

# EFFICIENT BREACH IN THE COMMON EUROPEAN SALES LAW

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## INTRODUCTION

Against a background where trade is growing and becoming more complicated in modern society, private parties are appealing for more flexibility and freedom in making decisions rather than strictly abiding by the documents they have signed. Correspondingly, the traditional study of contract law has embraced more theoretical resources rather than insist on the traditional conception that breach of the contract is wrong. The school of law and economics, with its efficient breach theory, provided a new approach to explaining contracts and breaches, and challenged the traditional notion of *pacta sunt servanda*<sup>1</sup> and the moralistic nature of obligation.<sup>2</sup> In 1897, Justice Holmes wrote in his well-known book *The Path of the Law*, “[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, and nothing else.”<sup>3</sup> Afterwards, this conception of contract became a dynamic support for the theory of efficient breach, which is assumed to have first appeared in Birmingham (1970)<sup>4</sup> and received its name from Goetz & Scott (1977).<sup>5</sup>

At the early stage, after the theory was born, it worked on one hand, on a superficial layer as a descriptive concept for a situation where breach of a contract would be profitable for the party who breached after placing the non-breaching party in as good a position as he would have occupied had the contract been performed.<sup>6</sup> In this situation, breach of contract, compared to performance, would make the promisor better off without making the promisee worse off. Hence, performing the original contract is assumed to be economically undesirable for the society. On the other hand, grounded in the theory of efficient breach, early scholars focused on the justification of EB and the doctrine’s contributions to the structure of contract law and contract

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1. “Pacta sunt servanda” is Latin for “agreement must be kept”.

2. Frank Menetrez, *Consequentialism, Promissory Obligation, and the Theory of Efficient Breach*, 47 UCLA L. REV. 859, 860 (2000); CHARLES FRIED, *CONTRACT AS PROMISE, A THEORY OF CONTRACTUAL OBLIGATION* 1-6 (Harvard Uni. Press 1981).

3. Oliver W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

4. Robert R. Birmingham, *Breach of Contract, Damages Measurex and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970).

5. Charles J. Goetz et al., *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 5 COLUM. L. REV. 554, 555 (1977).

6. Some scholars call the theory a simple efficient breach model, which makes a comparison between the cost of performance and the expected benefit. See, e.g., Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 949 (1982).

remedies. They asked whether or not breach is immoral and what the rules of contract law should be so as to provide incentives to parties to breach efficiently. It was proposed that the contract remedy rules should encourage breach when breach is efficient, but discourage it otherwise.<sup>7</sup>

The EB doctrine, in its simplest form, stops here and has been in debate since it first appeared in academic work. For instance, it is stated that the theory of efficient breach is cultivated in a simple and short-term mind without the consideration of long-term interests from cooperation. On the other hand, people argue that the moral and ethic factors contained in contract obligations have been ignored.<sup>8</sup> Furthermore, the significant disconnect between the theoretical hypothesis and legal realities put those early findings into plight.<sup>9</sup> After almost forty years of controversy, the topic of efficient breach has essentially lost its attraction in the normative construction of contract rules.<sup>10</sup> Since 2000, many scholars have raised radical attacks against this doctrine and suggested it be ended.<sup>11</sup> The plight of efficient breach theory also indicates the problems embedded in the law and economic analysis. As Posner indicated, the law and economic analysis of the last decades, has almost stayed at establishing economic models without explaining the existing law or examining the practical matters. As a result, the analysis has failed to produce a real economic theory of contract law and cannot provide a solid basis for criticizing and reforming contract law.<sup>12</sup> Starting from this point, this paper will not keep on building ideal efficient breach models, but it will set the efficient breach theory against the background of real law and analyze

7. Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 343 (1984).

8. See, e.g. Dawinder S. Sidhu, *A Crisis of Confidence and Legal Theory: Why the Economic Downturn Should Help Signal the End of the Doctrine of Efficient Breach*, 24 GEO. J. LEGAL ETHICS 357, 397 (2011).

9. *Id.* at 393.

10. Gregory Klass, *Efficient Breach*, in THE PHILOSOPHICAL FOUNDATIONS OF CONTRACT LAW 2-29 (Gregory Klass, G. Letsas & Prince Saprai eds., 2013), available at <http://ssrn.com/abstract=2228072> (last visited Mar. 29, 2014).

11. Sidhu, *supra* note 8, at 360.

12. "In the last ten years, theory has become divergent, and impasses have emerged. The simple models that dominated discussion prior to the 1990s do not predict observed contract doctrine. The more complex models that emerged in the 1980s and dominated discussion in the 1990s failed to predict doctrine or relied on variables that could not, as a practical matter, be measured. As a result, the predictions of these models are indeterminate, and the normative recommendations derived from them are implausible." See Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 830 (2003).

whether this doctrine can be promoted in the existing rules.

Another premise set in the beginning of this paper concerns a trend toward forming the Common European Contract Law. This development, also referred to as the Europeanization of contract law, was created by a number of factors including the increasing cross-border trade across the common European market, efforts from scholars, the European Union and the common law. Although some critical voices also arise, questioning the necessity and possibility of this undertaking of unification,<sup>13</sup> the topic of Europeanization is still being developed in both academic work and real practice for the purpose of achieving greater coherence and a more general common European civil law. In the present stage, the harmonization of European private law has gained great achievement, focusing on contract law, especially on sales contracts and consumer law. A recent achievement was presented as the publication of the European Proposal on Common European Sales Law<sup>14</sup> by the European Commission on October 11<sup>th</sup> 2011, which was largely based on the Draft Common Frame of Reference<sup>15</sup> and the previous Principles of European Contract Law<sup>16</sup> ("PECL" 1994). As is indicated in the beginning of the CESL, the purpose is to improve the conditions for the establishment and the functioning of the internal market by making available a uniform set of contract law rules.<sup>17</sup> Based

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13. For example, the Tiebout argument in favor of legislative competition provides a strong argument for decentralization of European law. As is pointed out, legal diversity contributes to the competition among different legal systems and in that sense increases the quality of law. Moreover, the "transaction costs" argument that has been pointed out by the traditional literature in favor of Europeanization has also been challenged. On the one hand, the cost of Europeanization is assumed to surpass the benefit brought out by this undertaking and on the other hand, the cost of transactions incurred by cultural, social or economic factors is thought to be larger than that is incurred by legal diversity. For more information about the debate on Europeanization and decentralization, see Michael. G. Faure, *How Law and Economics May Contribute to the Harmonization of Tort Law in Europe*, in GRUNDSTRUKTUREN DES EUROPÄISCHEN DELIKTSRECHTS 31 (Reinhard Zimmermann ed., 2003).

14. *Commission Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law*, COM (2011) 635 final (Oct. 11, 2011). The CESL is comprised of three main parts: a Regulation (hereinafter Reg. CESL), Annex I to the Regulation consisting of the contract law rules (hereinafter CESL), and Annex II containing a Standard Information Notice.

15. PRINCIPLES, DEFINITIONS AND MODEL RULES OF EUROPEAN PRIVATE LAW: DRAFT COMMON FRAME OF REFERENCE, OUTLINE EDITION (Christian von Bar et al. eds., 2009) [hereinafter DCFR].

16. PRINCIPLES OF EUROPEAN CONTRACT LAW, PART I (Ole Lando & Hugh Beale eds., vol. I, 1995); PRINCIPLES OF EUROPEAN CONTRACT LAW: PARTS I AND II (Ole Lando & Hugh Beale eds., 2000); PRINCIPLES OF EUROPEAN CONTRACT LAW, PART 3 (Ole Lando et al. eds., 2003) [hereinafter PECL].

17. Reg. CESL, *supra* note 14, art.1.

on this goal, the CESL provides a set of standard terms for cross-border sales covering contracts for the supply of goods to be manufactured or transferred and contracts for the supply of digital contents, as well as the service contracts related to the sales contracts.<sup>18</sup> Moreover, emphasis is placed specially on offering a specific, largely protective sales regime for consumers and small medium sized entrepreneurs (“SME”),<sup>19</sup> for whom negotiations about the applicable law are less possible.

Putting those two contexts together, the concern of this paper will be merely placed on the substantive content of those contract rules, which have been drafted in the CESL. The paper will answer to what extent efficient breach doctrine can be promoted within the content of the CSEL. Moreover, efficient breach in the past, to a large extent, is only considered as a seller’s breach and has been analyzed within the context of general sales contracts. The scope of this paper, however, will be narrowed down to the consumer contract in which one of the parties is a natural person and acting for purposes which are outside his trade, business, craft or profession. Following this logic, the structure of the contracts (“contracts for the supply of goods to be manufactured or transferred”) includes a business seller (or a producer), a consumer buyer, a duty to convey a property (or to produce a good) and a price.<sup>20</sup>

As is inferred from the doctrine of efficient breach, the primary issue driving the introduction of efficient breach theory is the situation where strictly performing the original contract is economically inefficient. To deal with this situation, the seller can choose to break the contract, or negotiate with the buyer or make a possible substitutive performance. Breach and compensation of the non-breaching party is just one option that a seller may choose and discussion about this issue can fit into a broader framework of law and economic analysis of contract law in which the basic hypothesis is that contract actors are rational and welfare maximizers. By the same token, the theory of

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18. *See id.* arts. 4-5.

19. CESL has made a clear differentiation between a trader and a consumer. As is given in Article 2 of the CESL Regulations, a “trader” means any natural or legal person who is acting for purposes relating to that person’s trade, business, craft, or profession.” *Id.* art. 2(e). A “consumer” means any natural person who is acting for purposes[,] which are outside that person’s trade, business, craft, or profession.” *Id.* art. 2(f). In addition, Article 7 of the CESL Regulations defines a small medium sized enterprise as “a trader which (a) employs fewer than 250 persons; and (b) has an annual turnover not exceeding EUR 50 million or an annual balance sheet total not exceeding €43 million, or, for an SME which has its habitual residence in a Member State whose currency is not the euro or in a third country, the equivalent amounts in the currency of that Member State or third country.” *Id.* art. 7, § 2.

20. In this section, the words “seller” and “buyer” will also be used in the same meaning as the words of “promisor” or “debtor” and “promisee” or “creditor.”

efficient breach may be applied to consumer contracts based on the assumption that both consumers and traders engage in contracting behavior to enhance their welfare which is measured by either wealth or happiness. Each party to the contract expects to receive more than he or she relinquishes.<sup>21</sup> Starting from this cognition, the discussion about efficient breach in this paper will focus on the CESL rules in relation to the situation where strictly performing the original contract is economically inefficient but neither party to the contract prefer welfare-decrease. In this sense, the doctrine of efficient breach provides a viewing point to make the economic analysis of the substantial rules of the CESL. To make this evaluation, Section 2 of this paper will first summarize what has been achieved in law and economic literature and establish the basic benchmarks for evaluating remedy rules. Afterwards, the general remedy system in EU sales contract law will be discussed in Section 3. In addition, the doctrine of efficient breach will be discussed. Although it has been discussed widely, in prior literature it was limited to the simplest model of non-performance. To overcome this problem, Section 4 will analyze the applicability of efficient breach under the context of specific types of breach.

## I. EFFICIENT BREACH IN AN ECONOMIC PERSPECTIVE

The terminology of efficient breach, which appeared in the literature, was used on the basis of general contracts. This section will give a brief introduction to the doctrine of efficient breach and assess what it can contribute to the structure of contract law, especially for the contract remedy rules.

### A. A Seller's Efficient Breach

The classical statement of efficient breach was indicated in Birmingham 1970 "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."<sup>22</sup> Around the same time, another paper by Scott and Goetz first used the concept of efficient breach.<sup>23</sup> Afterwards, this concept was largely cited as the basis for the common law remedy

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21. See Jan M. Smits, *Party Choice and the Common European Sales Law, or: How to Prevent the CESL from Becoming a Lemon on the Law Market* 8-9 (Maastricht European Private Law Inst., Working Paper No. 2012/13, 2012), available at <http://ssrn.com/abstract=2060017> (last visited Apr. 2, 2014).

22. Birmingham, *supra* note 4, at 284.

23. Goetz et al., *supra* note 5, at 557-59.

of expectation damages.<sup>24</sup> Under this concept it is required that the breacher pay damages in an amount that would make the victim of breach as well off as she would have been had the breach not occurred.<sup>25</sup> The reason is given as “if the promisor is willing to breach and pay damages equal to the promisee’s lost surplus, he must be earning a surplus from breach that is greater than the surplus yielded from performing the contract.”<sup>26</sup>

A party to a contract, therefore, is induced to breach as long as he is able to retain the remaining part of the profits yielded by his breach after compensating the expected loss of the other party. By this way, if a contract turns out to be disadvantageous or wasteful after its formation, the promisor to this contract can be released from it by paying damages rather than by seeking a successful renegotiation; similarly, if and only if a contract stays valuable, the promisor will complete it as agreed.<sup>27</sup> Moreover, in the case that one party breaks a contract, the non-breaching party is entitled to expectation damages so that he will be in the same position as if there had been performance. Therefore, the non-breaching party will be indifferent between having the breacher breach and pay damages or having the breacher perform the contract.<sup>28</sup> This situation is in accordance with the Potential Pareto Improvement (or Kaldor-Hicks improvement).<sup>29</sup>

Another inference derived from the early study of efficient

24. Peter Linzer, *On the Amoralism of Contract. Remedies—Efficiency, Equity, and the Second “Restatement”*, 81 COLUM. L. REV. 111, 111 (1981).

25. Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 N.Y.U. L. REV. 1679, 1680 (2008).

26. David W. Barnes, *Anatomy of Contract Damages and Efficient Breach Theory*, 6 S. CAL. INTERDISC. L.J. 397, 425 (1997-1998).

27. *Id.*

28. Richard Craswell defined the Indifference Principle as: “the stated goal of contract damages is to put the plaintiff in as good a position as he would have been in had the defendant kept his contract.” Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988).

29. ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 47 (6th ed. 2011). The potential Pareto efficiency is the modification of Pareto efficiency. The later one refers to a movement that makes at least one person better off and nobody worse off. It requires the gainer explicitly compensate the loser in any change. If there is no payment, the loser can veto any change. So any change is only possible by unanimous consent. However, according to Kaldor-Hicks efficiency, if a movement creates a winner and a loser but the winner can compensate the loser and still have some gain left, then the movement is efficient. Breach of a contract can be Kaldor-Hicks Efficient, but not Pareto Efficient. The breach may create a loser (promisee) although it can generate a higher surplus and enhance the net welfare. Therefore, only if the breacher can still be better off after he fully compensates the other party’s loss, the breach will eventually create a Pareto Efficient state. It is noted that the compensation by a contract-breacher should place the victim in the position that he would have been in had the contract been performed. *Id.*

breach doctrine was the critiques over penalty clauses (or punitive damages) that are created deliberately over-compensatory by the parties so as to deter breach or ensure performance. The penalty clauses, which are mostly created through a damage agreement (liquidated damages clauses) between the parties, are accused of causing a problem of overcompensation and deterring efficient breach.<sup>30</sup> That is, a promisee that is subject to penalty clauses will be motivated to take undue precaution and to always perform the contract in fear of paying penalty damages.<sup>31</sup> This idea has been incorporated into some courts' opinions in the U.S. One such case, *Leasing Serv. Corp. v. Justice & Childers*, states "contractual terms fixing damages in an amount clearly disproportionate to actual loss seek to deter breach through compulsion and have an in terrorem effect: fearing severe economic loss, the promisor is compelled to continue performance, while the promisee may reap a windfall in excess of his just compensation."<sup>32</sup>

Two simple models have been established for explaining the efficient breach theory. Suppose a contract, which is assumed to be advantageous to the parties at the time of contract formation.<sup>33</sup> After the contract is signed, a number of unspecified contingencies arise in the ongoing contract relationship, which might change an advantageous contract into a disadvantageous contract. When a contingency increases the performance cost so that performing the original contract will decrease the profits earned by the contract parties, the promisor will choose to breach the contract in order to avoid the cost of performance. This is referred to as an unfortunate contingency. In addition, after the formation of a contract, if an external buyer comes, willing to pay a price which is much higher than that of the original buyer, the seller will be motivated to breach in order to earn more surplus. This is a fortunate contingency.<sup>34</sup>

The following are examples of a fortunate contingency and an unfortunate contingency: Suppose Y agrees to produce a car and sell it to X at a price of €10,000. Suppose at the time when X and Y enter the contract, Y estimates the production cost of the car will be €5,000 but X estimates he can resell the car for €15,000. Two situations might

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30. Juan P. Moreno, *The Efficient Breach Hypothesis: Its Impact and Effect on the Penalty Clause as Defined under Colombian Law*, 1 ILL. BUS. L.J. 4, 5 (2010).

31. See Goetz et al., *supra* note 5, at 556.

32. Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 677 (2001).

33. At the time two parties enter a contract, both of the parties consider performance of the contract as efficient, otherwise the parties would not sign the contract.

34. COOTER & ULEN, *supra* note 29, at 325-26.



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happen after the formation of the contract. First, it might be an unfortunate contingency that increases the production cost (for concreteness, I will use PC to describe it) to €16,000.<sup>35</sup> Or, second, it might be a fortunate contingency that offers the seller Y another trading opportunity. Assume that Z approaches Y and explains that he desperately needs this car and he would pay €20,000. Suppose the car is worth €25,000 for Z and the highest price he would bid is €25,000.

Tables 1 and 2 indicate each party's surplus in the case when the performance cost increases and when a third party places a higher value on the car provided that perfect expectation damages can be awarded. In the first case, Y is supposed to be better off if he tries to seek a lease from performance by paying €15,000 as compensation rather than investing €16,000 in producing the car. Moreover, the buyer X may keep a fixed surplus of €5,000 no matter whether or not the contract is performed as long as a compensatory damage measure is available. In this sense, it is possible to reach a Pareto Efficiency through Y's non-production and avoid the decrease in the total surplus. Similarly, when the second scenario occurs, breaking the original contract and transferring the car to the alternative buyer may bring out a higher surplus of €20,000 than transferring the car to the original buyer does. Breach is efficient.

**Table 1. Surplus of Each Party if PC increases<sup>36</sup>**

PC=16,000	Y's decision	X	Y	Total
Expectation damages	<i>Perform</i>	€5,000	-€6,000	-€1,000
	<u><i>Breach (✓)</i></u>	<u>€5,000</u>	<u>-€5,000</u>	<u>0</u>

35. These two examples are modified from the examples that have been used by Cooter and Ulen. See *id.* at 326-31. Similar examination can be found in Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 CAL. L. REV. 975, 998-1015 (2005).

36. We use "N" to indicate the net profit, "p" to denote performance and "b" to denote breach. If Y performs the contract, each party's profit is calculated as:  $N_{px} = €15,000 - €10,000 = €5,000$ ;  $N_{py} = €10,000 - €16,000 = -€6,000$ . If Y decides not to perform, then each party's surplus is measured as:  $N_{bx} = €15,000 - €10,000 = €5,000$ ;  $N_{by} = 0 - N_{bx} = 0 - €5,000 = -€5,000$ .

**Table 2. Surplus of each party if a third party bids a higher price<sup>37</sup>**

		X	Y	Z	Total
<b>Value</b>		€15,000	€5,000	€25,000	
Expectation Damages	<b>Y sells the car to X</b>	€5,000	€5,000	0	€10,000
	<b>Y sells the car to Z</b>	€5,000	€10,000	€5,000	€20,000

### B. Efficient Breach, Negotiation and Remedies

As is indicated in the previous examples, the primary issue that motivates the scholars to talk about efficient breach theory is how to deal with the situations where breach of the contract will be more efficient than performing the contract. To deal with this situation, the parties have multiple solutions, either ex-ante or ex-post.

Through ex-ante negotiation, the parties can specify each other's rights and obligations in reaction to the possible uncertainties, such as writing a price reduction clause in case of a sharp increase in performance cost. Or they can decide how to react to those contingencies by ex-post renegotiation after disputes arise and try to use a more efficient contract to replace the previous one.<sup>38</sup> For example, after a second bargainer comes to a party to a contract, all the parties involved in this transaction may gather together and re-negotiate the price. Through this approach, a bidding war may occur and thus prevent the promisor from implementing the less efficient contract. Or, if a seller fails to sell a product to the buyer who values it more,<sup>39</sup> this buyer can transact with the buyer who received the product. In this way, resources will also be allocated to the best user in the end. What's more, since the parties are the best judge of their own benefits, the approach of ex-ante or ex-post negotiation may always achieve an efficient result.

37. When Y performs and the car is sold to X, each person's profit can be calculated as this: the  $N_{px} = €15,000 - €10,000 = €5,000$ ;  $N_{py} = €10,000 - €5,000 = €5,000$ ;  $N_z = 0$ ;  $N_{px} + N_{py} + N_z = €5,000 + €5,000 + 0 = €10,000$ . If Y breaches and resells the car to Z, then the net profits are calculated:  $N_{bx} = €15,000 - 10,000 = 5,000$ ;  $N_{by} = (€20,000 - €5,000) - (€15,000 - €10,000) = €10,000$ ;  $N_z = €25,000 - €20,000 = €5,000$ ;  $N_{bx} + N_{by} + N_z = €5,000 + €10,000 + €5,000 = €20,000$ .

38. COOTER & ULEN, *supra* note 29, at 326.

39. For example, a buyer who values a property less might have already received the goods according to the property law. For instance, in many civil law countries, registration is an important requirement for obtaining ownership over real property. Suppose there are two people who want to buy a house. If the first buyer has done the registration in the public authority, the second buyer cannot get the property, even if he is willing to pay a higher price.

However, ex-ante or ex-post negotiations might fail for several reasons. The trading parties' limitation of foresight may prevent contract parties from predicting all the possible events and writing a complete contract ex-ante; or the costs of negotiation and the conflicts in the parties' interests might sometimes discourage a successful renegotiation. In this sense, there is some space for legal rules, especially remedy rules, which may fill up the contract gaps and offer the conflicting parties a legal basis for solving the problem.

Within the framework of legal rules, nevertheless, different options are available for achieving an efficient consequence. Or in other words, legitimating breach and issuing expectation damages is far from the only way to avoid performance of an inefficient contract. In the simple efficient breach doctrine, the assumption that the approach of breach is economically efficient is based on two conditions: (1) the expectation damages may motivate those behaviours which will increase the total surplus created in the transaction ( $N_b = 0$  or  $€20,000 > N_p = -€1,000$  or  $€10,000$ ); and (2) the non-breaching party is able to get full compensation ( $L = €5,000$ ). Nevertheless, a similar result may be realized as long as the seller is not forced to strictly perform the original contract when a fortunate contingency or an unfortunate contingency occurs. For instance, even if the default remedy is specific performance, avoidance of an inefficient contract is still available. On the one hand, the parties may negotiate with each other in order to reach a desirable solution. When an unfortunate contingency arises, the seller might be willing to pay the buyer up to €5,999 for a release from the contract rather than loss €6,000 in producing the car; or the buyer would accept a price higher than €5,000 for the buyer's non-performance.<sup>40</sup> On the other hand, the law may set some exceptions to specific performance in reaction to the situation where performing the contract turns out to be socially inefficient. This refers to the impractical doctrine dealing with "the circumstances in which a party's performance is physically possible but will cause severe hardship".<sup>41</sup> Moreover, the goal of full compensation could be also, or even better, accomplished through the remedy of specific performance. Especially, when the subject of a contract is a unique good or subjective values have been attached to a contract, it is difficult for a court (a third party) to use the baseline of "market price difference" or "lost profits" to assess the amount of

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40. Klass, *supra* note 10, at 13.

41. Donald J. Smythe, *Impossibility and Impracticability*, in CONTRACT LAW AND ECONOMICS 2011, at 207 (6 ENCYCLOPEDIA OF LAW AND ECON., 2nd ed., 2011).

compensation.<sup>42</sup> In those cases, either determining the baseline for evaluating the subject of the contract is complicated or finding a substitution in the market is impossible. In addition to these two concerns which may influence the efficiency of the result, if more than one approach would lead to a similar result, then the difference in efficiency of the rules is related to the transaction costs under different rules.<sup>43</sup> Contractual parties are supposed to prefer the approach which is less costly so that their net profits from transactions are maximized. Therefore, if a contract dispute has been brought to a court, then the problem that should also be recognized is the level of transaction costs facing the plaintiff and the defendant under different remedy rules,<sup>44</sup> such as the cost of litigation, the cost of assessing damages or the cost of execution.

Beyond the worries within the expectation damages, questions arise as to the effect of punitive damages in relation to the possibility of efficient breach. In contrast to the traditional concerns about penalties' deterrence to efficient breach, my argument is that damages stipulated by parties have advantages in inducing rational decisions, precluding conflicts or costly litigation and allocating risks. Behavioural experiments and economic assumptions about rational theory add much more force to support this statement. For example, as is shown in either Gneezy & Rustichini's *Day-care Centre Study* (1998)<sup>45</sup> or Wilkinson-Ryan's observation of *Sick-leave Case* in the Boston Fire Department

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42. A non-breaching party's expectation loss can be calculated as the market price difference or the value difference. When a buyer breaches, the expectation loss of the seller is normally calculated as the discrepancy between the market price at the time when the breach occurs and the contract price. When a seller breaches, the expectation loss of the buyer is normally calculated as the difference between the contract price and the value that the buyer places on the contract-for goods. However, if the buyer has a substitutive offer after the breach happens, then what he has lost is the discrepancy between the price set in the substitutive contract and the price set in the original contract. For instance, suppose a contract to produce a product. If the parties agree on a price of €10,000 at the time of contract formation and the production cost is estimated to be €5,000, then the expected surplus of the producer is €5,000. Assume that the parties also learn that the market price for this product is assessed as €12,000. In this case, the expectation loss will be €2,000. COOPER & ULEN, *supra* note 29, at 309-10; Eisenberg, *supra* note 35, at 991.

43. Macneil, *supra* note 6, at 957.

44. Ulen, *supra* note 7, at 369.

45. In 1998, Gneezy and Rustichini made the famous study of the "day care centre" in Israel. They researched the relationship between a penalty and the possibility that parents pick up their kids late. A result is found that the number of late-coming parents increased significantly after a monetary fine is attached to the behavior of coming late. As is explained, introduction of a fine may remove the non-market nature that actors place on being late. Actors are willing to treat a fine as a price for being later and no guilt or shame will be attached to the act of buying a commodity. See Uri Gneezy & Aldo Rustichini, *A Fine is a Price*, 29 J. LEGAL STUD. 1 (2000).

(2001 – 2002)<sup>46</sup>, it is found that people's behaviour becomes more strategic and self-interested when the punishment of uncooperative behaviour (late coming, sick-leaving) has been clarified.<sup>47</sup> The reason, given by those observers, is that actors are more likely to deny social norms and moral concerns of complying promises and be more self-seeking when there is an explicit and real penalty for non-cooperation.<sup>48</sup> Therefore, efficient breach will be promoted rather than be deterred when there is an explicit arrangement of contract damages. Moreover, within the dimension of rational theory, it is inferred that the permission of penalty clauses would encourage other rational behaviour beyond efficient breach. An example is that offering contract parties more freedom in drafting damages clauses would promote risk-allocation and "a penalty clause may represent the best effort of the parties to allocate risk"<sup>49</sup> because people would carefully stipulate the amount of compensation in relation to each party's risk attitude rather than agree on an amount which is unreasonably high. If the seller is risk-averse, the seller would prefer a kind of damage payment that will guarantee him a fixed profit and is unaffected by neither the performance cost nor any outsider's offer.<sup>50</sup> The seller would not accept any damage measure that is higher than the expected loss suffered by the buyer and penalty clauses will not be drafted into the contract. In another case where a seller is risk-preferring or risk-neutral and a buyer is risk-averse, the parties might use a high amount of damages to shift the risk of non-performance from the buyer to the seller.<sup>51</sup> However, it is hardly for the

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46. "In December of 2001, the Boston Fire Department changed its sick-leave policy to allow fifteen sick days per year. The previous system had allowed unlimited sick time, and the new rule was part of an initiative to bring professional management tools to the department. In 2001, firefighters took a total of 6,432 sick days. In 2002, the total number of sick days rose to 13,431—more than double the previous year." Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, 108 MICH. L. REV. 633, 635 (2010).

47. Daniel Houser et. al., *When Punishment Fails: Research on Sanctions, Intentions and Non-Cooperation*, 62 GAMES ECON. BEHAVIOR 509, 522-23 (2008).

48. DiMatteo, *supra* note 32, at 705; Wilkinson-Ryan, *supra* note 46, at 664.

49. Wilkinson-Ryan, *supra* note 46, at 644.

50. Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 706 (1986).

51. The risk-averse buyer is willing to pay a premium in advance so as to shift the risk to the seller. So he would accept to pay a higher amount of contract price. *See id.* at 705-06. As is stated:

If the seller is risk neutral and the buyer is risk averse, it is beneficial to both parties for the seller to insure the buyer. . . . Damages in excess of full compensation would not appeal to a risk-averse buyer because he would face an unwanted variation in his income, depending on whether the product failed. He would not wish to pay a higher price for the product. . . . If the buyer is risk preferring, a clause that specified

parties to reach an extremely high amount of damage payment which is only aimed for punishing breach provided the process of contracting is based on equal condition. In one aspect, the party who bears a risk of paying penalty damages would require a higher price to cover any increase in the cost of performance.<sup>52</sup> The higher the amount of damages, the higher the price the buyer has to pay. So the buyer has no incentive to require unreasonably high damages. In another aspect, there is rare example in the commercial context where a seller is in favour of risk or gambling and would accept an unreasonable penalty clause.

### C. Implications for the Structure of Contract Remedies Rules

Put all those questions together and the simple efficient breach theory is not as convincing as what was assumed in the early stage. As shown in the previous section, a single expectation damages rule may not reach the ideal result which is consistent with the efficient breach model. Moreover, social or economic factors other than the threat of legal liability will also influence the possibility of efficient breach, such as the fear of losing reputation or the long-term benefit in cooperation. Today, few scholars are in favour of the simple efficient breach doctrine. However, the doctrine of efficient breach is still valuable in the sense that it opens a window for evaluating contractual behaviour and assessing legal remedies in a wider perspective. In response to the unspecified risks arising after the contract formation, the efficient breach doctrine is an optional approach that would be taken by legislators and contract parties. In this paper, three implications of efficient breach theory on contract remedy rules are drawn.

One of the most important implications is that by differentiating an efficient performance zone (or inefficient breach zone) and an efficient breach zone (or inefficient performance zone), the doctrine makes us re-think the behaviour that either falls into the efficient breach zone or into the efficient performance zone.<sup>53</sup> Take the previous case set in Section 2.1 as an example; the efficient breach point is where the production cost increases to €15,000 or the external bidder values the car for €15,000. If the production cost increases to higher than €15,000,

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damages in excess of losses would provide an opportunity to gamble.

Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147, 152 (1984).

52. Kornhauser, *supra* note 50, at 720.

53. Gerrit De Geest, *Specific Performance, Damages and Unforeseen Contingencies in the Draft Common Frame of Reference*, in *ECONOMIC ANALYSIS OF THE DCFR: THE WORK OF THE ECONOMIC IMPACT GROUP WITHIN COPECL NETWORK OF EXCELLENCE* 123, 126-27 (Filomena Chirico & Pierre Larouche eds., Munich: Sellier 2010).

the entire surplus produced by the original contract will be consumed by the increasing production cost and the contract will turn into the efficient breach zone. Within the efficient breach zone, breach would be efficient because it produces higher surplus than performance does for the society. In another sense, a slight increase in performance cost (for example,  $PC = \text{€}1000$ ) would not necessarily denote an efficient breach. Moreover, breaches in reality actually involve other types of costs such as the litigation cost, cost of damage calculation and the loss of reputation and future trading opportunities, other than the cost of legal liability.<sup>54</sup> Thus, when, and only when the extent of the increase is clear and well beyond the normal range, performance of the contract will become inefficient. By the same token, only when a second buyer comes with a price which is much higher than the value that the first buyer would pay, does breach of the original contract fall into the efficient breach zone.<sup>55</sup> In addition, another interesting topic arousing quite a lot of discussions in law and economics refers to the concept of opportunistic breach. A breach is deemed as opportunistic when "one-party attempts to reap the benefit of the bargain without bearing the agreed-upon cost".<sup>56</sup> For example, a seller may appropriate all the prepayment by the buyer and invest the money in other uses without providing reciprocal performance.<sup>57</sup> We may want the law of contracts to discourage this type of breach and consider depriving the actor of all the benefits he could obtain from the opportunism.

Another lesson we can learn from the efficient breach theory is that remedies for breach may have multiple influences over the whole transaction. One important example is that the contract remedy has an influence on a person's breach-or-perform decision. By realizing this, we can better evaluate how contract remedies would affect people's incentives to behave intentionally.<sup>58</sup> To promote efficient breach and avoid wasteful performance, the contract law should create incentives to

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54. See *id.*; HANS-BERND SCHÄFER & CLAUS OTT, *THE ECONOMIC ANALYSIS OF CIVIL LAW* 320-24 (Matthew Braham trans., Edward Elgar Publ'g 2004).

55. Or a second seller is willing to accept a price which is much lower than that the lowest price the first seller would accept.

56. Klass, *supra* note 10, at 10.

57. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 118-19 (8th ed. 2011).

58. For instance, Barnes observes that the efficient breach theory is an example that scholars study the relationship between damages rules and surplus-increasing breach. See Barnes, *supra* note 26, at 398 ("The topic of greatest scholarly interest, judicial notice, and casebook teaching is the effect of rules on incentives to break promises intentionally. . . . Economists conclude that contract damage rules tend to provide incentives to breach contracts that align the self-interested preferences of a person contemplating breach with society's interest in ensuring that its scarce resources are used wisely.").

breach in the circumstances where breach may lead to a higher sum of surpluses than that yielded by performance and vice versa. On the one hand, the law should not force a promisor to strictly perform the original contract in the situation when a contract falls into the efficient breach zone. It does not necessarily require that expectation damages should be set as the default remedy. On the other hand, the remedy rules should be able to protect the expectation interest of the promisee, namely, to put the promisee in the same position as she would have been had the contract been performed.

The third point, that we can infer from the efficient breach doctrine is related to the freedom in contracting and renegotiation. As is noted, breach and compensation is the second-best tool for welfare maximization in many occasions. A more desirable approach to achieving an efficient result derives from private negotiation. After all, contract parties are better than courts or legal scholars at assessing their own preferences and working for their own welfare. They know more about how to deal with risks in their transactions, which kind of breaches are clearly efficient and should be priced rather than punished, through which remedy they can avoid inefficient breach more cheaply and so on.<sup>59</sup> We want the law to facilitate parties' ex-ante and ex-post contracting. One important point is to diminish mandatory rules in contract law and give parties more freedom in choosing their own remedies. For example, courts should reduce inference with liquidated damage clauses. Rather than scrutinize over the amount of damages stipulated by contract parties, a more preferable way for courts is to evaluate the formation process of those clauses.

Based on those three points, this paper will address some specific questions in relation to the application of efficient breach theory in the CSEL. With regard to the general case of breach and remedy, it is necessary to figure out the line between the efficient breach zone and the efficient performance zone drawn by the CESL and the CESL's approach to dealing with the situation where a contract falls into each zone. In addition, the findings deriving from the study of the general breach case will be put in the context of specific breach cases in order to examine the possibility of different types of efficient breach.

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59. Klass, *supra* note 10, at 24.



## II. APPLICATION OF THE EFFICIENT BREACH DOCTRINE IN THE GENERAL RULES OF THE CESL

As shown in the previous section, one important topic driving the discussion of efficient breach theory arises from the situations where breach of the contract is more efficient than performance. Using the economic surplus standard, a contract either falls into the efficient breach zone or into the efficient performance zone. According to economic theory, contract law should aim to optimize the contracting parties' incentives to take efficient actions, or to facilitate their abilities to maximize welfare from transactions.<sup>60</sup> It is assumed, based on this insight, that contract law should be able to motivate contract parties to avoid strict performance of a contract when it falls into the efficient breach zone, but encourage performance otherwise.

The proposal for regulation defines the CESL's scope to sales contract, covering contracts for transferring ownership of goods and contracts for the supply of goods to be manufactured or produced. As is noticed, one important feature of the sales contracts shaped by the CESL is the sharp distinction made between the business contracts (hereinafter B2B contracts) and the consumer contracts (hereinafter B2C contracts). However, the fundamental structures of these two types of contractual relationships are quite similar. Both the consumer party and the business party engage in transactions for their own profits, as a result of which, contracts entered into voluntarily by the parties will lead to welfare enhancement.<sup>61</sup> In the absence of a fully complete contract,<sup>62</sup> potential risks or opportunistic behaviour may arise in the contractual relationship and thus decrease or eliminate the utility of the contract. There are several factors leading to the incompleteness of a contract, such as the transaction costs<sup>63</sup>, or the limited foresight of the

60. Cf. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113. YALE L.J. 541, 544 (2003).

61. Smits, *supra* note 21, at 6.

62. Assume a complete contract. Then the trading parties have to consider every risk, consequence, possible opportunistic behaviour of the other one, etc. ("contingently completeness"). Correspondingly, the contract should specify the exact actions that one party should perform when every risk happens. For example, it should include the time, place, way and quality of performance ("obligationally completeness"). See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992).

63. In order to draft a complete contract, the trading parties have to take all the potential risks into account and deal in their contract with all of the risk in a specific way. Drafting complete contracts incurs the cost of searching information, the cost of negotiation and so on. Hence, a low possibility risk or insignificant risk may always be neglected by the contracting parties. See STEVEN SHAVELL, *FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW* 299-301 (Harvard Univ. Press 2004).

parties. Moreover, the risk of opportunism increases in consumer contracts caused by consumers' lack of information, the absence of a truly competitive market or even the standard form contracts that are not subject to negotiation.<sup>64</sup> As a result, the contract that was assumed to be efficient at the time of conclusion may turn out to be wasteful because the cost of implementing the original contract increases or businesses may opportunistically try to cut down the investment in the performance of a binding contract. Taking those concerns into account, there is space for introducing legal interference into consumer contracts in order to shape the parties' incentives to taking proper behaviour, for instance, to motivate a business party to comply with what he has agreed. What is debatable, however, is the desirable extent of legal interference. Applied to consumer contracts, if the law imposes a high requirement for performance on the business party, this would be converted into the price of the product or shrink the supply of products and hence to a decrease in social welfare.<sup>65</sup>

This section will discuss the general attitude taken by the CESL toward breach, remedies and efficient breach zone.

#### *A. Seller's Breach and Buyer's Remedy in General*

The central concept stressed in this paper refers to "breach". However, instead of using the concept of "breach", the CESL uses the term "non-performance" to include any failure to perform a contract obligation, regardless of whether the failure is excused.<sup>66</sup> Part IV of the

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64. In a normal case, the consumer contract is presented as a standard form contract in which the consumer cannot negotiate individually but can only "take it or leave it". As is argued by Slawson, *infra*, about 99% of consumer contracts are standard form contracts. In economic theory, standard contracts are preferable for the concern of lowering transaction cost. As to the consumer contract, which occurs at regular basis, it is costly for the business to negotiate with consumers individually. However, in another sense, consumers are compelled to adhere to the standard terms in the contract and the situation for the consumer is worse off if the business tries to exploit economic benefits without bearing any cost. See W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971); Cf. Michael J. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 594-608 (1990).

65. Smits, *supra* note 21, at 9.

66. The term of "non-performance" instead of "breach" has also been used in PECL, as well as subsequent European soft law texts. For example, Chapter 8 of PECL provides rules on "Non-Performance and Remedies in General"; Chapter III of Book III of DCFR offers the rules about "Remedies for Non-performance". In the CESL, Chapter 11 addresses "the buyer's remedies" and chapter 13 addresses "the seller's remedies". PRINCIPLES, DEFINITIONS AND MODEL RULES OF EUROPEAN PRIVATE LAW, *supra* note 15; PRINCIPLES OF EUROPEAN CONTRACT LAW, *supra* note 16; *Commission Proposal for a Regulation of the European Parliament and of the Council on a Common European Sales Law*, *supra* note 14.

CESL sets out the framework of the contractual parties' obligations and remedies. Cases of breach might be presented either as a business seller's breach or a consumer buyer's breach. This section will focus on the basic structure of a business seller's breach and a consumer buyer's remedies as indicated in the CESL.

Article 87 of the CESL includes two major types of a seller's non-performance, covering the situations where a seller fails to deliver the goods ("non-delivery") or the goods delivered are not in conformity with the contract ("non-conformity"). Breach of an obligation is the condition for awarding a consumer remedies. Generally, a consumer buyer is provided with a set of standard remedies in Article 106.<sup>67</sup> As is indicated, in the case that a breach takes place, a consumer buyer may require: (1) Performance (including specific performance, repair or replacement);<sup>68</sup> (2) Withholding the buyer's own performance<sup>69</sup> (usually payment of money); (3) Terminating the contract;<sup>70</sup> (4) Declaring a price reduction<sup>71</sup>; or (5) Claiming damages.<sup>72</sup>

Moreover, Article 106 contains important information for the consumer party, namely that the consumer is provided with a free choice of remedies and Article 108 adds mandatory nature to the general application of remedies rules in B2C contracts.<sup>73</sup> On the one hand, it means that a consumer buyer may either choose among any of the remedies listed in Article 106, or resort to more than one remedy in

67. CESL, *supra* note 14, art. 106, §§1, 3.

68. *Id.* art. 110, §1 (entitling the buyer to require performance of the seller's obligations).

69. *Id.* art. 113, §1 (stating that a buyer who performs at the same time as, or after, the seller performs, has a right to withhold performance until the seller has tendered performance or has performed).

70. *Id.* art. 114, §§1, 2 (stating that a buyer may terminate the contract within the meaning of Article 8 if the seller's non-performance under the contract is fundamental within the meaning of Article 87; in a consumer sales contract and a contract for the supply of digital content between a trader and a consumer, where there is a non-performance because the goods do not conform to the contract, the consumer may terminate the contract unless the lack of conformity is insignificant).

71. *Id.* art. 120, §1 (stating that a buyer who accepts a performance not conforming to the contract may reduce the price; the reduction is to be proportionate to the decrease in the value of what was received in performance at the time performance was made compared to the value of what would have been received by a conforming performance).

72. CESL, *supra* note 14, art. 159, §§1, 2 (stating that a creditor is entitled to damages for loss caused by the non-performance of an obligation by the debtor, unless the non-performance is excused; the loss for which damages are recoverable includes future loss which the debtor could expect to occur).

73. *Id.* art. 108 (stating that in a contract between a trader and a consumer, the parties may not, to the detriment of the consumer, exclude the application of this Chapter, or derogate from or vary its effect before the lack of conformity is brought to the trader's attention by the consumer).

the same case as long as the remedies he chooses are not incompatible. For instance, if a buyer chooses to terminate a contract, it means the bond created by the contract will be brought to an end and he cannot ask for repair or replacement. On the other hand, the consumer's free choice is not subject to cure by the seller, which is stated in Article 106(3).<sup>74</sup> Article 109 follows by specifying that the "cure" by a seller in the case of "non-conformity". As is shown, a seller whose early tender was not in conformity with the contract may make a new and conforming tender within the time allowed for performance or cure the defect at its own expense even after the time allowed for performance.<sup>75</sup> The buyer may terminate the contract if the non-conformity amounts to being fundamental.<sup>76</sup> This is the normal case in commercial sales, where both the seller and the buyer are professional businessmen, but not in the B2C contract. The message conveyed in Article 106(3) is that a consumer buyer has great freedom in choosing remedies. He may require the seller to either repair the defects in the goods he received or change the defective goods into conforming goods. But more importantly, the consumer is able to turn down any offer by the seller to cure so as to require price reduction, damages, or termination of the contract immediately.<sup>77</sup> The application of the remedy is at the consumer's choice. Furthermore, Article 114 adds that consumers may terminate the contract even when the lack of conformity is not fundamental, enhancing a consumer's free choice of remedies. Meanwhile, the application of a consumer buyer's remedies is mandatory so that the parties may not exclude it or derogate from or vary its effect in advance. However, the consumer's free choice of remedies is not absolute. The type of remedies that are available to a consumer buyer depends on the specific type of breach. Following Article 106, the CESL adds more provisions, coordinating the

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74. *Id.* art. 106, §3 (stating that "if the buyer is a consumer: (a) the buyer's rights are not subject to cure by the seller. . .").

75. *Id.* art. 109, §1 (stating that "a seller who has tendered performance early and who has been notified that the performance is not in conformity with the contract may make a new and conforming tender if that can be done within the time allowed for performance").

76. *Id.* art. 114, §1 (stating that "buyer may terminate the contract within the meaning of Article 8 if the seller's non-performance under the contract is fundamental within the meaning of Article 87 (2)").

77. See CESL, *supra* note 14, art. 114, §2; see also Gerhard Wagner, *Buyers' Remedies under the CESL: Rejection, Rescission, and the Seller's Right to Cure* (Apr. 5, 2012), available at <http://www.law.uchicago.edu/files/files/Wagner%20paper.pdf> (last visited Mar. 26, 2014) (presentation at the University of Chicago to Host Conference on European Contract Law); see also Régine Feltkamp & Frédéric Vanbossele, *The Optional Common European Sales Law: Better Buyer's Remedies for Seller's Non-performance in Sales of Goods?*, 6 EUR. REV. PRIV. L. 873, 894 (2011).

application of different types of remedies in specific types of breach, which will be discussed in Section 4.

### *B. Damage Rules*

As to the damages rules, the CESL has a separate part (Part VI) covering the issue of damage measurement, types of damages and conditions for damages.

Following the CISG and the DCFR,<sup>78</sup> the CESL also sets the aim of damages as compensatory; namely, it aims to make a non-breaching party indifferent to breach and performance of the contract.<sup>79</sup> As Article 160 indicates, “the general measure of damages for loss caused by non-performance of an obligation is such sum as will put the creditor into the position in which the creditor would have been if the obligation had been duly performed, or, where that is not possible, as nearly as possible into that position.” Article 160 also adds that the damages cover the loss which the creditor has suffered and the gain of which the creditor has been deprived, which includes a future loss caused by the breach of contract. Inferring from Article 165 of the CESL, a creditor’s loss from non-performance is generally measured by the discrepancy between the contract price and the market price. But Article 164 adds that if the creditor has arranged an alternative transaction to replace the original transaction reasonably, he could recover the shortfall between the value of what would have been payable under the terminated contract and the value of what is payable under the substitute transaction.<sup>80</sup> Suppose the buyer has arranged an alternative sale in which he paid a price ( $P'$ ) higher than the contract price ( $P$ ); what he can then recover on the basis of Article 164 is the discrepancy between  $P'$  and  $P$ , namely  $P' - P$ . A problem occurs in the situation where the buyer has arranged a cheaper substitutive transaction ( $P' < P$ ). In addressing the principle of “full compensation”, the commentary to the CESL states that “if the creditor’s loss is higher, he retains the right to recover the loss through a claim for damages on the basis of Article 159.”<sup>81</sup> However, in the case where a buyer could arrange a cheaper alternative purchase, the buyer actually suffers no loss and cannot obtain any compensation. As is shown, the CESL tries to entitle a creditor to his real loss rather than to

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78. See United Nations Convention on Contracts for the International Sale of Goods, arts. 74-5, Apr. 11, 1980, 1489 U.N.T.S. 3. [hereinafter CISG]; see also DCFR, *supra* note 15, bk. III, sec. 3-702.

79. COMMON EUROPEAN SALES LAW (CESL) COMMENTARY, 639-40 (Reiner Schulze ed., Nomos Verlagsgesellschaft et al., 2012) [hereinafter CESL COMMENTARY].

80. See CESL, *supra* note 14, arts. 164-65.

81. See CESL COMMENTARY, *supra* note 79, at 652.

motivate the creditor to make the best possible substitutive transaction.

The CESL, moreover, sets several limits and conditions on the expectation measure as well. First, not all types of loss are recoverable. Article 2 of the CESL specifies the losses that are recoverable by limiting them to economic loss and non-economic loss in the form of physical pain and suffering. Other forms of non-economic loss such as impairment of the quality of life and loss of enjoyment are precluded from recovery with emphasis. The second limit to expectation damages derives from the famous Hadly rules<sup>82</sup>, namely, a debtor is only liable for losses that he could foresee or could be expected to have foreseen when the contract was concluded as a possible consequence of his breach.<sup>83</sup> This is in accordance with one of the requirements needed for an efficient breach to take place. As is assumed, the debtor to a contract has to obtain sufficient information concerning the cost and the benefit of breach in order to assess whether it is more profitable to breach, to perform, or to negotiate with the other party. The Hadly rule builds a bridge between the debtor's incentive to breach and the creditor's incentive to disclose information in terms of his expected loss from the non-performance of the contract. Since the damages are limited to the loss that is foreseeable by the debtor at the time of contract conclusion, the buyer has to disclose as much information as possible at the stage of contract formation in order to fully recover his loss from the non-performance. Another condition for awarding expectation damages is the causal relationship between nonperformance and loss. However, the CESL doesn't establish any standard for evaluating this causal relationship.<sup>84</sup> In addition, the CESL exempts the debtor from compensating the loss to the extent that the creditor contributed to the non-performance or its effects, or the creditor omitted reasonable steps

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82. The Hadley Rule derives from the famous English case of *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Exch.); 9 Exch. 341. Two implications were drawn from this case:

(1)[T]hat it is not always wise to make the defaulting promisor pay for all the damage which follows as a consequence of his breach, and (2) that specifically the proper test for determining whether particular items of damage should be compensable is to inquire whether they should have been foreseen by the promisor at the time of the contract.

As is suggested, the "foreseeability" test is subject to defining what a hypothetical reasonable man would have foreseen at the time he signed the contract. See L. L. Fuller & William R. Perdue, *Reliance Interest in Contract Damages*: 1, 46 *YALE L. J.* 52, 84-85 (1936).

83. CESL, *supra* note 14, art. 161.

84. The commentary under Book III, §3-701 of the DCFR provides a basic standard for evaluating causation between non-performance and loss. As is required, the creditor can only recover the losses that would not have occurred without the failure in performance. DCFR, *supra* note 15, bk. III, sec. 3-701, comment B.

to reduce the loss.<sup>85</sup>

The CESL is silent in terms of the party-designed damages for the seller's non-performance. In the previous example, both PECL and DCFR take a similar approach toward party-designed damages as that of the "Resolution on Penalty Clause" (RPC 1971).<sup>86</sup> The attitude is to distinguish normal liquidated damages from pure penalty clauses. Liquidated damages, which are higher than the damages payable for breach, are generally allowed and enforceable. But in the situation where the damage clause has specified an excessive amount of damages disproportionate to the actual loss from non-performance, the court is authorized to reduce the sum of damages. The CESL, in contrast, doesn't incorporate this kind of rule. The CESL's concentration on regulating "unfair contract terms" in B2C contracts or B2B (SMEs) contracts to some extent is relevant to its silence in addressing the rule on liquidated damages or penalty clauses. In the context of a consumer contract, the contract usually takes the form of a standard contract drafted only by the business party and the consumer may either "agree or leave". Logically, the business party would not specify any damage clause against his own interest. Rather, the problem in standard contract terms arises from the business' advantageous position in drafting unfair terms that are unfavorable to the consumer, such as penalty clauses for consumers' non-performance. The business party has the incentive to insert an unfair penalty clause as long as his marginal cost of doing so is lower than the marginal value.<sup>87</sup> Then a desirable way of eliminating unfair penalty terms is to invalidate them. Article 85 of the CESL indicates that "a contract term is presumed to be unfair if its object or effect is to. . .(e) require a consumer who fails to perform obligations under the contract to pay a disproportionately high amount by way of damages or a stipulated payment for non-performance. . . ." If the damages clause is presumed unfair, it is not binding on the consumer party unless the business can prove it is not unfair.<sup>88</sup> By default, it is inferred that the CESL allows general liquidated damages but only excludes penalty clauses against consumer parties that have failed the

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85. CESL, *supra* note 14, arts. 162-63.

86. Resolution (78) 3 of the Committee of Ministers of the Council of Europe, Relating to Penal Clauses in Civil Law art. 7 (1978). "The sum stipulated may be reduced by the court when it is manifestly excessive. In particular, reduction may be made when the principal obligation has been performed in part. The sum may not be reduced below the damages payable for failure to perform the obligation. Any stipulation contrary to the provisions of this article shall be void." *Id.* Similar articles are §9:509 PECL, *supra* note 16, and Book III, sec. 3-702 of DCFR, *supra* note 15.

87. Meyerson, *supra* note 64, at 606-07.

88. CESL, *supra* note 14, arts. 79, 83, 85.

“Unfair Contract Terms” test.

### *C. Rules in the Efficient Performance Zone*

In economic theory, actors engage in contracting in order to enhance their welfare, thus the law should motivate the parties to comply with their agreement. Accordingly, breach of a mutually agreed upon contract should be refrained from unless performance of the contract would decrease the social welfare. Within a trade between a business and a consumer, the seller is motivated to comply with the contract consciously, by either the goal of earning money, his personal values, or as a means to protect his professional reputation.<sup>89</sup> Moreover, legal rules encourage performance in the efficient performance zone by, for instance, imposing obligations on the contracting parties and creating remedy rules for a non-breaching party that may increase the cost of breach and alter a promisor's incentive to breach. The CESL adopted this notion of encouraging the performance of those contracts within the efficient performance zone.

A general issue stressed in relation to the efficient performance zone concerns the remedies that are available to the buyer. According to Article 106 of the CESL, a hierarchy does not exist among those remedies. Within the five types of remedies provided by the CESL, performance is regarded as an important remedy arising from non-performance but not as the primary one.<sup>90</sup> Article 106(1) and Article 110(1) set the general provisions entitling a buyer to performance, including claiming specific performance, repair of the goods, or replacement of the goods. Basically, if a seller fails to deliver the goods or the goods delivered are not in conformity with the contract, the buyer may ask for delivery, repair or replacement unless some specific conditions set out in the CESL are satisfied.<sup>91</sup> Provided that the performance claim is available to the buyer, the seller's principal reaction to a contract will not be to breach, but rather to comply with the contract or negotiate with the buyer in order to buy the non-performance. Moreover, what motivates the seller to perform at an optimal level is a whole system composed of both legal and non-legal incentives.<sup>92</sup> Within the legal system, remedies beyond specific

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89. SCHÄFER & OTT, *supra* note 54, at 277.

90. Feltkamp & Vanbossele, *supra* note 77, at 891-92.

91. Section 3.4, *infra*, will discuss the exceptions to the claim of specific performance.

92. In terms of non-legal incentives, reputation and economic surplus may induce performance. For example, the seller is willing to perform in order to obtain reciprocal performance by the buyer; or he has to keep his promise in order to sustain a good reputation within the common playing field. See Schwartz & Scott, *supra* note 60, at 557-



performance and damages may also provide such deterrence to non-performance. For example, by withholding the obligation to pay, the buyer can, on the one hand shift away the risk of losing the value of his monetary payment if the seller fails to perform<sup>93</sup> and on the other hand, induce the seller to accomplish due performance since the seller expects economic surplus from the payment.

Within the efficient performance zone, Article 89(1) of the CESL recognizes a situation where performance of a contract has become more onerous, but the surplus from performance is still assumed to be higher than that from non-performance under the heading of "Change of Circumstances". Article 89 also provides two types of contingencies which may cause onerosity in performance, namely, an increase in the cost of performance, or a decrease in the value of what is to be received by a seller. Nevertheless, to be mentioned, the seller's obligation to perform the contract in general will not be affected if the extent that performance becomes more onerous is not great. In this sense, if a seller refuses to deliver the goods as required, or delivers defective goods merely on the ground of a minor difficulty in performance, the buyer may still make a claim for remedies including requiring performance.<sup>94</sup>

#### *D. Rules in the Efficient Breach Zone*

Following the theory of efficient breach, a contract falls into the efficient breach zone when an unexpected contingency arises so that the performance of the contract will create less profit than the breach does. As is noted in Section 2, either a drastic increase in performance cost, or an extremely high bid by a third party may bring a contract into the efficient breach zone. In the efficient breach zone, performance of the original contract should be refrained from so as to avoid economic waste and to enhance the total welfare that the contract parties obtain. Two questions will be stressed in this section: (1) When does a contract fall into efficient breach zone?; and (2) How does the CESL deal with the situations when the contract is in the efficient breach zone?

##### *1. When Will Contracts Fall into the Efficient Breach Zone?*

The CESL provides three examples where a seller's obligation to perform will be influenced, by the doctrine of efficient breach: (1)

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93. CESL COMMENTARY, *supra* note 79, at 514.

94. CESL, *supra* note 14, art. 89. More discussion about Article 89 will be presented in Section 3.4.1, *infra*.

“Excused Non-performance,” (2) “Change of Circumstance” and (3) “Impossibility or Impracticability.”

First, Article 88 provides the doctrine of “Excuse,”<sup>95</sup> referring to an impediment which is beyond the non-performing party’s control, and where that party could not be expected to have taken the impediment into account at the time when the contract was formed, or to have avoided or overcome the impediment or its consequences.<sup>96</sup> However, the CESL doesn’t give further explanation of prerequisites for “excused non-performance” or show any examples which may be recognized as these kind of impediments. The situation described in Article 89 can also be covered by the civil law principle of “Force Majeure,”<sup>97</sup> which is widely used in literature.<sup>98</sup> The requirements for recognizing force majeure can be traced back to the previous documents that Article 88 of CESL is based on. For example, the ICC Force Majeure Clause 2003 sets out that: (1) the impediment must be out of the debtor’s control, or not fall in the sphere of risk of the debtor; (2) it must have been unforeseeable at the time of contract formation; and (3) it or its consequences must have been unavoidable. It lists some typical events that amount to impediments, such as war, natural disasters or acts of terrorism. In addition, the commentary below Book III, Section 3:104 of DCFR provides some examples to show when an obstacle should be recognized as an insurmountable impediment that is outside of the debtor’s control and could not been taken into account by the debtor.

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95. Article 79(1) of CISG, Article 8:808(1) of PECL 1999 and Book III, Section 3-104(1) of DCFR 2008 are practically similar to Article 88(1) of CESL.

96. CESL, *supra* note 14, art. 88, §1.

97. Ingeborg Schwenzer, *The Proposed Common European Sales Law and the Convention on the International Sale of Goods*, 44 UCC L.J. 457, 469-71 (2012).

98. The principle of force majeure originated in the French Civil code of 1804. See CODE CIVIL [C. CIV.] art. 1148 (Fr.) (“There is no occasion for any damages where a debtor was prevented from transferring or from doing that to which he was bound, or did what was forbidden to him, by reason of force majeure or of a fortuitous event.”). International Institute for the Unification of Private Law, *Principles of International Commercial Contracts*, 169 (1994), available at <http://www.unidroit.org/english/principles/contracts/principles1994/1994fulltext-english.pdf> (last visited Apr. 1, 2014) [hereinafter UNIDROIT PRINCIPLES]. There are also other terms to describe similar supervening events that make contract performance impossible. For instance, the English law principle of “frustration” or German law principle of “impossibility”. In many situations, those terms are used interchangeably, except for some subtle difference. For instance, the English principle of frustration has a broader meaning, including that “which renders the contract something radically different from that which was in the contemplation of the parties.” See Peter Mazzacano, *Force Majeure, Impossibility, Frustration & the Like: Excuses for Non-Performance; the Historical Origins and Development of an Autonomous Commercial Norm in the CISG*, 2 NORDIC J. C. L. 38, 38-45 (2012), available at <http://ssrn.com/abstract=1982895> (last visited Apr. 1, 2014); see also HUGH BEALE ET AL., *CASES, MATERIALS AND TEXT ON CONTRACT LAW* 1106 (2d. ed. 2010).

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As is shown, an unexpected strike in the nationalised company which distributes natural gas can be recognized as out of the control of a debtor who only heats its furnaces with gas.<sup>99</sup> An earthquake is also considered as an impediment since it is insurmountable or irresistible unless the debtor can build a virtual fortress. In those cases, “one cannot expect the debtor to take precautions out of proportion to the risk,”<sup>100</sup> hence, the impediment or its consequence cannot be overcome or avoided and strictly performing the contract is impossible.

The CESL also contains a separate provision on “change of circumstance”, namely Article 89 which derives immediately from the DCFR and the PECL.<sup>101</sup> As noted in Section 3.3, whether or not a debtor’s obligation of performance is affected depends on what extent that performance has become more onerous. Article 89 indicates a situation under the name of “an exceptional change of circumstance.” An exceptional change of circumstance makes performance excessively onerous, because the cost of performance has increased or the value of what is to be received in return has diminished to a large extent. However, Article 89 doesn’t draw a clear line between the situation where “performance becomes more onerous” and the situation where “performance becomes excessively onerous.” It merely indicates that the excessive onerosity is caused by “an exceptional change of circumstances,” which is also an ambiguous terminology. The task of distinguishing an exceptional change of circumstance from simple changes in the surrounding conditions of a contract is left to judges in individual cases. Another name which is more commonly used by scholars to denote the situation depicted in Article 89 is “hardship.”<sup>102</sup> Different from force majeure, performing the original contract is only excessively onerous, but physically possible, when the principle of “change of circumstance” or “hardship” applies. It might be a great

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99. DCFR, *supra* note 15, at 809.

100. See De Geest, *supra* note 53, at 128; see also DCFR, *supra* note 15, at 810.

101. The identical article in DCFR is Book III, Section 1-110 and in PECL is Section 6:111. Conversely, the CISG, upon which both the PECL and DCFR were drawn, includes both the force majeure and “change of circumstance” in the same Article: 79. As is indicated by some scholars, the approach taken by the CISG is preferable, because it is difficult to draw a distinction between “force majeure” and “hardship”. Many subsequent events, as is argued, will just make performance more onerous, rather than render it impossible. Meanwhile, the prerequisites for both cases are the same. Therefore, to some extent, hardship is just one situation of force majeure and should be regulated in the same provision covering the later case. Schwenzer, *supra* note 97, at 470.

102. See *id.*; see also Hector L. MacQueen, *Change of Circumstances: CISG, CESL and A Case From Scotland*, 11 J. INT’L TRADE L. & POL’Y 300, 300 (2012); Ulrich Magnus, *CISG and CESL*, in LIBER AMICORUM OLE LANDO, 225, 251 (Michael Joachim Bonell et al. eds., 2012).

fluctuation of price in the material market that raises the seller's costs of production greatly, for instance, to 200%.<sup>103</sup> In such a situation, producing the commodity as required by the contract is still possible, but the increased costs will consume all the profits that may be created by the contract and thus performance of the contract is economically inefficient. Except for "being exceptional", a "hardship" is recognized only when three prerequisites are satisfied. Article 89(3) requires that the change of circumstance should occur: (1) at the time after conclusion of the contract; (2) when its possibility or scale could not have been taken into account by the debtor; and (3) when the risk of it has not been assumed by the aggrieved party or cannot reasonably be regarded as having been assumed.<sup>104</sup> Apply those conditions to a consumer contract. Changes of circumstances in relation to matters within the area of professional expertise may normally be precluded from the scope of Article 89. As a professional, the business seller is considered to have assumed or should have assumed risks arising out of his profession.<sup>105</sup>

In addition to Articles 88 and 89, which are included in the general chapter of obligations and remedies, what should be mentioned as well is Article 110(3), which puts forth two exceptions to the remedy of specific performance. Two cases are recognized where a buyer cannot require specific performance. The first case refers to a situation where performance of the contract is impossible or has become unlawful. Another one occurs if the burden or expense of performance would be disproportionate to the benefit that the buyer would obtain.<sup>106</sup> Situations embodied in Article 110(3) are recognized in relation to the traditional contract law theory of "impossibility" or "impracticability."<sup>107</sup> With regard to assessing when performance of a contract is impractical (or uneconomic), the standard adopted in Article

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103. Ingeborg Schwenzer, *Force Majeure and Hardship in International Sales Contracts*, 39 VICTORIA U. WELLINGTON L. REV. 709, 715-17 (2008) [hereinafter Schwenzer, *Force Majeure*].

104. CESL, *supra* note 14, art. 89, § 3.

105. This has been clearly stressed in the commentary of DCFR.

106. CESL, *supra* note 14, art. 110, § 3 (stating that performance cannot be required where: (a) performance would be impossible or has become unlawful; or (b) the burden or expense of performance would be disproportionate to the benefit that the buyer would obtain).

107. As to the "impossibility principle", it covers not only physical impossibility, but also legal impossibility. However, more information about when and how performance should be judged unlawful cannot be found in the CESL. It leaves us to wonder which law should be applied to make this judgment. For instance, will performance of a contract be rendered unlawful if it violates mandatory rules in the national laws and regulations? See Feltkamp & Vanbossele, *supra* note 77, at. 897.

110(3), which is grounded on the comparison between the costs of performance and the benefit that a buyer will obtain, is analogous to the requirement for the situation where efficient breach arises because of an unfortunate contingency. Performance of a contract is rendered impractical if the cost of performance exceeds the benefit that the buyer can obtain from it. In other words, an impractical contract may fall into the efficient breach zone where performance of the contract is inefficient. In contrast to Article 88 and Article 89, Article 110(3) has not set any prerequisite for the cause of impossibility or impracticability. Hence, even if a situation of impossibility or impracticability is induced by some events that are expectable or controllable to the seller, Article 89 may apply as long as the performance becomes impossible or extremely costly; meanwhile, the CESL is chosen by the contracting parties.

To summarize, situations where a sales contract may fall into the efficient breach zone have been recognized by the CESL. With regard to the type of contingency rendering a contract economically inefficient, the CESL only includes unfortunate contingencies which have increased a seller's cost of performance or decreased the benefit that the seller may obtain in return. The general qualification for this type of contingency is based on a "cost-benefit" rule of comparing the cost or burden of performance and the cost incurred by non-performance. A contract falls into the efficient breach zone only when its performance becomes impossible or is excessively costly. As a result, the seller's obligation of performance will be influenced. Nevertheless, the CESL doesn't specially mention the circumstance where non-performance is motivated by the higher surplus yielded from contracting with a third party. Even if a third party bids a price that is much higher than the highest price offered by the buyer, the seller's obligation of performance will not be affected and he must perform his obligation as required by the contract.<sup>108</sup>

## *2. The CESL's Reaction to Contracts with the Efficient Breach Zone*

When a contract falls into the efficient breach zone, there are two basic conditions for qualifying the seller's breach as an efficient breach. First of all, the law should not force the seller's to perform the contract so that the seller is able to make free choice of breach, performance or offer to negotiate. Moreover, the buyer should not be worse off on account of the seller's non-performance. This would be possible if the buyer's expectation interest is protected through the award of

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108. CESL, *supra* note 14, art. 89, § 1.

expectation damages.<sup>109</sup> Then, questions arising in relation to the CESL are whether the CESL allows non-performance or not, and if so, whether it entitles the aggrieved buyer to the claim of expectation damages or not.

Concerning the situation of force majeure, the CESL follows the traditional doctrine by exempting the seller from liability for non-performance. The general rule of excuse for non-performance is drafted in Article 88. Moreover, Article 106(4) adds information on the effects of excuse by extending excuse to damages claims and performance claims.<sup>110</sup> Other remedies remain available to the buyer.<sup>111</sup> Therefore, in the case of force majeure, a buyer may still withhold his payment, claim price reduction, or termination of the contract except for requiring specific performance and damages. Paragraph (3) of Article 88 further specifies an obligation of notification by the party who is unable to perform. After the seller is aware or could be expected to have been aware of an impediment, he has to give notice to the buyer of this impediment and its effect without any undue delay. The text of the CESL also clearly indicates the sanction for violation of the duty to notice by holding the party liable for any damages incurred from his failure to give notice.<sup>112</sup>

Rather than directly allowing non-performance, the CESL imposes a duty to renegotiate on the contract parties in the case of hardship. As is set in Article 89(1), when performance becomes excessively onerous, the parties have to enter into negotiations in order to adapt or terminate the contract. Following the previous DCFR,<sup>113</sup> Section (2) of Article 89 carries the idea of encouraging re-negotiation further.<sup>114</sup> If the parties fail to reach an adaptation or termination of the

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109. Qi Zhou, *Is a Seller's Efficient Breach of Contract Possible in English Law*, SELECTEDWORKS (2008), available at [http://works.bepress.com/qi\\_zhou/1](http://works.bepress.com/qi_zhou/1) (last visited Feb. 19, 2014).

110. Magnus, *supra* note 102, at 251.

111. CESL, *supra* note 14, art. 106, §4 (stating that if the seller's non-performance is excused, the buyer may resort to any of the remedies referred to in paragraph 1 except requiring performance and damages).

112. *Id.* art. 88, §3. The party who is unable to perform has a duty to ensure that notice of the impediment and of its effect on the ability to perform reaches the other party without undue delay after the first party becomes, or could be expected to have become, aware of these circumstances. The other party is entitled to damages for any loss resulting from the breach of this duty. *Id.*

113. DCFR, *supra* note 15, bk. III, § 1-110(3)(d).

114. CESL, *supra* note 14, art. 89 ¶ 2. If the parties fail to reach an agreement within a reasonable time, then, upon request by either party a court may: (a) adapt the contract in order to bring it into accordance with what the parties would reasonably have agreed at the time of contracting if they had taken the change of circumstances into account; or (b)

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contract within a reasonable time, a court or arbitral tribunal can do so upon the request of either the seller or the buyer.<sup>115</sup> Two general restrictions are set in relation to the adjustment of the contract by a court or arbitral tribunal in Article 89(2). First of all, the court or arbitral tribunal cannot decide to adjust the contract without any request of either party. Only if the parties cannot negotiate successfully within a reasonable time and one of the parties makes a request to the court or arbitral tribunal for a solution, may the court adapt or terminate the contract.<sup>116</sup> Secondly, the CESL requires that the adaption should be made from the perspective of the contracting parties, namely, it should be “in accordance with what the parties would reasonably have agreed at the time of contracting if they took the change of circumstances into account.” In brief, although Article 89 doesn’t expressly allow non-performance, its clarification of the parties’ duty to renegotiate as well as a possible adjustment of the contract to hardship implicitly interferes with any direct claim for specific performance of the contract by the buyer.

In addition to invoking Article 89 to defend against a buyer’s performance claim, the seller may also resort to Article 110(3) to avoid performing the contract if performance has become excessively burdensome or costly. As Article 110(3) provides, performance cannot be required if it is objectively impossible or legally impossible, or it incurs excessively high costs or burdens.<sup>117</sup> Implicitly, application of exceptions to performance, which is based on the balance between costs and benefits, should be applied to two other forms of performance, namely, repair and replacement. If cure is impossible or the cost or burden of cure exceeds what a buyer can benefit from it, the seller may decline the buyer’s request of cure. Nevertheless, the CESL has not exempted a debtor from damages when performance is impossible or impracticable. Article 159 entitles a creditor to any damages for loss caused by non-performance of an obligation by the debtor, with the only exception in the situation where the rule of force majeure applies and

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terminate the contract within the meaning of Article 8 at a date and on terms to be determined by the court. *Id.*

115. See Feltkamp & Vanbossele, *supra* note 77, at 891; see also Schwenzler, *supra* note 97, at 471.

116. See MacQueen, *supra* note 102, at 301.

117. See DCFR, *supra* note 15 (goes a step further by specifying the consequence if a creditor insists on specific performance; DCFR III. 3:302 (5) indicates that a creditor cannot recover damages for loss or a stipulated payment for non-performance to the extent that she has increased the loss or the amount of payment by insisting unreasonably on specific performance in circumstances where the creditor could have made a reasonable substitute transaction without significant effort or expense).

the debtor's non-performance is excused.<sup>118</sup>

From the above statements, three primary conclusions can be drawn. First, specific performance is generally not allowed if contracts fall into the efficient breach zone where performance is impossible or impracticable. Second, with regard to the issue of damages, whether or not the buyer is able to obtain damages depends on the cause of non-performance. In principle, a buyer is still entitled to damages when he is not able to claim for specific performance of the contract. However, where the non-performance is caused by an impediment that the seller did not expect and did not assume the risk; the procedure of renegotiation should be intrigued. Furthermore, if this kind of unexpected impediment is uncontrollable and unavoidable or could not be overcome by the debtor, the creditor cannot ask for damages because non-performance is excused. In other words, the idea implied in the damages rule is to correlate the possibility of damages to the allocation of risk. The CESL makes the debtor who assumed the risk of impediment take the risk and pay damages to the other party. If the seller is risk neutral, he is indifferent to risk and should assume the risk of non-performance after the conclusion of the contract. By awarding expectation damages, the CESL removes the risk of non-performance from the buyer and shifts it to the seller. Nevertheless, non-performance will be excused in the circumstance where the seller has not assumed the risk. Third, cooperation and renegotiation is generally encouraged within the efficient breach zone. Some special obligations or rules have been established by the CESL in order to promote the communication and cooperation between contract parties. On the one hand, the debtor who has been influenced by a force majeure event is imposed of an obligation to inform, upon which the other party may understand the situation and take appropriate measures without any delay. For instance, the creditor may negotiate with the debtor to either adapt or terminate the contract or to arrange a substitute sale to reduce the loss incurred by non-performance. On the other hand, Article 89(2) directly puts forth the parties' duty to negotiate within a reasonable time and the possibility of a court or an arbitral tribunal's adjustment of the contract in light of a hardship. However, imposing an obligation to renegotiate and permitting a court to adjust the contract also gets some critiques from scholars. For instance, as is pointed out, "allowing the court to directly interfere in the content of a contract is a serious challenge to the principle of party autonomy and the *pacta sunt servanda*

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118. CESL, *supra* note 14, art. 159.



rule.”<sup>119</sup> Moreover, creation of a duty to negotiation and a mandatory renegotiation period is accused of being unnecessary. The reason, as is given, is that the parties already have a strong incentive to renegotiate and settle disputes because settling is cheaper than going to a court.<sup>120</sup> Nevertheless, the rule on renegotiation will just intervene with the parties’ freedom in choosing between renegotiation or going to trial directly.<sup>121</sup>

### III. EFFICIENT BREACH IN SPECIFIC CASES OF CONSUMER CONTRACTS

It was shown in Section 3 that the CESL partially absorbs what has been derived from the law and economic analysis of efficient breach. Although the CESL doesn’t directly use the terminology of efficient breach, the idea of differentiating the efficient breach zone and the efficient performance zone, based on the balance between costs and benefits of performance is present in it. What may lead a contract to fall into the efficient breach zone is only an unlucky impediment that increases a seller’s performance cost or decreases the value of what he is assumed to receive in return. In those situations, a claim of specific performance is not allowed even though it is possible for a buyer to require damages unless the seller’s non-performance is excused. The amount of damages that a buyer obtains should be equal to the amount that will put the buyer into the position he would have been in if the contract had been duly performed. Theoretically, efficient breach is possible within the framework of the CESL.

Those findings can also be applied to specific cases of consumer contracts. In consumer sales, if the seller’s breach can generate more profit than performance does and bring no loss to the buyer, the breach is economically efficient and should not be condemned. This is the ideal model. In specific cases, a seller breaks the contract in different ways. The seller might refuse to deliver the goods, or the delivery might be finished after the time required for performance, or the goods

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119. Feltkamp & Vanbossele, *supra* note 77, at 891.

120. See De Geest, *supra* note 53, at 132-33.

121. *Id.* De Geest states: “(T)he likely effects of a duty-to-renegotiate are usually (a) that court decisions are delayed, because when a party comes to the conclusion that settlement is not possible (for instance, because parties have different expectations as to what the court will decide, so that there is no ‘settlement range’), she still has to wait until the mandatory renegotiation period is over before going to court; and (b) that parties are obliged to play a you-quit-first game in which they have to try to make the other party leave the negotiation table first, so that the other one is held responsible for the failure of the negotiations.”

offered might be in conformity with the contract. Under the general provisions covering breach and remedies, the CESL recognizes two major forms of non-performance and provides corresponding remedy rules.

*A. Hypothesis of Efficient Non-Delivery or Delayed Delivery*

The first case of non-performance that is present in the CESL is non-delivery or delayed delivery of the goods. Suppose a case of non-delivery. If we apply the findings in Section 3 to the specific case, efficiency is realized if the seller is not forced to deliver the goods and the buyer's position will not be worse off when the contract has fallen into the efficient breach zone.

An important condition for making efficient non-delivery is that the contract has fallen into the efficient breach zone recognized by the CESL. That is, the delivery of the goods is either impossible, impracticable because the cost or burden of delivery increases dramatically, or the value of the payment decreases to a great extent. For example, the earthquake destroyed all the products so that the seller is unable to provide the products as required or it would be extremely expensive for the seller to find alternative products. Nevertheless, a more profitable opportunity from a third party's offer will not affect a seller's obligation to deliver the goods. The seller still has to deliver the good to the original buyer as is required by the contract even if selling the goods to a third party may create higher surplus. To be noted, efficient non-delivery would only happen to the contracts that involve future performance.<sup>122</sup> Within the passage of time between the exchange of promise and the delivery, unexpected contingencies may arise and increase the cost of delivery or render delivery impossible. To the contrary, discussion of efficient non-delivery doesn't make sense in the case of simultaneous exchanges where delivery of the goods happens at the same time the contract is concluded. Suppose the contracts happening on a regular basis, such as the purchase in grocery shops or eating at restaurants. Products are delivered as long as a consumer finishes a series of behaviour, such as picking up items and making payment at the cash desk. In those cases, the contract is performed at the same time as the contract is concluded.

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122. As is indicated by Cooter & Ulen, there are three models of promise: (1) "one party pays now for the other party's promise to deliver goods later ('payment for a promise'); (2) one party delivers goods now for the other's promise to pay later ('goods for a promise'); and (3) one party promises to deliver goods later and the other party promises to pay when the goods are delivered ('promise for a promise')." COOTER & ULEN, *supra* note 29, at 283.

According to the CESL, a seller is generally not forced to make delivery if the contract has fallen into the efficient breach zone recognized by it. In this case, the seller is free to choose the welfare maximizing breach. As to the remedies available to the consumer buyer, what he may claim depends on whether or not the seller's non-delivery is excused. If the intervening event amounts to force majeure covered by Article 88, the seller is exempted from non-delivery and the buyer cannot claim for damages, but can withhold payment of the price, terminate the contract, or reduce the price.<sup>123</sup> But since delivery of the goods as required is impossible because of the force majeure, the consumer in theory may not resort to price reduction. He is able not only to refuse to pay for the goods, but also to terminate the contractual relationship and claim his money back if he has already made the payment. As a result of termination, the contractual relationship of the parties will end and any benefit that a party had received from the other party returned.<sup>124</sup> In other cases which fall outside the scope of Article 88, the seller is not excused from non-delivery and the consumer is entitled to expectation damages in addition to the rights to withhold his payment and to terminate the contract.<sup>125</sup> The amount of damages that a consumer may obtain is equal to the benefit that he would get had the product been delivered,<sup>126</sup> namely, the value that was placed on the product at the time the contract was formed. In this sense, the consumer may balance the remedies available and choose either to terminate the contract or to make a claim for damages. Thus, non-delivery will only happen if it is impossible or it is more profitable than delivery after the seller compensates the consumer's expectation losses.

### *B. Hypothesis of Efficient Non-Conformity (Defective Performance)*

Suppose another circumstance of non-performance which happens frequently in real life, namely, a seller has delivered the goods, but the goods delivered are not in conformity with the contract. This situation is also referred to as defective performance. It is assumed that the contract falls into the efficient breach zone when the cost of providing conforming products is disproportionate to the benefit of it in the hands of the buyer.

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123. CESL, *supra* note 14, arts. 88, 106.

124. *See id.* art. 172. Where a contract is avoided or terminated by either party, each party is obliged to return what that party ("the recipient") has received from the other party. The obligation to return what was received includes any natural and legal fruits derived from what was received.

125. *Id.* arts. 110 ¶ 3, 159.

126. *Id.* art. 160.

Basically, the goods provided by a seller should be of the quantity, quality, and description required by the contract; they should be contained, packaged, and supplied along with any accessories or instruction in the manner as required by the contract according to Article 99 of the CESL. Article 100 further states seven criteria for assessing non-conformity. Generally, the goods should comply with any particular purpose made known to the seller at the time of the conclusion of the contract and the usual or ordinary purpose for the goods.<sup>127</sup> Moreover, Article 102 further requires that the goods be free from any right or not obviously unfounded claim of a third party, including rights or claims based on intellectual property.<sup>128</sup>

According to the CESL, if the goods provided by a seller are not in conformity with the contract, the consumer buyer may freely choose remedies among a variety of options which include, requiring specific performance, withholding the payment of the price, terminating contract, reducing the price, and claiming damages. To be noted, specific performance in the case of defective performance is present either to repair the defects or to replace the defective goods with conforming goods. Moreover, as is indicated in Article 111(1), the choice between repair and replacement is at the consumers will,<sup>129</sup> which carries the consumers free choice of remedies one step further. A consumer buyer, thus, is able to make the choice of remedies based on the relative benefit and cost of different remedies.<sup>130</sup> He may decide whether or not to give the seller a chance to cure the defects and in which way the seller should cure the defects according to his own preference. Repair or replacement might be preferable if a consumer thinks the value of the cured goods is great, for example because the goods are unique or the market prices of the goods have gone up.<sup>131</sup> But once the consumer has validly required remedying the lack of

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127. According to Article 100, the product must be in conformity with what has been agreed to by the contractual parties. See *id.* art. 100. It should be fit for any particular purpose made known to the parties at the time of the conclusion of the contract, possess the qualities of the product held out to the buyer as a sample or model and possess the qualities indicated in any pre-contractual statement which forms part of the contract terms. Moreover, Article 100 requires that the product provided by the seller comply with what has been considered usual or reasonable. It should be fit for the purposes of ordinary use; be contained or packaged in the manner usual or adequate for such goods or; be supplied along with such accessories or instructions as the buyer may reasonably expect to receive; and possess such qualities and performance capabilities as the buyer may expect. CESL, *supra* note 14, art. 100.

128. *Id.* art. 102; see Feltkamp & Vanbossele, *supra* note 77, at 888.

129. CESL, *supra* note 14, art. 111 §1; Wagner, *supra* note 77, at 5.

130. Wagner, *supra* note 77, at 18.

131. *Id.*

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conformity by repair or replacement, he can not resort to other remedies except for withholding payment within a reasonable time, not exceeding thirty days.

Consider the CESL's attitude toward the remedy of cure in the situation when the contract falls into the efficient zone so that defective performance has more economic efficient than offering conforming goods. Except for setting general limits by Articles 88, 89 and 110, the CESL adds more to the restriction of the buyer's choice of remedies through Article 111. As is stated, a consumer's choice between repair and replacement is hindered if the option chosen would be unlawful or impossible, or would impose high costs on the seller compared to the other option available. Article 111 provides three indicators to evaluate whether the cost of cure is high or not, including: (1) the value of the goods without a lack of conformity; (2) the significance of the lack of conformity; and (3) whether the alternative remedy could be completed without significant inconvenience to the consumer. According to the doctrine of efficient breach, non-conforming performance is considered efficient if the cost of providing conforming goods is so high that it consumes all the benefit from it. The benefit yielded by offering conforming goods, to some extent, can be measured in relation to the criterion established in Article 111(1). For example, suppose consumer *X* receives a product which was expected to be worth €800 and this product was the last one offered in the shop owned by seller *Y*. If the product contains defects and repairing it may cost the seller €1,000; then the net profit yield from cure would be -€200. In this situation, cure is inefficient compared to other approaches available to the consumer.

Although a consumer's claim for cure will not be supported by the CESL if the contract falls into the efficient breach zone, the consumer may still resort to other remedies. The application of remedies for the consumer buyer is similar to that in the model of efficient non-delivery. A consumer may choose to withhold his payment of price, terminate the contract, reduce the price, or claim for expectation damages unless the inconformity is excused. What needs to be specially mentioned in the situation of lack of conformity is the remedy of price reduction. A precondition for this remedy is that the consumer decides to accept the non-conforming goods rather than terminating or rejecting it. In this situation, the value of what has been received by the consumer is disproportionate to the price set in the contract. Correspondingly, the CELS entitles the consumer to reduce the price or recover the excess, in proportion to "the decrease in the value of what was received in performance at the time performance was made compared to the value

of what would have been received by a conforming performance.”<sup>132</sup> To be mentioned, price reduction works as an alternative to damages for the decreased value of what has been received.<sup>133</sup> Hence, once a buyer reduces the price, he cannot also claim for damages for the loss thereby recovered, but he is only entitled to damages for any further loss suffered.<sup>134</sup> To a certain extent, the amount of price reduction is calculated by the similar measurement as what is applied in damage calculation. According to Article 160 of the CESL, the amount of damages should be equal to the discrepancy between the hypothetical status that he would have enjoyed by receiving conforming products ( $V_c$ =Value of the conforming product) and the actual status of him when he receives the non-conforming products ( $V_d$ =Value of the defective product). The formula shows the relationship between the price after reduction ( $P'$ ) and the price of the original contract ( $P$ ). As is shown, regardless of whether the expectation damages or price reduction is awarded, the goal is to put the consumer in the position as if he had received goods in conformity with the contract.

$$V_d/V_c = P'/P$$

### C. Limits of the Application of Efficient Breach in Consumer Contracts

Efficient breach is possible in a legal framework where a seller will not be forced to perform the contract specifically and the buyer will not become worse off because of the non-performance if the contract falls into the efficient breach zone. This framework of efficient breach within the CESL is composed by the rules of “force majeure,” “hardship,” “impossibility and implacability,” and remedies. Within this framework, efficient non-performance from which the surplus is greater than that from strict performance is possible, either in the form of efficient non-delivery or efficient non-conformity. Nevertheless, situations in real-world consumer sales are much more complicated. Except for the legal rules, several other factors may have an influence on the possibility of efficient breach in consumer contracts.

First, consider the possibility that specific performance is impossible or costly. Take the model of efficient non-conformity as an

132. CESL, *supra* note 14, art. 120 ¶¶ 1, 2.

133. As is indicated, the justification for price reduction is to prevent unjust enrichment for partial failure of consideration and compensates the creditor for simply not getting the full performance. It works partially as the simplified right to damages and as the simplified right to partially terminate the contract. See CESL commentary, *supra* note 79, at 526-27.

134. CESL, *supra* note 14, art. 120 ¶ 3.

example in which providing conforming goods is impossible or extremely costly. As is indicated in Section 4.2, specific performance in the case of lack of conformity is present as either repair or replacement. Only when both types of specific performance are impossible or extremely costly, namely when it is costly to either repair the defect or make a replacement, is efficient breach assumed to be possible. The cost of replacement depends on several factors, for example, whether the object of the contract is a general product or a unique product and the price of the product. In the premise of consumer contract, especially in retailing contracts, firms in markets may optimize over availability of different products according to the demand of consumers.<sup>135</sup> Normally, with regard to general goods, such as the brand of a laptop, a firm may have more than one item in stock. Moreover, empirical studies show that “consumers are often willing to buy substitute items in the same shop when faced with stock-out in frequently purchased consumer market.”<sup>136</sup> Therefore, even if there is a sold-out problem, it might not be expensive for a seller to arrange an alternative when it comes to general products. In contrast, in the case of unique goods, such as works of art or antiques, it is impossible to find close substitutes.<sup>137</sup>

Second, the way of dispute resolution may also matter. As to the way of avoiding specific performance, a seller may choose to not break the contract unilaterally but to reach a settlement. For instance, he may offer to make a new tender, reduce the price, or return the money paid by the consumer back. From the standpoint of a consumer, he is willing to choose the dispute resolution that is less costly, easier, or less time-consuming. If we put the background to the cross-border purchasing, the cost involved in suing a foreign trader is huge. Therefore, what might be preferable to the consumer is also to reach a settlement with the seller, by either price reduction or termination of the contract and getting the money back rather than going to the court and suing for monetary damages if the cost of litigation is taken into account.

Another issue involved in assessing the possibility of efficient breach concerns the question of whether the remedies available to a consumer buyer are adequate to make him indifferent between

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135. Christopher Conlon & Julie Holland Mortimer, *Effects of Product Availability: Experimental Evidence* (Nat'l Bureau of Econ. Research, Working Paper No. 16506, Oct. 2010).

136. Ravi Anupindi, Maqbool Dada & Sachin Gupta, *Estimation of Consumer Demand with Stock-out Based Substitution: An Application to Vending Machine Products*, 17 *MKTG. SCI.* 406, 407 (1998).

137. COOTER & ULEN, *supra* note 29, at 320.

performance and breach. To guarantee that the consumer's position will not worsen within the efficient breach zone, the CESL offers him free choice among a series of remedies including withholding performance, terminating the contract, price reduction, and expectation damages. But a crucial dimension to evaluate the adequacy of remedies is what the buyer expects from the contract, namely the consumer's purpose of buying. In consumer sales, the consumer's purpose of purchasing is outside of his trade, business, craft, or profession.<sup>138</sup> Most of the time this refers to individual use. In other words, consumers engage in transactions not only for obtaining promises or compensation, but for accomplishing instrumental goals, such as obtaining ownership, using properties, and receiving services. "The fact that an act leads to good consequences is irrelevant if it is wrong."<sup>139</sup> So whether a consumer's expectation can be satisfied is closely correlated to whether a consumer can obtain the concrete products. With regard to general goods, it is easy for a consumer to find a substitute in the market. In theory, as long as the buyer can make a substitutive transaction and what he can receive from the breaching party covers the additional amount necessary to purchase the substitute plus the cost of making a second transaction, the buyer will be fully compensated.<sup>140</sup> However, since finding a close substitute is not possible when the object of a contract is unique, what a consumer expected from performing the contract cannot be fully recovered if the contract is broken. In addition, consider the type of losses defined by the CESL that are compensable. As is shown in Section 3.2, the CESL only recognizes the non-economic loss in the form of pain and suffering, but excludes other forms of impairment of life and loss of enjoyment. Think of the "wedding dress" case, where the loss that is actually suffered by the buyer is neither purely economic loss nor any physical pain, but the enjoyment of wearing the exactly same wedding dress that was bought.<sup>141</sup> No matter whether the "current price" rule or "substitutive price" rule applies, what the buyer can recover according to the CESL is merely the price difference not the happiness that she would enjoy from wearing the expected dress in the wedding. As long as the buyer is worse off due to the breach, it is impossible for Pareto efficiency to take place and efficient breach can hardly be created.

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138. Reg. CESL, *supra* note 14, art. 2.

139. Avery W. Katz, *Virtue Ethics and Efficient Breach*, 45 SUFFOLK U. L. REV. 777, 787 (2012).

140. Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 275 (1979).

141. CESL COMMENTARY, *supra* note 79, at 644-45.



Fourth, some special legal devices used for consumer protection will also have an impact on the possibility of efficient breach by influencing how contractual parties react to their on-going relationship in the case where the contract falls into the efficient breach zone. One example is warranty clauses written in the contract. In practice, many firms attach a warranty to their products as their marketing strategy<sup>142</sup> in addition to the mandatory warranty required by the law.<sup>143</sup> A warranty guarantees the consumer buyer can make claims against the producer, supplier, retailer, or seller if the products delivered are not in conformity with the contract within a specified period. For instance, it guarantees repair, replacement, or money return under special situation. Suppliers, moreover, use warranty clauses as one type of implicit insurance policy since the non-conformity is uncertain and adverse. When drafting warranty clauses, suppliers have to consider the probability and expected cost of product defects as well as the corresponding settlements ex-ante.<sup>144</sup> In this sense, warranty clauses make the contract more complete and provide consumers with explicit information about what he should do in the case where non-conformity is costly. As a result, ex-post settlements are promoted.

Put all those considerations above together in relation to the remedy rules offered by the CESL, efficient breach would take place in a very limited frame. With regard to non-delivery, only in those contracts involving future performance, is there space for efficient breach to take place. Furthermore, the nature of the product has an impact on the probability that the contract falls into the efficient breach zone. It is more difficult to find replacement in the sales of unique goods than in the sales of general goods. So the probability that a contract falls into the efficient breach zone is higher when it comes to unique goods. But the paradox is that consumers can hardly get full compensation if the seller breaks a contract involving unique goods. What is more, compared to a damage claim, private settlement is assumed to be preferable to both consumers and sellers in solving

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142. A warranty might be imposed by law or created by contract. See Stefan Haupt, *An Economic Analysis of Consumer Protection in Contract Law*, 4. GER. L.J. 1137, 1155 (2003).

143. For instance, the European Union imposed a mandatory warranty for consumer sales through the directive 1999/44 on certain aspects of the sale of consumer goods and associated guarantees. See Council & Parliament Directive 1999/44/EC, art. 5, 1999 O.J. (L 171) 12.

144. In exchange of warranties, suppliers will also increase the price of the products proportionally "because the promised measures are costly for the seller". See Haupt, *supra* note 142, at 1155-56.

conflicts, if the under-compensation problem and transaction cost are taken into account.

Put the other way around, situation will be different if efficient breach is assumed to be committed by the consumer buyer. First, the criterion for termination of the contract is lenient for the consumer. As provided by Article 114(2) of the CESL, if there is a defect in the product delivered by the seller, a consumer may terminate the contract unless the defect is insignificant.<sup>145</sup> In this case, a consumer has more freedom in choosing to get rid of the contract when he thinks the value from performing it decreases. Second, Article 132(2) provides buyers an exception to the obligation to make the payment. As is stated, "where the buyer has not yet taken over the goods and it is clear that the buyer will be unwilling to receive performance, the seller may nonetheless require the buyer to take delivery, and may recover the price, unless the seller could have made a reasonable substitute transaction without significant effort or expense."<sup>146</sup> In many consumer transactions, products provided by a seller are standardized and it would not be difficult for the seller to arrange an alternative transaction by selling the products to others. The seller, in those occasions, cannot require the other party to take over the delivery and make the payment. What is more, the CESL entitles consumers the right to withdraw the contract without giving any reason and at no cost within a certain period after the conclusion of the contract (fourteen days).<sup>147</sup> Accordingly, after a contract is formed, its binding power is comparatively weaker. The consumer can easily get out of a contract if he gets a much more lucrative opportunity or thinks it is wasteful to buy the product from the original seller.

#### IV. CONCLUDING REMARKS

A starting point taken in this paper is that contract parties should not be forced to perform the contract when non-performance leads to wealth-maximisation. Rather than to defend expectation damages or to encourage breach, the function of the efficient breach theory, as is suggested in this paper, is to assess the approaches to motivating contract parties to perform the contract unless strictly performing it is not as profitable as what was expected at the time of contract formation.

The CESL takes the position that encouraging performance of the contract and cooperation between consumers and sellers through a

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145. CESL, *supra* note 14, art. 114 ¶ 2.

146. *Id.* art. 132 ¶ 2.

147. *Id.* art. 41-43.

variety of rules including a performance rule, an information rule, and a damage rule. For example, motivating information exchange and establishing the criteria for damage measurement may facilitate the seller to assess the price for non-performance. But the CESL also opens a window for efficient breach with the aim of avoiding economically wasteful performance. When drawing the border of the efficient breach zone, the CESL compares the cost of performance with the surplus that the parties are expected to obtain from the contract. According to the CESL, specific performance is not allowed within the efficient breach zone, but other options of remedy including withholding performance, terminating the contract, price reduction and expectation damages are available to consumers. In addition, the CESL takes the concern of risk allocation into account as well, by making the seller who is assumed to bear the risk of non-performance pay damages. Among other remedies, the CESL offers the consumer a free choice of remedy, especially presenting in the consumers right to terminate the contract in the case of non-performance. Most importantly, under the premise of consumer sales, the emphasis is placed on how to guarantee that a consumer's position will not worsen because of the non-performance, rather than on how to avoid wasteful performance. This could be understood if the issue of consumer protection is taken into consideration. More research is needed in relation to balancing on the one hand how to shape the seller's incentive to take an optimal level of performance and on the other hand how to protect a consumer's expectation from the transaction.

The CESL, nevertheless, also has its shortages in relation to the issue of optimal incentives to breach, negotiate or perform. In terms of damage rules, the CESL excludes non-economic losses in the form of impairment of life and loss of enjoyment, which commonly arises in the case of consumer contract. Provided that there is no current market price to evaluate the buyer's loss, it is difficult to make an accurate calculation of contract damages. Moreover, within the efficient breach zone, the CESL's imposition of the obligation to negotiate is opaque and unnecessary. On the one hand, the CESL mentions that to renegotiate is the parties' duty, but it does not indicate clearly the consequences of a violation of this duty. On the other hand, by making the failure to reach negotiations within a certain period as the prerequisite for the court's interference the CESL imposes an unnecessary burden on the contracting parties. In the circumstance where reaching an agreement via negotiations is costly, the parties should be able to go to court directly. Moreover, what has been neglected by the CESL is the possibility of breach with the aim of

pursuing a higher economic surplus. The CESL doesn't show expressively whether it allows or prohibits these types of breaches. What we can infer from the provisions in the CESL is that the seller is generally obliged to perform and the seller is entitled to specific performance even if there is a more lucrative opportunity offered by a third party. Paradoxically, in any circumstance where the outside bidder has obtained the right to the good according to property law, the damages that the buyer may claim is the expectation damages. In this sense, the seller has the incentive to breach the contract as long as he can still obtain an economic surplus after paying expectation damages.