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THE EFFICIENCY OF A DISGORGEMENT AS A REMEDY FOR BREACH OF CONTRACT

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Thesis: Economic analysis suggests that to give a contract promisee a general remedy that would require a breaching promisor to disgorge any benefit of breach would hinder the efficient post-contractual reallocation of performance resources. This article explores certain situations in which disgorgement appears to be an efficient remedy for breach of contract, including cases in which the breaching party refuses to pay contract damages at the time of breach. A rule permitting promisees to recover as "prejudgment interest" the breacher's benefit from withholding payment of damages would, in theory, be efficient in allocating the risk of the breacher's credit worthiness to the best risk bearer. Colorado has implemented this remedy, but has, over time, extended it to require the defendant to disgorge the benefits of breach instead of the benefits of withholding damages. This extension appears to be unwarranted. Moreover, serious practical and theoretical difficulties in defining and measuring the benefits of either breaching or withholding damages cast doubt on the utility of the disgorgement remedy.

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I. INTRODUCTION

It is by now a commonplace that the law of contract remedies should take efficiency¹ into account by encouraging contract parties to

1. A definition of efficiency often used in legal analysis is that used by Posner in the second edition of his treatise: "Efficiency' means exploiting economic resources in such a way that, 'value'—human satisfaction *as measured by aggregate consumer willingness to pay* for goods and services—is maximized." R. POSNER, *ECONOMIC ANALYSIS OF LAW* 10 (2d ed. 1977) (Emphasis in original). Posner employs the Kaldor-Hicks concept of efficiency with respect to voluntary transactions: a transaction is efficient if it leads to a reallocation of resources that increases net social value as measured by willingness to pay. *Id.*; Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 *HOFSTRA L. REV.* 509, 513-14 (1980). See also R. POSNER, *ECONOMIC ANALYSIS OF LAW* 106-08 (3d ed. 1986).

This article will differentiate between transactional efficiency, or the net gain in wealth from a single exchange, and rule efficiency, or the tendency of a rule to establish incentives that would lead parties to act in efficient ways. Inefficient transactions can occur under efficient rules.

allocate resources to their highest valued uses even after the contract is formed. Whether or not efficiency should be the only criterion of contract remedies,² it remains at least a relevant topic of inquiry.

The usual remedy for breach of contract, expectation damages, is designed, with some notable limitations,³ to put the non-breaching party (the promisee) in the position he would have enjoyed if the contract had been performed,⁴ and to permit the breaching party (the promisor) to retain any excess benefit obtained as a result of the breach.⁵ This article explores some of the efficiency ramifications of a remedy that would require a breaching party who refuses to pay damages at the time of breach to disgorge the benefits of the breach to the non-breaching party. It also examines some of the conceptual problems in defining the "benefits of breach."

Part I analyzes the efficiency of disgorgement as both a contract and tort remedy. Cost avoidance analysis suggests that disgorgement is inefficient as a general remedy for breach of contract because it inhibits efficient reallocation of performance resources by requiring

2. For a sample of the controversy over the role of efficiency as a normative value, see Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980); Coleman, *supra* note 1, at 531-51; Dworkin, *Why Efficiency? A Response to Professors Calabresi and Posner*, 8 HOFSTRA L. REV. 563 (1980); Kornhauser, *A Guide to the Perplexed Claims of Efficiency in the Law*, 8 HOFSTRA L. REV. 591 (1980).

3. See *infra* notes 47-56 and accompanying text.

4. RESTATEMENT (SECOND) OF THE LAW OF CONTRACTS § 344(a) (1979) [hereinafter cited as RESTATEMENT (SECOND) OF CONTRACTS]. See also U.C.C. § 1-106(1) (1977) ("The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed, but neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law."); 5 A. CORBIN, CORBIN ON CONTRACTS §§ 992, 1002 (1964) ("The effort is made to put the injured party in as good a position as he would have been put by full performance of the contract, at the least cost to the defendant and without charging him with harms that he had no sufficient reason to foresee when he made the contract."); *Id.* at § 1002.; S. WILLISTON & G. THOMPSON, CONTRACTS § 1338 (rev. ed. 1937).

The promisee's interest in performance (his expectation interest), is contrasted to alternative bases of recovery: restitution (the return of benefits conferred upon a breaching party) and reliance (compensation for amounts spent in reliance upon the promised performance). See Fuller & Perdue, *The Reliance Interest in Contract Damages: I* 46 YALE L.J. 52 (1936). Briefly described, reliance damages and restitution damages put the promisee and promisor, respectively, in the positions they would have enjoyed had the contract not been entered. Farnsworth, *Legal Remedies For Breach of Contract*, 70 COLUM. L. REV. 1145, 1148 (1970).

In addition to money damages, contract parties are sometimes entitled to specific performance of the contract promise. See Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978).

5. R. POSNER, ECONOMIC ANALYSIS OF LAW 107-08 (3d ed. 1986).

contracting parties to negotiate before efficient breach can take place. By contrast, disgorgement appears to be an efficient remedy for the tort of conversion, where the possible benefit of the convertor's efficient reallocation of converted goods is outweighed by the benefit of the certainty gained when the convertor is required to establish the efficiency of the reallocation in a voluntary transaction. This rationale, premised on the uncertainty of judicial determinations of value, might also justify a disgorgement remedy in some contract breach situations. Two such situations are analyzed.

Part II turns to the question of whether a contract breacher may "efficiently" withhold payment of contract damages. It compares the efficiency of using expectation and disgorgement measures for calculating prejudgment interest. Here, too, cost avoidance analysis suggests that a disgorgement remedy is more rule efficient than an expectation damages remedy in calculating prejudgment interest.

Part III describes the statutory and case law of a jurisdiction that has adopted a disgorgement method of calculating prejudgment interest. It also traces the history whereby that remedy has been enlarged so as to permit a plaintiff to recover the benefits of efficient breach instead of the benefits of withholding damages. The results of this evaluation are troublesome and suggest a practical inability to contain a prejudgment interest disgorgement remedy to its theoretical conceptual limits.

Part IV seeks the source of this inability by analyzing the assumption that the "benefit" caused by either a breach of contract or a withholding of damages can be determined by traditional legal analysis. Inherent limitations on the causal reasoning employed by courts will increase the uncertainty and cost of the disgorgement remedy, impairing its ability to achieve its theoretical efficiency.

II. REMEDY EFFICIENCY AS COST AVOIDANCE

A. *The Cost of Contract Remedies*

Like the rest of the substantive law of contracts, the law of contract remedies can be seen as a set of ready-made contract terms supplied by the state to govern the contracts of parties who do not otherwise agree to specific remedy terms.⁶ Because the law of contract remedies will directly affect the risks and rewards of contracting, it is reasonable

6. Goetz & Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983). See also Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 88-92 (1977).

to assume that rational parties will take those remedies into account when they negotiate the price of contractual promises.⁷ A promisee will pay more for additional contract remedies,⁸ while a promisor will demand a contract price that reflects the full costs of the risks that the law allocates to her⁹ in its remedy provisions.¹⁰

When, for whatever reason,¹¹ the parties have failed to agree about the remedies for a breach that comes to pass, economic analysts have argued that the law should impose the remedy that the parties would have agreed upon.¹² In the absence of evidence about actual agreement, it is assumed that the parties would have selected remedies that would minimize the joint costs of the bargain.¹³

The cost analysis method of recreating the remedy the parties would have selected posits that a promisor would be willing to sell any remedy

7. See Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 642 (1988). Critical to this step are the assumptions that parties are perfectly informed about the law and the costs that contract remedies will impose, and that they can bargain over the forms and contract prices of the remedies costlessly.

8. The value of remedies is only one component of the value of a contractual promise. The value of the contract to the promisee is the combination of the value of the promisee's expectation that the promisor will perform as promised and the expected value of the remedy available upon breach. These two elements are interrelated in complex ways. Thus, the relative probabilities of performance and breach will depend in part on the severity of the remedy the promisor expects to pay in the event of breach. The value of performance will often depend upon the degree to which the promisee can rely on the promised performance, which will in turn depend upon the expected value of the remedy in the event of breach. See Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CALIF. L. REV. 1, 13-14 (1985).

9. This article will conventionally refer to the contract promisor as female and the promisee as male.

10. Economic cost is opportunity cost, the value of the alternative foregone as a result of the activity in question. See R. POSNER, *THE ECONOMICS OF LAW* 6 (3d ed. 1986). The total cost of the contract to the promisor is the cost of performance, considered as opportunity cost, plus the expected liability cost of breach.

11. The parties may fail to agree to explicit remedy provisions either because the costs of the agreement process exceed the expected value of the agreement or because they prefer the remedies supplied by the law in the absence of agreement. If the law selects the remedy that would most often be selected, transaction costs are reduced.

12. R. POSNER, *supra* note 5, at 82; Craswell, *supra* note 7, at 663. *But cf.* Schlag, *An Appreciative Comment on Coase's "The Problem of Social Cost:" A View from the Left*, 1986 WIS. L. REV. 919, 929 n.39 (transaction costs may not be distinguishable from costs of production).

13. Goetz & Scott, *supra* note 6, at 972; See Cooter, *supra* note 8; Compare the argument in G. CALABRESI, *THE COSTS OF ACCIDENTS* 26-31 (1970) that the goal of tort law is to reduce the sum of accident costs, consisting of both the losses to the injured party and the costs of avoiding accidents, consisting of investments in accident prevention and the opportunity costs of reduced production and consumption.

This does not mean that the parties will allocate contract risks simply so as to minimize outlays. "Costs" mean opportunity costs.

for a price at least equal to the costs of the remedy to her, and that a promisee would purchase only those remedies that were worth more to him than their cost to the promisor. If it can determine the relative sizes of these quantities, a court applying this method will impose any remedy the promisee would have purchased and the promisor would have sold.

This method will result in contract remedies that assign specific risks associated with breach of contract to the party who could have avoided or minimized the risk at the lower cost, the "least cost avoider."¹⁴ The court applying this method would thus reason that a promisee must bear the risk of any loss as to which he was the least cost avoider because the parties would have contracted to allocate the risk to him.¹⁵

B. Efficient Breach of Contract

The cost avoidance theory is related to the concept of efficient breach of contract. During the period of time after entering into the contract and before performing it, a promisor may have opportunities to reallocate the resources that she would expend in performing the contract (the "performance resources") to some alternative use or purchaser. These opportunities represent a potential source of profit to the promisor if reallocation would yield a positive return after deducting contract damages and the other costs of breach.¹⁶ Such a reallocation has been termed, somewhat misleadingly, "efficient breach,"¹⁷ and analysts have argued that the law of contract remedies

14. READINGS IN THE ECONOMICS OF CONTRACT LAW 52 (V. Goldberg ed. 1989).

15. This assumes that both parties are risk-neutral. Risk neutrality means that the person is indifferent between a certain outcome and a probabilistic one with an equal expected value. Thus, a risk neutral person would value a certainty of receiving \$100 equally with a 50% chance of receiving \$200 and a 50% chance of receiving 0. R. POSNER, ECONOMIC ANALYSIS OF LAW 11 (2d ed. 1977). Most people are not risk neutral. If the promisee is risk averse, he might be willing to shift to the promisor a risk as to which the promisee is the least cost avoider and pay the increased price the promisor would demand. But a system of remedies has no reason to assume that promisees are, as a class, more risk neutral than promisors.

16. These other costs would include costs the promisor may face in future contracts because of the effect of the breach on the promisor's reputation and the transaction costs of litigation or adjustment arising from the promisee's claim to damages for breach. This analysis will assume that the promisor has determined that the alternative use will be sufficiently profitable to cover these other costs.

17. "Efficient breach of contract" is a misleading phrase. "Efficiency" is commonly used by law and economics analysts to compare the total wealth created by alternative ways of allocating resources among parties. One allocation of resources is said to be more efficient than another if the total amount that all affected parties would be willing to pay to bring

should encourage such breaches.¹⁸

The opportunity for efficient breach can be analyzed as a risk as to which the promisor is the least cost avoider. To illustrate, imagine that the promisee is considering purchasing a remedy that would give him the benefit of any gain the promisor might obtain by breaching the contract and reallocating the performance resources. The cost avoidance method asks whether the value of such a remedy to the promisee would exceed its cost to the promisor. Promisors who "sell" a disgorgement¹⁹ remedy must forego at least some opportunities for

it about is greater than the amount that they would pay to bring about the alternative allocation.

Because efficiency is a relative term, a breach of contract can be considered efficient only by comparing performance of the contract with some specific alternative allocation (use) of the resources that the promisor would have expended in the performance of the contract. It is the reallocation of these resources to an alternative use, not the breach per se, that may produce efficiency. Thus, it is more accurate to speak of "efficient reallocation of performance resources" than of "efficient breach."

18. "Repudiation of obligations should be encouraged where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered." Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970); See also R. POSNER, *supra* note 5, at 107.

The principle of efficient breach has gained the approval of the drafters of the RESTATEMENT (SECOND) OF CONTRACTS. *Id.* Ch. 16 reporter's note. The Restatement conditions its approval upon the compensation by the breaching party of loss "calculated according to the subjective preferences of that party." *Id.* However, the law of contract damages rarely awards the full subjective value of the performance to the promisee. See *infra* notes 48-53 and accompanying text.

Critics have advised that the doctrine of efficient breach be used with caution. See MacNeil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982) (whether different remedies will lead to efficient breach depends upon untested assumptions about transaction costs); Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 ARIZ. L. REV. 733 (1982); Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981) (arguing that using money damages instead of specific performance leads to inefficient breaches because it ignores values not easily quantified in dollars); Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427 (1983) (the efficiency of the expectation damages rule, compared to other damages measures, depends upon the relative risk aversion of the promisor and promisee); Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980) (problems of detection make expectation damages undercompensatory and supercompensatory damages are often necessary to deter inefficient breach); Schiro, *Prospecting For Lost Profits in the Uniform Commercial Code: The Buyer's Dilemmas*, 52 S. CAL. L. REV. 1727, 1734-35 (1979) (arguing that inefficient breaches occur because proof requirements make expectation damages undercompensatory).

19. The term "disgorgement" is preferable to the more general term "restitution," which refers to the return of a benefit that has been conferred on the defendant by the plaintiff and the return of which is necessary to avoid unjust enrichment. See Farnsworth,

profitable breach that would be available to them under the expectation damages remedy. They will charge a premium for such a remedy at least equal to the value to them of the lost opportunities. The efficiency question then becomes whether promisees would value the remedy enough to pay this premium.

Cost avoidance analysis suggests that they would not. The opportunity to redirect promissory resources is generally more valuable to promisors, who, unlike promisees, are usually in the business of selling the performance resources. Promisors will have more accurate information than promisees about the likelihood that an opportunity for profitable reallocation will arise. Promisors will usually face lower costs of seeking out and selling the resources to alternative users. This cost analysis suggests that, because promisors can make more profit by redirecting performance resources than can promisees, promisors will charge more for the lost opportunities than promisees will be willing to pay and that a disgorgement remedy is inefficient.²⁰

The disgorgement remedy does not, however, necessarily foreclose efficient reallocation of performance resources. A promisor who is presented with an opportunity for efficient breach could negotiate with the promisee to be released from the contractual obligation. Efficient reallocations could take place despite a disgorgement remedy.

In the frictionless fantasy worlds that economists fondly imagine, people can find each other and negotiate endlessly at no cost. In such a world, the ability to negotiate around contract remedies would make all remedies equally efficient in permitting optimum allocation of performance resources.²¹ When this negotiation involves transaction costs,²²

Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract, 94 YALE L.J. 1339, 1342 (1985); "Disgorgement" refers to the transfer to the plaintiff of a benefit obtained by the defendant from some source other than the plaintiff and will be used in this sense throughout this article, with apologies for its unsavory alimentary connotation.

20. Promisees who anticipate having unforeseen opportunities of their own which would increase the value of performance beyond the foreseeability limitation on expectation damages can protect themselves by bargaining for liquidated damages or specific performance remedies. See generally Kronman, *supra* note 4; Schwartz, *The Case For Specific Performance*, 89 YALE L.J. 271 (1979). Promisees might also wish to shift risks of breach to promisors because of risk aversion.

21. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15-19 (1960); Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1449-1450 (1980); Craswell, *supra* note 7, at 636-40 (noting that remedies will nevertheless affect the choice of contract partner and levels of precaution parties take); Schiro, *supra* note 18.

The Coase theorem suggests that, in the absence of transaction costs and wealth effects, the law's initial allocation of remedy entitlements will not affect the efficient outcome because the parties can reallocate entitlements by bargaining. Thus, if they could do so costlessly,

however, as it does in the real world, contract remedies will have differing allocative effects.²³

The renegotiation transaction costs of a disgorgement remedy will not be insignificant. Because neither the promisor nor the promisee can deal with any other party in negotiating a buy-out of the contractual undertaking, each is motivated to try to capture the entire gain from the reallocation, secure in the knowledge that the other can deal with no one else.²⁴ In the absence of a market measure of their relative entitlements or claims to this gain, neither has any reason to give up any of the gain and the negotiation may never reach an agreement, even though both parties are aware that both would be better off if some division of the premium could be agreed upon. Although the parties could negotiate to an efficient outcome in a world of no transaction costs, many analysts have argued that the dead-weight cost of a "bilateral monopoly" negotiation between promisor and promisee is so high as to remove the promisor's incentive to seek out and engage in efficient reallocations.²⁵ Thus, a general disgorgement remedy for breach of contract seems inefficient.

contract parties would negotiate to the correct breach or performance decision regardless of the presence or absence of particular contract remedies. In the presence of transaction costs, such reallocations may not occur and the remedial law's initial allocation of risk will have allocative effects. Coase, *supra*, at 15.

22. Coase, *supra* note 21, at 1 (1960) (in the absence of transaction costs, parties will negotiate to efficient outcomes regardless of initial entitlements).

"Transaction costs" refers to the costs of the activities involved in engaging in a transaction, such as finding the other party, negotiating a contract, and enforcing it. Transaction costs constitute one of the more controversial elements of economic analysis. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979); Goldberg, *Production Functions, Transaction Costs, and the New Institutionalism*, ISSUES IN CONTEMPORARY MICROECONOMICS 395-402 (G. Feiwel ed. 1984), reprinted in READINGS IN THE ECONOMICS OF CONTRACT LAW, 21-23 (arguing that if "transaction costs" merely refers to anything that prevents an efficient outcome, the concept is a useless tautology).

23. See *supra* note 22.

24. R. POSNER, *supra* note 5, at 107. Economists refer to this behavior as "rent seeking." See Goldberg, *supra* note 22, at 50, 70, 71. One problem is that the promisor may be reluctant to disclose the existence of her opportunity for reallocation to the promisee for fear that he will take advantage of it. Because of this reluctance and the mistrust of bargaining, the promisee will have to guess at how much potential profit the promisor could make from reallocation. This uncertainty might lead the promisee to make unrealistic demands.

25. See, e.g., R. POSNER, *supra* note 5, at 117-18 (discussing specific performance); Barton, *The Economic Basis for Damages for Breach of Contract*, 1 J. LEGAL STUD. 277 (1972); Goetz & Scott, *supra* note 5, at 982-83 (discussing opportunism in renegotiation).

Some dissenters from this view contend that the transaction costs of negotiation do not exceed the transaction costs of "breach first, talk afterward" that are encouraged by the expectation damages remedy. MacNeil, *supra* note 18, at 968; See also *id.* at 959-60,

C. *The Efficiency of Traditional Disgorgement Remedies For Breach of Contract*

Despite the arguable inefficiency of a general remedy of disgorgement, restitutionary remedies²⁶ are common in various "failed contract" situations.²⁷ Parties to valid contracts are often awarded restitution of

n.42 (noting that the expense of bilateral monopoly negotiations depend on several factors, including the relations between the parties); Kronman, *supra* note 4, at 353 (negotiations for a voluntary transfer of contract rights between existing parties to a contract avoid many costs, such as search costs, that might attend other forms of negotiation); Farber, *supra* note 18, at 1453-54 (transaction costs requiring an alternative purchaser to negotiate with the original buyer probably less than the transaction costs of breach and settlement or litigation); Schwartz, *supra* note 20, at 284-91.

26. See *supra* note 19 on the distinction between restitution and disgorgement. While the expectation damages remedy seeks to achieve the goal of compensation (i.e., making the plaintiff whole) the remedy of restitution seeks to achieve the goal of preventing unjust enrichment, compelling the defendant to disgorge profit wrongfully obtained. A. CORBIN, *supra* note 4, at 1104 (defining "restitution"); G. PALMER, *LAW OF RESTITUTION* § 1.1 (1978); *RESTATEMENT (SECOND) OF CONTRACTS* § 370. See also Barton, *supra* note 25.

27. E. Farnsworth, *Contracts* § 12.19 (1982) (which lists several such situations).

One must distinguish between restitution as a remedy for quasi-contractual claims and restitution as a remedy for breach of contract. A plaintiff may recover restitution under the quasi-contract doctrine in the absence of contractual promise. Thus, the law will "imply" a contract to pay restitution when the plaintiff mistakenly confers a benefit on the plaintiff. *RESTATEMENT (SECOND) OF RESTITUTION* (Tent. Draft No. 1 April 5, 1983) sec. 8. The law will also provide a restitutionary remedy in cases of promisory estoppel, in which the defendant's promise induced reasonable detrimental reliance on the part of the plaintiff. *RESTATEMENT (SECOND) OF CONTRACTS* § 90.

Often the restitutionary remedy is available in various forms of "failed contract" situations, in which for some reason a contemplated contract has not been formed and even where the defendant has not been enriched. Dawson, "Restitution Without Enrichment," 61 *Boston U.L.R.* 563 (1981); See e.g., *Kearns v. Andree*, 107 *Conn* 181, 139 *A.* 695 (1928) (restitution of seller's costs of renovating property at buyer's request although sale contract was unenforceable because of vagueness); *Farash v. Sykes Datatronics, Inc.*, 59 *N.Y.2d* 917, 452 *N.E. 2d* 1245 (1983) (awarding restitution of lessor's costs of renovating leasehold at lessee's request although oral lease was unenforceable under Statute of Frauds). Cf. *Boone v. Coe*, 153 *Ky.* 233, 154 *S.W.* 900 (Ct. App. *Ky.* 1913) (denying restitution where plaintiffs' expense in preparing to perform a contract unenforceable under the Statute of Frauds did not benefit defendant).

Restitution is available as a remedy to require return of benefits conferred by a non-breaching party upon a breaching party in some cases of breach of contract. *Restatement (Second) of Contracts* § 371; E. FARNSWORTH, *CONTRACTS* §§ 12.19, 20 (1982); Friedman, *Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong*, 80 *COLUM. L. REV.* 504, 513. A non-breaching party who has rendered partial performance may recover the value of that performance even if that recovery exceeds the party's expectation interest. 12 S. WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 1485 (W. Jaeger ed. 1970) (recovery should be undiminished by any loss promisee would have incurred on performance); *United States v. Algernon Blair, Inc.*, 479 *F.2d* 638 (4th Cir. 1973) (nonbreaching subcontractor could recover from breaching prime contractor in

benefits which they have conferred upon other parties.²⁸ However restitution as a remedy for breach of contract is limited to benefits conferred upon the defendant by the plaintiff,²⁹ and only rarely is a party awarded the remedy of disgorgement of profits the breacher obtained from some other source, as she would by reallocating performance resources to another use.³⁰ In most situations in which disgorgement is permitted, one can argue that it is not inconsistent with the goal of efficiency.

Thus, what appears to be a disgorgement remedy may simply be the most convenient method of measuring the plaintiff's expectation interest.³¹ For example, a disgorgement remedy is common in contracts for the sale of real property. Sellers who breach a contract to sell land by selling it to a third party have been required to pay the non-breaching buyer the amount by which the sale price to the third party exceeded the contract price.³²

quantum meruit for labor and materials furnished even though the contract would have been a losing contract for subcontractor). See E. FARNSWORTH *supra*, § 12.20.

Restitution is denied, however, where the plaintiff has fully performed and the only breach by the defendant is payment of the contract price. Restatement (Second) of Contracts § 371; *Oliver v. Campbell*, 43 Cal. 2d 298, 273 P.2d 15 (1954) (*quantum meruit* denied for attorney who had fully performed contract for legal services); *Fay, Spofford & Thorndike, Inc. v. Massachusetts Port Authority*, 7 Mass. App. Ct. 336, 387 N.E.2d 206 (1979) (justifying the rule as avoiding unnecessary valuation problems).

28. One example of disgorgement as a remedy for breach is the requirement that a promisor who is guilty of total breach or repudiation must return the full amount of any contract payments received, even if they exceeded the promisee's expectation damages. E. FARNSWORTH, *supra* note 27, § 12.20; RESTATEMENT (SECOND) OF CONTRACTS § 373 comment d. In *Bush v. Canfield*, 2 Conn. 485 (1818), the buyer paid seller \$5,000 in advance for 2,000 barrels of flour at \$7 per barrel. Seller failed to deliver, although at the time of delivery the price had dropped to \$5.50. Buyer would have lost \$3,000 on the sale. The court refused to deduct the \$3,000 from the damages and ordered the seller to return the entire price paid. The Uniform Commercial Code goes farther, giving the buyer a right to the return of any purchase price paid not only upon the seller's repudiation or failure to deliver but also upon the buyer's rejection or revocation of acceptance, with respect to any goods involved and regardless of whether the contract was a losing one for the buyer. U.C.C. § 2-711(1). *see also* § 2A-508(1)(b) for similar rule applying to leased goods.

29. RESTATEMENT (SECOND) OF CONTRACTS § 370. The exceptions to this limitation are not considered in this article. See J. CALAMARI & J. PERILLO, *CONTRACTS* 652-53 (3d ed. 1987).

30. G. PALMER, *supra* note 26, § 4.9 at 437 (generally "mere breach of contract will not make the defendant accountable for benefits thereby obtained, whether through dealings with a third person or otherwise."). Commentators have argued for limited extensions of the right to restitution of the breacher's benefits. See Farnsworth, *supra* note 19, at 1384-86 (arguing for extension of the disgorgement remedy to "abuse of contract" cases); Friedmann, *supra* note 27, 516-27 (arguing for restitution where the breach has deprived the promisee of a property or "quasi-property" interest).

31. Farnsworth, *supra* note 19, at 1360; Dawson, *Restitution or Damages*, 20 OHIO ST. L.J. 175, 179 (1959).

32. See cases cited in Friedmann, *supra* note 27, at 516; G. PALMER, *supra* note 26,

Disgorgement in such cases can be seen as a measurement of the plaintiff's expectation interest if one assumes that the plaintiff could have sold the land to the alternative purchaser.³³ The fixed location of real property and the existence of property records make it likely that the alternative purchaser could have found and negotiated with the plaintiff as easily as with the defendant. It is reasonable for the law to presume that the buyer could have sold it to the alternative purchaser at the price received by the seller, which is, therefore, selected as a convenient measure of the expected value of performance to the buyer.

Similar use of disgorgement to measure the promisee's expectation occurred in *Laurin v. DeCarolus Constr. Co., Inc.*³⁴ Defendant seller contracted to sell land to the plaintiff. After the contract but before the closing, the seller removed and sold gravel from the land. Even though testimony indicated that removal of the gravel had not diminished the market value of the land, the plaintiff recovered the seller's net profits on the gravel, the court reasoning that the plaintiff could have obtained those profits had the seller not breached.³⁵

Disgorgement also serves as a measure of plaintiff's loss in the award of profits made on sales in breach of a covenant not to compete.³⁶ Proof of the plaintiff's actual lost profits in such cases is highly speculative because of the difficulty in proving that plaintiff would have gotten the business the defendant enjoyed. The convenient assumption is made that the plaintiff would have profited by as much as the defendant did.

In these instances, disgorgement is probably the best measure of the expectation damages plaintiff suffered. Despite inhibiting promisors from efficient breach, the remedy is not thought to be inefficient, in part because the promisors have no cost advantage over the promisee in reallocating the performance resources to the alternate use.

In addition to the traditional uses of disgorgement outlined above, Professor Farnsworth has suggested the remedy of disgorgement for what he calls "abuse of contract."³⁷ Farnsworth argues that disgorgement is

at 438; *Timko v. Useful Homes Corp.*, 114 N.J. Eq. 433, 168 A. 824 (1933). In such cases, courts sometimes characterize the non-breaching buyer as having acquired a beneficial ownership in the land by entering the sales contract. The seller's subsequent sale of the land to a third party is seen as a conversion of this beneficial interest. Another approach has been to attribute the sale to a fictional agency relationship between the buyer and seller.

33. Friedmann, *supra* note 27.

34. 372 Mass. 688, 363 N.E.2d 675 (1977).

35. The court in *Laurin* rejected a claim for conversion, on grounds that plaintiff was not entitled to possession at the time of the removal of the gravel. *Id.* at 689, 363 N.E.2d at 677.

36. Farnsworth, *supra* note 19, at 1367.

37. *Id.*

appropriate when the breach denies the promisee an opportunity to obtain substitute performance. He considers the classic situation of the contractor who secretly substitutes cheaper materials in the construction of a building under a contract calling for more expensive materials.³⁸ By the time the breach is discovered, the expense of tearing down and rebuilding the structure greatly exceeds the diminution in market value caused by the breach. In such cases, courts usually limit the promisee's recovery to the diminution in value of the structure.³⁹ Because the promisee can no longer purchase the performance he desired, Farnsworth argues that the promisor should also be required to disgorge the savings she realized in using the cheaper materials.

Cost avoidance analysis suggests that disgorgement would be efficient in such circumstances. Assume that *ex ante* a contractor knows that the project will offer her opportunities to "cheat" by substituting cheaper materials. These opportunities will reduce her costs and increase the profit she can make. If she successfully escapes detection by the promisee until re-construction becomes unfeasible, then under the traditional judicial rule, she can capture the difference between these cost savings and the diminution in market value caused by the substitution, if any. It is important to note that this figure will be at most equal to the cost savings, and could be less. The expected value of this capture will be taken into account in pricing the job, reducing the contractor's costs by an equal amount.

Now assume that Farnsworth's proposed remedy of disgorgement is put into place. The promisor's incentive to cheat will be removed because the promisor will have to give back any cost savings otherwise obtainable by substitution. The contractor's opportunity cost of the contract will rise by the amount of the forgone cheating premium, and the price of the contract to the promisee will rise by the same amount.

Whether the disgorgement remedy is efficient in this situation depends upon whether the promisee would be willing to pay this increased price. This question turns on the amount by which the promisee values the use of the specified materials over the inferior materials. If this amount exceeds the cheating premium, Farnsworth's proposed rule is efficient.

There is good reason to believe that the promisee values the superior materials more highly than the inferior materials by more than their

38. The classic chestnut in this field is *Jacob & Youngs, Inc. v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921) in which Judge Cardozo held that where a contractor inadvertently substituted pipe of the wrong brand, the owner was entitled to recover only the reduction in value of the building, rather than the cost of tearing out and replacing the pipe, on grounds that the breach was "insubstantial."

39. E. FARNSWORTH, *supra* note 26, § 12.13, at 868. The rule is otherwise if the cost of repairs is insubstantial. If the breach is willful, the finding of substantial performance may be questionable. *Id.* at 593-94.

price difference: He must value them by at least their price difference (otherwise he would have specified the cheaper materials)⁴⁰ and he might value them by more. Thus, while the cheating premium is less than or equal to the price difference, the value of the remedy to the promisee is greater than or equal to the price difference. On these assumptions, Farnsworth's remedy is likely to be more valuable to promisees than it is expensive to promisors.

Disgorgement is also an efficient remedy in contracts in which the promisor is financially unable to respond in damages. In such situations, disgorgement can discourage inefficient, opportunistic behavior that the expectation damages remedy would encourage. An example will illustrate: Assume that in March, Seller contracts to sell Buyer widgets for delivery in June. Seller's expected profit is \$1 per widget. In May, the market having risen, Alternative Purchaser offers Seller the then market price for the widgets, which is \$15 over the contract price. Widgets are relatively fungible but the market is highly volatile. Seller knows that there is a 90% chance that, at the time Buyer must cover,⁴¹ the market will have risen to \$50 over the contract price and a 10% chance that it will have fallen to \$3 over the contract price.

If Seller will be financially able to pay the Buyer's full claim for damages, she will reject the offer: 90% of the time she will receive \$16 in gross profit but will have to pay Buyer \$50 damages, leaving her \$34 in the hole. Ten percent of the time she will have to pay the Buyer only \$3, leaving her a net profit of \$12. The combined value of these chances, or the expected value of the breach, is minus \$29.40,⁴² which is less than the certain profit of \$1 that performance would yield. In other words, the breach is inefficient.

However, if the Seller is judgment-proof, so that she cannot pay Buyer's claim for damages, the gamble is a good one. The effect of market rise is simply to wipe out the chance of any profit, not to subject the Seller to a loss of \$34. The effect of a market fall still gives her a \$12 profit. The expected value of breach is \$1.20,⁴³ which exceeds the \$1 profit available if Seller performs.

Because the judgment-proof seller can speculate with less risk than the financially responsible seller, an expectation damages remedy en-

40. This analysis assumes that the promisee knows of the price and the value of the substituted materials. If not, it cannot be assumed that the promisee would not have specified them in the original contract.

41. It is assumed that the seller can sell to the Alternative Purchaser without repudiating the contract and thus that the buyer's remedy, by cover or market formula, will be measured as of a later time.

42. $(0.9 \times -34) + (0.1 \times 12) = -29.40$.

43. $(0.9 \times 0) + (0.1 \times 12) = 1.20$.

courages judgment-proof sellers to engage in inefficient breaches. Under a general disgorgement remedy for breach of contract, the judgment-proof seller will not engage in inefficient breaches of this sort because the remedy removes any opportunity for gain. Such a remedy tends to reduce the transacting costs related to insuring against the credit risks of doing business with judgment-proof promisors. In summary, although cost analysis suggests that disgorgement would not be efficient as a generally available remedy for breach of contract, the remedy would appear to be efficient in some situations. First, disgorgement may be efficient when expectation damages are difficult to calculate and are likely to approximate the disgorgement measure. Second, disgorgement can be more efficient than expectation damages when the promisor's inability to recover the full amount of expectation loss creates incentives for the promisor to engage in certain types of inefficient, opportunistic behavior.

D. The Efficiency of Disgorgement as a Remedy for Conversion

Although inefficient as a general remedy for breach of contract, disgorgement is a common remedy for the tort of conversion. Traditional restitutionary remedies permit a plaintiff suing a convertor to "waive the tort" and to require the defendant to disgorge all profits made as a result of the conversion, even if they exceeded the plaintiff's losses.⁴⁴

Some of the efficiency arguments made against disgorgement as a contract remedy seem equally applicable to disgorgement as a tort remedy. It is obvious that conversion can be just as transactionally efficient as a breach of contract. The convertor might make more profit from the plaintiff's property than the plaintiff would lose from the unlawful use. Thus, requiring disgorgement of such profits weakens incentives for convertors to seek out and enter into efficient "reallocations."

Yet, contemporary law and economics literature does not propound a doctrine of "efficient conversion." A different efficiency argument is marshalled to support the law's refusal to countenance involuntary transactions of this sort, one that goes something like this: Even if the converted good is traded in a recognized market, a court cannot be sure of the subjective value of the good to the owner and so cannot be certain of the efficiency of reallocating the good to the convertor. A judicial determination of the value of the converted good to its owner incurs this cost of uncertainty as well as significant transaction costs. Because the convertor can obtain the converted good from the market at much lower transaction costs, the law requires her to obtain the goods

44. See Friedmann, *supra* note 27; Dawson, *supra* note 27; Farnsworth, *supra* note 19, at 1361.

in a voluntary exchange to insure that her use will indeed be allocatively efficient.⁴⁵

E. Disgorgement Reconsidered

The analysis of conversion has some application to the previously stated efficiency justification for rejecting the disgorgement remedy for breach of contract. A contract breacher, like a convertor, makes a unilateral decision to reallocate resources and relies on a post-breach judicial decision to fix the amount of the promisee's damages. Our previous efficiency analysis of the disgorgement remedy did not consider the transaction costs of a judicial determination of contract damages because of the implicit assumption that expectation damages give the promisee the equivalent of full performance.⁴⁶

If expectation damages fulfilled their theoretical purposes, promisees would be indifferent as to whether contractual promises are performed or damages are awarded.⁴⁷ In practice, however, promisees are not indifferent to performance because awards of damages under the ex-

45. Calabresi & Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). Analogizing the efficiency of rules against conversion to the efficiency of rules against theft, Landes and Posner argue that depriving the convertor of his profit will have the efficient effect of compelling him to resort to the marketplace whenever possible. See W. LANDES & R. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 153-58 (1987). They also argue that failure to protect property interests would lead owners to over-invest in security measures to prevent unlawful takings. *Id.* This argument seems questionable. If owners of converted property or beneficiaries of looted trusts are awarded full compensatory damages, they would be indifferent whether the torts were committed or not. Because they would experience no economic loss as a result of the wrong, they would not spend excessive amounts on security. If remedies are undercompensatory, of course, this argument stands up, but so would an analogous argument applied to remedies for breach of contract.

46. Professor MacNeil offers an example of the arbitrariness of distinguishing conversion from breach of contract on the basis of "property" interests by an example of a seller who "reclaims" goods that have been shipped to the buyer's warehouse in order to engage in efficient breach. The buyer would be entitled to disgorgement for conversion, yet in many complex commercial transactions, "there is no *a priori* basis for selecting any particular time or event for determining that the transaction is closed, that new property rights are now established, and that with them a new, efficiency-neutral status quo has been achieved." MacNeil, *supra* note 18, at 963-64.

47. R. POSNER, *supra* note 5, at 107. *But see* U.C.C. § 2-609 comment 1:

"...the essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit and . . . a continuing sense of reliance and security that the promised performance will be forthcoming when due is an important feature of the bargain."

pectation doctrine rarely give a promisee the complete value of his loss.⁴⁸ Many forms of a promisee's loss are not recoverable: losses whose existence is uncertain;⁴⁹ losses that were not foreseeable at the time the contract was formed;⁵⁰ losses that the promisee could have avoided or mitigated;⁵¹ losses from emotional disturbance;⁵² and losses from the expenses of contract enforcement.⁵³ Whether or not these limitations on recovery are justified by considerations of rule efficiency,⁵⁴ the result is

48. See Schiro, *supra* note 18, (arguing that remedies under the Uniform Commercial Code systematically undercompensate plaintiffs for lost profits and therefore encourage inefficient breaches); Farber, *supra* note 18, (arguing that, because of litigation costs and detection costs, "supercompensatory" damages are more efficient than expectation damages); Schwarz, *supra* note 20, at 276-77 (damage awards are undercompensatory); Sebert, *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565 (1986). This has suggested to many commentators that expectation damages should be made more compensatory.

It might also be argued that expectation damages are insufficient to prevent inefficient breaches because they are not awarded to non-contracting parties at the time of formation of the contract, but nevertheless must be "counted" in determining the transactional and rule efficiency of breach, because they are part of the "aggregate willingness to pay" on which the criterion is premised.

49. RESTATEMENT (SECOND) OF CONTRACTS § 352. See *Harry Rubin & Sons, Inc. v. Consolidated Pipe Co. of America*, 396 Pa. 506, 153 A.2d 472 (1959) (under the U.C.C., refusing to award damages for loss of goodwill as too speculative).

50. *E.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 351; *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (Ex. 1854); *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540 (1903); *Keystone Diesel Engine Co. v. Irwin*, 411 Pa. 222, 191 A.2d 376 (1963) (refusing to award lost profits). See also Restatement (Second) of Contracts § 350.

51. Restatement (Second) of Contracts § 350; *Rockingham County v. Luten Bridge Co.*, 35 F.2d 301 (4th Cir. 1929).

52. RESTATEMENT (SECOND) OF CONTRACTS § 353. Emotional distress reduces aggregate human satisfaction if people would pay to avoid it. See *supra* note 8. If the promisor is forced to negotiate with the promisee before the breach, the value of the emotional distress of breach can enter into the negotiation and an otherwise inefficient breach can be avoided. On the other hand, failing to award damages for emotional distress makes sense under a regime of expectation damages because it encourages parties who have idiosyncratic attachments to contract performance to disclose these and secure additional security for performance from the promisors.

53. Thus, under the "American Rule" in the absence of a contractual agreement, the attorney's fees expended in enforcing a contract remedy are not recoverable. *Alyeska Pipeline Service Co. v. Wilderness Society*, 421 U.S. 240, 247 (1975). See Restatement (Second) of Contracts § 356 comment d. It has been argued that, because of the expenses of enforcement, the non-breaching party should always be willing to accept less than the expectation damages from the breaching party. See Leff, *Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 80 YALE L.J. 1 (1970).

54. An efficiency analysis of the limitations on expectation damages is beyond the scope of this article. See, *e.g.*, R. POSNER, *supra* note 5, at 114-15 (foreseeability requirement efficiently requires promisees to disclose potential losses in advance, permitting promisors to take appropriate precautions); Cooter, *supra* note 8 (contract damages limitations create

that contract damages are undercompensatory.⁵⁵ Expectation damages do not measure the promisee's willingness to pay for performance at the time of breach. The limitations on expectation damages will lead to transactionally inefficient breaches.⁵⁶ Because of problems of subjective valuation, the promisee's consent to a reallocation of performance resources is the only certain proof of the efficiency of a breach of contract.

The problematic nature of the judicially determined expectation damages remedy raises the issue considered in the analysis of "efficient conversion." If the cost of uncertainty in a post-conversion determination of damages exceeds the transaction costs of requiring potential tortfeasors to resort to the market, it is possible that the cost of uncertainty in post-breach determination of damages likewise exceeds the transaction costs of requiring a promisor to negotiate with the promisee before breaching. Requiring a voluntary exchange between the promisor and promisee before breach would provide assurance that the breach will be truly efficient, just as would requiring a voluntary exchange between the convertor and her victim.⁵⁷ But this gain in certainty would be purchased at the expense of any lost opportunities for efficient breach that were frustrated by the costs of negotiation.

The problem reduces to this: Are the transaction costs of a bilateral monopoly negotiation between the two contract parties "relatively high" so that the court is justified establishing a liability rule, permitting unilateral breach on condition that expectation damages be paid, or "relatively low" so that the court is justified in requiring recourse to the market to avoid the risk of an inaccurate determination of damages?⁵⁸ To date most economic analysis has answered "relatively high," and has supported a liability rule rather than a property rule⁵⁹ for the

efficient incentives to minimize losses); Goetz & Scott, *supra* note 6 (efficiency of mitigation requirement); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 568-74 (1977).

55. See *supra* note 18. Even when the promisee is the least cost avoider of a risk of loss due to breach, the promisor's failure to take that risk into account in deciding to breach will lead to transactionally inefficient breaches whenever the promisor would be willing pay more for performance than the alternative user at the time of breach.

56. The theory of efficient breach posits that the promisor will breach whenever she can show a profit after paying the promisee's expectation damages. But in such cases, breach will be inefficient when the promisor's gain from breach does not exceed the amount by which expectation damages fall short of actual value of performance to the promisee.

57. See W. LANDES & R. POSNER, *supra* note 45.

58. See Schlag, *supra* note 12, at 930-31 n.43 (asking what a court should do in situations in which the transaction costs of trading in entitlements are "middle.").

59. See the discussion in Kronman, *supra* note 4, citing Calabresi & Melamed, *supra* note 45.

promisee's contract interest. The breacher is free to breach without obtaining the promisee's consent, but must pay damages.

That this conclusion is correct is not at all obvious, but it is not within the scope of this Article to test it, or even to speculate about how that might be done. Instead, two other facets of the disgorgement remedy that might bear on its efficiency will be examined. First, even if one accepts that the promisee's interest in performance is protected by a liability rule, should the promisee's interest in payment of damages for breach be protected by a liability rule or a property rule? Second, is a property rule, a disgorgement remedy, practically feasible as a remedy for protection of either interest?

III. DAMAGES FOR FAILURE TO PAY DAMAGES

Although a party in breach of contract becomes liable to the non-breaching party for payment of damages, the breaching party may, and usually does, withhold payment of damages until ordered to do so by a court. General use of the term "efficient breach of contract" has obscured the distinction between two separate breaches: the breach of the duty to perform and the breach of the duty to pay damages for non-performance. A breacher who fails to pay the full amount of the promisee's damages at the time of breach⁶⁰ can obtain economic gain through the use of the money she should have paid. The promisee can incur economic loss because of the delay in receiving payment.

The literature of efficient breach has not addressed the possibility that failure to pay contract damages when due might itself be efficient if the promisor can earn more on the money than the promisee would

("[A] right or entitlement is protected by a property rule when it can be appropriated by a non-owner only if he first purchases permission to do so from the owner of the right. When a right is protected by a rule of this sort, one who appropriates it without the owner's permission will always be subject to a special sanction—typically, a fine or imprisonment. If a right is protected by a liability rule, in contrast, a non-owner who unilaterally appropriates it need only compensate the owner, after the taking, for any loss the owner suffers. The compensatory amount which a non-owner must pay for taking a right protected by a liability rule is set by a representative of the state rather than by the owner of the right in a voluntary transaction between owner and taker.>").

The expectation damages rule is a liability rule and the disgorgement rule is a property rule.

60. Much will depend upon the time when breach occurs. Breach normally occurs at the time of performance. However, breach may occur before the time of performance if the promisor repudiates the contract. *Hochster v. De la Tour*, 2 El. & Bl. 678 (1853); *Missouri Furnace Co. v. Cochran*, 8 F. 463 (W.D. Pa. 1881); U.C.C. § 2-610 (permitting non-breaching party to resort to any remedy for breach upon promisor's repudiation of contract).

lose by not receiving it. The above discussion suggests two possible analyses of the efficiency of withholding damages, corresponding to the liability and property rules, or expectation damages and disgorgement. A liability rule/expectation damages approach would promote efficient withholding of damages and would evaluate the rule efficiency of interest remedies by their tendency to encourage or deter efficient withholdings. A property rule/disgorgement analysis would reject efficient withholding of damages and would evaluate interest remedies by their tendency to encourage the breaching party to borrow money in the financial market rather than to "borrow" damages from the plaintiff.

A. *Ex Ante Cost Avoidance Analysis of Prejudgment Interest*

The law recognizes a claim for interest, damages for delay in the payment of money due, as a remedy for breach of contract.⁶¹ As with any other contract remedy, a promisee's right to recover interest accruing before judgment will affect allocative efficiency. The efficiency of the disgorgement remedy of prejudgment interest can be analyzed by the cost avoidance method: Would the parties be likely to give the promisee a disgorgement remedy for failure to pay contract damages immediately upon breach? They will do so only if the benefit of the remedy to the promisee/plaintiff exceeds the opportunity cost of such a remedy to the promisor/breacher. These values can be analyzed at the time of contracting, *ex ante*, and after breach, *ex post*. The parties would presumably prefer the remedy that maximized the joint value of the contract.

Under a compensation theory of prejudgment interest the promisor is assigned the power to withhold contract damages. Under a disgorgement theory of prejudgment interest the promisee is granted the right to immediate payment of contract damages. There is no *ex ante* reason to suppose that either promisors or promisees will have, as a class, superior investment opportunities at the time of breach.⁶² Thus, there appears to be no reason to believe that relative opportunity costs alone would lead to an *ex ante* assignment of the risk of delayed payment of contract damages to either party.

61. See Restatement (Second of Contracts) § 354. Although parties may agree to the payment of interest as compensation for the use of money, such agreements are not discussed in this article, which concerns only judicial remedies for the non-payment of contract money damages. Such agreements may provide for interest to be paid either before or after maturity of the obligation. See 5 A. CORBIN, *Supra* note 4, § 1045; D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* 3.5 (1973).

62. Promisees will often have need of funds to effect cover or other mitigation of the injury caused by the breach. Promisors may, however, have need of the funds to effect the alternative, more profitable, performance. It is impossible to say which of these two forms of investment has the greater expected return in the abstract.

B. Post-Breach Cost Avoidance Analysis of Prejudgment Interest

The method chosen for the award of prejudgment interest will affect the post-breach behavior of both the breaching promisor and the promisee, who will have the relation of debtor and creditor.⁶³ Both debtors and creditors have borrowing costs⁶⁴ as well as opportunities to obtain returns on money they invest. It is assumed that parties will tend to borrow whenever their investment returns exceed their borrowing costs.⁶⁵ The efficient remedy would "assign" the post-breach damage payment to the party with the superior post-breach investment opportunity. Only the compensation method tends to have this result, as is shown by the following analysis.

1. *Compensation Method.* The compensation method compensates the creditor for the deprivation of the use-value of the money until payment. The measure of this loss is either the creditor's cost of cover—the interest that the creditor must pay to borrow the funds elsewhere—or the loss of profit on investment that the creditor was unable to make because of the lack of the money. The principle of mitigation of damages⁶⁶ would deny the creditor any losses that could have been avoided had the creditor covered by obtaining funds elsewhere at a rate that is less than his investment return. If the creditor cannot cover, his loss is the forgone investment return, if any.

If a compensation remedy is used, debtors will tend to withhold payment whenever they will earn more from the withheld money than they will ultimately have to pay to the creditors. The compensation remedy would award creditors the lesser of their borrowing expense in obtaining "covering" loans or, if profitable cover is impossible, their forgone investment returns. Debtors will withhold payment only when both their borrowing costs and their investment returns are higher than their creditors' losses. Such debtors can, in effect, borrow at below market rates from their creditors and would lose more by paying the debt than they would ultimately owe in damages measured by the creditors' losses.

63. The following discussion assumes that the parties are risk-neutral.

64. For the purposes of this discussion, "borrowing costs" include returns on existing investments that must be foregone if the investment is liquidated to obtain cash for payment of a debt or to make another investment. In such cases, the party in question is, in effect, borrowing from himself.

65. As usual, this analysis assumes that the parties are risk-neutral. Risk-averse parties might not borrow to invest. This analysis also ignores the possibility of consumption rather than investment of the indebtedness. Consumption can be seen as an investment that has a value known to the consumer.

66. RESTATEMENT (SECOND) OF CONTRACTS § 350.

If either the debtors' borrowing costs or investment returns are less than the losses of their creditors, the compensation method would induce debtors to pay promptly. If debtors' borrowing costs are less than the damages they owe, they would be better off borrowing and paying damages. If debtors' investment returns are less than the damages they will owe, any gains they would realize by withholding the funds would be exceeded by their liability for their creditors' losses.

As can be seen, under the compensation method the money owed will tend to move toward the party with the highest investment opportunities, whether or not that party has the higher borrowing costs. This apparently efficient result is not achieved by the disgorgement method, however.

2. *Disgorgement Method.* The disgorgement method measures the benefit to the debtor, who enjoys the use-value of the money until payment. The measure of this benefit is either the borrowing costs saved because the debtor did not have to borrow the money elsewhere or the return on any investment that the debtor made with the money.

If the disgorgement method is used, debtors with superior investment opportunities will tend to pay the debts regardless of their borrowing costs or the losses of their creditors.⁶⁷ They have no motive to withhold payment because any profit they may make will be captured by the creditors. This capture might sweep in some profits resulting from the debtors' own skill or efforts in connection with the investments.

The result under the disgorgement method is more ambiguous if debtors with no advantageous investment opportunities have higher borrowing costs than the damages they will owe. If such debtors must borrow to pay the debt, then their "benefit" from non-payment is their borrowing cost. Even if they must ultimately disgorge this benefit to their creditors, they have no incentive to choose repayment over withholding. In such cases, and in cases in which debtors can pay the debt without borrowing, the following analysis applies.

If the disgorgement method is the creditors' exclusive remedy, so that they can recover only their debtors' gain and not their own losses, debtors with inferior investment opportunities have nothing to lose by withholding and nothing to gain by repayment. Such debtors might strategically withhold payment. Their creditors, facing losses larger than their potential recovery, may offer a discount for prompt payment.

If the disgorgement method is supplemented by the compensation method, so that creditors can recover the greater of their losses or their

67. Such debtors may negotiate with their creditors to obtain loans at rates that are less than the debtors' borrowing costs but greater than their creditors' investment returns. This does not, however, affect the analysis.

debtors' gains, such debtors will pay promptly in all cases unless they are judgment proof. They will have nothing to gain and everything to lose by withholding payment.

In summary, under the "pure" disgorgement method, unsupplemented by a compensation remedy, the money will, without negotiated transfers, tend to remain with or gravitate to the party with the poorest investment opportunity. Under a combination compensation and disgorgement method, the money will move toward the creditor regardless of the parties' investment opportunities.

C. *The Effect of Borrowing Rates*

So long as the effects of different borrowing rates are ignored, the compensation method of prejudgment interest appears to be more efficient than the disgorgement method in allocating money to the party whose investment opportunities are the highest. But this analysis ignores the factors that determine the "borrowing rate" of each party. Variations in this rate are almost entirely due to the riskiness of the loan, that is, the creditworthiness of the party.⁶⁸ If the contract creditor is required to mitigate his losses by obtaining funds elsewhere, his borrowing costs will be the measure of his losses.⁶⁹ The compensation method permits the debtor, in effect, to utilize her creditor's lower borrowing costs, or stronger credit rating, as her own expense of borrowing. The debtor obtains money at a cost below the rate that she would be charged in the money market. The creditor, however, is not being compensated for the risk associated with the debtor's use of the money, risk that would be reflected in the debtor's borrowing rate.

Like a potential convertor, a contract debtor can obtain the withheld good (money) in a market transaction. The debtor can enter the market for the withheld good at low transaction costs. Lenders in established credit markets probably face lower costs of extending credit to a debtor⁷⁰

68. R. HAMILTON, *FUNDAMENTALS OF MODERN BUSINESS* § 1.16 (1989); See R. POSNER, *supra* note 5, at 180, 368. The other elements of the interest rate are common to all borrowers and include the time value of money and the normal rate of return.

69. A debtor should not be permitted to count her creditor's actual borrowings and investments as "covering" transactions if they would have been economically rational in the absence of the withholding. One might expect a risk-neutral creditor to borrow and invest whenever his investment opportunities exceed his borrowing costs. By analogy to the theory of the lost volume seller, a creditor's "covering" loan and investment should not reduce the debtor's liability if it would have been made in the absence of the withholding. To show damage from the withholding, however, a creditor should have to show that he had exhausted his ability to borrow and still missed favorable investment opportunities.

70. This would include the costs of obtaining and evaluating information relevant to the riskiness of the loan and of insuring against unavoidable credit risks by loss spreading. See R. POSNER, *supra* note 5.

than does her contract creditor. The contract creditor is, therefore, not the least cost avoider of the costs of the debtor's credit risks and should not be assigned that risk by the compensation method of prejudgment interest.⁷¹ In addition, a post-breach judicial determination of a creditor's compensatory damages presents a special risk of inaccuracy because his forgone investment opportunities might be, or appear to be, speculative or convenient afterthoughts. Despite its apparent allocative inefficiency, the disgorgement measure of prejudgment interest is more efficient than the compensation method for reasons similar to those pertinent to the conversion remedy.

IV. A CASE STUDY IN DAMAGES AS INTEREST

We now descend from the crystalline forms of economic theory to the woolly world of law as it is. In practice, remedies law rarely employs either the compensation method or the disgorgement method as a measure of prejudgment interest. The requirements of mitigation and foreseeability limit inclusion of consequential damages in prejudgment interest.⁷² Prejudgment interest is awarded, if at all, at a statutory rate.⁷³ Such statutes have provided for interest at a fixed rate to be awarded on amounts found to be due for breach of a duty to pay liquidated sums due under contracts, notes, and bills; for money obtained by fraud; and in other situations.⁷⁴ Statutory interest may roughly approximate an award under the compensation method, which is intended to compensate the creditor for the loss of use of the money.⁷⁵ Interest is measured by the disgorgement method only when the money was obtained by breach of fiduciary duty.⁷⁶

Attempts to implement a more efficient prejudgment interest remedy can run afoul of practical and theoretical problems not taken into account in the assumptions of economic models. A case in point is furnished

71. In other words, a rational contract promisee would discount the value of a promise by a higher assumed interest rate on potentially withheld damages than a lender would charge the promisor. The promisor would therefore not purchase the right to withhold damages, i.e., would not take a loan, from the promisee.

72. A. CORBIN, *supra* note 4, §§ 995, 1046; RESTATEMENT OF CONTRACTS § 337 (1932); RESTATEMENT (SECOND) OF CONTRACTS § 354. See *Archer-Daniels-Midland Co. v. Paull*, 313 F.2d 612 (8th Cir. 1963); *Columbian Mut. Life Assur. Soc. v. Whitehead*, 193 Ark. 598, 101 S.W.2d 455 (1937).

73. See generally Note, *Prejudgment Interest: Survey and Suggestion*, 77 Nw. U.L. REV 192 (1982).

74. The Colorado statute *infra*, note 77, is an example.

75. D. DOBBS, *supra* note 61, at 169. (contrasting the award of interest as damages intended as compensation for the losses of the plaintiff with award of interest as restitution, intended to prevent unjust enrichment of the defendant).

76. See Friedmann, *supra* note 27.

by the state of Colorado, which has by statute⁷⁷ adopted the disgorgement remedy to measure prejudgment interest. The statute permits a promisee to recover from the promisor any gain that the promisor realizes from the wrongful withholding of money or property until it is paid or judgment is entered.

The ostensible purpose of the statute is to implement the disgorgement method of calculating prejudgment interest. But this principle has undergone a mutation in breach of contract cases. Courts applying the rule have forced defendants to disgorge the benefits that they have realized by reallocating performance resources rather than the benefits they have realized by withholding the damages payments. Given the propensity for breachers to withhold damages and incur liability for prejudgment interest, the new statute is tantamount to a general disgorgement remedy for breach of contract.⁷⁸ The story of how a simple prejudgment interest statute effected such a change in contract remedy law is a cautionary tale of the perils of legal conceptualism in the new age of law and economics.

The statute had its genesis in *Davis Cattle Co. v. Great Western Sugar Co.*,⁷⁹ an innovative application of disgorgement as a remedy for breach of a sale of goods contract. The Great Western Sugar Company was sued for breach of contract in a class action by its suppliers, some 3,600 growers of sugar beets. The growers had sold sugar beets to the company under a contract that fixed the price as a percentage of the company's net receipts from the sale of the sugar made from the beets. Although that price could not be determined until the beets had been processed and the sugar sold, the contract required the company to make an initial payment shortly after delivery of the beets. The initial payment was to be followed by interim payments over the course of the next eleven months, during which time the beets were processed and the sugar was sold.⁸⁰

The contract required the initial payment to be at a rate that "shall be at the highest rate per ton [of beets] that the Company may deem to be justified taking into consideration anticipated returns from the sale of sugar and the sugar content of beets."⁸¹ The company had

77. COLO. REV. STAT. § 5-12-102 (Supp. 1982). This statute is described and discussed more fully below.

78. See *infra* notes 79-93 and accompanying text. Colorado is apparently unique in this respect. Farnsworth, *supra* note 19, at 1369 ("In no jurisdiction do courts generally apply the disgorgement principle."); Friedmann, *supra* note 27.

79. 393 F. Supp. 1165 (D. Colo. 1975), *aff'd* 544 F.2d 436 (10th Cir. 1976), *cert. denied*, 429 U.S. 1094 (1977).

80. *Davis Cattle*, 393 F. Supp. at 1167-70.

81. *Id.* at 1169.

historically estimated what it would ultimately pay the growers and had paid about 85% of the anticipated total payment in the initial payment.⁸²

In 1974 the sugar market was affected by several events that caused the price of sugar to skyrocket. The company paid the growers an initial payment much lower in relation to the (higher) price of sugar than its historical practice had been in more stable markets. The growers sued on grounds that the initial payment was so low as to breach the contract.⁸³

The court found that, in making this payment the company did not consider the anticipated returns from the sale of sugar as the contract required, but instead selected a lower payment level in order to save interest costs it would otherwise have incurred in borrowing the money to make a larger payment.⁸⁴ The court held that the company breached the contract by fixing the payment in this way.⁸⁵ In an alternative finding, the court held that the company breached the contract by setting the initial payment in bad faith.⁸⁶

Because full payment was made by the end of the processing year, the growers' damage from the breach arose from the delay in payment.⁸⁷ An interest award premised purely on the doctrine of expectation damages would have equalled the growers' economic injury resulting from the delay in receiving the initial underpayment. In Colorado, interest at the statutory rate supplanted expectation damages from breach of contract to pay money.⁸⁸ Under Colorado statutory law, however, the growers could recover no prejudgment interest because their claim for underpayment was unliquidated.⁸⁹

The court met this obstacle creatively. Although agreeing that statutory interest could not be awarded on an unliquidated claim, the court held that under the common law, "moratory interest," or interest as damages, could be awarded on an unliquidated claim.⁹⁰ The court also

82. *Id.*

83. *Id.* at 1170.

84. *Id.* at 1178. The company argued unsuccessfully that the lower payment was essential to avoid the risk of overpayment, which might have occurred if the price of sugar dropped during the processing/sale period (as in fact it did).

85. *Id.* at 1175.

86. It did not help the company's argument on this point that, in attempting to prevent a hostile tender offer for its shares, the company had projected a net return on sugar much higher than the projection upon which the growers' initial payment was calculated. *Id.* at 1177.

Interestingly, the court did not allude to the good faith requirements of the Uniform Commercial Code, then in effect in Colorado and in at least some of the states in which the growers resided.

87. *Id.* at 1177-78.

88. COLO. REV. STAT. § 5-12-102.

89. *Id.*

90. *Davis Cattle*, 393 F. Supp. at 1193-94. The trial court relied on an extensive

rejected the company's alternative argument that the growers were limited to the statutory rate of interest, then six percent. The court looked instead to restitution law, which measured damages by the amount of benefit to the wrongdoer resulting from breach.⁹¹

Even so, the path to judgment was not yet clear because the company was not shown to have made a profit on any money withheld. The court instead awarded as moratory interest the amount of interest expense the company saved by not borrowing against its bank lines of credit in order to make an initial payment at the required level.⁹² The evidence indicated that the company would have had to pay at least 11.5% to borrow the extra money, and the court awarded the growers prejudgment interest at this rate.⁹³

The *Davis* case appeared to establish a "pure" disgorgement remedy for breach of a contractual duty to pay money.⁹⁴ Breach of a contractual promise to pay money presents a special case in which the two duties, performance or payment of damages, are effectively, if not conceptually, identical. Thus, in *Davis* the same benefit accrued to the company from its withholding of performance and from its withholding of damages. Nor did the court have reason to clarify whether the "failure to pay money due" was the failure to perform or the failure to pay damages. Perhaps this ambiguity was responsible for the ensuing legislative failure to clarify the scope of the remedy in cases in which the withholding of performance and the withholding of damages diverged.

Soon afterwards, in 1979, the Colorado legislature adopted some aspects of the disgorgement remedy theory of *Davis* in an amendment

review of Colorado caselaw, including *Bankers Trust Co. v. International Trust Co.*, 108 Colo. 15, 113 P.2d 656 (Colo. 1941), which held that interest as damages, and not as statutory interest, could be awarded for the tortious withholding of money or property. The plaintiff in *Banker's Trust* sought rescission of a purchase of securities induced by fraudulent misrepresentation. *Banker's Trust* was thus a garden variety restitution case, involving a tortious taking or detention of money. *Id.* at 33-34, 113 P.2d at 665. The *Davis Cattle* court applied this rule to a breach of contract case, holding that the measure of moratory interest is the gain or benefit realized by the wrongdoer. 393 F. Supp. at 1191.

91. Indeed, the language of the court in *Davis Cattle* suggests that the plaintiffs did not even have the option of recovering expectation damages, which is consistent with restitutionary precedent but not general contract principles. 393 F. Supp. at 1178.

92. *Id.* at 1194-95. Except where the wrongdoer saved an amount owed to the plaintiff, none of the cases cited by the court as precedent had measured the wrongdoer's benefit by the amount saved, only by the amount realized. The *Davis Cattle* court did not comment on this difference, which could be argued to be economically irrelevant.

93. *Id.* In fact, the evidence showed only that the company could have borrowed an additional \$25 million at this rate. *Id.* at 1195. It was unclear whether the company could have borrowed sufficient money to make an adequate initial payment at any rate, since the company's available bank loan financing for the sugar beet payment was less than the initial payment amount that the court found to be required under the contract.

94. *Id.* See *supra* note 91.

to the Colorado prejudgment interest statute. The amended statute provides that when there is no agreement as to the rate of interest to be paid, creditors shall receive interest as follows:

(a) When money or property has been wrongfully withheld, interest shall be an amount which fully recognizes the gain or benefit realized by the person withholding such money or property from the date of wrongful withholding to the date of payment or to the date judgment is entered, whichever first occurs; or, at the election of the claimant [interest on the amount withheld at the statutory rate of 8%] . . .

(3) Interest shall be allowed . . . even if the amount is unliquidated at the time of wrongful withholding or at the time when due.⁹⁵

The statute contains at least three striking features not present in the predecessor statute: prejudgment interest is permitted on unliquidated claims, the interest is measured by the wrongdoer's benefit, and the interest runs against a person withholding "money or property."

The statute suffers from a drafting ambiguity because of the uncertain meaning of "the gain or benefit realized by the person withholding such money or property." This can refer either to benefits resulting from the breach of contract or to benefits resulting from withholding payment of damages after breach, or perhaps to both.⁹⁶ *Davis* gives no guidance to interpretation because the benefits from the company's withholding of the initial payment and the benefits from the company's withholding of damages were the same. One is left with the question of what is the correct measure of gain or benefit where the breach involves failure to deliver something other than money.

This question was answered in *Great Western Sugar Co. v. Northern Natural Gas Co.*,⁹⁷ in which the same sugar company, now versed in the magic of moratory interest, essayed its hand as a plaintiff. The company purchased natural gas used in the processing of its sugar beets from a natural gas company. The gas was purchased under contracts that permitted the seller to interrupt service to the company whenever, "in its absolute discretion and without liability" to the buyer, the seller was "required to do so" in order to meet the demands of higher priority residential and commercial users.⁹⁸

95. COLO. REV. STAT. § 5-12-102.

96. See *infra* note 106.

97. 698 P.2d 769 (Colo. 1985), *aff'd on reh'g for damages sub nom.* *Great Western Sugar Co. v. KN Energy, Inc.*, No. 87CA1477, slip op. (Colo. App. May 4, 1989) *aff'd* 778 P.2d 272 (Colo. App. 1989).

98. *Great Western*, 698 P.2d at 773.

During the winters of 1973 through 1979, the seller interrupted service to the company several times under the authority of the interruption provision.⁹⁹ During these interruptions, the company was required to use fuel oil, which was more expensive. To recover this extra expense, the company sued the seller, arguing that the interruptions breached the contract because they were not "required." The court found that the interruptions breached the contract and awarded the company damages of \$3.6 million, representing its increased costs of cover in the fuel oil market.¹⁰⁰

Relying on the new statute, the company also sought disgorgement of the benefit to the seller resulting from the breach.¹⁰¹ The company offered two theories supporting such a claim, one based on the benefit to the seller from its retention of the gas withheld and one based on the benefit to the seller from its retention of the damages payments found to have been owing to the company.¹⁰²

In support of the first theory, referred to as the "gas husbanding" model, the company introduced evidence that the seller had benefited from its withholding of the gas in several ways: the overall price of gas had increased, thus increasing the value of the withheld gas in the seller's hands; the gas withheld was available for sale at higher prices to residential users; and the seller had used the value of withheld gas to increase its rate base, and thus its income. From these increases in value, the model deducted the interest that would have been earned by the defendant on the contract price of the gas had it been sold to the buyer.¹⁰³ As of the time of the trial on interest in 1987, the court found the net benefit to be nearly \$12 million.¹⁰⁴

In support of the second theory, the company submitted three calculations of the seller's benefit on the damages withheld using, alternatively, the seller's internal rate of return on equity, the interest rates

99. The seller sought unsuccessfully to justify these interruptions by the national policy of conservation resulting from the gas crisis of the 1970's. *Id.* at 778.

100. *Great Western Sugar Co. v. KN Energy, Inc.*, No. 87CA1477, slip op. at 1.

101. *Id.*

102. 778 P.2d at 273; Slip opinion, *supra* note 97, at 1-2.

103. 778 P.2d at 274. The rate used to calculate this interest component was the average internal rate of return on investment achieved by the seller over the interest period. *Id.* While this measure is reasonable, reflecting a possible investment of the sale proceeds, it is not necessarily the "correct" rate. What, for example, if the seller had invested the sale proceeds by purchasing more natural gas? If the seller was indeed husbanding natural gas in anticipation of future price increases, such a purchase would seem natural. Presumably, the seller could have purchased at least as much gas as it sold to the buyer, and so would have realized benefits on the purchased gas equal to those that it realized on the withheld gas. This theory would result in no *net* benefit from the withholding.

104. *Id.* at 273.

that the seller paid for capital, and the rate of interest paid to the seller by its subsidiaries for money loaned to them. These calculations produced benefit figures ranging from \$7.8 million to \$8.7 million.¹⁰⁵

The trial court held that the first theory must be applied and that damages must be measured by the benefit the seller gained by withholding the gas rather than by withholding damages. The court relied upon the statute's reference to the "gain or benefit realized by the person withholding such money or *property*."¹⁰⁶ From the \$11.9 million in benefit accruing from the withheld gas, the court deducted the \$3.6 million in compensatory damages and awarded the company \$8.3 million in pre-judgment interest.¹⁰⁷

By selecting the gas husbanding model, the *Northern* court completed the transformation of the prejudgment interest statute into a general rule of disgorgement of the benefits to be gained from reallocating the performance resources. *Northern*, like *Davis*, does not even appear to give the plaintiff the option to recover the benefits the defendant realizes

105. Slip opinion, *supra* note 97, at 2.

106. COLO. REV. STAT. § 5-12-102(a). The statute is ambiguous: Does it mean "realized by the person [as the result of] withholding such money or property," or does it mean "realized by the person [who is] withholding such money or property?" The *Northern* court interpreted the statute in the first sense. The legislative history suggests that lawmakers considered the application of the statute to compel the disgorgement of benefits resulting from property withheld. See Transcript of Colorado Senate Judiciary Committee Hearing on S. 463, March 12, 1979, at 12 (analogy of convertor of a cow being liable for the value of milk obtained during its wrongful detention). When the phrase is read to apply to the "withholding" of property due under a contract, breach of contract is conceptually transmuted into the tort of conversion of the subject matter of the contract.

107. *Great Western*, No. 87CA1477, slip op. at 2. The trial court deducted the actual damages suffered by the plaintiff from the moratory interest award on the theory that "it is proper to deduct from the gross amount of such gain or benefit derived from the wrongful withholding of gas the amount [KN Energy] now has to pay in order to exercise its retention rights in that gas. Only in this manner can the Court fully recognize [KN Energy's] gain or benefit. A contrary finding would be punitive in nature as [KN Energy] has already paid for the gas that was not delivered to [Great Western]." Slip op. at 6. This reasoning was upheld on appeal. *Great Western*, 778 P.2d at 275-77.

An example may clarify the point. Consider a goods contract breached by the seller by sale to a third-party. Assume that the contract price is 100, the market price at the time of breach is 125, and the price realized by the seller from the sale to a third party is 150. The buyer, who covers at the market price, will recover expectation damages of 25, equal to the benefit of his bargain. If he also recovers as restitution the entire 50 that the seller realized on breaching the contract, the buyer will have a windfall of 25, receiving the equivalent of performance for 75.

The court in the *Northern Gas* case avoided this result by deducting the actual damages (the first 25 in the example) from the interest damages, which would lead to a total recovery of 50 in the example given. The court reasoned that the seller did not realize the full 50 as a result of the breach because the seller's "cost" of the breach was the 25 the seller had to pay the buyer as expectation damages.

from the withheld damages payment. Under Colorado's rule a defendant's liability for delayed payment is now wholly unrelated to the gain she realizes from delaying payment and the plaintiff's award is wholly unrelated to his losses from delayed payment. Thus, Colorado has achieved neither a disgorgement nor a compensation scheme of prejudgment interest. What it has done is to make efficient breach perilous if the breacher cannot accurately estimate the amount of her promisee's damages so that they can be paid at the time of breach.¹⁰⁸ While it creates a deterrent to the withholding of contract damages, the irrelevance of the disgorgement amount to the actual benefit of withholding will make the remedy either excessive or inadequate in most cases.

The Colorado courts have liberally construed the disgorgement remedy. It has been held to apply not only to contracts to pay money or deliver goods but to the "withholding" of any contractually required performance.¹⁰⁹ The courts construe withholding to commence whenever a right to damages arises.¹¹⁰ Despite the statute's use of the word

108. There is no precedent yet on the effects of an inadequate but good faith payment of damages at the time of breach. Presumably, prejudgment interest would be due on the unpaid amount. But if, as *Northern* mandates, interest is computed on the withheld *property* rather than the withheld damages, defendant's attempted payment of damages will be unavailing and will not reduce the defendant's liability for prejudgment interest.

109. *Benham v. Digby Trucking Co.*, 685 P.2d 249 (Colo. App. 1984) (insured's breach of contractual obligation to pay assessment to receiver of interinsurance exchange); *Great Western Sugar Co. v. Kansas-Nebraska Natural Gas Pipeline Co.*, 661 P.2d 684 (Colo. App. 1982) (breach of contractual obligation to sell natural gas); *Hott v. Tillotson-Lewis Constr. Co.*, 682 P.2d 1220, 1222-23 (Colo. App. 1983) (breach of contract to construct a house).

In *Isbill Assoc. v. City and County of Denver*, 666 P.2d 1117 (Colo. App. 1983), applying the statute to the damages due on a lessee's tort claim against its lessor for water damage, the court noted that the legislative history of the statute expressed an intention to benefit all plaintiffs, not just those seeking recovery of money due on a contract to pay money. *Id.* at 1122.

The federal district courts sitting in Colorado have refused to apply the statute as broadly as has the state appellate court. *Lowell Staats Min. Co. v. Pioneer Caravan, Inc.*, 645 F. Supp. 254 (D. Colo. 1986) (refusing to apply the statute to "garden variety breach of contract cases."). *Id.* at 259. See also *EEOC v. Trailways*, 28 FEP 552 (D. Colo. 1981) in which Judge Winner, the author of the opinion in *Davis*, refused to apply the statute to an employee's claim for wages in a wrongful discharge case, stating: "To extend to a wrongful discharge case the concept of awarding interest for money wrongfully withheld would mean that every time anyone won a suit for breach of contract, monetary interest would have to be awarded. Having spent the time I did in studying prejudgment interest before writing *Davis Cattle*, I am unable to conclude that prejudgment interest should be awarded on the unliquidated amount here involved, and I say this with full awareness of the amendment to the Colorado interest statute. [citation omitted]." 28 FEP at 553-54. Unfortunately the judge did not explain how his opinion in *Davis* should be limited so as not to apply to all suits for breach of contract.

110. See *Isbill Assoc.*, 666 P.2d 1117. (applying the statute to a tenant's tort claim for property damage against its landlord).

“wrongfully,” plaintiffs have not been required to show that the withholding was tortious or in bad faith.¹¹¹ As a result, the statute applies to any breach of contract.

V. THE PROBLEM OF CAUSATION: LEGAL CONCEPTUALISM AND ECONOMIC ANALYSIS

This part analyzes the formidable transaction costs of calculating the benefits to be awarded under a disgorgement remedy. The foregoing analysis has proceeded on the assumption that the “benefits of breach” or the “benefits of withholding damages” could be identified and measured. These phrases imply a direct causal relationship between the breach or withholding and some benefit. As Professor Farnsworth has pointed out, the causal relationship between breach and benefits is often simply assumed in restitutionary theory.¹¹² Likewise, the misnomer “efficient breach” implies a false causal relationship. The benefits related to efficient breach are not “caused” by the breach. The benefits result from some allocation of performance resources, an allocation that itself may or may not also “cause” the breach. These relationships do not coincide with traditional legal conceptions of causation, which erect intractable problems in the calculation of disgorgement benefits.

The relationship among the breacher’s allocation of resources, the breach, and some benefit may be quite tenuous. Both before and after contracting, a promisor may make allocational decisions that make performance less likely or impossible. Promisors may accept additional contracts, invest potential performance resources in other projects, and take various other risks that jeopardize the performance of the contract. These decisions presumably benefit the promisor.

A disgorgement remedy aimed at these benefits would have to satisfy some standard of legal causation.¹¹³ Classically, this would require showing that the benefits were caused by the contract breach, for it is the breach and not the resource allocation upon which a plaintiff’s claim is based. When the benefits precede the breach, this burden cannot be met.¹¹⁴ The Colorado statute, by employing an explicit temporal condition,

111. *Benham*, 685 P.2d 249 (breach of contractual obligation to pay assessment to receiver of interinsurance exchange).

112. Farnsworth, *supra* note 4, at 1343.

113. On the meaning of legal causation see H. HART & A. HONORE, *CAUSATION IN THE LAW* (2d ed. 1985). On the role of cause in economic analysis see Coase, *supra* note 21; Landes and Posner, *Causation In Tort Law: An Economic Approach*, 18 J. LEGAL STUD. 325 (1989); Culp, *Causation, Economists, and the Dinosaur: A Response to Professor Dray*, 49 LAW & CONTEMP. PROBS. 23 (1986).

114. For example, in performing Contract A a promisor may suffer damage to equipment, making it impossible to perform Contract B. One might analogize this to a sale of goods to the Alternative Purchaser, so that the Promisor’s profit from Contract A is a “benefit” obtained “as a result of” the breach of contract B.

precludes recovery of benefits that do not arise "from the date of wrongful withholding" until payment or judgment.¹¹⁵ If the date of withholding is the date of performance, and if the wrongdoer has fully realized the benefit *before* the date of performance, disgorgement of the benefit is presumably unavailable.¹¹⁶ The need to tie the disgorgement remedy causally to the breach rather than to the decision to reallocate (and breach) creates the opportunity for strategical evasion of the pre-judgment interest remedy. If the breacher can time her transactions so as to realize the benefit of withholding before the breach, she can avoid disgorgement liability for the withholding, although the practical effect may be identical to a realization of benefit after the withholding. Economically, the results are identical but the requirements of legal causation lead to disparate treatment.

A. *Calculation of the Benefits from Reallocating Performance Resources*

1. *Identified Performance Resources.* At times, such as in the sale of goods existing at the time of the contract, the parties may informally recognize an intention to use specific performance resources in the performance of the contract, yet the buyer may never acquire a right to recover for their conversion.¹¹⁷ When these goods are reallocated to some other use, calculation of the benefits of the reallocation would seem simple.

But this is not always the case. Consider the well-known case of *Acme Mills & Elevator Co. v. Johnson*.¹¹⁸ Defendant Johnson, a farmer, contracted to sell 2,000 bushels of wheat to the plaintiff Acme, a grain dealer, at \$1.03 per bushel to be delivered at harvest time. The market rose sharply, and the alert Johnson sold his wheat at \$1.16 to a different buyer. By the time of harvesting, however, the market had dropped to \$1.00 per bushel. When Johnson failed to deliver, Acme sued for the extra \$.16 per bushel Johnson realized on the second sale.¹¹⁹ This remedy

115. COLO. REV. STAT. § 5-12-102(a).

116. Actions that amount to repudiation might be construed as "wrongful withholding," however, as they constitute breach giving the promisee the immediate right to damages. U.C.C. § 2-610.

117. The concept of identification to the contract is used in the Uniform Commercial Code, § 2-501, as the process whereby a buyer of goods obtains a special property and insurable interest in the goods. Identification occurs for existing goods at the time of contracting (U.C.C. § 2-501(1)(a)); and for future goods when the seller ships them or marks them as the goods to which the contract refers. U.C.C. § 2-501(1)(b).

118. 141 Ky. 718, 133 S.W. 784 (1911).

119. *Id.* Under the Uniform Commercial Code, the *Acme* breach would not have been efficient if Johnson had informed Acme at the time of his sale to the alternative

was refused, the court measuring damages as the difference between the market and contract price at the time and place for delivery. Under this measure Acme had suffered no loss (and had in fact benefited from Johnson's failure to perform).

Had a disgorgement remedy been available, the benefit of the reallocation would seem to have been thirteen cents per bushel, the price the breacher received for the goods less the contract price. Yet, Johnson could have purchased grain in the market at \$1.00 to satisfy his obligation to the buyer. If he had, he could have realized his profit and fulfilled his contract as well (earning three more cents a bushel in the process.) One could argue that the benefit caused by the breach was, therefore, only the amount by which this market price exceeded the contract price: in the *Acme* case, zero.

Professor Farnsworth's leading commentary on the application of the disgorgement remedy to breach of contract would apply such a version of legal causation in determining the benefit resulting from breach.¹²⁰ Professor Farnsworth calls for a "strict cause in fact" requirement that would limit disgorgement to benefits as to which breach was essential in a "but-for" sense, i.e., benefits that the breacher could not have obtained without the breach. Benefits would be measured as the least amount of savings that the breacher could have realized by not performing the contract. Thus, if instead of breaching the contract, the breaching party could have purchased goods in the market in order to satisfy the alternative transaction, disgorgement would be limited to the amount the breacher saved by not doing so.¹²¹

This approach would have led to a different result in *Northern*. The gas seller could have both realized its gain and fully performed at a minimal cost. At the time of breach, for example, it could have purchased additional gas for sale to the buyer or for storage to replace the gas it sold. Its savings would have been the purchase price of gas at the times of breach less its sales price from the sale to the plaintiff. The breach was in all likelihood not necessary to the gain the seller realized, and Farnsworth's method would have precluded a disgorgement award.

purchaser that he would not be able to perform his contract. Under Section 2-713, Acme's damages for Johnson's repudiation would be the difference between the market price at the time Acme learned of the breach, presumably \$1.16, and the contract price. These damages would have eliminated Johnson's profit.

120. See Farnsworth, *supra* note 4.

121. See *id.*, at 1344 (possibility of seller's market purchase of substitute widget to sell to alternative buyer destroys causal link between breach and gain). Ironically, by permitting disgorgement only where the breach was necessary to the gain, Farnsworth's strict cause requirement absolves promisors who unnecessarily breach contracts and punishes those whose breach was necessary to the gain.

A corollary of Farnsworth's strict cause requirement is the doctrine of joint cause. Any part of the breaching party's gain that results from her own skill or efforts must be deducted from the total gain in order to calculate the amount of gain "caused" by the breach. Farnsworth analogizes this principle to the deduction of brokerage or similar costs or fees from a wrongdoer's gross profit in cases of fiduciary disgorgement.¹²²

This doctrine, too, would have altered the *Northern* result. The \$11.3 million gain in value of equity that the seller realized was due in large part to the seller's contribution to the value of the gas in storing it, in using the gas in rate-making, and in diverting the gas to higher paying customers. In addition, the seller took market risks of price changes in gas. Deduction of the value of the seller's contribution would have greatly reduced the award.

To allow breachers the benefits of Farnsworth's imaginary or hindsight efficiencies will not encourage them to act efficiently at the time of breach. But such an approach is preferable to the *post hoc ergo propter hoc* fallacy exemplified in *Northern*. In neither case are the benefits of reallocation causally linked to breach with sufficient vigor.

2. *Non-Identified Performance Resources*. To attempt to trace the benefits from the allocation of resources that have not been designated to the contract is even more of an exercise in fiction. For example, in *Northern*, the court purported to value hypothetical gas that was not sold to the buyer by deeming it to have been stored for years in an underground storage facility, where it generated an increase in the seller's equity. But the seller could plausibly have argued that the "buyer's gas" was never purchased by the seller, or that it was sold to residential customers, or even that it was sold in later years to the buyer itself. All these stories would have been equally "correct" in the absence of any identification of specific gas to the contract. In selecting from among the fictional futures of the fictional gas, the court has no economic or other principle to guide it. A remedy so unmoored to reality can achieve neither efficiency nor justice.

3. *Measuring Benefit by "Savings" Resulting from Breach*. An even deeper level of fiction is reached when courts consider, as did the court in *Davis*, that a breacher benefits from breach by the amount of "savings" realized from failure to perform. When performance resources have never been allocated to the contract, one cannot speak meaningfully of their "re"allocation to higher valued uses. For example, consider a manufacturer who sells goods that may contain defects that will cause predictable losses. The manufacturer should spend resources on quality

122. *Id.* at 1347-48.

control to the point of diminishing return, measuring amount spent against loss avoided. At this level of precaution the manufacturer is acting efficiently and the joint cost of the product is minimized even though some defects will occur.¹²³

If the inevitable defective product breaches the contract, how is the "benefit of the breach" to be calculated? The manufacturer did not realize a gain from any obvious intentional breach, but a court applying the "savings" rationale might ask what the promisor would have had to spend in order not to breach, as did the court in *Davis*. The amount the manufacturer might have saved by not spending enough to reduce defects to zero percent might approach infinity. Disgorgement of this amount would give the plaintiff a property interest in the hypothetical dollars that the manufacturer did not spend, nor even considered spending. The principle would also reach, for example, breaches in which the promisor acted efficiently by overbooking or overscheduling production. The "benefits of breach" would equal the cost of the excess capacity the promisor would have had to maintain to assure performance.

A general disgorgement remedy would not be efficient in such cases because it would lead the promisor to overinvest in precautionary care and raise the joint costs of the contract. Promisees profit when the joint costs are minimized and would be charged more for a general disgorgement remedy than it would be worth to them.

4. *Informational Transaction Costs of Calculating the Breacher's Benefit.* The administrative and uncertainty transaction costs of calculating the benefit under a disgorgement remedy will usually exceed those of calculating a loss under an expectation damages remedy.¹²⁴ In the case of breach of contract, the injury is the shortfall between the breach situation and the promisee's expectation; the benefit of breach is the improvement of the promisor's condition over that which performance would have created. The benefit is often more costly to calculate than the injury because of the parties' unequal access to relevant information. The party in possession of the best information about the injury, the contract plaintiff, is the one with the burden of proving it. The party in possession of the best information about the benefit, the breaching promisor, is the one resisting the claim. The same inequality applies to information about the hypothetical world that would have ensued upon full performance. The promisee knows what he was expecting from performance, but not what the promisor was expecting. Finally, a prom-

123. Cooter, *supra* note 8.

124. It has been noted that courts tolerate more uncertainty in calculating losses than in calculating benefits for restitutionary purposes. Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 72 (1985).

isor may subjectively value reallocation of performance resources in ways that the promisee can never prove.¹²⁵ Subjective benefits of breach would be immune to disgorgement, although they would be very real.

These information inequalities are magnified by the conjectural nature of the calculation of the breacher's gain. The transaction costs of such a calculation are lower for the promisor than for the promisee. This suggests that the promisor is the least cost avoider of the risk of her benefit from a reallocation of performance resources. Assigning the remedy, and therefore the risk, to the promisee is inefficient.

B. Calculation of the Benefits from Withholding Payment of Damages

Even where the disgorgement remedy is limited to the benefits from withholding the damages payment, legal causation does not furnish an acceptable measure. Unlike the typical fiduciary case, a breach of contract rarely involves an identifiable fund from which to trace benefits, and the resulting calculations are fictional and arbitrary.¹²⁶

An example is furnished by the benefit measurements rejected by the court in *Northern*. The plaintiff introduced evidence of the seller's average investment return, its lending rate to its subsidiaries, and its average borrowing rate.¹²⁷ These produced measures of benefit that differed by almost \$1 million. But which of these is the "correct" measure of the seller's benefit from withholding payment of damages?

One possibility requires the promisor to disgorge the benefit of the alternative transaction, the result reached in *Northern*. Such an approach recognizes that breach damages may be deemed "invested" in any of the promisor's property, including the profit-making activity that replaced performance of the contract. But the *Northern* court did not compare the amount of the unpaid damages to the amount the seller had invested in the withheld gas. The reallocation is only one of the plausible in-

125. This would not only include the rare case when the promisor takes malicious delight in breaching, but would include more common cases, as when the promisor consumes the performance resources herself, i.e., by going fishing instead of painting plaintiff's barn. A disgorgement of this benefit would require a measure of the promisor's subjective valuation of her leisure. While a plaintiff may seek to prove *his* subjective valuation of performance as a measure of expectation damages, it is not likely that he could succeed in proving his adversary's subjective state. See also Tredennick and Cairns, *Colorado's Prejudgment Interest Statute: Potential for Market Rate Interest* 12 COLO. LAW. 1605 (1983).

126. On the problem of tracing, see G. Palmer, *supra* note 26 §§ 2.14, 2.16; Restatement (Second) of Trusts § 202; Restatement (Second) of the Law of Restitution, Tentative Draft No. 2 (April 6, 1984) §§ 34-41.

127. See Farnsworth, *supra* note 4 (referring to the cost of substitution, the least cost the wrongdoer would have incurred in performing the obligation).

vestments the promisor might have made with the damages payment.

A second method, suggested by Professor Farnsworth's cost of substitution analysis, gives the breacher the benefit of the doubt by measuring the benefit as the lowest cost that the breacher could have incurred in discharging the damages obligation.¹²⁸ This method assumes that if the breacher were forced to pay damages on time, she would have done so at the lease expense to herself, a not unreasonable assumption. The seller in *Northern* could have liquidated its least profitable investment or borrowed at the lowest available rate in order to pay the damages.

Yet this method involves the problem of retrospection. If the breacher's benefit is to be measured by her return on some investment, and if the investment chosen is to be the one with the least return, then as of when will that return be measured? The breacher can wait until trial, pick her least profitable investment, and perhaps pay nothing in interest. This method would encourage the breacher to invest in hedge-type speculations in which "losers" are expected to be balanced against "gainers." After entry of judgment, the plaintiff can be given the "benefit" of whichever investment dropped while the breacher will enjoy the winner. A possible solution is to attempt a judicial, *ex post* determination of the expected return of the investments at the time of breach, but this method creates obvious valuation problems and attendant costs.

A third approach is to measure the benefit to the breacher as if the breacher had invested the withheld damages in the highest return investment in her "portfolio." Such a measure will give the breacher an efficient incentive to pay damages upon breach and the breacher will determine the most efficient way to manage her portfolio so as to make that payment. Again the problem of retrospection will arise, permitting the plaintiff to "cherry pick" from the defendant's portfolio at the time of judgment. In this case, however, the defendant will probably avoid the risk by paying the damages on time.

Even if a fund from which the damages payment would have been made could be identified with certainty, a court attempting to apply a disgorgement remedy would still face the problem of tracing. Professor Farnsworth argues that a court applying a disgorgement remedy should refuse to "trace" ill-gotten gain through transactions that enhance its value.¹²⁹ While it might simplify judicial determinations, this approach would certainly stimulate strategic behavior in potential disgorgement defendants, who would simply "launder" money before investing it. If disgorgement is an efficient remedy, courts must engage in tracing in order to make the remedy work.

128. *Id.*

129. *Id.*

VI. CONCLUSION

The disgorgement remedy responds to our sense that no one should be able to profit from her own wrong. But things change when wrongs are very profitable. As a general remedy for breach of contract, disgorgement would violate the principle of cost avoidance in all but a few specific situations. Whether or not the storied costs of post-contract renegotiation would exceed the gains in preventing inefficient breach, any such excess would soon be dwarfed by the transaction costs of judicial calculation of benefits from breach. Our ideas of legal causation are poorly suited to this calculation.

As a remedy for withholding damages, disgorgement is more promising, although problems of calculating benefits remain. A judicial rule of thumb that selected the highest rate of investment or borrowing in the breacher's portfolio would seem appropriate. Approaches, such as Colorado's, that award the benefits of reallocation as a remedy for withholding damages are better left to the place where unsuccessful legislative experiments go.

