but may, in fact, be quite costly. To understand why, assume that the loss contract is inefficient. If the parties attempt to renegotiate termination of the contract, there is no guarantee that the renegotiation will be successful. Successful renegotiation yields a "pie" (relative to court proceedings) that can be divided between the parties, but theory does not tell us *how* they will divide the pie.[1] There are multiple equilibria in a renegotiation process, and this can, at least potentially, make renegotiation problematic. If the parties are stubborn, renegotiations to terminate the inefficient contract may fail

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http://dx.doi.org/10.1016/j.irle.2012.11.004

[1] If there is a clear protocol governing the renegotiation process and this is known to both parties, then theory predicts a single equilibrium. Thus, for instance, if the promisor gets to make a take-it-or-leave-it offer, the result is an ultimatum game, with the promisor receiving the entire surplus. In general, however, such a protocol does not exist, and renegotiation processes are not well structured enough to yield a predictable outcome.

(Polinsky, 1980, p. 1092) [2]and, in that case, the sides may end up in court.[3]

If renegotiation is likely to fail, the choice of default remedy can be consequential. Scholars have suggested that in order to attain the goal of allocating the property to the highest valued consumer at the lowest cost, it is best to use a liability rule (*à la* Calabresi & Melamed, 1972) such as expectation damages, that awards the promisee his loss from the breach, and thereby encourages the promisor to breach when his value from the breach is greater than the promisee's loss. If expectation damages can be well specified by the courts, this will replicate the renegotiation outcome (Shavell, 1980, 1984).[4] This benefit from using expectation damages led many to conclude that this remedy always give precise incentives for breach of contracts. It leads to a Pareto optimal solution without the sides ever having to speak.[5]

Other scholars, conversely, used Calabresi and Melamed's methodology to reach the opposite conclusion from those who promoted expectation damages. They claim that there is no reason to suspect that the parties would have difficulty in reaching agreement to terminate an inefficient contract through renegotiation, and, in fact, this path may be far less expensive than going through court (Farber, 1980, pp. 1450–1455; Friedman, 1989, pp. 6–7; Dodge, 1999, pp. 634, 670–672). The sides to the dispute are well acquainted with each other and there are few participants, both parameters that should lead to an efficient and speedy resolution (Ulen, 1984, pp. 369–370). Thus, it is better to use a property rule such as specific performance, under which the promisor is required by court order to fulfill the contract if he breaches. Under such a rule the promisor's dominant strategy will be not to breach unilaterally, but rather to buy his way out of the contract by offering the innocent party a payment for surrendering his right.[6]

Although using the Calabresi and Melamed methodology did not lead to concurrence regarding which default remedy is preferable, it is nevertheless agreed that under the expectation damages regime, the promisor can breach if renegotiation is not economically feasible, and to settle out of court if it is. For this reason, it would seem that if the feasibility of renegotiation depends on the circumstances of the case, the model of efficient breach is preferable to a property rule since it is more flexible, allowing for both solutions; the promisor may unilaterally breach the contract (if he believes the renegotiation costs will be great or will fail) and go to court, or renegotiate a settlement.

In this paper we bring the purported flexibility and superiority of expectation damages into question. Two conclusions from efficient breach theory are that the promisor has a precise incentive whether to breach and that the parties to the dispute will choose correctly whether to renegotiate or go to court. These conclusions, however, disregard a key variable that must be considered when comparing such regimes – the value of time. Including this element in the analysis causes many of the accepted understandings to fall by the wayside.

The reason time needs to be taken into account when considering breach is immediate. It is clear that one of the major differences between breach and performance is the amount of time involved – breach allows the promisor the flexibility to push off payment of damages for the entire period of the court proceedings, which can be quite prolonged. Thus, the choice made by the promisor determines not only the size of the expenditure, but also *when* the expenditure is incurred. The choice, then, of immediate performance or breach depends on which is greater – the immediate cost of fulfilling the contractual obligation or the *present value* of the future payment from court proceedings, where the present value is calculated using the promisor's *subjective* discount factor.[7] And yet, while pretty much any economic model with temporal implications will include discounting in the basic setup, this factor has been completely missing from the discussion of efficient breach theory.[8]

While at first glance time costs would seem to be no different than other costs created by the litigation process, the implications are quite different. Note that while the effects of time are caused by the litigation process, they are not actually costs paid by the parties; rather, they reflect the value of the payments at different points in time. As a result, while litigation costs can only decrease the payment each party receives, the effect of time can increase or decrease the payment (for instance, it tends to work in *favor* of the promisor, and is therefore comparable to a "negative" litigation cost).

The length of the court proceedings changes the implications from breach in two manners: it has a distributional effect on the promisee, and it affects the efficiency of the choice made by the promisor.

Consider first the promisee, who is entitled to compensation for his loss from the breach. In general, if the award is set equal to the loss caused by the breach, the promisor will have proper incentives to breach; he will breach when and only when he is left with a profit after compensating the promisee. However, if the promisee is not compensated *at the time* when the breach occurs, he is liable to suffer.[9] What is necessary to fully compensate the promisee, is for

[2] For more on this, see Ayres and Talley (1995, pp. 1029–1030). For a general discussion, see Cooter and Ulen (2008, pp. 93–94, 264–265).

[3] Polinsky (1980, p. 1092 and footnote 37) himself does not ascribe to this. He believes that strategic behavior will at most cause a delay in reaching an agreement. In the next Section we explain that from a game-theoretic perspective such a delay will only occur in the presence of uncertainty.

[4] Also, remedies that protect a value lower than expectation damages, such as reliance damages (which give the innocent party any additional expenditure spent in order to maximize his welfare or his profit from the contract) and restitution of the contractual price are liability rules. As Shavell (1984) points out, these remedies give the promisor an incentive to breach excessively, and are thus inferior to expectation damages.

[5] Of course, it requires the promisor to know what damages will be ruled in court. In the absence of this he may have to renegotiate with the promisee to terminate the contract for an agreed upon payment, which returns us to the bilateral monopoly problem.

[6] Such is the case also for punitive damages in which the promisor must pay the promisee some multiple ($\alpha > 1$) of his loss, and disgorgement in which the promisor transfer to the promisee any profit he realized from the breach. In all these cases the overcompensation the promisor is forced to pay to the promisee in court will generally 'swallow' the benefit from the breach. Therefore he will not dare breach, but will rather either complete the contract or renegotiation with the promisee for release.

[7] A discount factor is the number by which a future cash flow must be multiplied in order to obtain the value today. For example, someone who is willing to push off payment of a fine of 100 to a known future point as long as the payment at that point, including interest and penalties, will not be greater than 150 is said to be indifferent between a payment of 100 today and a payment of 150 at that future point. His discount factor over this period is 2/3 (150/100). There are many reasons that people might prefer pushing off payment to a later date rather than pay immediately. Immediate payment may require the person to take out a loan on which he will have to pay interest, and in some circumstances he may not have access to the credit market, as discussed in Section 2.1. Alternatively, the party may have to pay using funds which would otherwise accrue interest. In addition, the party may foresee an improvement in his economic circumstances, thus making payment in the future more attractive. A discount factor is said to be subjective if it depends on personal factors that affect the value of time to the party under consideration, but do not necessarily affect other parties in the same manner.

[8] Note that there is also an effect of time in other legal settings, such as in accident law and externalities.

[9] Note that there is another time cost which harms promisees as a class. Given the passage of time, there is a positive probability that the promisor will become insolvent prior to completion of the court proceedings, in which case the promisee will not be compensated at all, or only partially. This is another reason, in additional to the many others discussed in the literature, that explain some of the shortcomings of an expectation damages regime. For more on this issue, see Schwartz (1979,