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Those crazy transaction costs: on the irrelevance of the equivalence between monetary damages and specific performance

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Abstract The Coase theorem tells us that monetary damages and specific performance remedies for breach of contract have identical effects when transaction costs are zero. This has become a standard part of the literature on the economics of contract law. This note argues that the traditional view is somewhat misguided, as monetary damages and specific performance remedies are unnecessary in a zero transaction costs world. We go on to show how the presence of transaction costs impact the decisions of contracting parties as between the inclusion of liquidated damages clauses in contracts and resorting to litigation that could result in the application of either monetary damages or specific performance remedies.

Keywords Coase theorem · Specific performance · Monetary damages

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1 Introduction

In 1960, Ronald Coase suggested that, under appropriate assumptions (those characteristic of the neoclassical economic analysis of the day), private action could efficiently resolve externality problems. “It is necessary,” he said, “to know whether the damaging business is liable or not for damage caused since without the establishment of this initial delimitation of rights there can be no market transactions to transfer and recombine them. But the ultimate result (which maximises the value of production) is independent of the legal position if the pricing

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system is assumed to work without cost" (1960, p. 8). This result, later codified as the "Coase theorem" by George Stigler (1966) has been restated in many ways. As regards legal disputes, it can be stated as follows: assuming transaction costs are zero and rights are fully specified, the allocation of resources is both efficient and unaffected by the initial assignment of legal rights.

The last five decades have witnessed the application of the Coase theorem across the legal spectrum, and with interesting results or implications. In the case of contract law, the theorem tells us that monetary damages and specific performance remedies for breach of contract have identical effects when transaction costs are zero. This has become a standard part of the literature on the economics of contract law. It is a simple story and a standard textbook example of the Coase theorem in action.[1] But, as so often happens with simple stories, the conclusions drawn are misleading.

This note argues that the traditional view of the application of the Coase theorem to the realm of contract law is somewhat misguided, as monetary damages and specific performance remedies are unnecessary in a zero-transaction-costs world; liquidated damages clauses will be included in all contracts and obviate the need for post-breach litigation. One of the virtues of the examination of life in a world of zero-transaction-costs is that it provides insights into a world in which transaction costs are positive. With this in mind, we go on to show how the presence of transaction costs impacts the decisions of contracting parties as between the inclusion of liquidated damages clauses in contracts and resorting to litigation that could result in the application of either monetary damages or specific performance remedies. From there we move to a brief analysis of the rent-seeking incentives that may exist when it is not economical to insert a liquidated damages clause into the contract.

2 The traditional story

The traditional Coase theorem-contract law story goes something like this. Ronald owns a house which he values at 30,000 dollars. Richard, who is interested in purchasing the house and values it at 60,000 dollars, offers Ronald a price of 50,000 dollars for the house. A bargain is struck at this price, and Ronald and Richard sign a contract that will allow Richard to take ownership of the house in 30 days' time. The sale price of the house, 50,000 dollars, leaves Ronald with a surplus of 20,000 dollars and Richard with a surplus of 10,000 dollars. Five days after this contract is signed, Guido, who also fancies the house and values it at 100,000 dollars, comes along and offers Ronald a price of 80,000 dollars for the house. Ronald breaches his contract with Richard and signs a contract to sell the house to Guido for 80,000 dollars. Richard then files suit against Ronald, alleging breach of contract and requesting that he be awarded the house (specific performance) or compensated for the value of his loss (monetary damages).

[1] See, e.g., Cooter and Ulen (1988, pp. 291–292) and Polinsky (1989, p. 31).

Let us assume that the judge rules in favor of Richard. There are two damage remedies that can be employed: monetary damages and specific performance. We will further assume that the monetary damages remedy is "expectation damages," which place the victim of breach in a position where he is as well off as he would have been had the contract been performed. Under the monetary damages remedy, the contract between Ronald and Guido stands and Guido thus ends up owning the house. Ronald is forced to compensate Richard for his loss—10,000 dollars for his lost surplus, plus any necessary restitution. If the remedy selected by the judge is specific performance, the original contract between Ronald and Richard stands, and Ronald thus must sell the house to Richard. Under a monetary damages rule, then, Guido ends up owning the house, whereas Richard ends up owning it if the remedy imposed is specific performance. This is the end of our story under the traditional common law view of the situation. From an economic perspective, however, only the monetary damages remedy generates the efficient result—placing the house with the individual who values it most highly.

But the Coase theorem tells us that this is *not* the end of the story in the case of specific performance. Guido, who has been deprived of the ability to purchase the house from Ronald, will approach Richard and offers him 80,000 dollars for the house. As Richard values the house at only 60,000 dollars, he will accept Guido's offer. The house thus ends up in the hands of Guido under specific performance, just as it does under monetary damages. That is, the remedy employed by the judge has no impact on the final allocation of resources: both monetary damages and specific performance result in the house being placed in its highest-valued use. All that differs between these two outcomes is the distribution of the surplus. In the monetary damages case, the distribution of the surplus is 40,000 dollars to Ronald, 20,000 dollars to Guido, and 10,000 dollars to Richard. The distribution of the surplus under specific performance is 20,000 dollars for Ronald, 20,000 dollars for Guido, and 30,000 dollars for Richard.[2] The Coase theorem thus tells us that the damage remedy employed in breach of contract cases is of no relevance for the final allocation of resources—only for the distribution of income.

3 Life in the world of zero transaction costs: the case for liquidated damages

The problem with this story—now a commonplace in law and economics—is that, in the assumed world of zero transaction costs, we would never get to these processes in the first place. One can approach this from two different directions. The first, following, e.g., Stigler (1966), the classic treatment by Carl Dahlman (1979), and Douglas Allen (1991), recognizes that zero transaction costs implies not only costless negotiation, but full and complete information (i.e., no uncertainty) on the part of all parties. In such a world, breach of contract would never exist, meaning that one would never get to the issue of damages in the first place. Both Ronald and Richard would know that, 5 days hence, Guido would arrive on the scene offering a

[2] Since Guido receives the same payout regardless of the legal rule, tension concerning the division of economic surplus will exist only between Richard and Ronald.

higher price for the house than that offered by Richard. As such, Ronald would never have entered into the contract with Richard in the first place. It goes without saying that such a world is, in the words of Alan Randall (1975, p. 741 n. 44), a "transactions costs-free fairyland." And life in such a world is indeed unique. As George Stigler put it, life in a zero-transaction-cost world is "as strange as the physical world would be with zero friction," one in which "Monopolies would be compensated to act like competitors, and insurance companies and banks would not exist" (1966, p. 112). In short, it bears no relationship to the world in which we live, but under what might call the strict interpretation of the zero-transaction-costs assumption, this is the world of the Coase theorem.[3]

But even if we relax the zero-transaction-costs assumption a bit, there remains a second issue with the whole discussion of the relationship of the Coase theorem to contract damage remedies. Suppose that zero transaction costs is defined to mean that there are zero costs associated with negotiating/contracting, but *not* that parties possess full and complete information (the sort of omniscience implied by the Stigler-Dahlman-Allen formulations). If negotiating/contracting is costless, then it costs nothing for the parties to draw up a contract that specifies contingencies over all possible future states of the world and to specify liquidated damages associated with each. As a result, there would be no need to resort to the courts and thus for a court-imposed monetary damages or specific performance remedy; under conditions of zero transaction costs, all possible contingencies and associated damages will have been dealt with in the contract itself.

In short, regardless of which of the interpretations of zero transaction costs one accepts, the demonstrated equivalence between monetary damages and specific performance under a regime of zero transaction costs is irrelevant. In fact, one might then argue that people are indifferent between liquidated damages, monetary damages, and specific performance, except for the fact that liquidated damages allows them to avoid court costs and is thus preferred for that reason.[4] The question then becomes one of whether there are, in such a world, factors which would lead the parties to prefer liquidated damages or court-imposed remedies—the question to which we now turn our attention.

4 Liquidated damages versus court-imposed remedies in a world of uncertainty

We will assume, as before, that the costs of the negotiation process are zero, but that the contracting parties are less than completely omniscient. In particular, we assume

[3] On this strict definition of a zero-transaction-costs world, see, in addition to the references cited above, the discussion in Medema and Zerbe (2000).

[4] We recognize that it is a bit odd to allow for the possibility of positive court costs in a world where the costs of negotiation are zero. However, the assumption of an environment in which parties can costlessly negotiate and draw up fully-specified contracts does not negate the ability of courts to charge fees for the filing of lawsuits.

that they do not know with certainty which remedy—monetary damages or specific performance—the court would apply in the event of a contractual breach.

In this situation, each party will then form a subjective estimate of the likelihood of monetary (expectation) damages versus specific performance. Let $p =$ the probability that the court imposes a monetary damages rule; then, $1 - p =$ the probability that the court will impose specific performance. We will assume for convenience that both parties have identical expectations on this score. In each of the two cases elaborated above, the joint surplus earned by Ronald and Richard is 50,000 dollars; all that varies is the distribution of it. Ronald and Richard's expected surplus without a liquidated damages clause are given by:

$$\text{Ronald} : ES = p(40,000) + (1-p)(20,000)$$

$$\text{Richard} : ES = p(10,000) + (1-p)(30,000).$$

Let $p = .50$. Ronald's expected surplus is then 30,000 dollars and Richard's is 20,000 dollars. We can now determine the conditions under which Ronald and Richard will insert a liquidated damages clause into the contract under costless contracting conditions. If both Ronald and Richard are risk averse, each will prefer a liquidated damages clause specifying that Ronald receive 30,000 dollars of his gain from the breach and that Richard receive 20,000 dollars. Of course if both parties are risk-neutral, they will be indifferent between a liquidated damages clause and taking their chances in court, and if they are risk lovers they will prefer an adjudicated solution.[5]

Of course it is unreasonable to assume in this world of imperfect information that, at the time the contract is executed, the parties are aware of the offer that will be forthcoming from Guido or its magnitude; as such, they would wish to specify in the liquidated damages clause the shares of any surplus rather than absolute dollar amounts. In the examples given above, Ronald earns 80% of the joint surplus under a monetary damages rule and 40% of the surplus under specific performance. Let us assume that these are their respective expected shares under these two judicially imposed remedies. The problem then becomes:

$$\text{Ronald} : ES = p(.80) + (1-p)(.40)$$

$$\text{Richard} : ES = p(.20) + (1-p)(.60).$$

If $p = .50$, then Ronald expects to receive 60% of the surplus and Richard 40% under a court-imposed remedy. Here, then, if both parties are risk averse, a liquidated damages clause mandating that Ronald disgorge 40% of his profits to Richard will be preferred by both parties.[6]

Now let us generalize the argument. Let s_{mi} be the share of the surplus earned by individual i under monetary damages and s_{pi} be the share earned by individual i under specific performance. Likewise, let p_{mi} be individual i's subjective probability that the court will order monetary damages; thus, $1 - p_{mi}$ is individual

[5] Holdout problems and the like are irrelevant here because of the assumption of zero costs of negotiation.

[6] Of course the parties will be indifferent between liquidated damages and a court-imposed remedy if they are risk neutral and will prefer to forego a liquidated damages clause if they are risk lovers.

i's subjective probability estimate that the court will order specific performance. Then, each party's expected surplus is given by

$$ES_1 = p_{m1}s_{m1} + (1 - p_{m1})s_{p1}$$

$$ES_2 = p_{m2}s_{m2} + (1 - p_{m2})s_{p2}.$$

Assuming risk aversion, ES_i is the minimum share that individual i would accept in order to agree to a liquidated damages clause.

We can now determine the conditions under which the parties would agree to a liquidated damages clause under conditions of risk aversion. If $ES_1 + ES_2 \leq 1.0$, both parties will find it in their interest to insert a liquidated damages clause into the contract. If $ES_1 = ES_2$, the reservation price for each party is exactly met. If $ES_1 + ES_2 < 1.0$, there are gains above the reservation price available to both parties. However, if $ES_1 + ES_2 > 1.0$, it will not be in the parties' interest to insert the clause as one or both of them would have to accept a share of the surplus that is below their reservation price.

5 Monetary damages versus specific performance in a positive transaction costs world

A further interesting implication of this analysis has to do with the rent-seeking incentives that result which it is not optimal to insert a liquidated damages clause into the contract. The successful plaintiff in a breach of contract suit will receive a greater share of the surplus under specific performance than under monetary damages. As such, we would expect that plaintiffs will ask for specific performance at trial whenever transaction costs are low, relative to the differential surplus. In fact, the plaintiff would be willing to expend resources up to $\frac{s_{p2} - s_{m2}}{s_{p2}}$ percent of the expected winning under specific performance in order to secure this result. Likewise, the breaching party, who will prefer monetary damages to specific performance ($s_{m1} > s_{p1}$) will be willing to spend up to $\frac{s_{m1} - s_{p1}}{s_{m1}}$ percent of the expected winning under specific performance in an effort to persuade the court to award monetary damages. Since these surplus differentials will be equivalent between the two parties, however, the efforts will cancel out.

In fact, when we examine a few special cases of this model, we observe some interesting phenomena. For example, suppose that the plaintiff spends the resources $s_{p2} - s_{m2}$ in order to ensure that the court imposes a specific performance ruling at the trial ($p = 0$). It follows that each party's expected surplus is given by

$$ES_1 = s_{p1} = 0.4$$

$$ES_2 = s_{p2} - \left(s_{p2} - s_{m2}\right) = s_{m2} = 0.2.$$

Similarly, if the breaching party spends $s_{p2} - s_{m2}$ in order to ensure that a monetary damages rule is applied ($p = 1$), it follows that each party's expected surplus is given by

$$ES_1 = s_{m1} - (s_{m1} - s_{p1}) = s_{p1} = 0.4$$
$$ES_2 = s_{m2} = 0.2.$$

Thus, we find that even in the situation whereby one party has a vested interest in ensuring that a specific rule is applied to a case, the outcome that results remains the same. In short, while the outcome is not invariant under alternative legal rules, the *expected* surplus is. As such, parties have no incentive to engage in rent-seeking behavior in an attempt to ensure the application of one legal remedy rather than another.

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