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Fault in Contract Law

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Fault in Contract Law  
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*Abstract.* A promisor is strictly liable for breaching a contract, according to the standard account. However, a negligence-based system of contract law can be given an economic interpretation, and it is shown that such a system is in some respects more attractive than the strict-liability system. This may explain why negligence ideas continue to play a role in contract decisions, as a brief discussion of cases shows.

Anglo-American contract law is said to be a strict liability system, but it could just as well be a fault-based system. Indeed, one can make a plausible case that a fault-based contract law would be superior to the strict liability system. A fault-based system would result in courts enforcing optimal contracts more systematically than they do currently—if courts could implement the system with sufficient accuracy. The disadvantage of such a system is that courts would need to make difficult inquiries and could make more errors. How the advantages and disadvantages balance out is hard to determine.

As many authors have noticed, although Anglo-American contract law is usually called a strict liability system, it does contain pockets of fault. Fault-like notions, such as good faith and best efforts, recur in the cases; and terms are often implied in order to ensure that obligations are reasonable rather than absolute. These doctrines reflect some

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of the advantages of the fault-based system, and strengthen the theoretical basis for the claim that fault ought to play a role in contract law.<sup>2</sup>

This paper has three parts. In Part I, it lays out the case for a fault-based contract law. In Part II, it shows ways in which this idea is reflected in doctrine—not in all doctrine, but in some cases and rules. In both parts, I will limit my discussion to fault in the perform or breach decision: the question is whether the promisor’s breach may be excused because the breach was not his fault, or was not negligent. I will for the most part ignore negligent representation and other doctrines related to the decision to enter a contract in the first place.<sup>3</sup> I also use a very simple model; a more complex model could well lead to different results.

I conclude that the case for strict liability for breach of contract is not particularly strong, and so we should not be surprised that so many pockets of fault-based liability exist in contract law. The main puzzle that emerges from the discussion is why contract law puts the burden on the wrongdoer to show that he was not at fault in order to avoid paying damages, while tort law puts the burden on the victim to show that the wrongdoer was at fault in order to obtain damages. In Part III, I discuss this puzzle.

## I. Theory

### A. A Model

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<sup>2</sup> Cohen’s article is the most comprehensive discussion; however, he focuses on damages rules, which I will for the most part ignore. See George M. Cohen, *The Fault Lines in Contracts Damages*, 80 Va. L. Rev. 1225, 1238-39 (1994).

<sup>3</sup> On this, see Cohen, *supra* note 2.

Consider a contract where Buyer values a good at  $V$ , Seller's cost in producing the good is  $c_H$ , with probability  $q$  ("bad state of the world"), and  $c_L$ , with probability  $(1-q)$  ("good state of the world"), where  $c_H > V > c_L$ . Buyer pays in advance a price,  $p$ , such that  $p$  just covers Seller's expected costs. Prior to performance, Seller can incur some cost  $x$ ; if Seller incurs this cost,  $q$  drops to 0; in other words, Seller can ensure that performance will be at the low cost. The contract is made at time 0; Buyer pays at time 1; Seller invests  $x$  or not at time 2; Seller's cost of performance ( $c$ ) is determined at time 3; and Seller performs or breaches at time 4. Damages ( $d$ ), if any, are paid at time 5. Renegotiation is assumed to be impossible.

The conventional analysis of this setup in the literature is as follows.<sup>4</sup> Performance is desirable if and only if the cost is low (the good state of the world), because  $V > c_L$  and  $V < c_H$ . The investment  $x$  is desirable if and only if  $x$  is less than the cost savings from reducing the probability of  $c_H$  from  $q$  to 0. Those cost savings equal the social benefit of the transaction being consummated (generating  $V - c_L$ ) where otherwise it would not go through (with probability  $q$ ). Thus, efficient investment requires that  $x < q(V - c_L)$ .

Optimal incentives can be easily provided in this setup. To ensure efficient performance or breach, let Seller pay damages if she does not perform, and set those damages equal to  $V$  ( $d=V$ ). This remedy also ensures efficient investment. Because Seller

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<sup>4</sup> I use a simplified version of the model that has been developed in the literature. See Lewis A. Kornhauser, *Reliance, Reputation and Breach of Contract*, 26 *J. L. & Econ.* 691 (1983); Robert Cooter, *United in Tort, Contract, and Property: The Model of Precaution*, 73 *Cal. L. Rev.* 1 (1985); Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem*, 17 *J. Legal Stud.* 401 (1988); Richard Craswell, *Performance, Reliance and One-Sided Information*, 18 *J. Legal Stud.* 365 (1989); Lucian Ayre Bebchuk & I.P.L. Png, *Damage Measures for Inadvertent Breach of Contract*, 19 *Inter'l Rev. L. & Econ.* 319 (1999). These articles focus on the extent to which different damage measures provide the promisor with proper incentives to take precautions. With a few exceptions to be noted, they do not discuss whether a fault-based liability rule should be used.

pays Buyer's lost valuation if Seller does not perform, Seller fully internalizes the cost of breach. Here, Seller will invest  $x$  as long as  $x < q(V - c_L)$ , as this reduces expected costs from  $qV + (1-q)c_L$  to  $c_L$ . And if Seller does not invest  $x$  because  $x$  is high, Seller will perform in the good state of the world and not perform (instead paying damages) in the bad state of the world.

## B. Fault

As has frequently been noted, this analysis does not depend on any notion of fault. Seller is strictly liable for breach of contract.

However, we can imagine a fault-based approach that yields the same behavior. Suppose that Seller is liable for breach of contract only if her breach was the result of fault or willful action. Let us use the following definitions:

Seller's breach is *willful* if the cost of performance is less than Buyer's valuation ( $c = c_L$ ); efficient breach is not willful.

Seller's breach is *negligent* if the cost of performance is higher than Buyer's valuation (that is,  $c = c_H$ ), and Seller could have taken a cost-justified action to prevent this from happening (that is,  $x < q(V - c_L)$ ) but did not. In other words, breach, whether or not efficient, after failure to engage in efficient investment is negligent.

Seller's breach is *inadvertent* (not her fault, and not giving rise to liability), if the cost of performance is higher than Buyer's valuation (that is,  $c = c_H$ ), and Seller could not have taken a cost-justified action to prevent this from happening (that is,  $x > q(V - c_L)$ ). Efficient breach after efficient investment is not negligent.

Seller pays damages only if the breach was willful or negligent. In either case, let damages equal  $V$ .

It can be shown that this fault system produces efficient performance at time 4 and efficient investment at time 2. Efficiency requires that performance occur if and only if  $V > c$ , that is, where  $c = c_L$ . Suppose that Seller engaged in efficient investment at time 2. Her cost is then  $c_L$ , and at time 4 she will perform if  $d > c_L$ . Because  $d = V$ ,  $d > c_L$  and so Seller will perform.

Now consider whether Seller will engage in efficient investment at time 2. If Seller does, she incurs cost  $x$ ; and she will perform (see above), resulting in cost,  $c_L$ . Thus, the cost of investment is  $x + c_L$ . If Seller does not engage in investment, she does not incur cost  $x$ . In the good state of the world ( $c = c_L$ ), she will perform, at cost  $c_L$ , because  $c_L < d$ . In the bad state of the world ( $c = c_H$ ), she will breach and pay  $d = V$ . Thus, her cost of not investing is  $qV + (1-q)c_L$ . She will invest only if it is cheaper than not investing, that is, where  $x + c_L < qV + (1-q)c_L$ , or  $x < q(V - c_L)$ , which is also the condition for efficient investment.

### C. A Comparison: Strict Liability Versus Negligence

Although the strict liability system and the fault system lead to the same outcome—efficient breach and efficient performance—they have several important differences.

First, the fault system requires the court to make the negligence determination, which might be difficult. The strict liability system does not. In particular, the negligence approach, but not the strict liability approach, requires the court to determine whether both  $V > c$  and  $x < q(V - c_L)$ —so it must determine  $V$ ,  $c$ ,  $x$ , and  $q$ . The strict liability system requires that the court make an accurate damages determination—so it must

determine  $V$  and  $c$  only. Thus, along the dimension of administrative and error cost, strict liability is superior to negligence.<sup>5</sup>

Second, the negligence system reduces the expected costs of transacting relative to the strict liability system. In the negligence system, the potential breacher knows that he does not have to pay damages in the bad state of the world if he could not have prevented it from happening at reasonable cost. In the strict liability system, he does have to pay.

To see this difference more clearly, return to our example. Recall that Seller charges a price that just covers her cost. Suppose also that  $x$  is arbitrarily close to zero, so that Seller will always incur  $x$  in order to eliminate the risk of  $c = c_H$ . Under the strict liability system  $p = x + c_L$ . In the negligence system, we have the same result:  $p = x + c_L$ .

Now imagine that  $x$  is arbitrarily high. In the strict liability system,  $p = qV + (1-q)c_L$ . The price must cover damages in the bad state (where  $d = V$ ) and the cost of performance in the good state. In the negligence system,  $p = (1-q)c_L$ . In the negligence system Seller does not have to pay  $d = V$  in the bad state of the world, as long as the bad state could not have been avoided in cost-justified fashion. So for a range of  $x$ 's, the price difference is somewhere between 0 and  $qV$ .

Thus, for any contract where  $x$  is not arbitrarily close to zero, the price will be higher under the strict liability system than under the negligence system. In return for the higher price, Buyer gets de facto insurance against the bad state of the world—a damages payment equal to  $V$ .

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<sup>5</sup> See, e.g., Cooter, *supra* note 4 at 31.

From an *ex ante* perspective, the parties would almost certainly prefer the negligence regime along this dimension. Buyer has no reason to purchase from Seller insurance against the bad state of the world. Although it is possible that in some cases, Buyer is more risk-averse than Seller, and therefore would be willing to purchase insurance from Seller, in the vast majority of cases either both parties will be risk-neutral, Buyer will be less risk-averse than Seller, or Buyer can more cheaply purchase insurance from a third-party insurance company. The default rule should therefore not supply insurance (which is the same thing as saying that there should be a negligence regime), allowing the parties to opt out and agree to insurance in those rare cases when doing so is in their mutual interest. The strict liability system, in effect, forces Seller to sell an insurance policy to Buyer, unless the parties incur drafting costs or renegotiation costs to avoid this outcome.<sup>6</sup> If, as I have argued, the parties will rarely want to engage in a collateral insurance transaction, then the negligence regime is superior.

A comparison to tort law is instructive. In a simple setup, where only one party can cause the accident and take care, strict liability provides optimal incentives both for that party to take care and for that party to choose the level of activity. In particular, the party chooses the efficient activity level precisely because it pays damages if it causes an accident even if it is not at fault. Strict liability forces the party to internalize all the third-party costs of his behavior.

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<sup>6</sup> See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and the Theory of Efficient Breach*, 77 *Colum. L. Rev.* 554 (1977). This point has also been made about supracompensatory damage measures, such as punitive damages. See, e.g., Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 *S. Cal. L. Rev.* 629, 643-44 (1988); Richard Craswell, *Deterrence and Damages: The Multiplier Principle and Its Alternatives*, 97 *Mich. L. Rev.* 2185, 2229 (1999).



But this activity-level logic does not carry through to contract law.<sup>7</sup> The promisor does not impose an externality on the promisee by entering a contract with him. Thus, the only effect of strict liability in contract law is to force the promisor to pay money to the promisee in the bad state of the world, and demand a higher price *ex ante* (or a lower price if the relevant promisor is the buyer)—or incur extra transaction costs in order to bargain around the rule. As noted, the promisee will not usually gain from insurance, and so strict liability makes the parties worse off than a negligence regime would—either because it creates an unnecessary insurance contract or because it raises transaction costs.

#### D. A Note on Victim's Precautions

The analysis can be extended to the case where the victim can take precautions to minimize the probability of breach or the harm that occurs as a result of the breach. In the literature, this behavior is typically called “reliance.” In a strict liability system, if the victim is fully compensated, he has an incentive to “overrely” because the promisor bears the full cost. To address this problem, scholars have suggested that the victim’s damages should be limited to what his loss would be if he took efficient precautions (requiring a highly fact-intensive judicial inquiry).<sup>8</sup> In deciding how much to rely, the victim will realize that he will not be compensated for the extent of overreliance, and thus will not have an incentive to engage in overreliance. Meanwhile, the promisor will still have correct incentives to perform or breach because damages for breach will be equal to the victim’s actual (as well as efficient) reliance.

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<sup>7</sup> Except in the context of products liability, where the normal justification for strict liability is that buyers are unlikely to discover information about the riskiness of the product except (implicitly) through the price system. See Steven Shavell, *Strict Liability Versus Negligence*, 9 *J. Legal Stud.* 1, 20-22 (1980).

<sup>8</sup> See Cooter, *supra* note 4 at 11.

The problem with this approach is that it would be difficult for courts to determine whether the victim has engaged in efficient reliance, and thus to limit damages to the cost of efficient reliance, and, as far as I know, courts have never attempted to do so. By contrast, under the negligence system, it would be unnecessary for courts to determine the efficient level of damages, or to award damages different from the victim's actual loss. Because the victim receives no compensation when the promisor breaches inadvertently, the victim will have no reason to engage in overreliance.

These observations suggest that the administrative advances of strict liability are more limited than has generally been recognized. If victim precaution matters, than the advantage of strict liability—that one does not need to determine whether the breach was inadvertent or wrongful—is offset by the disadvantage that one needs to determine the degree of efficient reliance. Under the negligence regime, the advantages are the opposite. The liability determination is more complex, but the damages determination is simpler.

#### E. Summary

I have argued that the negligence regime provides better incentives than the strict liability regime does. In most ordinary commercial contracts, it is optimal for the seller to perform in the good state of the world and not to supply insurance in the bad state of the world. Thus, the default contract should include insurance. Yet under the strict liability regime, such insurance is supplied. If, as I have argued, parties do not usually want such insurance, the negligence regime is superior.

The strongest argument for the strict liability regime is that it does not require courts to distinguish between inadvertent and wrongful (that is, negligent or willful)

breaches. However, such an inquiry may well be unavoidable if there is a question of overreliance by the victim, in which case this advantage is greatly diminished.

## II. Doctrine

Contract law is conventionally understood to be unconcerned with fault. In the influential words of the Restatement:

Contract liability is strict liability. It is an accepted maxim that *pacta sunt servanda*, contracts are to be kept. The obligor is therefore liable in damages for breach of contract even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated.<sup>9</sup>

If the analysis demonstrating the potential benefits of a negligence standard in Part I is correct, however, it would be surprising if negligence ideas played no role in contract law. In fact, as many scholars have noticed, they do.<sup>10</sup> Here, I will briefly describe some of this doctrine, and then explain how it fits or does not fit the theoretical analysis.

Throughout, the focus will be on doctrines that excuse the promisor from liability, or dramatically reduce damages when the promisor could not avoid breach by taking cost-justified precautions. I do not try to prove that all or most or even many cases actually reflect negligence-style thinking. I argue instead that, in some cases, negligence-style thinking provides a natural interpretation of what the court did.

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<sup>9</sup> Restatement (Second) of Contracts ch. 11, introductory note, at 309 (1981).

<sup>10</sup> See especially Cohen, *supra* note 2. See also G.H. Treitel, *Fault in the Common Law of Contract*, in M.Bos & I. Brownlie eds., *Liber Amicorum for the Rt. Hon. Lord Wilberforce* 185 (Oxford, 1987).

I should be clear that I am not claiming that negligence plays the same role in contract law as it does in tort law. In tort law, the plaintiff must, in most cases, prove that the defendant acted negligently, and a court will evaluate the defendant's behavior against some substantive standard of fault in the course of determining liability. Clearly, courts do not routinely and clearly engage in a similar process in breach of contract cases. What I will argue, however, is that, under doctrinal cover, courts do sometimes apply an implicit fault standard—in the sense of releasing defendants from liability if the alleged breach was “inadvertent” rather than the result of negligent or willful behavior.

*Impossibility/impracticability.* The impossibility and impracticability doctrines (henceforth, I will mention only the latter) provide that a promisor is excused from performance when performance is “impracticable.” The standard interpretation of this doctrine is that performance is excused only when it is extremely costly, not when it is merely not cost-justified to perform in the sense meant in this paper. Thus, one might be led to believe that the impracticability doctrine applies only when performance is rendered excessively costly on account of risks that could not have been prevented, and when the promisee is the cheaper risk-bearer.<sup>11</sup> On reflection, however, this argument turns out to be unconvincing. The problem is that most contracting parties who end up in

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<sup>11</sup> Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 *J. Legal Stud.* 83, 92 (1977):

The foregoing discussion indicates the factors that courts and legislatures might consider in devising efficient rules for the discharge of contracts. An easy case for discharge would be one where (1) the promisor asking to be discharged could not reasonably have prevented the event rendering his performance uneconomical, and (2) the promisee could have insured against the occurrence of the event at lower cost than the promisor because the promisee (a) was in a better position to estimate both (i) the probability of the event's occurrence and (ii) the magnitude of the loss if it did occur, and (b) could have self-insured, whereas the promisor would have had to buy more costly market insurance.

As will become clear, my argument is that (1) should be sufficient for discharge and (2) is irrelevant.

litigation—businesses, chiefly—are probably risk neutral or close to it, because they are big or because they can purchase insurance from a third party.<sup>12</sup>

The impracticability doctrine has another possible meaning. Suppose that a carrier promises to deliver goods to a destination by a certain time, but then is unable to keep the promise because of an event outside its control—a war that shuts a canal, for example.<sup>13</sup> In cases such as this, courts do not automatically find against the carrier (as strict liability would imply), nor do they evaluate the relative risk-aversion of the parties. Instead, they examine whether the promisor could have kept its promise by taking reasonable precautions. For example, suppose the carrier could have stopped the ship at a distance from the canal, waited a reasonable time for further developments, and then taken a less onerous alternate route if the canal turned out to be closed. A court is more likely to release the carrier from liability if it takes this precaution (but ultimately continues on the same route and is blocked) than if it does not. Here, again, the court is influenced by notions of fault. It examines whether the cost of the relevant precaution would have been low enough, and the benefit great enough.

The Restatement, §261, recognizes the role of fault in the impracticability doctrine:

Where, after a contract is made, a party's performance is made impracticable *without his fault* by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.<sup>14</sup>

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<sup>12</sup> Victor P. Goldberg, Impossibility and Related Excuses, 144 J. Institutional & Theoretical Econ. 100 (1988); Alan O. Sykes, The Doctrine of Commercial Impracticability in a Second-Best World, 19 J. Legal Stud. 43 (1990).

<sup>13</sup> See, e.g., *American Trading & Prod. Corp. v. Shell Int'l Marine*, 453 F.2d 939 (1972).

<sup>14</sup> Restatement (Second) of Contracts, §261 (1981) (emphasis added).

If taken literally, this rule would seem to recognize that a negligence regime already exists—almost. Recall that under the negligence regime the promisor is liable if (1) he fails to perform when performance is cost-justified, or (2) he fails to perform and performance is not cost-justified only because the promisor failed to take cost-justified precautions. If “impracticable” means “not cost-justified,” and if “fault” means “failure to take cost-justified precaution,” then §261 has the same meaning as the negligence rule: the promisor is excused if performance is not cost-justified and if it would not have been cost-justified if the promisor had taken a cost-justified precaution.

The phrase “basic assumption” would need to be interpreted as any event that rendered performance not cost-justified. This interpretation might seem implausible, but, on the other hand, no one has supplied a satisfactory definition of “basic assumption.” Some judges and scholars fall back on the notion of foreseeability, arguing that the impracticability doctrine applies only when the supervening event is unforeseeable. But this argument makes little sense. The relevant question for the parties is not whether a particular event occurs or can be foreseen but whether the parties’ costs rise, and everyone can foresee that costs may rise. That is, for example, all sellers know that their input costs might rise even if they cannot always foresee the particular events that *cause* those costs to rise. It does no violence to the sweeping language of §261 to interpret it as consistent with a negligence standard.

*Reasonable or Substantial Performance.* Courts distinguish between material and technical breaches, and between substantial and full performance; these distinctions often turn on the question of fault. In Louisiana, courts can decline to dissolve a lease at the

request of the lessor “where it finds that the breach of the lease is not major or where the breach was not the fault of the [lessee] or where the [lessee] was in good faith.”<sup>15</sup> The Restatement similarly provides that, in determining whether a material breach occurred, a court should take account of “the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.”<sup>16</sup> In one of the Louisiana cases, the lessor had the right to cancel the lease if the lessee violated a municipal ordinance and failed to correct the violation within ten days. The court found that because the violations were “technical,” did not threaten immediate harm, and were difficult to correct because of the complexity of municipal law, the breach was not the result of the lessee’s fault, and thus could not justify termination.<sup>17</sup>

This line of cases provides important evidence that fault matters in contract law. However, the cases do not unambiguously conform to the model described in Part I. To see why, observe that victims of breach retain the right to obtain damages even for “technical” breaches; what they do *not* have is the right to *terminate* the contract on account of such breaches. Thus, the victim of a technical breach has the right to damages; the victim of a material breach has the option to terminate (and sue for damages) or to sue for damages alone. Clearly, the victim of the material breach has a more valuable remedy, inasmuch as his remedy encompasses the remedy of the victim of the technical breach; and he can, in effect, obtain supracompensatory damages whenever the breacher is willing to pay him some amount not to terminate. By contrast, in the model, the

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<sup>15</sup> Karno v. Joseph Fein Caterer, Inc., 846 So.2d 105, 110 (La.App. 4 Cir. 2003); see also Karno v. Bourbon Burlesque Club, Inc., 931 So.2d 1111 (La.App. 4 Cir. 2006).

<sup>16</sup> Restatement (Second) of Contracts, §241(e).

<sup>17</sup> Bourbon Burlesque Club.

negligent breacher pays compensatory (rather than supracompensatory) damages and the non-negligent breacher pays zero (rather than compensatory) damages.

The usual explanation for the right to terminate for material breach is not to punish the breacher, but to ensure that the victim of breach can protect himself in a world in which breachers are often judgment-proof. In other words, the right to sue for damages is often worth nothing, while the right to terminate is worth a great deal. If this is the case, then we can redescribe the cases in a manner that brings them roughly in line with the model. When the breacher is negligent (or willful), courts ensure that the victim has a remedy; when he is not, courts do not ensure that the victim has a remedy.

*Good Faith and Best Efforts.*

In *Feld v. Henry S. Levy & Sons, Inc.*,<sup>18</sup> the contract required the defendant, a bread-baking business, to sell to the plaintiff all of its breadcrumbs output for a certain period. Later, the defendant decided to stop production of breadcrumbs in order to create space for a computer room. Because the contract required defendant only to sell its output, and its output ceased when it dismantled the equipment for making breadcrumbs, the defendant argued that it had not breached the contract. The plaintiff argued that the defendant had breached the contract by failing to act in good faith. The court agreed.

The court acknowledged that the defendant could have reduced its output without violating the contract, and could even have ceased production if its losses were “more than trivial.” But it held against the defendant because the defendant asserted in a “conclusory” fashion, that is, without evidence, that the breadcrumb operation had

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<sup>18</sup> 335 N.E.2d 320 (N.Y. 1975).



become “uneconomical.”<sup>19</sup> The court also mentioned that the six-month cancellation clause allowed the defendant to protect itself to some extent, that the defendant offered to resume breadcrumb production if plaintiff paid a slightly higher price than that stipulated in the contract, and that the defendant did not take steps to obtain “more economical equipment.”<sup>20</sup>

The court appeared to believe that the defendant’s breach was willful. The defendant had simply discovered that the price it obtained was less than its costs, including its opportunity costs, tried to hold out for a higher price, and then shut down operations when the plaintiff refused the offer. What is relevant to the argument here is the reference in the opinion to the conditions under which defendant’s behavior might have been excused. The language implies that defendant could have avoided liability by showing that it could not have taken reasonable steps to reduce its costs to a tolerable level.<sup>21</sup> Because the defendant did not make such a showing, we do not know whether the court would have excused liability based on the absence of fault (on the cost-benefit interpretation or any other), but the language does suggest such an outcome.<sup>22</sup>

*Interpretation/implied terms.* One might respond by arguing that the court in *Feld* was not so much relying on notions of fault as interpreting the contract. The case was a strict liability case; it is just that the court (in effect) interpreted the contract to implicitly

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<sup>19</sup> Id. at 322-23.

<sup>20</sup> Id. at 320.

<sup>21</sup> However, the court expressed doubt about whether such a test would be feasible. Id. at 323 (“In any event, ‘economic feasibility’, an expression subject to many interpretations, would not be a precise or reliable test.”)

<sup>22</sup> Cf. Charles J. Goetz & Robert E. Scott, Principles of Relational Contracts, 67 Va. L. Rev. 1089 (1981). Goetz & Scott similarly argue that in such “relational contracts,” courts cite the doctrines of good faith and best effort when they are really just trying to determine whether continued performance would be value-maximizing.

provide that the baking company could cease output when cost-justified steps could not ensure efficient performance and not otherwise. Having construed the contract in that way, the defendant was strictly liable for failing to engage in cost-justified behavior.

But this is just an argument by definition. We could say that courts import fault principles when they interpret contracts in order to preserve strict liability in making the liability determination; or we could say that courts interpret contracts literally and use a negligence rule in the liability determination. The two statements amount to the same thing. The larger point is that courts, one way or the other, try—at least sometimes—to eliminate or limit damages when the promisor could not have avoided breach through cost-justified actions—that is, was not negligent.

Consider the following illustration from the second Restatement of Contracts. A mining company hires an engineer to help reopen a mine for “\$10,000 to be payable as soon as the mine is in successful operation.” The engineer performs but the mine cannot be reopened. The Restatement says that the engineer should nonetheless be paid.<sup>23</sup>

The point seems to be that the mining company most likely hired the engineer to provide a service, and not to provide insurance in case that the service does not result in successful opening of the mine. The only possible interpretation of this argument is that the engineer should supply cost-justified efforts and no more. Again, the negligence idea reappears. It is idle to argue about whether the doctrinal reason for this result is that the contract “really” provides for only cost-justified performance or that the contract requires performance but the engineer will be excused from liability as long as the performance

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<sup>23</sup> Restatement, 2d, of Contracts, s. 227, Ill. 2.

that he actually provides is cost-justified. In both cases, contract law operates as a negligence-based system rather than as a strict liability system.<sup>24</sup>

*Conditions.* Many contracts contain express conditions, and the promisor is obligated to perform only if those conditions are met. Even when contracts do not contain express conditions, courts frequently imply conditions. There are no hard and fast rules governing when conditions are implied, but there are patterns. For example, courts frequently make payment conditional on performance even when the contract does not say so.

Courts also imply conditions in much the same way that they imply other sorts of terms, based on a judgment about what the parties would have agreed to. This kind of judgment will reflect principles of fault when courts believe that parties would have wanted such principles in their contract. For example, in *Jacobs & Young*,<sup>25</sup> a contractor breached a contract by failing to install the type of pipes that the contract specified. The promisee refused to pay, invoking the traditional rule that payment is conditional on performance.

The court appeared to believe that the cost of performance, tearing down the building and installing the correct pipes, exceeded the value of performance, installation of the correct pipes, which apparently were not functionally different from the pipes that were installed; the question is whether it also believed that the failure to notice the mistake before installation occurred was inadvertent rather than negligent. In pointing out

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<sup>24</sup> To be sure, if the contract explicitly provides for a negligence standard of liability—that is, it says that the promisor must take cost-justified actions—then “strict” enforcement of such a contract would produce the same outcome as fault-based enforcement.

<sup>25</sup> 129 N.E. 889 (N.Y. 1921).

that an architect inspected but failed to notice the error, the court implied that the error was inadvertent.<sup>26</sup> In the face of explicit contractual language to the contrary, the court eliminated liability (or greatly reduced it) because the breach was not negligent or willful.

For another example, consider *Royal-Globe Ins. Co. v. Craven*.<sup>27</sup> An insurance contract conditioned payout on notice of the claim within twenty-four hours of the accident. Theresa Craven, the insured, was unconscious during that period and so could not provide notice, but failed to give notice until three months after she was released from the hospital. The court excused her from the promise to give notice within twenty-four hours but held that she failed to comply with an implicit obligation to give notice within a reasonable time after she had recovered, and thus was not entitled to payment. Alternatively, one could describe the result in terms of a negligence system. Craven's breach of her promise to give notice within twenty-four hours was not willful or negligent—she was unconscious. Further, there was nothing she could have done prior to the date of performance to ensure that she could have given notice when her duty to do so arose. By contrast, the failure to inform promptly after she returned to health was clearly negligent (or even willful). It would have cost Craven very little, while notice gives the insurance company a chance to verify the claim before the evidence becomes stale.

*Damages.* George Cohen argues that the damage measures reflect fault principles. He points out that courts sometimes award restitution damages when breach is willful, and sometimes award reduced damages—reliance damages, for example—when the

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<sup>26</sup> *Id.* at 890. The brand was printed on the outside of the pipe in intervals but the pipe was otherwise indistinguishable from other pipes.

<sup>27</sup> 585 N.E.2d 315 (1992).

breach was inadvertent or negligent.<sup>28</sup> Similarly, the draft third Restatement of Restitution provides that the remedy for “opportunistic breach” may be disgorgement of the breacher’s gains.<sup>29</sup> When the breacher’s gains are significant, the victim’s remedy may be supracompensatory.

In fact, in a fault-based system courts should award zero damages rather than reliance damages when breach is inadvertent, and should award at least full damages (V minus any unpaid portion of the price) when breach is negligent. Thus, a negligence regime would operate by excusing conduct through liability rules rather than adjusting damages. Nonetheless, Cohen may well be right that the range of damage remedies reflects different attitudes toward willful, negligent, and inadvertent breach. In a strict liability system of contract liability, a supracompensatory remedy for breach makes no sense. Putting aside special cases,<sup>30</sup> a supracompensatory remedy just deters efficient breach under strict liability.<sup>31</sup> In a negligence regime, by contrast, a supracompensatory remedy for opportunistic breach does not deter efficient breach, as long as opportunistic breach means that  $V > C$ , that is, as long as breach would be, in fact, inefficient. The promisor should always perform when performance is efficient. There is no reason to

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<sup>28</sup> Cohen, *supra* note 2.

<sup>29</sup> Restatement of Restitution §39 (tentative draft no. 4). For similar principles, see Restatement (Second) of Contracts §357.

<sup>30</sup> Such as the use of damage multipliers when breach is difficult to detect. See Richard Craswell, Deterrence and Damages: The Multiplier Principle and Its Alternatives, 97 Mich. L. Rev. 2185, 2230 (1999).

<sup>31</sup> See Alan Schwartz, The Myth That Promisees Prefer Supercompensatory Remedies: An Analysis of Contracting for Damage Measures, 100 Yale L.J. 369 (1990).

award greater damages when breach is willful than when breach is negligent, but no harm comes from this practice, either.<sup>32</sup>

### III. Burden-Shifting: A Puzzle

A “pure” fault-based system for contract law, analogous to the fault-based system of tort law, would look like this: the plaintiff recovers for breach of contract only if he can show that the defendant’s breach was wrongful rather than inadvertent—for example, that the defendant failed to take a cost-justified precaution that would have ensured that performance was value-maximizing, or engaged in inefficient breach.

The real system looks, arguably, more like this: the plaintiff makes out a prima facie case for breach of contract by showing that a breach occurred. However, the defendant can rebut that case—or reduce damages—if he can show that his breach was not wrongful—that is, that performance was not value-maximizing and he could not have ensured that it would have been by taking a cost-justified precaution.<sup>33</sup>

This difference raises a puzzle. Why does the tort victim have the burden of proving that the defendant acted willfully or negligently, while the contract victim does not have such a burden—must merely show causation?

To answer this question, one must draw on the literature on burdens of proof in civil procedure, where one finds two approaches. First, some people argue that the burden of proof is, or should be, put on the party with better access to the relevant information. In our setting, the claim would have to be that the tort victim has better access to

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<sup>32</sup> Again, a similar result can be found in the literature on tort law. See, e.g., Shavell *supra* note 7.

<sup>33</sup> In some cases, for example, in interpretation cases, however, the burden is effectively on the victim to prove the relevant interpretation.

information about the defendant's precautions, while the contract breach victim has worse access to information about the breacher's precautions than the breacher does. This seems plausible for the contract case but backwards for the tort case. Normally, the tortfeasor has better information about his own precautions than the victim does, so one would expect that once the victim shows causation, the tortfeasor should have the burden to show that he took adequate precautions.<sup>34</sup> So the approach seems like an unfruitful way to explain the contract rule, even though it is consistent with it.

Second, others have argued that burdens of proof can be used to sharpen the incentives of parties to engage in desirable activities. For example, Chris Sanchirico shows that burdening the victim of a tort sharpens the incentives of potential tortfeasors to take care because taking care allows them to avoid litigation costs when the victim has the burden and not when the tortfeasor has the burden. This argument also does not help. Just as we want to strengthen the incentives of potential tortfeasors to take care, we want to strengthen the incentives of promisors to take care.

Most likely, a satisfactory explanation of the puzzle lies in the murky common law history of the two doctrines. The case for negligence and the case for strict liability are about equivalent—both in tort<sup>35</sup> and, as I have argued, in contract. It would follow that courts might have trouble coordinating around a single approach. Indeed, just as there are pockets of negligence in contract law, there are pockets of strict liability in tort law. The different patterns probably reflect arbitrary historical contingencies rather than a

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<sup>34</sup> Chris William Sanchirico, *A Primary Activity Approach to Proof Burdens*, unpub. m.s. 2006.

<sup>35</sup> See Shavell, *supra* note 7. The two rules do not always lead to identical results, of course; but even when they do not, each rule is superior under equally plausible (but different) conditions.

normatively relevant difference in the types of behavior regulated by the two bodies of law.<sup>36</sup>

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<sup>36</sup> German contract law is a fault-based system but fault is presumed, and in many settings there are strict liability exceptions to the general rule of fault. For a very helpful discussion, see Karl Riesenhuber, *Damages for Non-Performance and the Fault Principle* (unpub. m.s. 2008). So American and German law have different starting points but may well end up at a midpoint. Riesenhuber identifies a similar mixing of fault and strict liability principles in many other bodies of law, including French and Japanese. See also G.H. Treitel, *Remedies for Breach of Contract: A Comparative Account* ch. II (1988).