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Allocation of fault in contract law

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ABSTRACT

In this paper we consider situations in which the parties are in disagreement about the allocation of a certain risk, and either party could have acted ex-ante to prevent breach, to lower its probability or to insure against it ("least-cost avoidance" in tort law), but neither did so. When the state-of-the-world is revealed there remain steps the parties can take to prevent breach or mitigate damages. We consider strict liability and other regimes such as negligence and comparative fault, and show that the first-best solution is not achieved in those regimes because they incentivize the parties to consult the court in order to determine the identity of the obligor, and this is done only after the contract has collapsed.

We design a mechanism that yields the first-best solution *without the need for court intervention*, thereby allowing the parties to move forward and fulfill efficient contracts. In this mechanism, the court announces that any party that invests half the optimal level of precautionary costs *as determined jointly by the parties* is off-the-hook, and that if each party invests this amount the total costs and damages will be split. We demonstrate that this achieves optimality by leading the parties to jointly determine the optimal level of precautionary costs and to allocate the desired steps to the low-cost bearer. In addition, the mechanism leads to revelation of private information. Finally, we discuss the possibility of making the rule mandatory. By predetermining the equal split, the suggested mechanism brings renegotiation costs to a minimum because the parties only have to allocate the physical tasks between them.

1. Introduction

Contract law is designed to prevent efficient transactions from collapsing. By forcing the breaching party to pay the damages caused by his breach to the innocent party, the law aims to cause him to act optimally in attempting to avoid inefficient breach. To help the promisor in this task, contract law contains techniques that enable him to accurately evaluate these damages, thus allowing him to choose an optimal level of precaution against breach.[1] This works fully if the contract allocates the risk of every contingency that can possibly occur throughout the contractual period, in which case the parties can be assured that as long as the contract remains efficient it will not collapse. Such a contract, for our purposes, is a complete contract.

In this paper we consider instances in which contracts are *not* complete, and after the contract has been signed a contingency occurs, or stands to occur, that increases the cost of fulfilling the contract (i.e. it adversely affects the profits from the contract). The contract itself does not contain any clause that addresses this contingency. Such situations can arise due to a conscious decision to exclude contingencies from the contract because the cost of including them outweighs the benefit (Shavell, 1980), due to errors that occur at the time of contracting such as an error in understanding the state of the world at the time the contract was signed or an inability to foresee future events (Farnsworth, 1999, p. 619), or due to faulty wording in the contract allowing for multiple interpretations, causing each party to believe that the risk of the disruptive event that occurred or stands to occur was allocated to the other party (Hermalin, Katz, & Craswell, 2007, pp. 66–70). In all of these cases the agreement between the parties contains an element of an "accident" in that it does not reflect the rights and obligations the parties believed they were taking upon themselves at the time of contracting. We denote these occurrences "contractual accidents."[2]

Consider first contractual accidents for which it is clear that the liability falls solely on the promisor, i.e. cases in which the payor is, by definition, passive. As Posner and Rosenfield (1979, p. 111) explain, this occurs in situations in which "the only relevant actors are performer and payor and the productive activity under the contract is controlled and conducted entirely by the former." This is a

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[1] For instance, by limiting liability to only damages that were foreseeable at the time of contracting, they induce the promisee to reveal the extent of damages that will be caused by breach (*Hadley v. Baxendale* 9 Exch. 341, 156 Eng. Rep. 145 (1854)).

[2] A term coined in Procaccia (2009).

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case of "unilateral care" in which only the promisor can take steps to avoid or mitigate the probability of the accident (although the promisee may be able to take steps to lessen the amount of damage by lessening his reliance). In such cases the promisor is, in principle, liable for all consequences of the accident unless the court grants him an excuse from his contractual obligation (Cooter, 1985, p. 12), for instance, on the grounds of mutual mistake, impossibility or impracticability.[3,4] It is illuminating to note, however, that the accident need not mean the end of the contact; since there is no disagreement regarding which party is the obligor, then as long as the court's decision (whether to grant or refuse to grant an excuse to the obligor) is certain and known ahead of time to the parties, the parties should be able to jointly decide to complete efficient contracts or terminate inefficient ones once the unexpected contingency becomes known.[5,6] Contractual accidents with these properties are *not* the main subject of this paper, but we shall return to them in Section 6.

What we *do* consider are instances in which the parties are in disagreement regarding the identity of the obligor with respect to this accident. For a disagreement to exist regarding which party is the obligor, it must be the case that either party could have taken steps ex-ante to avoid the accident, lower the probability of it occurring or lessen the damages to the parties from an accident. This is a case of "bilateral care," which can be further divided into cases in which it is sufficient for one of the parties to act (denoted "exclusive care" herein and "least-cost avoidance" in the torts literature, see Dari-Mattiacci and Garoupa, 2009) and cases in which both parties optimally take actions ("joint care"). Consider, for example, the famous case of *Raffles v. Wichelhaus*[7] in which the plaintiff was to ship cotton to the defendant "ex-Peerless from Bombay," and the defendant was to receive the shipment in Liverpool. As it turned out, there were two ships named Peerless that fulfilled the conditions of the contract. Note that in this case the information (that there were two ships named Peerless) could have been discovered (almost) costlessly by *either* party before the contract was signed (a case of exclusive care), and had this been done the accident would have been avoided. The result of this situation is that when the accident occurs, or stands to occur, each party may believe that if the case goes to court, the court will allocate the risk to the other party, and he will be absolved from responsibility.

Further restricting the relevant set, we are concerned with only those instances in which, when the state of the world is revealed, *there are still steps that can be taken that can help avoid breach or lessen the damages from it occurring.* In *Raffles*,[8] for instance, the defendant claimed that he expected the shipment to arrive on the ship that arrived in October, while the plaintiff shipped the goods on the ship that arrived in December, when the defendant no longer required the goods. It would have been efficient, when the goods did not arrive in October, for the defendant to notify the plaintiff not to send the goods. In cases such as these, the question is whether the parties will be able to reach agreement to allocate the risk and take the desired steps despite the dispute that has emerged from the contractual accident. As we shall explain, the strict liability regime that typifies contract law makes it particularly difficult for the parties to successfully rise above the current crisis. In such a regime the court allocates the entire responsibility to a single party (Cooter and Porat, 2004, pp. 162–163; Porat, 2009, pp. 1407–1408), and if each party believes he will escape court proceedings unscathed, he may refuse to renegotiate any continuation of the contract. Put differently, because entitlements are not well defined between the parties, it could be difficult for them to reach an agreement *even if renegotiation is costless*. As a result, the required actions will likely not be carried out and efficient contracts could collapse.

These problems with a strict liability regime may find their solution in a fault-based regime that assigns responsibility for harm according to the fault of the parties, and grants an excuse from liability if the party takes sufficient precautions (Cooter, 1985, p. 7). Several scholars have recently considered the benefit from moving toward a fault regime in contract law and a number of possibilities have been suggested.[9] One option is to adopt the comparative fault defense to contract law, thus allowing apportionment of damages between the parties according to their fault (Porat, 2009). An alternative option is to give the promisor a release from responsibility if he took the precautions required by the court (Posner, 2009). In this case, the promisor will be excused from damages he could not prevent, so the innocent party will internalize these damages. This yields a similar result to the first solution.

These solutions, however, are particularly problematic when dealing with contractual accidents that stem from disagreement about the allocation of risk. Consider what is required for such rules to attain the desired goal of having the parties take optimal steps to complete the efficient contract. First, the court will have to determine which party is the obligor for this contractual accident. Second, they will have to specify what precautionary steps will be deemed sufficient to grant the obligor an excuse from liability (Posner, 2009, p. 1434). Third, and most difficult, they will have to determine all of this *ex-ante* so that the parties can have certainty when the accident occurs and know how to act. In other words, the courts will have to specify a set of rules that give the parties a clear guideline for all contingencies whose risk is not allocated in the contract, thus removing all uncertainty regarding all costs and damages in the minds of the parties to the contract *without them having to actually consult the court*. If the court cannot give a clear signal and each party believes the other will be found liable, the desired result of saving efficient contracts will not be attained.

[3] Some scholars believe that because it is always possible for the promisor to breach and pay damages, the impossibility doctrine is included in the impracticability doctrine (Triantis, 1992, p. 452).

[4] There is disagreement among scholars whether such an excuse can be economically justified. Posner and Rosenfield (1979, p. 90) state that in instances in which the promisee is the low-cost risk bearer it is efficient to grant such an excuse, since this allocates the damages efficiently. Porat (1991) disagrees, and says that since the granting of an excuse stems from the inability of the parties to foresee the contingency that occurred, it makes little sense to expect the promisee to have foreseen what the promisor could not. Therefore, there is no efficiency to be gained from transferring the damages to the promisee. If we accept this latter reasoning, it would seem that the granting of an excuse should transpire only when the desire of the parties has not been fulfilled given the current risk allocation.

[5] Consider, for example, *Mineral Park Land Co v. Howard*, 172 Cal. 289, 156 p. 458 (1916). In this case, a contractor agreed to haul gravel from the plaintiff's land for construction purposes. As it turns out much of the gravel was below water, and removing this gravel would have been prohibitively costly. However, gravel can be bought on the open market. If the court does not give the contractor an excuse and the parties know this ahead of time, and if the cost of the gravel on the market is less than the benefit from using the gravel, the contractor will be willing to pay the plaintiff to allow him to purchase the gravel. If the court gives the contractor an excuse and the parties know this ahead of time, and if the cost of the gravel on the market is less than the benefit, the plaintiff will be willing to pay so that the contractor will purchase the gravel and continue building. If the cost of the gravel on the market is greater than the benefit the contract will be terminated in all instances.

[6] Of course, the granting of an excuse lessens the promisor's incentives to take proper precautions and increases the probability of breach. The more broadly excuses are construed, the more the promisor will externalize some of the costs of breach (Cooter, 1985, pp. 12–14).

[7] 2H. & C. 906, 159 Eng. Rep. 375 (hereinafter "*Raffles*").

[8] *Supra* note 7.

[9] See Cooter and Porat (2002, 2004) and articles in the May 2009 issue of the *Michigan Law Review* which was devoted in its entirety to the conference on Fault in Contract Law held at The University of Chicago in the summer of 2009. Some of the papers in this conference were concerned with building proper incentives for the promisee to act when he can do so, and helped inspire this paper.