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In Defense of the Impossibility Defense

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Essay

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I. INTRODUCTION

Generally, the common law follows the rule of *pacta sunt servanda*[1] under which contractual obligations are absolutely binding on the parties.[2] The impossibility defense is an exception to this general rule.[3] Under the impossibility defense, a promisor may default without incurring liability for the promisee's expectation damages.[4]

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1. *"Pacta sunt servanda"* means "agreements (and stipulations) of the parties (to a contract) must be observed." BLACK'S LAW DICTIONARY 1109 (6th ed. 1990).

2. For an erudite discussion of *pacta sunt servanda*, see generally Richard Hyland, *Pacta Sunt Servanda: A Meditation*, 34 VA. J. INT'L L. 405 (1994) (examining the socio-historical roots of the maxim).

3. *See, e.g.*, O'Hara v. State, 590 A.2d 948, 953 (Conn. 1991) (noting that "[t]he impracticability doctrine represents an exception to the accepted maxim of *pacta sunt servanda*, in recognition of the fact that certain conditions cannot be met because of unforeseen occurrences"); Dills v. Town of Enfield, 557 A.2d 517, 523 (Conn. 1989) (recognizing that the impracticability doctrine is an exception to the maxim of *pacta sunt servanda* where certain conditions cannot be fulfilled in the face of unforeseen occurrences). At the outset, it is important to note that the terms impossibility and impracticability refer to the same general doctrine. *See* Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 86 (1977) ("There is no functional distinction between impossibility and frustration cases on the one hand and impracticability cases on the other."). The discharge of obligations to which this Essay refers can be called either the impossibility or impracticability doctrine. The impossibility defense was the name given to the defense at common law. The UCC uses the term 'impracticability' to refer to essentially the same doctrine. For purposes of simplicity, the term 'impossibility' will be used throughout this Essay.

4. Expectation damages normally envision protecting an aggrieved party by placing him in the position he would have occupied had the contract been performed. *See generally* Robert Cooter & Melvin A. Eisenberg, *Damages for Breach of Contract*, 73 CAL. L. REV. 1432 (1985) (defining and distinguishing "injury," "compensation," and "expectation" in the context of contract damages). The protection of that expectation interest will allow recovery for any loss in value to the plaintiff under his particular circumstances, as well as any other loss caused by the breach including incidental and consequential damages. *See* U.C.C. § 2-610 (1989); RESTATEMENT (SECOND) OF

Over time, the general rule of *pacta sunt servanda* narrowed while the scope of the exception expanded.[5] Early writings in economic analysis of the law addressed the doctrine of *pacta sunt servanda* with a favorable bias. Judge Posner, for instance, has shown that the common law rule, with its attendant exception, was efficient in the sense that it yielded incentives for wealth maximizing behavior.[6] Consistent with Judge Posner's work, many commentators justified the doctrine of impossibility as an instrument of efficiency, maintaining that it provided efficient contractual insurance over otherwise uncontrollable risks.[7] In recent years, however, economists and legal scholars have criticized the doctrine.[8] These critics question the basic

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CONTRACTS §§ 344, 347 (1979). The discussion in this paper assumes a male promisor and a female promisee.

5. *See, e.g.*, Andrew Kull, *Mistake, Frustration, and the Windfall Principle of Contract Remedies*, 43 HASTINGS L.J. 1, 22 (1991) (explaining that the "Coronation Cases," resulting from the coronation of King Edward VII in 1902, played a significant role in transforming the "impossibility" defense into the modern day "frustration" and "impracticability" defenses). *See also* Opera Co. of Boston, Inc. v. Wolk Trap Found., 817 F.2d 1094, 1097 (4th Cir. 1987) (explaining that the constraints of the impossibility doctrine have relaxed due to the growth of commercial activity in the nineteenth century; the rigidity of the doctrine made it "economically and socially unworkable"); *Dills*, 557 A.2d at 523 (noting that the impracticability doctrine has been liberalized by the requirements of the courts over the years). *See generally* George G. Triantis, *Contractual Allocations of Unknown Risks; A Critique of the Doctrine of Commercial Impracticability*, 42 U. TORONTO L.J. 450, 450 (1992) (explaining that the impossibility doctrine requirement was loosened to allow explicitly excuses in circumstances where the cost of performance increased so much as to render performance commercially impracticable, unless the parties agreed otherwise).

6. *See* Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980) (explaining that wealth maximization is supported by the presumption of consent to efficient institutions). *See also* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW § 2.2, at 23 (4th ed. 1992) [hereinafter POSNER, ECONOMIC ANALYSIS] ("The theory is that the common law is best (not perfectly) explained as a system for maximizing the wealth of society.").

7. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 277-81 (1988) (explaining that courts should strive to fill contract gaps with performance excuses, such as the impossibility doctrine, to achieve efficient risk allocation); Christopher J. Bruce, *An Economic Analysis of the Impossibility Doctrine*, 11 J. LEGAL STUD. 311 (1982) (modifying slightly the Posner-Rosenfield economic approach by placing greater emphasis on mitigation of damages and the willingness of courts to overturn certain contractual agreements, and offering several suggested constraints courts could apply to the impossibility doctrine to achieve economic efficiency). For the seminal article in this area, see Posner & Rosenfield, *supra* note 3.

8. *See, e.g.*, Kull, *supra* note 5, at 55 (criticizing the judicial intervention supported by the law and economics approach to impossibility because "[n]o set of judicially imposed default rules can usefully allocate unidentified risks nor can judges do anything to optimize risk spreading . . . ."); Allen O. Sykes, *The Doctrine of Commercial Impracticability in a Second-Best World*, 19 J. LEGAL STUD. 43 (1990) (criticizing the impossibility doctrine on the basis that it creates uncertainty, increases litigation, and provides only minimal economic benefits); Triantis, *supra* note 5 at 455 (criticizing the

legitimacy and economic soundness of the defense as compared with the common law rule of absolute contractual liability.[9] They argue that if a basic assumption on which the contract was formed fails, the ordinary remedy of expectation damages, in most cases, is superior to the rule of no liability.

This Essay evaluates the recent critique of the impossibility doctrine in light of the current economic theory of contract law. First, the Essay provides a short overview of the current scope of the impossibility doctrine.[10] Then, the Essay reviews efficient contract formation, in both the ideal and real worlds.[11] Next, the Essay describes the incentives required for both parties to a contract to achieve the social goal of efficiency in contract law, and analyzes the impossibility defense in light of that goal.[12] The Essay then addresses the role of the defense in situations where contract clauses expressly provide for

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continued application of the impossibility doctrine because the presumed intent of parties regarding risk allocation no longer requires such a doctrine); Michelle J. White, *Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory*, 17 J. LEGAL STUD. 353, 374 (1988) (arguing that both breach of contract and discharge of contract remedies should follow a unified theory based on contract breach rather than separate theories because a contract should never be discharged). *See also* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 128-30 (1993) (criticizing gap-filling doctrines, such as impossibility, as rules which created new risks and uncertainties while attempting to reduce the economic costs attendant to the risks of contracting).

9. *See* Triantis, *supra* note 5, at 450-51 (challenging the premises of the doctrine of commercial impracticability). Kull relies on the Rule of Chandler v. Webster, 1 K.B. 493 (1904) and quotes in pertinent part:

> [W]here, from causes outside the volition of the parties, something which was the basis of, or essential to the fulfillment of, the contract, has become impossible, so that, from the time when the fact of that impossibility has been ascertained, the contract can no further be performed by either party. . . the parties are both discharged from further performance of it . . . . The rule adopted by the Courts in such cases is . . . to some extent an arbitrary one . . . . Time has elapsed, and the position of both parties may have been more or less altered, and it is impossible to adjust or ascertain the rights of the parties with exactitude. [Yet] . . . the law treats everything that has been done in pursuance of the contract as validly done, but relieves the parties of further responsibility under it.

Kull, *supra* note 5, at 24 (quoting *Chandler*, 1 K.B. at 499-500). *See also* Sykes, *supra* note 8, at 47-50 (explaining that the impracticability defense is a "crude" remedy when a contract breach occurs because the cost of performance is too expensive for one of the parties); MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 127-85 (1987) (analyzing the impossibility defense with relation to critical legal studies). For a more aggressive attack on Posner's economic approach to law, see generally Arthur A. Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451 (1974).

10. *See infra* part II.

11. *See infra* part III.

12. *See infra* part IV.

future contingencies.[13] Finally, the Essay concludes by arguing that the impossibility defense provides appropriate incentives to both promisors and promisees to make socially efficient decisions in performing contracts.[14]

II. THE SCOPE OF THE IMPOSSIBILITY DEFENSE TODAY

Under current law, a party who fails to perform a contractual duty is in breach of contract and must reimburse the other party for its expectation damages.[15] Common law generally equates non-performance of a contract with breach, regardless of the promisor's reason for failing to perform his contractual duty.[16] Despite the strictness of this common law principle, the doctrine of impossibility is well established in both English and American common law.[17] Under this doctrine, the promisor's failure to perform is excused if a supervening event renders performance impossible.[18]

Impossibility may arise under two circumstances.[19] First, the

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13. *See infra* part V.

14. *See infra* part VI.

15. *See supra* note 4.

16. In the famous English case of Paradine v. Jane, 82 Eng. Rep. 897 (K.B. 1647), the Court of King's Bench held: "[W]hen the party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract." *Id.* at 898.

17. *See* Martin Emerich Co. v. Siegel, Cooper & Co., 86 N.E. 1104, 1106 (Ill. 1908) (holding that the continued existence of a material thing is essential to the contract; if the thing ceases to exist, performance becomes impossible); Siegel v. Eaton & Prince Co., 46 N.E. 449, 451 (Ill. 1896) (discharging contract to "furnish and erect" an elevator when the store was destroyed by fire); Downing v. Stiles, 635 P.2d 808, 812 (Wyo. 1981) (comparing the legal analysis of the doctrine of impossibility with the English and American points of view). *See also* Posner & Rosenfield, *supra* note 3, at 85 n.7 (noting that the leading case on this issue is Taylor v. Caldwell, 122 Eng. Rep. 309 (1863), in which a contract for a musical performance in a specific music hall was discharged based on impossibility of performance when the auditorium was destroyed by fire). *See generally* Bruce, *supra* note 7, at 323-32 (discussing and comparing in-depth English and American cases in which non-performance resulted in the discharge of the contract).

18. For a thorough discussion of the common law with respect to the impossibility and impracticability defenses, see E. ALLAN FARNSWORTH, CONTRACTS §§ 9.5-9.9, at 700-37 (2nd ed. 1990). *See also Downing*, 635 P.2d at 813 (explaining the impossibility doctrine and noting that where a party's principle purpose is substantially frustrated without fault by the occurrence of an event, her remaining duties to render performance are discharged, unless there is contractual language to the contrary).

19. Some courts and commentators have relied on what is known as the majoritarian default rule, imputing terms to the contract which the court believes most parties would have wanted because they maximize their joint gains from the contract. For a general discussion of the concepts of majoritarian and penalty default rules, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default*

supervening event may render performance physically impossible,[20] as with the death of the promisor where his personal services are vital to performance of the contractual obligation.[21] Physical impossibility may also follow where a particular item necessary for performance is destroyed.[22] Second, the impossibility defense may arise if the supervening event renders performance legally impossible.[23] The excuse of supervening illegality encompasses situations in which performance of a contractual duty is still possible but would violate a law or government order.[24]

In the last century, courts have extended the doctrine of impossibility beyond those instances of strict physical or legal

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Rules, 99 YALE L.J. 87 (1989).

20. The Restatement (Second) of Contracts declares a contract impossible when a supervening death or supervening destruction occurs of a specific thing necessary for performance of the contract. RESTATEMENT (SECOND) OF CONTRACTS § 261, cmt. b (1977). The Restatement comments, in pertinent part: "In order for a supervening event to discharge a duty under this Section, the non-occurrence of that event must have been a basic assumption on which both parties made the contract." *Id.* *See also* Karl Wendt Farm Equip. Co. v. International Harvester Co., 931 F.2d 1112, 1117-18 (6th Cir. 1991) (holding that an economic downturn in the farm equipment market, although unforeseeable, does not constitute a supervening event as mere unprofitability does not excuse performance of a contract).

21. *See* Mullen v. Wafer, 480 S.W.2d 332, 334 (Ark. 1972) (setting aside the personal services aspect of a sale of an accounting business when seller died two months after sale of the business); Posner & Rosenfield, *supra* note 3, at 100 (arguing that if an employer seeks damages as a result of an employee's death because death breached the employee's obligations, then the contract should be discharged).

22. For example, in Taylor v. Caldwell, 122 Eng. Rep. 309 (1863), the parties formed a contract under which the defendant was to supply a music hall and surrounding gardens for a concert. *Id.* at 309. Before the date of the concert, an accidental fire destroyed the facilities. *Id.* at 311. The court discharged without penalty the defendant's duty to perform despite the fact that the parties failed to provide for such a contingency. *Id.* at 315. The court found in the contract an implied condition canceling the contract in the case the music hall was destroyed without fault of the promisor. *Id.* at 314.

23. The courts treat that which is illegal as impossible. *See, e.g.*, Vimar Seguros Y. Reaseguros v. M/V Sky Reefer, 115 S. Ct. 2322, 2337 (1995) (comparing an arbitration clause with other contracts and holding that if a provision is unconscionable, or illegal, the clause may be invalid); Stuart Park Assoc. Ltd. v. Ameritech Pension Trust, 846 F. Supp. 701, 707 (N.D. Ill. 1994), *aff'd*, 51 F.3d 1319 (7th Cir. 1995) ("[A] contract whose performance would violate federal law is unenforceable and, therefore, neither party can recover on it."). *See also* Columbus Ry. Power & Light Co. v. City of Columbus, 249 U.S. 399 (1919).

24. Abbot of Westminster v. Clerke, 73 Eng. Rep. 59 (K.B. 1536). *See also* Texas Corp. v. Hogarth Shipping Co., 256 U.S. 619, 630-31 (1921) (discharging the contractual obligation where the ship necessary for performance was requisitioned by the British government); Held v. Goldsmith, 96 So. 272, 275 (1923) (discharging the contractual obligation where the British vessel needed to ship goods to the United States became unavailable due to war between Germany and Britain).

impossibility.[25] Indeed, the court's grant of the defense no longer requires that performance be completely impossible.[26] Rather, the promisor is excused if he can show the occurrence of a supervening event which aggravates the costs of performance and makes compliance *impracticable.*[27]

III. EFFICIENT CONTRACT FORMATION

Some critics argue that the impossibility defense is unnecessary because parties to a contract necessarily allocate all unknown risks.[28] This theory is flawed, however, because it does not achieve efficient allocations between the parties in real-world transactions.[29] This Part first examines the ideal of the perfectly efficient contract and questions whether such contracts truly exist.[30] Then, it turns to real world

25. *See infra* note 26.

26. *See* Wassermann Theatrical Enterp. v. Harris, 77 A.2d 329, 330-31 (Conn. 1950) (stating that the tickling in and tightening of an artist's throat caused the "apprehension that he could not go on with the show" such that it "reasonably justified [him] in canceling the performance."); The Kronprinzessin Cecilie, 244 U.S. 12 (1917) (excusing the owner of a German steamship from crossing the North Atlantic on the eve of World War I by apprehension the vessel would be seized as prize); Mineral Park Land Co. v. Howard, 156 P. 458, 459 (Cal. 1916) (discharging the contractual duty of an excavator to take out further earth and gravel because "any greater amount could have been taken only at a prohibitive cost, that is, at an expense of 10 or 12 times as much as the usual cost per yard.").

27. The case of Florida Power & Light Co. v. Westinghouse Elec. Corp, 826 F.2d 239 (4th Cir. 1987), *cert. denied*, 485 U.S. 1021 (1988), illustrates the scope and force of the impossibility defense as applied to a single contract. In *Westinghouse*, a public utility bought a nuclear power reactor from Westinghouse. *Id.* at 240-41. The contract required that Westinghouse not only furnish the fuel necessary to operate the plant for the first ten years, but also that it "[r]emove the irradiated fuel from the Plant site and dispose of it as Westinghouse sees fit." *Id.* at 241. At the time of contracting, both parties assumed that (1) the waste fuel would be reprocessed and (2) Westinghouse would make a profit of $20 million reprocessing the waste and reselling it as fuel for breeder reactors. *Id.* at 277. Subsequent to the signing of the contract, the federal government adopted a policy of nuclear waste disposal such that the option of reprocessing became unavailable to Westinghouse. *Id.* at 265. Westinghouse not only lost the opportunity to earn its anticipated profit, but it incurred an added expense of $80 million for the storage of the fuel at off-site deposits. *Id.* at 277. The *Westinghouse* court excused Westinghouse's duty to perform under the defense of impossibility because the change in circumstances "not only wiped out the expected profit but resulted in a loss of some four or five times greater than the expected profit." *Id.*

For a critical analysis of the *Westinghouse* opinion, see Douglas G. Baird, *Self-Interest and Cooperation in Long-Term Contracts*, 19 J. LEGAL STUD. 583, 589-90 (1990); Sykes, *supra* note 8, at 77. *See supra* note 3 for an explanation of the functional equivalence of impossibility and impracticality.

28. *See infra* notes 174-76 and accompanying text.

29. *See infra* notes 179-80 and accompanying text.

30. *See infra* part III.A.

contracts, where parties employ a variety of contingency clauses in an effort to approach true efficiency.[31]

A. Ideal Contracts and Efficient Outcomes

A well-settled axiom of economic analysis of the law states that courts should respect and enforce fully negotiated bargains.[32] This respect for private agreements rests on the notion that rational and self-interested parties who transact in a competitive market will include in their contract only those terms which promote economic efficiency.[33] If a contract is ideal, it includes an efficient allocation of the risks of non-performance, thereby negating the need for the impossibility doctrine.

Nevertheless, equating efficient outcomes with real outcomes in a competitive market is frustrated by two problems. First, there is no guarantee that rational self-interested parties will reach an efficient agreement. Much of the work of game theory deals with problems like the "prisoners' dilemma," a situation in which the parties may not reach optimal outcomes even though such outcomes are possible and would benefit both parties.[34]

The second problem hindering the perfect bargain concept is its application to real transactions. It is uncertain whether perfect markets and perfect bargains occur.[35] Indeed, it is nearly impossible to identify and separate perfect bargains from bargains struck under imperfect conditions where there is no guarantee that the agreement is optimal.

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31. *See infra* part III.B.

32. *See, e.g.*, Karl Wendt Farm Equip. Co. v. International Harvester Co., 931 F.3d 1112, 1117-18 (6th Cir. 1990) (finding the impracticability defense inappropriate after considering the intentions of the parties as to the apportionment of risk under the contract); Dills v. Town of Enfield, 557 A.2d 517, 525 (Conn. 1989) (holding that courts must consider the terms of the contract when considering doctrines that may shift the presumed intentions of the parties).

33. *See generally* POSNER, ECONOMIC ANALYSIS, *supra* note 6, § 1.2, at 11 ("[T]he only way in which willingness to pay can be determined with certainty is by actually observing a voluntary transaction. Where resources are shifted pursuant to a voluntary transaction . . . [it is most likely] that the shift involves a net increase in efficiency.").

34. The prisoners' dilemma represents a situation where what is best for each person individually leads to non-cooperation although everyone would be better off with mutual cooperation. DOUGLAS G. BAIRD ET AL., GAME THEORY AND THE LAW 33-35 (1994). *See also* Baird, *supra* note 27, at 583 ("Two parties may desire that the transaction go forward, but each may fear that the other will not perform. The parties may rationally decide either not to make promises or not to keep them, even though each would be better off if both made promises and kept them.").

35. *See generally* POSNER, ECONOMIC ANALYSIS, *supra* note 6, §§ 1.2-1.3, at 12-19 (analyzing the nature of the market by, for example, considering the inequality of incomes, the federal minimum wage law, the purchasing of undervalued stock, and other aspects of the economy).

Hence, courts may have difficulty discerning when an ideal contract exists, thus rendering the impossibility doctrine inapplicable.

Nevertheless, markets do exist that approach the ideal of full competitiveness, in which one finds conditions of equal bargaining power, relatively full information, and low transaction costs.[36] Where these conditions are found, real-life outcomes may indicate what perfect bargains look like. Furthermore, if ideal agreements do yield efficient outcomes, an examination of real-life agreements struck under conditions which do not deviate too far from the economic model can be instructive about efficiency. The next section explores some of the tools that real life parties use to attempt to approach the efficiency ideal.

B. Real World Contracts and Attempts at Efficiency

To allocate efficiently risks which are unknown and unknowable at the time of contract formation, parties commonly use contingency clauses. One example of such clauses is the *force majeure*, or "act of God," clause. Unfortunately, it is difficult to obtain empirical evidence as to the extent to which these clauses are used in real-world contracts. However, an examination of case law indicates that contingency clauses, such as the *force majeure* clause, are frequently used.[37]

Contingency clauses that provide explicit allocations of risks are especially prevalent in long-term business contracts.[38] It is this type of contract that may come closest to the ideal of a fully negotiated contract between rational, well-informed parties of equal bargaining power.[39]

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36. *See generally* POSNER, ECONOMIC ANALYSIS, *supra* note 6, § 1.1, at 10 (discussing an "equilibrium" in the market where the economy becomes stable when "the forces of competition tend to make opportunity cost the maximum as well as minimum price.").

37. *See, e.g.*, United Equities Co. v. First Nat'l City Bank, 383 N.Y.S.2d 6 (N.Y App. Div. 1976), *aff'd*, 363 N.E.2d 1385 (N.Y. 1977); *see also* Victor Goldberg, *Impossibility and Related Excuses*, 144 J. INSTITUTIONAL & THEORETICAL ECON. 100, 100 (1988) (recognizing that the use of *force majeure* clauses by private parties are "very common"); Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 288 n.41 (1992) ("Force majeure clauses are inserted as standard clauses into contracts."); Triantis, *supra* note 5, at 451 (recognizing that *force majeure* clauses are inserted as standard clauses into contracts).

38. *See* TREBILCOCK, *supra* note 8, at 130; *see also* Schwartz, *supra* note 37, at 291 (advising that "the probability that a supervening event will make performance physically impossible increases with contract length; the longer the contract period, the more likely bad things will happen.").

39. *See* POSNER, ECONOMIC ANALYSIS, *supra* note 6, §1.1, at 3 (advising that "rational and self-interested parties who transact in a competitive market will include in their contract only those terms which promote economic efficiency.").

The widespread use of contingency clauses in these types of cases, therefore, creates a presumption that rational parties believe that these provisions help maximize potential contract benefits.[40]

Contingency clauses are not the only means by which parties can allocate the risks of changing circumstances. Rather, a variety of devices are available to protect parties from risks, such as changes in prices or production costs and demand. For instance, parties may employ an "escalator clause" that ties the contract price to a price index, or may include "reopener provisions," which create duties to renegotiate in case of changed conditions.[41]

The variety and widespread use of clauses that provide for future changes indicate that well-informed parties do desire to provide for contract adjustments after a basic assumption on which the contract was made fails.[42] The business practice of including such provisions does not prove that the default rule under current contract law, the impossibility defense, is inefficient.[43] To the contrary, valid reasons suggest that contracting parties, as well as society, benefit from a default rule which provides for some contractual adjustment in cases of dramatically changed circumstances.

IV. THE ECONOMICS OF IMPOSSIBILITY

As previously stated,[44] the impossibility defense has attracted criticism in recent economic literature. Its opponents claim that a rule of strict liability, under which courts award expectation damages for every non-performance, is superior to the current doctrine, which excuses performance in cases of impossibility. This Part demonstrates that these critics overlook a critical rationale of the impossibility defense, namely, to provide the incentive to promisees to make socially efficient reliance decisions.[45]

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40. *See* Schwartz, *supra* note 37, at 285-91 (discussing how parties to a contract can achieve their goals by (1) insuring that the contract price is approximate to the opportunity costs of performance, and by (2) protecting against potential inability to complete contract performance).

41. *See* Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53, 69 (W.D. Pa. 1980) (where the parties hired a prominent economist to design an appropriate escalator clause to provide for the world oil crisis); *see also* Schwartz, *supra* note 37, at 284-85 (discussing various clauses employed to allocate risks).

42. *See* Triantis, *supra* note 5, at 451 (advising that the widespread use of contract clauses providing for catastrophic events indicates that parties do allocate risks among themselves).

43. *See infra* part V.

44. *See supra* notes 8-9 and accompanying text.

45. *See infra* part IV.A.

Proponents of the impossibility defense likewise fail to appreciate the full rationale for the defense. These proponents focus on the impossibility defense as yielding a mechanism for efficient insurance.[46] The defense, however, plays a much more vital role: it carves out an area of no liability for breach of contract without causing moral hazard problems, i.e., without distorting the precaution and breach decisions of the promisor.[47]

Contract law poses problems for economic analysis because a variety of parameters exists concerning the parties' ability to optimize their outcomes. It is difficult to analyze all the functions of optimization with respect to one problem, such as the impossibility defense. While analysis of the defense may achieve incisive results by limiting the analysis to only one or two parameters, a reliable analysis must simultaneously consider all efficiency functions.

This Part attempts to incorporate the significant parameters of efficiency into analysis of the impossibility doctrine. First, it identifies the core of the problem the doctrine is designed to address, the promisee's incentives with respect to her decision to mitigate damages before and after a breach.[48] This Part then continues examining the adverse effects that the excuse of impossibility may have on the promisor's incentives to take efficient precautions against non-performance and breach and to disclose information regarding the likelihood of future events rendering performance impossible.[49] The Part concludes with a discussion of the insurance rationale for the impossibility doctrine.[50]

A. Optimizing the Decisions of the Promisee

The law of contracts basically imposes a system of strict liability on the promisor.[51] Every non-performance or major mal-performance is treated as a breach, regardless of the promisor's behavior.[52] It is a well-settled rule of the economic analysis of law that strict liability

46. *See supra* note 7 and accompanying text.

47. *See infra* part IV.B.

48. *See infra* part IV.A.

49. *See infra* part IV.B.

50. *See infra* part IV.C.

51. Strict liability is defined as "[l]iability without fault. Case is one of 'strict liability' when neither care nor ignorance will save defendant." BLACK'S LAW DICTIONARY 1422 (6th ed. 1990). *See also* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 11-14 (1985) (discussing strict liability).

52. *See* COOTER & ULEN, *supra* note 7, at 309 (analyzing incentives for efficient precaution and efficient reliance).

induces the promisor to take efficient precautions against the risk of his own non-performance.[53] A system of pure strict liability, however, also leads to inefficient behavior of the promisee, whom the rule is meant to protect.[54] Under strict liability, the promisee has no incentive to take precautions to avoid the loss because, at least in theory, she will be fully compensated by the injurer.

The promisee ordinarily is not able to affect the probability of performance. The promisee can, however, control the loss incurred in the case of breach.[55] The more the promisee invests in reliance, the greater her loss in case of non-performance.[56] Because the promisee is entitled to full recovery whenever the promisor does not perform as promised, however, strict liability leads to a socially and inefficiently high amount of reliance by the promisee.[57]

The impossibility defense modifies and transforms the rule of strict liability.[58] By excusing the promisor's non-performance in specific situations, the impossibility defense assigns some risk of loss to the promisee.[59] Thus, the promisee will no longer be sure that the promisor will either perform or reimburse her for her losses. This uncertainty forces the promisee to consider the probability of breach in making her reliance decision.[60] The following scenarios present helpful examples of the reliance decision by the promisee.

For simplicity, assume that reliance is not a continuous function, but a set of three distinct options available to the promisee before performance is rendered. One option is to refrain from investing in reliance. The second and third options represent different levels of reliance which yield different payoffs in case of performance and different losses in case of non-performance. The more resources the promisee

53. *See* Sykes, *supra* note 8, at 60.

54. *See* COOTER & ULEN, *supra* note 7, at 309-16 (analyzing incentives for efficient precaution and efficient reliance); Sykes, *supra* note 8, at 63.

55. *See* Cooter, *supra* note 51, at 3 (advising that "the promisee, by placing less reliance on the promise, can reduce the harm caused by the promisor's breach.").

56. *See id.* at 13-19 (analyzing the various alternatives for a promisor in a contract context). The promisee's "reliance" is the amount of money she places at risk after the contract is formed, under the assumption that the promisor will perform.

57. *See id.* at 11-14 (illustrating the effect of broad and narrow constructions of excuses for breach of contract on reliance behavior); Sykes, *supra* note 8, at 60-62. *Cf.* Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980) (discussing reliance activities in the context of different measures of damages for breach of contract).

58. *See supra* part II.

59. *See* Cooter, *supra* note 51, at 12.

60. The probability of uncompensated breach may still be too low, however, to actually alter the promisee's level of reliance. *See infra* Figure 3 and accompanying text.

invests in reliance, the higher her profits in case of performance, and the higher her losses in case of breach. From these options, assume the promisee will choose the one that maximizes her expected gain from the contract.[61]

To make the model more concrete, consider Robert Cooter's example of a contract concerning the construction of a store.[62] The promisee has the choice between three levels of reliance.[63] Her first option ("Option (1)") is to order no additional merchandise for the new store, relying instead on the goods she already has in stock at the site of another store. Her second option ("Option (2)") is to order a small amount of additional merchandise for the new store. Her third option ("Option (3)") is to order a large amount of merchandise which is due to arrive upon completion of the new store. She is able to increase her returns by ordering more merchandise up front. However, the risk of ordering merchandise up front is that she must incur storage costs if the store is not completed on time.

The promisor's liability in the event of breach affects the promisee's decisions both before and after any breach. Before breach, the promisee's expectations about the promisor's liability influence her amount of reliance.[64] After breach, these same expectations affect the promisee's incentives to mitigate damages. This section explores the promisee's decisions at each of these stages.[65]

1. Investment in Reliance and the Risk of Loss

This section demonstrates, through concrete scenarios, the degree of impact that the promisor's liability has on the promisee's reliance decision. The section first explores the liability scenario which induces the promisee to select the socially optimal level of reliance.[66] It then examines the way in which a pure strict liability policy distorts the promisee's reliance decision, causing social inefficiency.[67] It then turns to the informational dilemmas faced by the courts and by con-

61. The difference between the discounted value of gains and losses is the net gain the promisee can expect from the contract by adopting a particular strategy. *See infra* note 70.

62. Cooter, *supra* note 51, at 11. The author will utilize Cooter's names and scenarios but will supply numbers and probabilities to flesh out the Cooter hypothesis.

63. Cooter, *supra* note 51, at 17 (offering three levels of reliance).

64. The promisee's reliance decision is also referred to as before the fact mitigation because a promisee's choice of increasingly efficient reliance levels essentially reduces, or mitigates, after the fact damages.

65. *See infra* parts IV.A.1 and IV.A.2.

66. *See infra* part IV.A.1.a.

67. *See infra* part IV.A.1.b.

tracting parties which prevent adaptation of a default rule directly ensuring socially efficient choices by both the promisee and the promisor.[68] Finally, the section explores the role the impossibility doctrine can play in indirectly encouraging promisees to choose efficient reliance levels despite the lack of complete information.[69]

a. No Liability

In the first scenario, the promisor is not liable for damages in case of a breach. Therefore, the promisee must bear all of the losses herself. The decision chart concerning the promisee's reliance decision appears as follows:

Figure 1
Promisee Profit / Loss for No Liability for Breach of Contract[70]

	Performance *p=0.8*	Breach *p=0.2*	Expected Gain
Option (1) No Reliance	+$500	$0	+$400
Option (2) Low Reliance	+$700	-$200	+$520
Option (3) High Reliance	+$800	-$1500	+$340

At first glance, it seems the promisee will choose Option (3) over Option (2) since Option (3) produces an additional profit of $100 if performance occurs. In light of the risk of non-performance, however, it is not efficient for the promisee to make the additional investment in reliance. Rather, if the promisee chooses the course of conduct that maximizes her expected gain from the contract, she will follow Option (2), yielding an expected gain of $520 (($700 x 0.8) -

68. *See infra* part IV.A.1.c.

69. *See infra* part IV.A.1.d; *see also infra* part IV.B. for a discussion of the impossibility defense's indirect encouragement of efficient choices by the promisor.

70. The "p" values shown in the table headings indicate probabilities selected by the author. Thus, the probability of contract performance in this scenario is 80% while the probability of breach is 20%. The expected gain is a weighted value for comparison of the various levels of reliance available to the promisee. The expected gain takes into account the probability of both performance and breach as well as the magnitude of the corresponding financial gain or loss: expected gain = [(probability of performance) x ($ gain if performance occurs)] - [(probability of breach) x ($ loss if breach occurs)]. A rational promisee will choose the option which maximizes her expected gain, as that value quantifies the risks and benefits associated with each option.

($200 x 0.2)). As this example shows, under the rule of no liability to the promisor, the promisee has an incentive to choose the strategy which promotes social efficiency because she must consider the actual probabilities of both performance and breach.

b. Strict Liability

If the law holds the promisor liable for every breach, the promisee will overinvest in reliance.[71] Under the expectation damages rule, the promisee receives the benefits of her reliance investment with certainty.[72] She will make her reliance decision in light of a performance probability of 1.0. This decision is inefficient because it does not take the true probability of performance and non-performance into account.

Figure 2
Promisee Profit / Loss for Strict Liability for Breach of Contract[73]

	Performance *p=0.8*	Breach *p=0.2*	Expected Gain
Option (1) No Reliance:	+$500	+$500	+$500
Option (2) Low Reliance	+$700	+$700	+$700
Option (3) High Reliance	+$800	+$800	+$800

In the strict liability scenario above, the promisee will choose Option (3) because this level of investment in reliance maximizes her expected gain from the contract. From the standpoint of social efficiency, however, the promisee should not make such a high investment in reliance. It is not socially efficient to expose oneself to the risk of incurring substantial storage costs ($1,500) in order to achieve an

71. *See* Cooter, *supra* note 51, at 13 (analyzing the various alternatives for a promisor in a contract context).

72. *See supra* note 4 for a definition of expectation damages; *see also* Sykes, *supra* note 8, at 60 ("The expectation damages rule provides the benefits of performance to the buyer with certainty, notwithstanding the fact that performance may prove inefficient ex post.") (citation omitted).

73. See *supra* note 70 for an explanation of the contents of this table. Note, however, that the table in Figure 2 differs from the table in Figure 1 in a significant respect: in Figure 2, the promisee suffers no losses as a result of a breach by the promisor. Rather, because the promisor is strictly liable for the breach, the promisee receives the same profit as if performance had occurred.

increase in profits of $100. There is a 20% probability that the promisor will breach the contract. The promisor would pay $2,300 in expectation damages ($1,500 storage costs + $800 lost profits). Under a strict liability rule, the promisee has no reason to consider the true probability of breach. Therefore, she will waste resources by overinvesting in reliance.

c. The Informational Dilemma

A comparison of Figure 1 and Figure 2 shows that no contractual liability on the promisor yields efficient promisee decisions while strict liability does not. The opposite is true, however, for the promisor's decisions: strict liability encourages efficiency, while no liability results in inefficient choices.[74] Neither extreme appears to be ideal.

Nevertheless, it is still possible to address the problem of over-reliance under strict liability. Reliance can be optimized by scrutinizing the actual level of reliance and allowing compensation of losses incurred by the promisee only to the extent that her reliance is efficient. For example, if the promisee's actual losses were $2,300 because she over-relied on the promisor's performance, an optimal legal rule—Option (2), in this case—would award damages of only $900, the efficient amount.[75]

Scrutinizing the behavior of the promisee and comparing such behavior to the socially optimal level of reliance, however, places a huge burden on courts.[76] In every case, the court would first have to determine the probability of both performance and breach.[77] The court would also have to calculate the prospective gains and losses of the parties in both cases and determine the efficient amount of reliance. Only after gathering this information could the court reduce the damage award to an efficient amount.

Imposing such an analysis on the courts is impractical for two reasons. First, such a determination would unreasonably burden the court's resources. Second, the court would not have access to the relevant data. For instance, the probability of performance or breach is determined by the promisor's costs and by the gains available to the promisor should he direct his resources to an alternative use, infor-

74. *See infra* part IV.B.1.

75. This scenario is optimal only from a reliance standpoint, not an overall contract standpoint.

76. *See* Schwartz, *supra* note 37, at 278-80, 290 (discussing problems courts have in obtaining information); Sykes, *supra* note 8, at 93 (analyzing court decisions in various types of disputes including contract disputes).

77. *See* Schwartz, *supra* note 37, at 293.

mation a court cannot gather and verify. This problem also arises with the identification and verification of the information needed to compute the outcomes associated with alternative levels of reliance by the promisee.

These informational dilemmas affect not only the choice of the legal default rule, but also the content of real world contracts. Contracts that include provisions allowing the promisee to recover damages only up to the amount compatible with an efficient reliance decision do not occur.[78] Rather, parties generally fix a sum as liquidated damages in case of breach.[79] It initially seems that such an arrangement would optimize the reliance decision of the promisee.[80] However, this is true only if the promisee fails to consider that the promisor might threaten to withhold performance after the contract is formed, forcing the promisee to enter into *ex-post* renegotiations.

Because reliance is a relation-specific investment, when a contract contains stipulated liquidated damages, it renders the promisee vulnerable to the promisor's holdouts.[81] After the promisee has invested in reliance, the promisor can threaten to withhold performance if the promisee refuses to pay a higher price. This strategy allows the promisor to capture a portion of the gain from the contractual surplus created by the promisee's reliance investment. Where the liquidated damages do not fully reimburse the promisee for her actual losses, the promisee is placed in a weak bargaining position as against the promisor. Successful renegotiations of the contract price raise concerns with contractual efficiency because the promisor shares only in the upside of the reliance investment and not in its downside. If the damage remedy is undercompensatory, the promisee can recover only a fixed amount of damages regardless of her actual reliance, and must bear the losses associated with her additional reliance investment.[82] Thus, the

78. *See* Sykes, *supra* note 8, at 60 (suggesting that parties should write a contract "requiring the buyer to invest only in Pareto-efficient measures"). Given the informational demands of such a provision, the only way for the parties to achieve this result may be to stipulate the investments for which the promisee will be reimbursed in case of non-performance. Adoption of such a strategy, however, leads back to an "indirect" approach to the reliance problem.

79. *See* Cooter, *supra* note 51, at 14-16 (analyzing various alternatives available to reduce or eliminate the effects of variations in damages due to reliance).

80. *Id.* at 14-16.

81. For a technical elaboration of this point, see Richard Craswell, *Performance, Reliance and One-Sided Information*, 18 J. LEGAL STUD. 365, 388-92 (1989).

82. *See* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988); G. Richard Shell, *Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend*, 82 NW. U. L. REV. 1198, 1245-46 (1988) (summarizing the argument of two scholars

notion that the promisee might have to share the gains from reliance with the promisor, but bear the full loss associated with it, will temper the promisee's inclination to invest in reliance, even to the extent the investment is originally efficient.

In contrast, if the parties stipulate a supracompensatory damage remedy,[83] a distortion of the promisor's incentives to take efficient precautions against non-performance will result.[84] Although the parties can renegotiate the contract if performance becomes inefficient, the promisee will not let the promisor "off the hook" for free. Instead, the promisee will insist on a payment exceeding her actual losses.[85]

The only way to escape either dilemma is to set the remedy precisely at the efficient reliance level. This returns us to the information restraints faced by the parties and the courts.[86] Furthermore, contract law invalidates stipulations of supracompensatory damage remedies as penalities.[87] The contracts, and the different scenarios for breaching

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who propose that victims in contract breach cases are undercompensated for three fundamental reasons). *See* John A. Sebert, Jr., *Punitive and Non-Pecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1573, 1648 (1986) (stating that if the plaintiff-promisee is under-compensated, she will suffer loss and the defendant-promisor will not bear the full cost of his breach). *See also* Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105, 117-18 (1989) (arguing that under-compensation will be efficient in most contract settings).

83. The term 'supercompensatory' refers to "awards of double, treble, or punitive damages that exceed both actual and expected losses caused by a breach of contract or other legal duty." Shell, *supra* note 82, at 1200. *See also* Henry Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller*, 92 YALE L.J. 14, 31 (1982) (defining 'supercompensatory' as "liability exceeding what is necessary to compensate the plaintiff for harm caused by the defendant's wrong.").

84. *See* Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 386-87 (1990), *and* COOTER & ULEN, *supra* note 7, at 295, for the proposition that a supracompensatory remedy could induce an inefficient performance. *But see* Shell, *supra* note 82, at 1210 (stating that "supracompensatory remedies seek to force compliance with minimal standards of acceptable commercial conduct by imposing sharply higher expected costs on parties who contemplate questionable courses of conduct.").

85. This payment qualifies as a supercompensatory damage. Questioning the sufficiency of expectation damages, at least one scholar has recommended that courts award supercompensatory damages in certain cases. *See* Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1412 (1982) (citing Daniel Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1474 (1980)).

86. *See supra* text accompanying notes 78-79. *See also* sources cited *supra* note 8 (criticizing the impossibility defense).

87. *See* Priebe & Sons, Inc. v. United States, 332 U.S. 407, 417 (1947); Truck-Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc., 361 N.E.2d 1015 (N.Y. 1977); Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985). For an economic critique of the common law's refusal to enforce penalities, see Charles J. Goetz & Robert E. Scott,

them, are too diverse to allow a single liquidated damages provision, or even a schedule of them, to work as a default rule.[88]

d. The Impossibility Doctrine as an Indirect Method of Achieving Efficiency

The informational problems which both the courts and the parties must confront are not unique to the reliance issue.[89] The legal system faces the problem of choosing a set of default rules yielding incentives for efficient behavior even though the information needed to determine what efficiency requires in a given case is not available. In an ideal world with no informational problems, there would not be a need for elaborate contract laws.[90] Courts would simply enforce efficient transactions and award damages in cases where it was efficient to do so.

Because the information necessary for adjudication directly aiming at efficiency is not available, however, the law enforces rules that indirectly promote efficient outcomes.[91] Thus, rather than having to assess the efficiency of a particular transaction, courts provide parties who have access to the relevant information with an incentive to engage in efficient behavior.[92]

The doctrine of impossibility is an "indirect" efficiency rule. Under this doctrine, the court need not address the issue of efficient reliance.

Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 COLUM. L. REV. 554 (1977).

88. *See generally* Barry Perlstein, *Crossing the Contract-Tort Boundary: An Economic Argument for the Imposition of Extracompensatory Damages for Opportunistic Breach of Contract*, 58 BROOK. L. REV. 877, 887 (1992) (asserting that "there is no single damage measure that is best in all situations.").

89. *See* Juliet P. Kostritsky, *Bargaining with Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for PreContractual Negotiations*, 44 HASTINGS L.J. 621, 668-69 (1993) (discussing various contexts other than reliance in which "informational assymetries" may inhibit efficient contracting).

90. In fact, one commentator has noted that a contract would be "self-executing" if the information was perfect during contract formation and throughout its performance. *See* Perlstein, *supra* note 88, at 882. Yet another commentator realizes that "information constraints inevitably force the legal system to choose among rules that would not otherwise be ideal." Sykes, *supra* note 8, at 50.

91. *See* Posner, *supra* note 6, at 495-96 (noting that the set of "judge-made rules tends to be efficiency-promoting").

92. *See, e.g.*, Gary Minda, *Employment At-Will in the Second Circuit*, 52 BROOK. L. REV. 913, 926 (1986) (discussing the covenant of good faith as a court-applied rule to promote efficiency and create economically-efficient incentives in the performance of contracts); *see also* Wakefield v. Northern Telecom, Inc., 769 F.2d 109, 112 (2d Cir. 1985) (finding that implied contractual obligations may coexist with express provisions which negate them where relationship of parties as structured by contract so dictate). *But see* Shell, *supra* note 82, at 1247, for a suggestion that private market forces, rather than court-imposed rules, are "generally credited with providing the primary incentives for parties to behave in a commercially reasonable manner."

This detour leads most commentators to erroneously neglect the reliance problem completely.[93] Nevertheless, it is worth considering the effects of contractual defenses on the reliance expenditures of the promisee available to the promisor in breach.

In Figure 3, the probability that the promisor will breach is 20%. Assume that in half of the cases involving breach (10% of all cases), the court will not hold the promisor liable for damages because he can successfully raise the impossibility defense.

Figure 3
The Effect of Defenses on the Reliance Decision[94]

	Performance *p=0.8*	Breach, No Excuse *p=0.1*	Breach, with Excuse *p=0.1*	Expected Gain
Option (1) No Reliance	+$500	+$500	$0	+$450
Option (2) Low Reliance	+$700	+$700	-$200	+$610
Option (3) High Reliance	+$800	+$800	-$1500	+$570

In Figure 3, injection of the impossibility doctrine into the model leads to the socially desirable Option (2) because the strategy maximizes the promisee's gain from the contract (($700 x 0.8) + ($700 x 0.1) - ($200 x 0.1)). The change in outcome occurs because the promisee is forced to consider the probability of breach. Note, however, that the promisee's reliance decision will not always be affected by the possibility of the promisor's excused breach. In other sce-

93. *See* Posner & Rosenfield, *supra* note 3, at 83-118 (discussing, from an economic viewpoint, impossibility and related doctrines without analyzing the reliance aspect of the doctrines); White, *supra* note 8, at 353-54. White acknowledges at the beginning of her paper that contract law is concerned with achieving economic efficiency in three separate dimensions, including "giving the promisee to a contract an incentive to make reliance expenditures only if they are economically worthwhile." *Id.* She does not, however, address this dimension in the rest of her paper. *Id.* at 353-54, 355 n.4.

94. *See supra* note 70 for an explanation of this table. Note, however, that the expected gain formula has been altered to take into account the additional scenario "Breach, with Excuse:" expected gain = [(probability of performance) x ($ gain if performance occurs)] + [(probability of breach, no excuse) x ($ gain if breach, no excuse)] - [(probability of breach, with excuse) x ($ loss if breach, with excuse)].

narios, impossibility may not weigh heavily enough in the expected gain equation to maximize expected gain at a socially efficient level of reliance.

Suppose, for example, that Option (2) is not available in Figure 3. This would leave the promisee with two choices. She can either (1) not rely, by ordering no new merchandise, or (2) make a high investment in reliance by ordering a large amount of merchandise. The promisee will order the merchandise because the expected gain of Option (3) still exceeds the expected gain in Option (1). Because the promisee stands to lose $1500 if the breach is excused in Option (3), it is easily inferred from Figure 3, and is shown explicitly in Figure 1, that both Option (2) and Option (1) are more socially efficient than Option (3). However, in the absence of Option (2), the promisee should choose Option (3) because of the greater expected gain.

It is still possible to adjust the impossibility defense so that it provides incentives to invest in precisely the efficient amount of reliance. Courts must refashion the doctrine in order to eliminate those cases in which performance is inefficient. Courts should excuse performance only if the promisor's costs of performance exceed the promisee's gains.[95] The impossibility defense encompasses situations in which performance costs have risen above the level contemplated at the time of contract formation.[96] Thus, the doctrine offers a chance to optimize both the promisor's decision to take efficient precautions and the reliance decision of the promisee. If the impossibility defense is defined to include exactly those cases in which performance is inefficient, then the promisee is entitled to collect her full expectation damages in those cases where performance would be the efficient outcome. To demonstrate this point, reconsider Figure 3. If the promisor has an incentive to breach only if non-performance is more efficient than performance—and is excused in all such cases—the promisee will internalize the losses caused by non-performance with a 20% probability. Under this scenario, Figure 1 and Figure 3 are congruent; in no cases of breach would the impossibility defense apply. In all cases, the court would refuse to discharge the parties'

95. *See supra* notes 58-60 and accompanying text.

96. *See, e.g.*, Mineral Park Land Co. v. Howard, 156 P. 458, 460 (Cal. 1916) (allowing discharge, finding contract performance impracticable because the great increase in costs was prohibitive); Florida Power & Light Co. v. Westinghouse Elec. Corp., 826 F.2d 239, 279 (4th Cir. 1987) (holding that contractor was excused by impracticability because of drastic increase in costs to perform from time of contracting). *See also* Posner & Rosenfield, *supra* note 3, at 89-90 (stating that the impossibility doctrine is invoked where "performance by one of the parties has become so much more costly than he foresaw at the time the contract was made.").

contractual obligations. Further, Option (3) would no longer dominate Option (1) in Figure 3. Rather, like in Figure 1, Option (3) would become inferior to both Option (1) and Option (2).

Under current law, however, it is clear that Figure 1 and Figure 3 are not congruent. In other words, the impossibility defense does not apply to the same set of cases as the theory of efficient breach. As a consequence, the promisor is not excused in every case in which breach would be efficient. Why this is, and must be so, can be explained only after analysis of the promisor's incentives with respect to the precaution and breach decision.[97] As noted previously, it is important to make this determination because contract law must address the decisions of both parties to achieve a result that promotes overall efficiency.

Although the impossibility defense and the theory of efficient breach do not cover the same ground, this does not lessen the virtues of the impossibility defense. Although it may be true that the impossibility doctrine does not completely solve the problem of over-reliance, it at least guides the legal system in the right direction. One can infer from Figure 3 that even if the impossibility defense does not capture the whole range of breaches, it does affect the promisee's incentives to temper her reliance investment. The quantitative impact of the impossibility doctrine rests on the relative proportion to which excuses due to impossibility share in the number of cases in which breaches occur because of the inefficiency of performance. The higher the probability that the court will excuse the promisor in the case of an efficient breach, the closer the expected gain to the promisee will track the expected gain under a regime of no contractual liability, and the more the promisee will temper her reliance investments to a socially desirable level.

Professor Alan O. Sykes argues against a theory which buttresses the impossibility defense with considerations of efficient reliance.[98] Viewing the incentives for over-reliance exclusively as a problem of the expectation damages rule, Professor Sykes maintains that the shortcomings of the expectation damages rule "will not supply a positive theory of the impracticability defense."[99] It is hard to see why this should be so since there is no general rule that problems of the

97. *See infra* part IV.B. for an examination of the adverse effects that the excuse of impossibility may have on the promisor's incentives to take efficient precautions against non-performance and breach and to disclose information regarding the likelihood of future events rendering performance impossible.

98. Sykes, *supra* note 8, at 60-63.

99. *Id.* at 63.

expectation damages rule are to be solved only within the context of this same rule.

As explained above, there are many problems that the law cannot address directly because the courts and the parties lack relevant information.[100] Because the shift in the cost function of the promisor and the reliance function of the promisee are neither observable nor verifiable to either the parties or the courts, the law must create an alternative method to achieve contractual efficiency. To the extent that this is accomplished, such a solution, like the impossibility doctrine, can and should be justified by the reality that no direct solution is available.

2. Mitigation After the Fact

If the promisor is held liable for all damages caused by breach, the promisee has no incentive to mitigate, as she is reimbursed for her losses regardless of fault.[101] One way to promote and ensure efficient mitigation is to impose a duty to mitigate on the promisee.[102] Another strategy is to deny recovery entirely to the promisee in the absence of mitigation.[103] Under the latter strategy, the promisee bears the whole loss and thus has an incentive to engage in cost-efficient efforts to mitigate damages. In light of the existence of these two alternate strategies to promote efficient mitigation after the fact, courts need not rely on discharge of contractual duties and complete denial of recovery alone. It is important to note, however, that the impossibility doctrine can solve the problem of mitigation at an early stage of the contract period, thereby sparing the courts the tedious task of evaluating the promisee's mitigation efforts. The efficiency of the promisee's reliance and mitigation decisions is a basic objective of the impossibility defense.[104] Still, while important, these decisions are not the only

100. *See supra* text accompanying notes 78-79; *see also* sources cited *supra* note 8 (criticizing the impossibility defense).

101. *See* Sykes, *supra* note 8, at 63 ("Under an inflexible expectation damages rule that awarded the full expectation interest regardless of the [promisee's] behavior, the [promisee] would lack the incentive to search for an adequate, alternative source of supply.").

102. *See* McClelland v. Climax Hosiery Mills, 169 N.E. 605, 609-10 (N.Y. 1930) (Cardozo, C.J., concurring) (explaining "duty" of mitigation); J. CALAMARI & J. PERILLO, CONTRACTS § 14-15, at 610-12 (3d ed. 1987).

103. *See* Bruce, *supra* note 7, at 316. Bruce suggests that the promisor be held strictly liable for failed performances, but that damage awards should be based only on the costs incurred by the promisee had she "taken optimal steps to mitigate damages." *Id.* Bruce proposes that this scenario will insure contract performance by offering incentives to the promisor and will provide the "promisee with the desired incentive to minimize [her] own damages." *Id.*

104. *See* Sykes, *supra* note 8, at 60-63 (proposing that the defense helps to relieve the problems of buyers/promisees lacking proper incentives to limit reliance

issues that courts must consider.

B. Optimizing the Decisions of the Promisor

This section evaluates the incentives of the promisor to make socially efficient decisions. First, the section explains the importance of the impossibility doctrine for the precaution and breach decisions of the promisor.[105] This section shows how much is at stake in the discussion about the proper scope of the contractual defenses. It then turns to the crucial objective of every excuse, which is to prevent the promisor from opportunistically reducing his efforts at ensuring performance, i.e., the danger of moral hazard.[106] Finally, the section examines the effect of the impossibility defense on the promisor's incentives to strategically disclose or withhold superior knowledge from the promisee.[107]

1. Efficient Precautions

The first steps in the economic analysis of contract law focus not on the promisee's decisions, but on the promisor's decisions. The provocative thesis is that the law should apply the expectation damages rule because it yields the correct incentives for the promisor to either efficiently continue performance or breach the contract.[108] Economic analysts criticize this "theory of efficient breach" because it considers a breach to be the only way to ensure that the goods or services for which the parties contracted end in their most efficient use.[109] The

investments and mitigation of damages). It follows that in solving these problems, efficiency may be achieved.

105. *See infra* part IV.B.1.

106. *See infra* part IV.B.2. "Moral hazard" refers to the "propensity of human beings to behave opportunistically." OLIVER E. WILLIAMSON, ECONOMIC INSTITUTIONS OF CAPITALISM 51 (1985). *See* Sykes, *supra* note 8, at 70-71 (discussing moral hazard and its effects on cost of performance).

107. *See infra* part IV.B.3.

108. *See* Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284-86 (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."); Sykes, *supra* note 8, at 51 (stating that the expectation damages rule can induce an efficient breach under certain conditions or otherwise encourage performance). *See also* POSNER, ECONOMIC ANALYSIS, *supra* note 6, at 119; Goetz & Scott, *supra* note 87, at 558-66; Yorio, *supra* note 85, at 1394 (stating that a "rule that awards expectation damages generally insures that breach will occur only if breach is, in economic terms, Pareto-Superior to performance."). Thus, if the prospect of breaching is not superior to performance, the rule will provide the promisor with the incentive to efficiently continue performance. *Id.* Additionally, Henry Mather encourages breach only when it will certainly increase "aggregate utility." Mather, *supra* note 83, at 22.

109. *See* Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L.

theory holds only if (1) renegotiating the contract in case of a second offer or a "cost push"[110] is prohibited, or (2) the transaction costs of the seller delivering the goods to a second buyer and reimbursing the first buyer are lower than in the alternative scenario where the seller performs and the first buyer sells the goods to the second.[111]

What critics overlook, however, is that the promisor's decision to continue performance or to breach is not the only decision about which the law is concerned. Today, it is an accepted wisdom of economic analysis of contract law that in cases of non-performance, the court must hold the promisor liable for expectation damages to encourage the promisor to take efficient precautions against obstacles to performance.[112] If the promisee can collect expectation damages, and if these damages amount to full compensation, the promisor has an incentive to take precautions against inefficient non-performance.[113] As a result, the court's objective is to optimize the incentives of the promisor concerning (1) the decision to perform or to breach, and (2) the decision to take precautions against non-performance. Therefore, the efficient breach theory is neither the only nor the primary economic explanation for the expectation damages rule. Rather, the most powerful rationale behind this legal remedy is the court's goal of inducing the promisor to take efficient precautions against non-performance.

A drawback to any exceptions to the expectation damages rule, under economic analysis, is that any reduction in damages tends to yield inefficient outcomes because it raises the problem of moral hazards. If, by raising a defense, the promisor can avoid liability, externalities result,[114] and the promisor's incentives to take cost-efficient

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REV. 947, 950-51 (1982) ("[B]reach is far from the only way to avoid performance of [a] contract [and] no conclusion can be deduced [that] the breach is any more (or less) efficient than other ways of securing the efficient result of non-performance.").

110. "Cost Push" is caused "by cost pressure[s] (either wages or new materials) which push up prices." Alan Budd, *How to Damp Down Demand; Economic Policy in Great Britain*, MGMT. PUBLICATIONS LTD., Feb. 1989, at 131.

111. Daniel Friedman, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 4-8 (1989).

112. *See* Bruce, *supra* note 7, at 322. Bruce states that "the promisor's obligations should not be discharged if [he] has taken inadequate precautions to ensure performance or to mitigate damages." *Id.*

113. Full compensation will not be efficient, however, if it "causes promisors to overinvest in precautions to guard against inadvertent breach." Yorio, *supra* note 85, at 1395 (citing Samuel A. Rea, *Nonpecuniary Loss and Breach of Contract*, 11 J. LEGAL STUD. 35 (1982)).

114. *See* Melvin A. Eisenberg, *The Principle of* Hadley v. Baxendale, 80 CAL. L. REV. 563, 573 (1992). Eisenberg explains that externalities arise when one party imposes costs upon another. *Id.* More specifically, externalities result because the impossibility defense does not require the promisor to balance the cost he will incur if

precautions weaken.[115] Because the impossibility defense distorts the promisor's incentives,[116] it seems that courts should abandon the rule in favor of a strict liability rule. Such a solution would reinstate the ancient rule holding that contractual duties are absolute and declaring every non-performance an inexcusable breach.[117]

In light of these considerations, the law of contracts seems burdened with an ambiguous analysis. As far as the promisor's decision to protect against non-performance is concerned, the efficient rule is strict liability. This rule, however, distorts the promisee's incentives concerning her reliance decision.[118] Therefore, the court must choose between the two efficiencies.

This pessimistic view does not prove that there is no solution to the problem of contractual efficiency. What is true, though, is that any solution must address both parties' incentives. In theory, there are at least two ways to accomplish this. First, the court may assess directly the promisor's precaution decision, impose a standard level of efficiency, and hold the promisor liable only if he failed to take efficient levels of precaution against non-performance. Because the promisor would bear the costs of an inefficient breach, he would have an incentive to take efficient precautions. The court can adopt such a standard of efficiency through a tort-like rule imposing liability on the promisor only in cases of fault. In fact, in some civil law jurisdictions, courts find liability if and only if the promisor is at fault for the non-performance.[119]

This solution runs into the same informational dilemmas as the "direct" approach to efficient reliance.[120] Under the fault-based analysis, in each case the court must determine if the promisor is at fault,

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he performs against the losses he and the other party will incur if he does not perform. *Id.* The promisee will suffer a loss of her share of the contract value unless the promisor is liable to pay expectation damages as a result of breach. *Id.*

115. COOTER & ULEN, *supra* note 7, at 277-81; Craswell, *supra* note 82, at 634-35, 646-56 (1988) ("To the extent that the non-compensatory remedies require a breaching defendant to pay more or less than the plaintiff's actual injury, they will induce an inefficiently high or low level of precaution.").

116. *See* Craswell, *supra* note 82, at 637 (arguing that excuse from performance gives the promisor an incentive to breach because the promisor is not liable for expectation damages).

117. *See* COOTER & ULEN, *supra* note 7, at 281 (stating that "[a]t common law, impossibility was not, in general, a valid excuse for not performing a contractual promise.").

118. *See supra* notes 54-61 and accompanying text.

119. See BGB §§ 280 & 325 (German Civil Code).

120. *See supra* note 64 and accompanying text.

that is, whether the promisor took efficient precautions.[121] To make this judgment, the court must know not only the cost function of the promisor, but also how different levels of precautions affect the promisor's cost of performance.[122] This information is at least as difficult to obtain, observe, and verify as the information necessary for the "direct" approach to efficient reliance.[123] Because of the court's informational restraints, it seems impossible to preserve the promisor's incentives to take efficient precautions against non-performance.

The civil law attempts to cope with these informational restraints by adopting a rebuttable presumption that a promisor who fails to perform is at fault. In order to obtain discharge, the promisor must prove either that (1) he could not influence the occurrence of the event rendering performance impossible, or (2) he took all the precautions possible to facilitate performance.[124] Although the difficulty of assessing the efficiency of alternate levels of precaution still exists, this approach may avoid the informational dilemma.

Under the common law's no fault system of contractual liability, the solution of the civil law is not available. Under common law, the only way to avoid moral hazard on the part of the promisor and excessive reliance of the promisee without running into the informational dilemma is to fine-tune the requirements for discharge of contractual duties. The next section shows how this is done.

2. Coping With Moral Hazard

In assessing the magnitude of the risk of moral hazard raised by the impossibility defense, it is important to start with the correct assumptions about the effects of a discharge in case of non-performance. Some commentators exaggerate the risk of moral hazard in claiming that the impossibility defense places all the risks of future contingencies on one party.[125] This assumption is false because the impossibility defense excuses all obligations under the contract.[126] The

121. *See supra* note 116.

122. *See* Triantis, *supra* note 5, at 474-83.

123. *See id.*; *see also supra* notes 74-79 and accompanying text.

124. *See* OTTO PALANDT, DAS BUERGERLICHE GESETZBUCH, Comment 1(e) to Section 282 (54th ed. 1995).

125. *See, e.g.*, Paul L. Joskow, *Commercial Impossibility, the Uranium Market and the Westinghouse Case*, 6 J. LEGAL STUD. 119, 160 (1977) ("Other things being equal, the seller bears all of the risk unless performance is extremely burdensome, in which case the buyer bears all of the risk."); Sykes, *supra* note 8, at 55 ("[T]he expectation damages rule insulates the risk-neutral party from risk and places all risk on the risk-averse party.").

126. *See* LINTON CORBIN, CORBIN ON CONTRACTS § 1321 (1962); Posner & Rosenfield, *supra* note 3, at 87 (recognizing the notion that the effect of granting

impossibility defense not only excuses the promisor from reimbursing the promisee, but it also releases the promisee from her obligations.[127] Thus, even if the promisor can raise the defense successfully, the promisor still bears the loss of his expected profits and the costs already incurred.[128] The only question the impossibility doctrine addresses is whether the promisor should also reimburse the promisee for the loss of her expected profits. In short, the outcome of the impossibility defense is not a complete shift of losses from one party to the other. Rather, it promotes a sharing of losses between the parties.

Clarification of these issues is important to understanding the problem of moral hazard, because the issues illustrate more precisely the strategies available to the promisor concerning his precaution decision. In the first category of impossibility, destruction of goods needed for performance,[129] the promisor has an incentive to go forward with the deal and to take cost-efficient precautions against such destruction so long as the contract is profitable to him.[130] For example, if a music hall lease generated a profit for the promisor, the promisor would have an incentive to take precautions against the destruction of the hall.[131] Further, if the bargain turns out to be a losing contract for the promisor, his losses will increase if the goods are destroyed, because the impossibility defense does not grant the promisor the contract price.[132] Thus, the promisor bears the full contract loss, excluding the amount of the promisee's lost profits.

Although the total social loss is equal to the sum of the value of the destroyed means of performance and the disappointed expectations of the promisee, the promisor still must absorb the bulk of the losses. Thus, the danger of moral hazard is slight in any case and may disappear completely where the precaution function of the promisor is discontinuous. Returning to the music hall example, the risk of the destruction of the hall alone may be enough to induce the promisor to take cost-effective precautions such as installing a sprinkler system.

The only situation involving a significant danger of moral hazard is the case in which the promisor purchases insurance against the risk of

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discharge is to place the risk on the promisee, while the effect of denying discharge is to place the risk on the promisor).

127. CORBIN, *supra* note 126, § 1321.

128. *Id.*

129. *See supra* notes 17-22 and accompanying text.

130. *See supra* notes 111-12 and accompanying text.

131. *See supra* notes 111-12 and accompanying text. For a further discussion, see Taylor v. Caldwell, 122 Eng. Rep. 309 (1863), *supra* note 22.

132. *See* CORBIN, *supra* note 126, § 1321 (discussing social loss).

destruction of the means necessary for performance.[133] In this situation, the promisor, because of the insurance, does not bear his full loss, and therefore might not take efficient precautions against destruction of the hall. This circumstance illustrates only that a strict and general rule of discharge might be inappropriate.

In the other two subcategories of impossibility, the promisor's death and supervening illegality,[134] the risk of moral hazard is even smaller. It is unlikely that a person will not take precautions against lethal injury to obtain a contractual discharge. With respect to supervening illegality, while a powerful promisor might influence governmental regulation, it is unlikely that the promisor will change its lobbying efforts to avoid performing a single contractual obligation. Nonetheless, promisors do enter into contracts that generate high losses, which may create incentives to forego lobbying against regulation rendering performance illegal, thereby allowing the promisor to utilize the impossibility defense.[135]

The explanation of the impossibility doctrine given so far has mainly referred to cases in which the exogenous event rendered performance virtually impossible. The recent economic literature is especially critical of the doctrine of impracticability because it allegedly fails to provide the parties with bright line rules which they can accept or contract around.[136] The critics argue that, unlike the classic impossibility rule, the impracticability defense spoils the dish by allowing discharge of a

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133. Sykes, *supra* note 8, at 85 n.125. Sykes states that:

> [I]ndeed, if the owners can recover the value of the hall from the insurance company, and that value is equal to the present value of expected future net revenues from the use of the hall, one could argue that the owners share of the convert profits is covered by the insurance policy. The only un-insured risk would then be the promoters' share of the convert profits. The decision in *Taylor* places that loss entirely on the promoters.

Id.

134. *See supra* notes 21, 23-24, and accompanying text.

135. Critics of the court's decision in Florida Power and Light Co. v. Westinghouse Elec. Corp., 826 F.2d 239 (4th Cir. 1987), *cert. denied*, 485 U.S. 1021 (1988), make this very point. One commentator remarked, "Westinghouse . . . could have pressed harder for the government to bear the costs of disposing the waste fuel." Baird, *supra* note 27, at 590. Another suggested that Florida Power, at least, was "in a superior position to develop or encourage the development of a substitute for reprocessing." Sykes, *supra* note 8, at 78. Of course, moral hazard is a valid argument against discharge of a contractual duty. The critics, however, fail to address the court's lengthy discussion of this point in the opinion. *See Westinghouse*, 826 F.2d at 274-76. It is beyond the scope of this Essay to decide whether Westinghouse could have behaved more diligently or even whether Westinghouse could have prevented the turnaround in government policy abandoning the reprocessing option.

136. Sykes, *supra* note 8, at 84. For an explanation of this Essay's use of the term impossibility, see *supra* note 3.

contract due to a mere increase in costs, although this requirement cannot be construed in a way that enables the courts and the parties to draw the line separating enforcement from discharge. Alan Schwartz infers from his economic analysis of long-term contracts that the extension of the impossibility doctrine to cases of mere impracticability should be rejected because it draws on information that is not verifiable, viz., the cost function of the promisor.[137] He also suggests that the discrimination between the two doctrines will be congruent with the difference between short-term and long-term contracts.[138]

Although it is true that the facts needed for the application of the impracticability doctrine are more difficult to observe and verify in a court proceeding than those needed to make a case for physical inability, the complete rejection of the impracticability defense does not seem justified. The proof Schwartz himself tries to draw from case law is not convincing. For instance, he cites *Florida Power & Light Co. v. Westinghouse Electric Corp.* as an impossibility case in which "government action prevents performance" and buttresses this result with the claim that "government's actions and their effects . . . were verifiable."[139] This reasoning is perfectly right but is incompatible with Schwartz's general theory. As *Westinghouse* indicates, the question whether the possibility of performance, or only its costs, were affected by an exogenous, unanticipated event *has nothing to do* with the different question as to whether the performance is "physically impossible" or merely too costly and thus "impracticable."

Therefore, the crucial requirement for a discharge of the duty to perform must be the occurrence of an exogenous event, i.e., an event which was beyond the scope of the actions of the promisor. Whether this event rendered performance physically or legally impossible altogether, or only aggravated the promisor's costs, does not matter. The crucial factor is the exogenous event, or more precisely, the exogenousness of the event. This requirement makes sure that the incentives faced by the promisor are preserved undistorted. Additional fine-tuning can be obtained by denying excuse whenever there is a hint that the promisor is at fault with respect to his non-performance, because he could have influenced the occurrence of the event which prima facie seems to be exogenous.[140]

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137. Schwartz, *supra* note 37, at 291.

138. *Id.* at 290.

139. *Id.* at 292 (citing Florida Power & Light Co. v. Westinghouse Elec. Corp., 826 F.2d 239 (4th Cir. 1987), *cert. denied*, 485 U.S. 1021 (1988)).

140. FARNSWORTH, *supra* note 18, at 714. Farnsworth explains:

> The third requirement for excuse is that the impracticability must have resulted

It should be added that this argument does not imply that the promisor should be excused in *every* case in which he can prove an increase of his costs which is due to an exogenous event. Instead, the duty to perform should only be discharged if there is a substantial increase in the anticipated cost of performance. The reason for this requirement has nothing to do with moral hazard, though. Rather, two different arguments suggest that the promisor should be held liable for minor increases in his anticipated costs even when they are due to exogenous events. One reason is the reduction in transaction costs and costs of litigation such a solution yields. If a minor cost increase triggered the impossibility defense, many long-term contracts would have to be discharged, and in every case the parties or the courts would have to investigate minor changes in the cost function of the promisor. Because the gathering and the verification of this information is difficult, the costs incurred are likely to outweigh the benefits of such a fine-tuned rule. In contrast to these cases, a major, substantial cost push due to an exogenous event is easy to observe and to verify.

In addition to these considerations, there is also a substantive argument in favor of a major threshold for contractual discharge. As explained above, investment in reliance renders the promisee vulnerable to attempts of the promisor to extort a higher contract price through *ex post* re-negotiations.[141] This prospect will in turn weaken her incentives to invest efficiently in reliance in the first place. The hazard will be augmented if the promisor can renege on his promise easily because this possibility will strengthen his bargaining position vis-à-vis the promisee. As it turns out, the economic explanation for the requirement of a major cost push is not the concern of moral hazard with respect to the precaution and breach decisions of the promisor, but rather the objective to protect the incentives of the promisee to efficiently invest in reliance.

The preceding argument again touches the problem of optimizing the decisions of both the promisor and the promisee at once. Now it is clear why the impossibility defense and the efficient breach theory do not cover the same ground.[142] The excuse of non-performance in

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without the fault of the party seeking to be excused. For example, a seller that is unable to deliver goods because they have been destroyed due to the seller's negligence is not excused. Neither is a party excused if unable to perform personal services because of a disability resulting from the party's own misconduct.

Id.

141. *Cf. supra* part IV.A.1.c.

142. *Cf. supra*, part IV.A.1.d.

every case in which breach rather than performance is efficient may be a perfect solution in theory, but it cannot be applied to real world transactions without seriously distorting the precaution decision of the promisor. Moral hazard can be effectively avoided only if the mere fact that the opportunity costs of performance have increased to a level rendering breach efficient is not sufficient to let the promisor "off the hook."

3. Strategic Nondisclosure of Information

The impossibility defense creates the danger that the promisor will withhold information concerning an exogenous event which ultimately renders performance impossible or impracticable in order to be excused from performance if the contingency materializes. Thus, the impossibility doctrine seems to facilitate and promote the strategic concealment of relevant information. Assuming that the law should, to a certain extent, provide the better informed party with incentives to disclose information, such an outcome would be a strong argument against the impossibility doctrine.[143]

Current requirements for discharge due to impossibility ensure that the promisor does not strategically withhold information, however.[144] In fact, the promisor seeking excuse is trapped between two requirements of the doctrine: (1) that the occurrence or non-occurrence of the exogenous event was a basic and mutual assumption of the contract and (2) that the promisor had not assumed the risk himself.[145]

In the case of *Wills v. Shockley*,[146] the defendant salvager made a contract to raise and float a ship that had run onto rocks.[147] After contract formation, the boat slipped off the rocks, sank, and the defendant could not raise it.[148] The court denied excuse because the defendant, "had many years of experience in the field of salvage, [and] entered into an absolute commitment . . . to raise and float the boat . . . ."[149]

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143. *See* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 4 (1978) ("[A] court concerned with economic efficiency should impose the risk on the better information gatherer."); *see also* Sykes, *supra* note 8, at 68 ("[T]he existence of asymmetric information about a given contingency will, in many cases, weigh in favor of placing the risk of that contingency on the better-informed party."). Because of the risk of liability, a better-informed promisor has an incentive to disclose any superior knowledge to the promisee.

144. *See* FARNSWORTH, *supra* note 18, at 708 (listing requirements of impossibility defense).

145. *See id.*

146. 157 A.2d 252 (Del. Super. Ct. 1960).

147. *Id.* at 253.

148. *Id.*

149. *Id.*

This example involved an implied assumption of risk by the party better informed about the risk, the promisor. The court apparently found that the salvager must have foreseen the possibility that the ship might slip off the rocks. Further, the salvager retained the information and explicitly failed to provide for that possibility in the contract.[150] Thus, the court arguably concluded that the salvager withheld the information in order to obtain a higher price than he would have had he disclosed the risk and limited his commitment.

A similar situation arose in *Waldinger Corp. v. CRS Group Engineers, Inc.*[151] In *Waldinger*, a subcontractor to a contract for the construction of a waste water treatment facility signed a subcontract, neglecting the provision: "SELLER MUST INDICATE IN WRITING THE SPECIFIC EXCEPTIONS, IF ANY, TO THE TERMS AND CONDITIONS OF THIS PURCHASE ORDER."[152] The subcontractor could not comply with the major requirement of the purchase order—conforming with an architect's prescriptions—because the architect insisted on a special, idiosyncratic design of a certain belt filter press.[153] Contrary to the majority opinion, the court should not have excused the subcontractor, because the subcontractor knew that his product did not perfectly match the contract descriptions, and did not reveal to the contractor that it relied on acceptance of the deviations by the architects when agreeing to the contract.[154]

One important factor to determine whether the promisor assumed a risk associated with a contingency is the foreseeability of the contingency.[155] Foreseeability does not totally foreclose the impossibility defense, contrary to the opinions of some courts.[156] On the other hand, foreseeability may be more than just an aid to interpretation, as some commentators argue.[157]

The criterion of foreseeability is only understandable if it is associated with the problem of strategic behavior with respect to

150. *Id.* The court noted that the defendant did not provide a means of relief in case of difficulty of performance. *Id.*

151. 775 F.2d 781 (7th Cir. 1985).

152. *Id.* at 793 (Pell, J., concurring in part and dissenting in part).

153. *Id.* at 783.

154. *Id.* at 793 (Pell, J., concurring in part and dissenting in part).

155. FARNSWORTH, *supra* note 18, at 718.

156. *Cf.* Eastern Air Lines, Inc., v. Gulf Oil Corp., 415 F. Supp. 429, 441 (S.D. Fla. 1975) (ruling that the contract was not commercially impracticable after finding that an energy crisis was foreseeable at the time of contracting).

157. FARNSWORTH, *supra* note 18, at 718. *See* Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53, 76 (W.D. Pa. 1980) (noting that foreseeability "does not preclude relief under the doctrine of impracticability").

information. If the promisor is in a position to foresee the contingency but either (1) does not gather the pertinent information or (2) declines to disclose the information, the law should not allow excuse if that contingency materializes. However, there are cases in which both parties have the same information about the contingency, but purposely choose not to allocate the risk.[158] Instead, both parties rely on the non-occurrence of events rendering performance impossible.[159] In such a case, if the promisor does not withhold information strategically, there is no reason to deny excuse if the contingency occurs.[160] The mere foreseeability of an exogenous event does not prove that the promisor assumed the risk of its occurrence.

C. Efficient Insurance

Every system of liability is open to analysis in terms of insurance. A system of contract law that incorporates the impossibility defense insures the promisee against breach of contract in cases where no exogenous event has rendered performance impossible or impracticable, and otherwise leaves the promisee with her loss which she can insure in the market or bear herself.

In their seminal article, Posner and Rosenfield analyzed the impossibility defense almost entirely with respect to the insurance aspect. The authors took for granted that "in the impossibility context . . . the risks with which that doctrine is concerned are generally not prevented by the party charged with nonperformance . . . if they were, that would normally afford a compelling reason for treating nonperformance as a breach of contract."[161] Posner and Rosenfield's

158. *See, e.g.*, Southwest Welding & Mfg. Co. v. United States, 373 F.2d 982, 989-90 (Ct. Cl. 1967) (permitting reformation of contract because parties mistakenly believed the price of steel was lower than it actually was); Walsh v. United States, 102 F. Supp. 589, 591 (Ct. Cl. 1952) (allowing reformation of contract because parties erroneously believed the minimum wage rate was a certain amount, even though it had increased earlier); *Aluminum Co.*, 499 F. Supp. at 60-64 (permitting reformation of a contract because the parties erroneously believed the Wholesale Price Index would accurately represent nonlabor production costs for the purpose of a contractual escalation clause).

159. *See Aluminum Co.*, 499 F. Supp. at 60-64 (permitting reformation where parties mistakenly base their contractual decisions on a contingent factor, aware that such factor may change).

160. *But see* American Trading & Prod. Corp. v. Shell Int'l Marine Ltd., 453 F.2d 939, 943-44 (2d Cir. 1972) (finding that tanker's having to take alternate route was foreseeable at the time of contracting and hence, commercial shipper was not entitled to impracticability defense). *Cf.* Alimenta (U.S.A.), Inc. v. Cargill, Inc., 861 F.2d 650, 654-55, (11th Cir. 1988) (ruling that the question of foreseeability of a peanut crop's failure presents a jury question involving impracticability).

161. Posner & Rosenfield, *supra* note 3, at 3.

explanation of the impossibility doctrine is that it serves the purpose of assigning the unpreventable risk to the party better able to deal with the risk because it is the "cheaper insurer."[162] It follows that the contract should be discharged in cases in which the promisee is the cheaper insurer because she can appraise the risk at a lower cost.

Although the insurance concern is valid, it is questionable whether the specific theory offered by Posner and Rosenfield deserves support. At first, it is necessary to recognize the limits of the analytic force of the insurance concern. It does not yield any normative implications if both parties are equally risk averse, risk preferring, or risk neutral; or, if both have equal access to market insurance. Moreover, these cases might not be so rare as it seems. One setting where the proposition of identical risk attitude might hold is where both parties to the contract are large, publicly held corporations. Although it may be unclear exactly what risk attitudes these entities really have, such ambiguities do not matter as long as it is clear that these entities will have the same attitudes. In addition, attitudes of the parties towards risk do not matter if both of them are able to self-insure or have access to insurance markets.

Apart from attitudes towards risk, Posner and Rosenfield try to determine the better insurer with respect to the knowledge available to both parties concerning the probability of non-performance and the damage caused by non-performance. To the extent the parties can buy market insurance to cover the risk, this inquiry is simply irrelevant. In such a case, the interesting question is whether the *insurer* has access to the pertinent information. For example, although the shipper, i.e., the owner of the cargo, may have very little information about the probability of a closure of the Suez Canal, a professional marine insurer may have better information than either the shipper or the carrier.

If the parties have no access to the insurance markets, it may be granted that information pertinent to these two factors, i.e., the probability that the contingency materializes and the amount of loss, affects the ability of both parties to self-insure the risk of non-performance. The serious objection to this supposition, however, is its indecisiveness. Typically, the promisor will be in a better position to estimate the probability of non-performance, and the promisee will be better able to foresee the amount of damages caused in case of non-performance.[163] In sum, it seems questionable whether it is possible to

162. *Id.*

163. TREBILCOCK, *supra* note 8, at 135

identify one of the parties as the "better insurer" of the risk of non-performance.

Finally, quite apart from these general concerns with respect to the insurance aspect, it seems questionable whether promisees would ever want to be insured against the risk of non-performance. Such insurance is not free, but must be paid for with a portion of the contract price. If price-discrimination with respect to the potential loss of each performance in case of breach is not feasible, insurance against non-performance leads to cross-subsidization of high-loss promisees by low-loss promisees.[164] Even if low-loss promisees were distinctly risk averse, and would therefore want to insure against non-performance, they would probably not be willing to pay a price for insurance which subsidizes the insurance policies of high-loss promisees.

This argument gains additional weight in the impossibility context. If the impossibility defense is a legal device to abate excessive reliance, the denial of excuse will be most profitable for those promisees who overinvested in reliance. The promisor will raise the contract price in order to cover the discounted value of damages he is forced to pay to high-loss promisees. Thus, part of the insurance premium hidden in the contract price will not only cross-subsidize high-loss promisees through the payments of low-risk promisees, but in addition will subsidize inefficient behavior, such as the losses associated with over-reliance. In sum, even if promisees were risk-averse, acquisition of insurance against the risk of non-performance from the promisor would only be optimal for high-loss promisees but not for low-loss or average-loss promisees. If the group of promisees is heterogeneous, it will not be in the interest of the majority of them to purchase insurance from the promisor rather than from a third party, i.e, a professional insurer. In any case, insurance provided by the promisor induces overreliance and therefore diminishes the joint gains from the contract.

V. CONTRACT PROVISIONS ADDRESSING FUTURE CONTINGENCIES

While parties must honor express contract terms assigning the risk of future contingencies,[165] they may also circumvent express

164. Gwyn D. Quillen, *Contract Remedies and Cross-Subsidization*, 61 S. CAL. L. REV. 1125 (1988).

165. *See* Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53, 53 (W.D. Pa. 1980) (finding that contracts are devices to allocate the risks of life's uncertainties and where parties allocate the risk of loss there is little room for judicial relief from resulting losses).

contractual terms by raising the impossibility defense.[166] Courts should abstain from excusing the promisor if contractual provisions such as *force majeure* or escalator clauses explicitly allocate the risk of future contingencies to the promisor. Viewed in this manner, the doctrine of impossibility is a default rule. Accordingly, the reasons for the non-mandatory character of the impossibility defense are the same as for any other default rule in contract law.

The impossibility defense raises a serious problem that requires closer scrutiny, however. From the very existence of a *force majeure* or escalator clause, courts may infer that the parties intended these clauses to be dispositive with respect to the scope of the impossibility defense.[167] Thus, the defense is precluded even if a risk materializes which was not accounted for in the express contract provisions.[168]

In *Eastern Air Lines v. Gulf Oil Corp.*,[169] the defendant entered into a requirements contract for aviation fuel.[170] The contract included an escalation clause tying the contract price to the market price for domestic crude oil, although an oil crisis was already looming.[171] The court denied the impossibility defense because the parties had agreed on a clause providing for adaption of the contract to future contingencies.[172] The court rejected the defendant oil company's argument that the future developments foreseen by the parties at the time of contract formation did not include a world-wide energy crisis arising out of an oil embargo.[173]

George G. Triantis carries this approach to an extreme, claiming that every contract provides for every risk because the uncertainties of the future are at least covered by broad contract terms like the promise to

166. *See, e.g.*, Transatlantic Fin. Corp. v. United States, 363 F.2d 312, 316 (D.C. Cir. 1966) (noting that closure of the Suez canal raised the issue of impossibility); Wills v. Shockley, 157 A.2d 252, 253 (Del. Super. Ct. 1960) (ruling that intervening impossibility does not absolve defendant from liability of performance); FARNSWORTH, *supra* note 18, at 715 (noting that a party may raise the impracticability defense to avoid liability, however, impractibility will not be an excuse); Posner & Rosenfield, *supra* note 3, at 99 (explaining that parties can contract to do the possible and be liable for failure to perform).

167. *See* Baird, *supra* note 27, at 593 (instructing that "[w]e can draw an inference from silence, just as Sherlock Holmes can draw an inference from a dog that did not bark.").

168. *See, e.g.*, Eastern Air Lines v. Gulf Oil Corp., 415 F. Supp. 429, 443 (S.D. Fla. 1975) (denying impossibility defense because the parties had agreed on a exculpation clause).

169. 415 F. Supp. 429 (S.D. Fla. 1975).

170. *Id.* at 432.

171. *Id.*

172. *Id.* at 442.

173. *Id.*

perform.[174] He states that "contrary to the widely held premise, risks of unforeseen contingencies are allocated by contract as part of more broadly framed risks to which they contribute as state variables."[175] Therefore, "[a]dvocates of the doctrine of commercial impracticability are mistaken when they assert that the risks of unforeseen contingencies . . . are not allocated by contract because they are not contemplated by the parties."[176]

Under this view, although the impossibility defense might make sense as a default rule, it would be irrelevant, because risks necessarily fall within the scope of broad contract provisions. Nevertheless, Triantis is correct that a contract need not address every contingency in order to allocate the risk associated with that contingency. If parties enter a contract for the shipment of goods from the United States to the Middle East at the time of the Suez crisis without providing for a particular route of shipment and after freight rates had already risen, one might infer that the promisor did in fact assume the risk of closure of the Suez Canal.[177] Similarly, in *Eastern Air Lines*, the court correctly denied the excuse, in light of both the looming oil crisis and threats from OPEC member states to cut back on oil supplies, because the parties had agreed on an escalator clause.[178] It is a question of interpretation whether a contract which includes a broad contingency clause explicitly or implicitly allocates the risks associated with a single contingency to the promisor.[179]

Contrary to Triantis's position, it is not possible to circumvent the difficulties of interpretation by a rule which automatically allocates all risks not addressed in a contract provision to the promisor. It is obvious that the parties do not want such an outcome because a system of absolute contractual liability does not maximize their joint gains from the contract. A scheme of liability incorporating the impossibility defense is superior because it tempers the promisee's over-reliance and provides her with incentives to mitigate damages after the fact.

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174. *See* Triantis, *supra* note 5, at 464-68 (arguing that parties contract at an informed, intelligent level and necessarily allocate risks within the terms of the contract).

175. *Id.* at 468.

176. *Id.* at 466.

177. *See* Transatlantic Fin. Corp. v. United States, 363 F.2d 312, 318 (D.C. Cir 1966) (assuming parties were aware of potential civil unrest at the time of contracting).

178. *Eastern Air Lines*, 415 F. Supp. at 440-41.

179. *See* TREBILCOCK, *supra* note 8, at 136 (stating that "courts would still remain free, and indeed would be unable to avoid, issues of contractual interpretation as to whether given risks fall within the scope of the promised performance.").

Andrew Kull suggests a "windfall" principle, similar to the Triantis approach, which leaves losses caused by a future contingency "where they fall."[180] Kull's position rests on the premise that courts are unable to administer a system of default rules likely to maximize the parties' joint contractual gains.[181] It is hard to understand why this pessimistic view should apply in the impossibility context only. If default rules, as Kull maintains, make no sense because the parties cannot perceive the allocation of risk, the notion that default rules are supposed to promote efficiency fails.

One of the basic flaws of Kull's claim is that it fails to consider that parties bargain and contract in an existing legal environment of default rules. Kull's conclusion that the parties mean to leave the risks not addressed "where they fall,"[182] is not compelling. More likely, parties intend to leave the allocation of these risks to the legal system and its default provisions. Additionally, Kull's claim that the courts are unable to administer a sensible system of default rules in the context of impossibility is not convincing. To the contrary, the impossibility defense is an attempt to overcome the informational problems with which the parties and the courts must grapple.

The only way to save the claims asserted by Triantis and Kull is to reinterpret their argument as one for the adoption of penalty default rules.[183] These rules are not designed to replicate the rule which the parties would have wanted. Rather, they are designed to force parties to explicitly contract around the default rule if the rule hurts their interests.[184] Such a strategy may be warranted if it serves either to induce one party to disclose information to the other side, or to deter both parties from misusing the publicly funded court system for the *ex post* drafting of contracts. Neither position seems pertinent in cases of impossibility. As to the first rationale for a penalty default, the need for incentives to disclose information, it has already been explained above that the requirements of the impossibility doctrine are designed

180. Kull, *supra* note 5, at 42-43.

181. *Id.* at 44. In the article, Kull stated "[b]ut the common-sense reasoning that permits a court to supplement a contract . . . is powerless to answer the question, incomparably more complex, of how the parties would have allocated the risk of a particular frustrating circumstance that they chose not to address in their agreement." *Id.*

182. *Id.* at 39 (arguing that by assigning the risk to a particular party, the court is in effect creating a contract that was never made between the parties).

183. *See* Ayres & Gertner, *supra* note 19, at 97-106 (explaining the general theory of penalty default rules).

184. *But see id.* at 108-18 (discussing the concept of a majoritarian default rule which replicates the provision most parties would have wanted had they addressed the problem at the time of contract formation).

to ensure that neither party takes advantage of undisclosed information available only to him or her.

It can be argued, however, that both parties collusively misuse contract law and the court system. In fact, that parties try to save transaction costs by failing to address every possible or imaginable contingency is a plausible theory as to why many contracts are silent with respect to impossibility. Nevertheless, this consideration alone does not justify the introduction of a penalty default rule. First, under current legal rules, many parties do address the problem through *force majeure* and other contingency clauses.[185] To the extent they refrain from doing so, it might be efficient for society to respect their choice. It is not desirable to force the parties to address every contingency in every contract. Contract law clearly economizes on transaction costs by supplying society with the public good of contractual default provisions. That objective is especially compelling if the probability that a certain contingency will occur is very low, as in the area of impossibility.[186] A penalty default rule might be justified if the courts were forced to render services they are ill-equipped to provide. However, given the elaborate requirements designed to circumvent informational restraints, the impossibility defense does not fall into that category.

VI. CONCLUSION

It is difficult to determine the exact problems of contractual efficiency that the impossibility defense is designed to resolve. The common economic purpose and explanation for the impossibility doctrine is efficient insurance.[187] With respect to risks beyond the parties' control, it is reasonable to assume that the law is only concerned with the efficient distribution of losses.[188] The theory advanced in this Essay departs from the dominant economic explanation, and examines the simultaneous optimization of the precaution decision of the promisor and the reliance decision of the promisee, which are the core

185. *See supra* part III.B.

186. POSNER, ECONOMIC ANALYSIS, *supra* note 6, at 92-93. Posner argues that "some contingencies . . . are so unlikely to occur that the costs of careful drafting to deal with them might exceed the benefits . . . . It may be cheaper for the court to 'draft' the contractual term necessary to deal with the contingency if and when it occurs." *Id.*

187. COOTER & ULEN, *supra* note 7, at 277-84; TREBILCOCK, *supra* note 8, at 127-36; Posner & Rosenfield, *supra* note 3, at 90-92; Triantis, *supra* note 5, at 474-83; White, *supra* note 8, at 368-74.

188. *See generally* Posner & Rosenfield, *supra* note 3, at 90-92 (outlining the parameters of the impossibility defense as it relates to contract law in general).

rationales of the impossibility defense.[189]

This author believes that the impossibility defense should address the problem of over-reliance resulting from the law's use of the expectation damages rule. The defense's central requirement that an exogenous event renders performance substantially impracticable ensures that the precaution decision of the promisor is not distorted. The denial of recovery because of discharge due to impossibility provides the promisee with the incentive to curtail her reliance investments. This "indirect" approach to the Janus-faced optimization problem is necessary because the information needed to resolve the problem "directly" is not available to either the courts or to the parties.[190] Because of informational restraints limiting the parties' ability to devise their contract *ex ante*, and limiting the court's ability to seek remedies *ex post*, the law cannot address the efficiency problems "directly." Absent these informational restraints, comparatively simple rules advocated by many economists ensure contractual efficiency.[191] Because the problems of gathering and verifying information are so severe, however, the law is forced to reach its goal indirectly by adopting doctrines such as the impossibility defense. It is true that the impossibility defense cannot achieve its objective perfectly. It is not possible to excuse every promisor where performance is inefficient, precisely because of the two-sided efficiency problem and informational restraints discussed throughout this Essay.[192]

However, even that shortcoming may not be as severe as it looks at first glance. The impossibility defense is not the only doctrine of contract law limiting the liability of the promisor. The same end is served by the various rules and doctrines which cut back on the expectation damages measure. Most important, of course, is the well-known rule of *Hadley v. Baxendale*[193] which excludes unforeseeable

189. *But see* Kull, *supra* note 5, at 41. Kull argues that the direct social interest in the outcome of cases of mistake and frustration is relatively slight. *Id.* Kull argues that the primary justification for the resolution of contract disputes must be the great social utility derived from the enforcement of promises. *Id.*

190. *See* Schwartz, *supra* note 37, at 278-80, 290 (discussing how incompleteness may cause problems); Sykes, *supra* note 8, at 62-63 (analyzing court decisions in various types of disputes including contract disputes).

191. *See* Alex Seita, *Uncertainty and Contract Law*, 46 U. PITT. L. REV. 75,130 (1984) (arguing that under certain conditions of significant uncertainty, common beliefs in contract law may be mistaken). Other commentators go further, arguing that although efficient default rules may not be what the parties contracted for, such rules might encourage them to disclose information needed to determine the required efficiency. *See e.g.*, Ayres & Gertner, *supra* note 19, at 97-100.

192. *See supra* part IV.

193. 156 Eng. Rep. 145 (1854).

losses from the damage award. The doctrine embodied in that decision may develop even more force with respect to the problem of over-reliance if it is reinterpreted in favor of a "tacit agreement" test.[194] Another major limit on the expectation measure is the certainty requirement which leaves future losses out of the scope of compensation if their actual occurrence is not sufficiently certain.[195] In addition to these limits on the amount of recovery in case of breach, the law treasures an arsenal of excuses available to the promisor which retains the power to discharge the contract and excuse the promisor from compensating the promisee altogether. It may well be that a concert of all these instruments in the end creates an efficient tune.

194. *See* Quillen, *supra* note 164, at 1137-40 (discussing the problem of cross-subsidization).

195. FARNSWORTH, *supra* note 18, at 912-921.