THE LOW TRANSACTION COSTS OF SPECIFIC PERFORMANCE AND THE BENEFITS OF EX-POST NEGOTIATIONS

BARAK YARKONI[*]

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Abstract

This paper challenges the case for Efficient Breach in "gain-seeking" breaches[1] and shows that the Expectation Damages remedy generates higher transaction costs then of Specific Performance. Expectation Damages forces the parties to negotiate the possibility of an efficient breach ex-ante while bargaining over the contract price. Specific Performance on the other hand, enables the parties to negotiate this issue only when needed, after a specific efficient breach actually happens. Thus, Specific Performance generates fewer negotiations with lower costs.

The paper examines the transactions costs of Expectation Damages versus Specific Performance and compares: Negotiation Costs; Disagreement Costs; Complexity Costs; Uncertainty Costs; Damages Negotiations; Litigation Costs; Risk Sharing; Incentive to Find a Second Buyer; and Coordination Costs. All of these elements of costs are shown to be generally higher under Expectation Damages, indicating that Specific performance is a superior remedy.

Key word: efficient breach; contract damages; expectation damages; specific performance.

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[*]Tel-Aviv University, The Zvi Meitar Center for Advanced Legal Studies, The Buchmann Faculty of Law.

[1] When an alternative third party appears and offers the promisor to breach the contract with promise and the alternative contract is more efficient. For a discussion on the different types of efficient breaches, see Bigoni, Bortolotti, Parisi and Porat (2014).

1. Preface

This paper shows that the argument for the Expectation Damages remedy is highly problematic when dealing with the Efficient Breach issue. The Expectation Damages remedy causes very high transaction costs over looked by previous literature.

The key point is that under Expectation Damages the Promisee knows that the Promisor will receive all the gains from the transaction with the third party. So the Promisee will demand to get her share of the EB gains ex-ante, by bargaining on the initial contract price.[2] The parties must therefore negotiate the Efficient Breach issue **ex-ante**, every time they make a contract and before any breach have yet to happen.

Under Specific Performance however, if the parties do not expect to chance their bargaining powers, then the Efficient Breach negotiations are held **ex-post**, only after a specific breach has actually materialized.

Negotiating the Efficient Breach issue (**"EB"**) ex-ante under Expectation Damages creates substantial additional transaction costs, making the ex-post negotiation under Specific Performance to be much more efficient and cost saving:

(i) **Number of Negotiations**: Under Expectation Damages, the parties must consider and negotiate the efficient breach issue in every contract they make, despite the fact that only a fraction of these contacts are eventually breached. Under Specific Performance however, the parties negotiate the EB issue only when an EB event actually materializes, so many unnecessary negotiations are completely avoided.

(ii) **Risk of Disagreement**: Under Expectation Damages, the ex-ante EB negotiations are part of the initial contract bargaining, so a disagreement in these negotiations at that stage will result in a breakup of the contract and the loss of the entire contract surplus. However under Specific Performance, the EB negotiations are held ex-post and are separated from the original contract bargaining, so even if there is a disagreement about the EB issue, the parties will still perform the original contract and will suffer only a minor loss of the additional EB gains.

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[2] See Markovits & Schwartz (2011).

(iii) **Complexity and Uncertainty**: Under Expectation Damages, the parties conduct the EB negotiations ex-ante, before any EB event actually happened. In this early stage, all the details of a possible EB are unknown, speculative and must be estimated by the parties. Under Specific Performance however, the EB negotiations are held after a specific EB already happened. In this stage, all the details about the breach are known to the parties, there are no uncertainties and there is no need for estimations.

I compare and evaluate in this paper nine different elements of transaction costs: (1) Negotiation Costs; (2) Disagreement Costs; (3) Complexity Costs; (4) Uncertainty Costs; (5) Damages Negotiations; (6) Litigation Costs; (7) Risk Sharing; (8) Incentive to Find a Second Buyer; and (9) Coordination Costs, and find that all these elements of transactions costs are generally greater under Expectation Damages than under Specific Performance.

I demonstrate the arguments in this paper first through a numerical example. A formal model will then follow.

2. Numerical Example

Assume a Promisor ("**Seller**") who owns a land. The Seller enters into a contract with a Promisee ("**Buyer**") in which the Seller commits to transfer the land to Buyer in one year's time. The Seller values the land at **100**. The Buyer values that same land at **200**. A contract between them will create a surplus of 100 (200-100). Let us assume that the parties have equal bargaining powers or that they decided to share any surplus evenly between them, meaning a 50:50 split. The parties will therefore want to set the contract price at **150**.

Now let us assume that in this one year period and before the land is "delivered" to the Buyer, there is a **20%** chance that a second buyer might approach the Seller and offer him a price of **300** for that same land. This alternative deal will create a surplus of **200** (300-100) which is greater than the original surplus of 100, so if this happens it will be efficient to breach the contract. The social optimum from both contracts is **120** (80%*100+20%*200).

As mentioned, the parties decide to divide the entire surplus[3] evenly among them. Therefore, the parties will negotiate for an outcome that will provide each of them with an expected utility of **60**.

In light of the possibility of an Efficient Breach, the parties will now bargain for a contract price, depending on which contractual remedy will they choose, **Specific Performance**[4]or **Expectation Damages**[5]:

Under **Specific Performance** the contract price will remain at **150** as before. There is an 80% chance that the parties will perform the contract as usual, with no breach and with no need to discuss the issue of an Efficient Breach. If however, the second buyer will appear (20% probability), then the parties will renegotiate and reach a new agreement that will free Seller from the original contract. Seller will pay Buyer a 100 for her permission to breach (the parties split the new surplus of 200 evenly). In total, each party will get **50** if the original contract holds (80%) and **100** if the contract is breached (20%). The average utility for each of them is **60** (80%*50+20%*100).

Under **Expectation Damages** however, calibrating the contract price is no longer an easy task. Seller can breach at will and he alone will collect all the gains from the efficient breach ("**EB gains**"). Buyer will not get any share of the EB gains ex-post, so she must get her share of the gains ex-ante. In order to maintain the agreed 50:50 spilt of the surplus, the parties will negotiate the EB issue ex-ante on and will agree to reduce the contract price, to compensate the Buyer for her share of the expected EB gains. The parties Under Expectation Damages will set the initial contract price at **140** (a discount of 10). Buyer is now guaranteed a fixed profit of **60** (200-140) no matter if a breach occurs or not. The Seller will get a lower profit of **40** (140-100) if the original contract holds (80%) and a very high profit of **140** (300-100-60) if the contract is breached (20%). The average

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[3]Although, one can argue for an alternative method of allocation of gains, where the parties share only the gains created from the direct transaction among them (80) and all the gains from the transaction between Seller and the second buyer (40) are allocated entirely to Seller. See also footnote __ and accompanying text. An analysis of this alternative method of allocation is done elsewhere and in general, its conclusions are also in favor of Specific Performance.

[4] The Specific Performance remedy entitles the Promisee to enforce the contract. If Promisor wishes to breach the contract, and in particular to efficiently breach, then the Promisor must approach the Promisee and negotiate with her in order to get her acceptance for the breach. At the beginning, I will assume that the parties will always succeed in reaching a new agreement, in exchange for a payment by the Promisor to the Promisee. Later on, I will relax this assumption and evaluate the costs when the parties do no reach an agreement on this matter.

[5] The Expectation Damages remedy entitles the Promisee in an event of a breach, to receive monetary compensations that will put her in a place she reasonably expected to be, if the contract had been performed. In effect, Expectation Damages entitles the Promisor to breach the contract and transact with the third party, while the Promisee's only claim is for monetary damages.

utility for the Seller is also **60** (80%*40+20%*140). Note that under either remedy, each party is expected to receive the same outcome (60).

I will now turn to examine the transaction costs question. I will consider nine elements of transaction costs and as I will show, in general in each of these elements Specific Performance creates fewer costs.

(i)   Negotiation Costs

The traditional view is that Specific Performance creates additional negotiation costs because of the need to perform additional renegotiations on the Efficient Breach issue. Is that so?

Let us assume that negotiating the issue of an Efficient Breach ("**EB issue**") creates an economic loss of **10** ("**Negotiations Costs**").[6]

Under Specific Performance, in 80% of the cases the original contract will be performed as usual, with no breach of contract and therefore with no need to negotiate the EB issue.[7] So in probability 80% the Negotiations Costs are **zero**. Only when a second buyer party appears with an offer to breach (in probability 20%), only then will the parties start a negotiating process on the EB issue. The parties will bear Negotiation Costs of 10 in probability 20%, resulting in expected Negotiation Costs of **2** (0.2*10).

Under Expectation Damages however, the parties must negotiate ex-ante over the possibility of an Efficient Breach and adjust their contract price accordingly (to 140). The parties will negotiate the EB issue as part of their initial bargaining in each contract they make (100% of cases) resulting in expected EB Negotiation Costs of **10** (1*10). Expectation Damages thus creates high Negotiation Costs, higher than Specific Performance (5 times higher in our example).

Note that on both contractual remedies, the parties negotiate the EB issue and agree on an amount that Seller will transfer the Buyer for her share in the EB gains (a price discount of 10 in Expectation Damages, or a transfer of 100 under Specific Performance). The Expectation Damages remedy forces the parties to negotiate this issue in every contract they make, while Specific Performance allows the parties to negotiate this issue only when this issue actually materialize (20%). Choosing Specific Performance enables to postpone the EB negotiations to a later stage and in many times (80%) even avoid these negotiations all

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[6] These additional costs are caused by the need to gather information, invest time and effort in the negotiation process, pay lawyers fee, etc.

[7] The Price of 150 is set regardless of the EB issue.

together. The parties are essentially saving costs by deciding to 'cross the bridge' when they get to it.

(ii)   Disagreement Costs

The traditional view is that Specific Performance creates additional disagreement costs: When an EB event happens, in order for a breach to happen Seller must renegotiate with Buyer and seek her permission to breach. These renegotiations might fail and then the Efficient Breach opportunity would be lost. These losses are **Disagreement Costs**. Expectation Damages allegedly solves this problem because Seller can breach at will and thus Expectation Damages guarantees the capture of the EB gains. Is that so?

Let us assume that whenever the parties discuss the EB issue, there is a **10%** chance that they will fail to reach an agreement on this issue.[8]

Under Specific Performance, in 80% probability the original contract will be completed as usual with no need to negotiate the EB issue, therefore there are **zero** Disagreement Costs in 80% probability. There is also a 20% chance that a second buyer will appear and the parties will then renegotiate the EB issue. In 10% of these 20% cases, the renegotiation will fail and the EB gains will be lost. Note first that a disagreement will happen in only **2%** of contracts. Second, in the event of disagreement the parties return to their original contract, which still gives them a nice surplus of 100, so the parties lose only the marginal addition of the gains expected from the breach (100). Under Specific Performance, Disagreement Costs will be **2** (0.8*0+0.2*0.1*100).

However under Expectation Damages, the parties must negotiate and settle the EB issue ex-ante, as part of their initial bargaining process. The EB issue is tied and tangled up with all other issues of the contract, so when a disagreement breaks over the EB issue (in 10% probability) it will cause a breakup between the parties[9]and a loss of the entire expected surplus[10] (120). Under Expectation Damages, the Disagreement Costs will be **12** (0.1*120).

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[8] I assumed here that the chance for a disagreement between the parties when negotiating the EB issue (10%) is constant, whether they negotiate this issue ex-ante or ex-post. However, it can be argued that likelihood for a disagreement might vary, for instance because of the different gains that are at stake.

[9] Another route that is available for the parties in such an event of disagreement is of course to move from Expectation Damages to Specific Performance.

[10] I assume here that if the original bargaining between Seller and Buyer fails, then Seller will not wait for a year for a 20% chance to contract directly with a potential second buyer (for further discussion on this matter, see ___). Therefore, a disagreement in the initial bargaining stage will create a loss of the entire surplus available (120) from both contracts. However, a different factual assumption is possible,

The Disagreement Costs under Expectation Damages are higher than under Specific Performance, six times higher in our example. The parties under Expectation Damages must negotiate the EB issue more often and much sooner, so the risk for disagreement is greater and the surplus at stake is a larger. Parties who wish to minimize possible disagreements and lower Disagreements Costs should therefore choose Specific Performance.[11]

(iii)   Complexity Costs

Another aspect of transaction and negotiation costs is the level of complexity of the negotiations process. The negotiation process can be described as a series of variables that the parties need to consider and negotiate on. The more variables there are for the parties to consider, the more complex the negotiations process becomes and the more costs the parties will have to bear.

For the sake of simplicity, let us assume that each variable of the negotiation process creates a Complexity Cost of **1**. Under Specific Performance, the parties do not need to know any details about the Efficient Breach issue in order to reach an agreement. There are only **3** variables they must consider: Seller's valuation (100) Buyer's valuation (200) and the parties' method of allocating gains (50:50 split). These 3 variables suffice to supply the contract price (150). In most cases (80%) a second buyer does not arrive and the original contract is performed as usual, without any need for further negotiations. In the remaining 20% of the cases, parties will have to renegotiate the EB issue. But note that by then, the parties need to consider only **one** more additional variable:[12] the second buyer's offer (300). Under Specific Performance, Complexity Costs will be **3.2** (3+0.2*1).

Under Expectation Damages however, the parties must consider in their bargaining all **5** different variables, the previous three variables plus the two EB variables - the probability of a better offer (20%) and the expected value of such

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where losing the contract with the original buyer A enables the Seller to wait a year and have a 20% chance to transact directly with the second buyer B, and still profit 200 by himself. This alternative possibility creates an available surplus of 40(0.2*200) which is not lost in an event of a disagreement, so the Disagreement Costs under this alternative assumption are 8 (0.1*0.8*100), still 4 times higher than the Disagreement Costs of 2under Specific performance.

[11]Another aspect of disagreement costs created solely under Expectation Damages, are the costs created when the parties disagree on the amount of damages that Seller must pay Buyer, in an event of an EB. A disagreement on this issue will imposes additional negotiation costs, as well as high litigation costs, as will be described in Section __.

[12] I assume that after a variable is evaluated by the parties in an early negotiation, this variable will no longer be accounted for and will not create additional complexity costs in later negotiations. An alternative method can be to count each variable whenever it is used. In this way, the Complexity Costs under Specific Performance will be **3.6**, and under Expectation Damages will **5 plus** all the negotiations costs on the Damages issue. See Section __.

an offer (300). The parties must consider all these 5 variables in their negotiations in each contract, resulting in high Complexity Costs of **5**.

Another way to demonstrate the high complexity costs of Expectation Damages is through the need to consider the **Probability Variable** for an Efficient Breach (20%). Under Expectation Damages, this variable affects the initial contract price and so it is of great importance. Parties under Expectation Damages must invest a great deal of time and effort in considering and negotiating the likelihood of an EB. However under Specific Performance, the parties can completely avoid this issue and this variable. Both the ex-ante negotiation (the contract bargaining) and the ex-post negotiations (the EB renegotiation) are done without the need to consider the probability of an EB[13]. The difference in Complexity Costs is therefore evident.

In sum, Parties who wish to simplify their negotiation process (or having trouble calculating, estimating or agreeing on the probability of an EB) will do wisely by choosing Specific Performance and thus will have fewer variables to consider and could even avoid the issue of probability altogether.

(iv)   Uncertainty Costs

Another important aspect of Transaction Costs is the level of uncertainty of the elements of the negotiations process. If the variables of the negotiation are vague, controversial or uncertain, then the negotiation process becomes more complicated and more costly. The parties will need to invest time and effort into collecting data and making estimations. An Uncertain Variable creates a gap between the parties' different estimations, causing longer and harder negotiations with greater risk of disagreement. Let us define all these additional costs as **Uncertainty Costs**. For sake of simplicity, let us assume that each uncertain variable creates an additional Uncertainty Cost of **1**.

Under Expectation Damages, the parties must consider two uncertain variables: the probability of an offer (20%) and the expectancy value of such an offer (300). These two variables are external, futuristic and must be calculated and estimated by the parties, ex-ante. Their Uncertainty Costs are **2**.

Under Specific Performance however, the parties suffer **zero** Uncertainty Costs, both ex-ante and ex-post. At the ex-ante stage, the parties bargain over the initial

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[13] In the ex-ante stage, the parties can disregard the possibility of an EB, because they will resolve this issue in a later date, if and when it will arise. In the ex-post stage, the EB already happened so there is no need to consider its probability.

contract price regardless of the uncertainty variables of an EB. At the ex-post stage when they renegotiate the EB issue, all of the EB variables are already known. After the second buyer has already appeared and made a specific offer to Seller, there is no need to estimate a possibility of an EB or the expected of such an offer.

In sum, Expectation Damages causes high Uncertainty Costs. If the parties wish to reduce their uncertainties' - because for instance, they find it hard to calculate or negotiate the probability of an EB or the expectancy of such an EB offer - they should move to Specific Performance.

(v)   Damages Negotiations

Another aspect of transaction costs is the costs of negotiating the Damages issue, meaning to assess the amount of damages that the Seller must pay the Buyer, in the event of a breach. The parties must negotiate this issue only under the Expectation Damages, whereas the Specific Performance remedy enables the parties to avoid this issue completely and to save these negotiating.

Under Specific Performance, the issue of damages for the Buyer is not negotiated at all: not at the initial stage of the bargaining[14] and not at the later stage of renegotiation.[15]

However under Expectation Damages, the parties must negotiate this issue whenever there is a breach and sometimes negotiate it even when there is no breach. The parties must agree on a specific amount that the Seller will pay the Buyer, or else the parties will have to settle this issue in court.[16]

The parties under Expectation Damages may choose to conduct these Damages Negotiations **ex-ante**: they can negotiate the damages issue at the initial bargaining stage and include a 'Liquidated Damages Clause' in case of an efficient breach.[17] The costs of these ex-ante Damages Negotiations are expected to be

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[14] Note that in the ex-ante bargaining, Seller does not get the option to efficiently breach, so the parties basically leave this issue to future negotiations, if needed.

[15] Note that in the ex-post renegotiations, Buyer does not demand Seller to pay her damages (50) but instead she demands her share of the additional gains from the EB (100). The parties deliberate on how to allocate the EB profits (meaning, an EB negotiation) and they do not negotiate on the Buyer's losses and expectations from the original contract (meaning, damage negotiation). However, one might argue that the EB renegotiation inherently includes also the aspect of Buyer's expectation and damages, at least as a starting point. On the issue of combing two negotiation processes into one, see also Section ___.

[16] See Section ___.

[17] Although, the parties may decide to draft a general liquidated damages clause that relates to all kinds of breaches by Seller. So in such a case, there will be no additional negotiating costs on the damages issue.

high[18]. Alternatively, they may choose to delay the Damages Negotiations by conducting these negotiations **ex-post**, only when and after an efficient breach actually materializes. These ex-post negotiations on the damage issue are expected to be difficult and expensive. Furthermore, these Damage Negotiations might fail and lead the parties to costly litigations in court, as described in the next Section.

(vi)   Litigation Costs

Under Expectation Damages, when an EB event occurs and the Seller breach, Buyer has a right to receive damages from Seller. The parties will have to negotiate[19] the terms of the damages payment[20] and there is a substantial risk that these discussions will fail[21], sending the parties to costly litigations in court.

Under Specific Performance however, there is no risk of courts involvement and therefore there are **zero** Litigation Costs. First, there is no controversy on the damages issue, so the parties will not negotiate or litigate this matter. Secondly, their controversy on the EB issue - on the question of how much will the Seller pay the Buyer for her permission to breach - does not lead the parties into court. Instead, they go back to perform their original contract which is still beneficial

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[18] For all the reasons that where discuss before: (i) the parties will have to negotiate this issue in every contract they make (100%) even when only a fraction of these contracts are eventually efficiently breached (20%); (iii) these damages negotiations will be held at a time when all the information about Buyer's possible damages are vague and uncertain (iii) a disagreement on this issue might will result in a total disagreement on the agreement itself.

[19] For a discussion on the costs of this negotiations, see Section __ above.

[20] Even if the parties succeed to agree on the amount to be paid, Seller might have an incentive to renege payment or raise issues about the terms of payment.

[21] Comparing the ex-post renegotiation under Expectation Damages ("ED") (on the damages issue) to the ex-post renegotiation under Specific Performance ("SP") (on the EB issue) I find strong indications that there Expectation Damages renegotiation creates a bigger risk for disagreement and litigation costs: (1) The starting point - The damages negotiations are held in light of the unilateral breach by the Seller. A hostile atmosphere might lead to further disagreements; (2) The end point - The damages negotiations are a 'zero sum game'. Seller has a negative incentive to reach an agreement to transfer money to Buyer (compare to the SP renegotiations, where both parties benefit from the renegotiations); (3) Asymmetric information - The SP negotiations are negotiated over the allocations of the second buyer's offer (300) and information that is known to both parties negotiating. The ED negotiations however are held when there is a basic asymmetry in information about the variable they negotiated, the expected value of the contract to the Buyer (200); (4) The time factor - The SP negotiations must be over quickly, because that second buyer is waiting. The maximum duration is confined to the duration of the second buyer's offer. The ED negotiations however, are not confined in time, and are only bonded by the statute of limitation; (5) Estimations on the alternative - The ED negotiations are held in light of the alternative remedy from the court. The parties might have different estimations on the outcome of the trial.

for both of them. Without a legal claim on other terms of the contract, claims which are outside of the scope of this paper,[22] the parties will stay out of court.[23]

(vii)   Risk Sharing

Usually, it is better to spread a risk between as many people rather than letting the risk fall on one person alone. That way, the costs associated with risk lessen.[24]

Under Expectation Damages, the Buyer is risk free (he always gets 60) but the Seller has a high degree of risk (he can get from 40 to 160). The Expectation Damages makes the Seller alone bear all the risk from the breach. Under Specific Performance however, both parties will share the risk associated with the breach.

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[22] Although, Specific Performance might incentives Seller to raise legal claims of other breaches by Buyer, in order to release him from the original contract. Assume a Seller who has a weak claim of an alleged breach by Buyer. In a normal scenario, Seller will withhold raising this claim because of its negative expectancy in court. However, if Seller has an opportunity to effect an Efficient Breach, the upside of litigation increases: Seller can argue for the cancellation of the contract, transact with the second buyer for a large profit and then get sued by the Buyer. Seller's expectancy from litigation might turn to be positive. A legal system with a court fee on the prosecutor (or other legal differences between being prosecutor or defendant) can also affect this incentive. However, note that this kind of a weak argument can also be used by the Seller under Expectation Damages, to justify his reluctance to pay damages.

[23] There are of course general problems with the Specific Performance remedy and its enforcement by the courts. See Schwartz (1979). However, these enforcement problems are not a part of this model: First, there is no issue of a regular breach, only the possibility of a 'gain-seeking' efficient breach; Secondly, whenever there is no possibility of judicial enforcement and of Specific Performance, there is also no real dilemma between specific Performance or Expectation Damages; Third, a remedy of Full Disgorgement (disgorgement of all Seller's EB gains, if Seller breaches without Buyer's consent) can allegedly be a good substitute for Specific Performance, whenever this remedy cannot be enforced.

[24] Due to the phenomenon of diminishing marginal utility, most people are risk averse and their dislike toward risk increases.

Specific Performance

Seller

80%   *20%*

50   100

Buyer

80%   *20%*

50   100

Expectation Damages

Seller

80%   *20%*

40   140

Buyer

100%

60
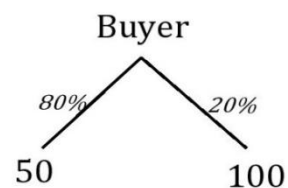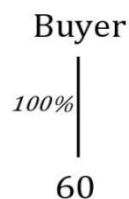
Specific Performance allows for distribution of the risk between both parties[25]. Expectation Damages on the other hand, allocates the entire risk on Seller alone, which creates additional costs. Parties who wish to spread and share the risk from a potential efficient breach should choose Specific Performance.

(viii)   Incentive to Find a Second Buyer

Traditionally it has been argued that Expectation Damages is a better remedy from the aspect of the incentives of the Seller to find a second buyer and capture the EB gains. Under Expectation Damages, Seller is "allowed" to breach and he alone will get the gains from the breach, so Seller has a full incentive to invest time and effort in finding such a second buyer. Specific Performance on the other hand, had been perceived as an inefficient remedy because it eliminates the Seller's incentive to efficiently breach. Seller is not allowed to breach and his gains from this breach will be diminished because of the "bribe" he need to pay Buyer, so the incentive to find a second buyer diminishes. Is that so?

It is true that under Expectation Damages, Seller has a full incentive to breach. In our example, in an EB event Seller gains an additional 100 (from 40 to 140). Under Specific Performance however, Seller's incentive to breach drops by half to **50** (from 50 to 100). But that is only half of the picture, because under Specific

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[25] I assume that both parties are risk averse and are more or less homogeneous toward risk. However, if for instance, the Seller is risk-seeking or Buyer is very risk-averse then the Expectation Damages remedy will work better than Specific Performance. Section __ will further discuss this issue.

Performance not only does the Seller has an incentive to breach, but also the Buyer has a strong incentive to invest and find a second buyer and to allow for an EB. Under Specific Performance, Seller and Buyer will each get an additional 50 in an event of an EB (from 50 to 100).

Specific Performance does not diminish the incentive to efficiently breach. Specific Performance simply divides this incentive to both parties, according to their bargaining power. Instead of Seller alone who gets the full incentive to find an EB, Specific Performance grants both parties with partial incentives to find such a buyer.

The possibility to allocate positive incentives on both sides presents substantial advantages. Now both parties will want to search for better buyers, and not just one party alone. Many times, granting incentives to both parties will be more efficient, so in these cases Specific Performance has a strong advantage. On the other hand, it may be argued that only Seller can find alternative buyers, or that Buyer's efforts are redundant, or that efforts from both parties may overlap. If it is more efficient to grant this incentive to Seller alone, then the parties would prefer using the Expectation Damages remedy.

(ix)   Coordination Costs

In this model, the parties have essentially two issues to negotiate on: price (150 or 140) and contractual remedy (Specific Performance or Expectation Damages). These two issues are linked, choosing to remain with the original price of 150 mandates Specific Performance, while choosing the Expectation Damages remedy mandates negotiating for a new adjusted price of 140. The coordination aspect between price and contractual remedy will also leads us to favor Specific Performance.

(a) Price is the first negotiated issue

In general, parties first negotiate and agree on the price issue before they move to other things. Usually price is the most important issue for the parties. In most business transactions, only after the parties have reached an agreement over the price will they continue and move on to discuss other matters, if at all.

Viewing the negotiation process as a price-oriented process will cause parties to favor Specific Performance. The parties will first agree on the price of 150. Only then they will move to discuss other issues such as the contractual remedy issue and the possibility of an Efficient Breach. If by then they will choose the

Expectation Damages remedy, then they will have to reopen the issue of price and renegotiate it (to 140) causing high transaction costs.

Specific Performance on the other hand, allows parties who already have an agreed price to move on and choose an efficient remedy that will not cause them to go back and reopen the price issue. Parties that usually first agree on the question of price will prefer Specific Performance over Expectation Damages.

(c) The agency effect

As a practical matter, business parties like to negotiate by themselves over the issues of price and to leave the legal issues to the hands of the lawyers. There is the business negotiation, where the parties themselves[26] give and take on the business issues (meaning, price) and there is the legal negotiation, which is conducted by the lawyers giving and taking on the legal issues (meaning, the contractual remedy).

A Specific Performance contract allows these two negotiations to advance separately. The businessmen can settle all the business issues and the lawyers can settle all the legal issues.

However, an Expectation Damages contract forces the parties to lift the curtain that was once drawn between these two negotiations. Now the parties have to coordinate and cross-negotiate between business and legal issues. The legal counsels can no longer settle all legal issues between themselves. The two negotiations are dependent in one another and must be coordinated between four sides. The need to coordinate between two negotiation teams under Expectation Damages will generate additional transactional costs. If Seller's lawyer rejects Specific Performance and insists on Expectation Damages, then the lawyers must halt their negotiations and reach out back to their clients and notify them of the need to negotiate an adjusted contract price. Lawyers might be reluctant to admit to their clients that there is a (legal) problem that both lawyers cannot work out by themselves and the clients need to provide a business solution (a reduction in the price) for a legal problem.

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[26] Or their business representatives.

Part II - The Model

3. Set Up

Assume the sale of an asset from a seller ("**Seller**") to a buyer ("**Buyer A**" or "**A**") for a price of **P**. The Seller values the asset at **c** (or c is Seller's cost of production). Buyer A values the asset at V_A. The bargaining power of buyer A over Seller is α. After the contract has been signed, a second buyer ("**Buyer B**" or "**B**") may appear in probability **β** and offer Seller a higher price for that same asset P_B. This event will be defined as an Efficient Breach[27] or ("**EB**").
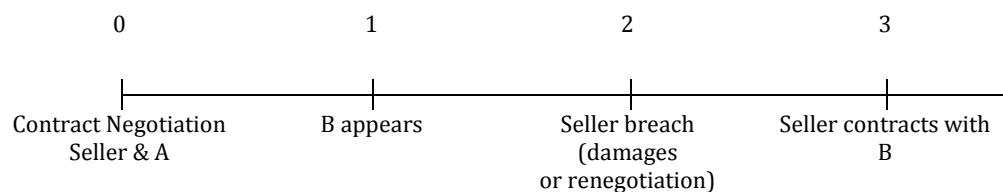
The contract between Seller and Buyer A can be protected by either a legal rule of Expectation Damages or a legal rule of Specific Performance:

Expectation Damages ("**ED**") means that the Seller has the right to breach his contract with A, as long as he pays A her expectance damages (V_A- P_{ED}). Seller will collect all the additional gains from transacting with B.

Specific Performance ("**SP**") means that the Seller has no right to breach his contract with A. Buyer A has the legal right to enforce the original contract. If Buyer B appears and offers Seller an Efficient Breach, Seller needs to get Buyer A's acceptance. Therefore, Seller and A will renegotiate. Buyer A will demand for himself part of the gains for the transaction with B. Seller will effectively try to bribe A for his permission to breach. Under Specific Performance, the gains from the Efficient Breach will be divided between Seller and Buyer A in accordance with their respective barraging powers.

4. Timeline

The timeline of the model is as follows:

0	1	2	3
Contract Negotiation Seller & A	B appears	Seller breach (damages or renegotiation)	Seller contracts with B

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[27] A breach of a contract will be an efficient one whenever the alternative Buyer B values the asset more than the original Buyer A (V_B>Va). But Seller will reject B′s offer to breach if B is offering a price smaller than A′s value of the asset (P_B<Va). Therefore, in order for it to be an Efficient Breach scenario, Buyer B must offer the Seller a price above A′s value of the asset (P_B>Va).

At t=0, the parties negotiate the initial contract. They have to decode on two issues: (1) price; and (2) the contractual remedy (either Expectation Damages or Specific Performance). If the Expectation Damages remedy is chosen, then the parties will also negotiate at this stage over the EB issue and this negotiation will be reflected in the price. If the parties fail to reach an agreement at this stage, then they will lose all their expected gains from contracting.[28] If the parties manage to reach an agreement, then they move to t=1.

At t=1, the parties learn whether a Buyer B appears with an Efficient Breach offer. If there is no EB offer, then the original contract is performed. At t=2, the parties try to breach the contract. If they agreed on Expectation Damages, then the Seller will breach and pay damages to Buyer A. If, however, they agree on Specific Performance, then the parties will have to renegotiate and try to find an amount that Buyer A will accept in exchange for her acceptance of the breach. At t=3, the Seller will contract with the new Buyer B. In the alternative, if the Seller and A renegotiated but failed to reach an agreement, then the parties will return to the original contract and perform it.

5. Assumptions

The following assumptions are made:

- (i)   Full and symmetric information is assumed.
- (ii)   No reliance expenditures are made by either party.
- (iii) Expectation Damages and Specific Performance are the only two contractual remedies available.
- (iv)   The parties do not change their bargaining powers (α) during the time line of the model. α is constant.[29]
- (v)   The parties share all available gains according to their respective bargaining power (α). Meaning, parties do not consider that the gains from the breach should be allocated to Seller alone.[30]

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[28] A possible alternative story is that after the parties fail to reach an agreement under ED, the Seller waits for the appearance of Buyer B. If B appears, then the Seller could contract with directly him without any need to breach. See Section ___.

[29] See Section __ for further discussion on this assumption.

[30] See Section __ for further discussion on this assumption.

6. The Contract Price - and the Allocations of Gains

Let us start with a scenario in which there is no chance of a second buyer appearing ($\beta = 0$). The parties' only surplus is from the original contract: $V_A - c$. This surplus will be divided according to α, the parties bargaining power:

Buyer A's utility is: $U_A = \alpha(V_A - c)$.

Seller's utility is: $U_{Seller} = (1 - \alpha)(V_A - c)$.

The contract price will be: $P = V_A - \alpha(V_A - c) = c + (1 - \alpha)(V_A - c)$.

Now let us explore the possibility of an Efficient Breach, a probability β for an alternative Buyer B to appear and offer Seller P_B. In an event when B does arrive (probability β), Seller will breach and a new surplus ($P_B - c$) will be available. The utility in this state of the world is $\beta(P_B - c)$. In the event that B does not appear $(1-\beta)$ parties will stay with the original contract, and the utility in this state of the world is $(1 - \beta)(V_A - c)$. The total surplus available is therefore: $\beta(P_B - c) + (1 - \beta)(V_A - c)$ or:

$$(V_A - c) + \beta(P_B - V_A) \tag{1}$$

The left side of the expression, $(V_A - c)$, is the surplus created from the original contract. The right side of the expression, $\beta(P_B - V_A)$, is the additional surplus created from the Efficient Breach (i.e., the EB gains). The parties will want to share this surplus between them in accordance with their bargaining power α:

Buyer A's utility is: $U_A = \alpha\left[(V_A - c) + \beta(P_B - V_A)\right]$ $\qquad$ (2)

Seller's utility is: $U_{Seller} = (1 - \alpha)[(V_A - c) + \beta(P_B - V_A)]$ $\qquad$ (3)

Note that the allocation of the surplus between the parties is constant and depends only on the parties bargaining powers (α) regardless which contractual remedy will be chosen.[31]

(i) *Specific Performance*

Under *Specific Performance*, the surplus is divided separately in each stage. At t=0, the parties negotiate and share the surplus from the original contract ($V_A - c$) according to α. The contract price under Specific Performance is:

$$P_{SP} = V_A - \alpha(V_A - c) = c + (1 - \alpha)(V_A - c) \tag{4}$$

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[31] This statement is of course derived from the famous Coase Theorem. For a more detailed discussion on this statement, see Markovits & Schwartz (2011).

When Buyer B does not appear in stage t=2 (probability 1- β), then parties will perform the original contract and will be left with the original contract gains $(V_A - c)$. But when B does decide to appear (probability β), then the parties will renegotiate and share the EB gains of $(P_B - c)$ according to their bargaining powers α. Seller will have to pay Buyer A the sum of α $(P_B - c)$ to get her consent to breach. Buyer A's and Seller's utility will be:

$$U_{Buyer\,A} = (1 - \beta)\,\alpha(V_A - c) + \beta\,\alpha(P_B - c) \tag{5}$$

$$U_{Seller} = (1 - \beta)(1 - \alpha)(V_A - c) + \beta(1 - \alpha)\,(P_B - c) \tag{6}$$

The left side of both expressions is the parties' utilities when B does not appear. The right side is their utilities when B does appear.

(ii) *Expectation Damages*

Under a contract remedy of Expectation Damages, Seller can breach the contract at will and he alone will get the entire EB gains from B. Buyer A knows this and will demand her share of the EB gains in advance as part of the initial contract price. Buyer A will demand a reduction in price at t=0 to compensate her for the fact that she will not obtain any share of those EB gains at t=3.

Buyer A's overall utility is $U_A = \alpha\,[(V_A - c) + \beta(P_B - V_A)]$. Under Expectation Damages, Buyer A will get this utility ex-ante in the initial contract. Therefore, the contract price under Expectation Damages will be:

$$P_{ED} = V_A - \alpha[(V_A - c) + \beta(P_B - V_A)]\text{, or:}$$

$$P_{ED} = V_A - \alpha(V_A - c) - \alpha\beta(P_B - V_A) \tag{7}$$

Following (4) this can also be written in the following way:

$$P_{ED} = P_{SP} - \alpha\beta(P_B - V_A) \tag{8}$$

Since the right hand side of the expression, is always negative, then:

$$P_{ED} < P_{SP} \tag{9}$$

We can conclude that whenever there is likelihood for a better buyer to appear and a possibility for an Efficient Breach, the contract price under Expectation Damages will be lower than the contract price under Specific Performance.

7. The Transaction Costs

In a world without transaction costs, both legal remedies should be identical in their outcome because the parties will adjust their contract prices ex-ante accordingly. The key question in evaluating the two contractual remedies is the question of transaction costs. What are the transactions costs associated with Expectation Damages and Specific Performance? Which of the two remedies generates fewer costs?

I will now compare the endogenic negotiation costs of Expectation Damages and Specific Performance, and present a discussion of nine categories: Negotiation Costs, Disagreement Costs, Complexity costs, Uncertainty costs, Damages Negotiations; Litigation Costs; Risk Sharing; Incentive to Find a Second Buyer; and Rigidity to Change. All of these costs are higher under Expectation Damages; this is a strong indication that the Specific Performance remedy usually creates fewer costs and is therefore more efficient.

8. Negotiations Costs

Let us define the costs created by the need to negotiate the EB issue as nc. Under Specific Performance, the parties negotiate the EB issue only when B appears, in probability β. Negotiation Costs ("**NC**") under Specific Performance are:

$$NC_{SP} = \beta nc.$$

Under Expectation Damages, the parties must negotiate the EB issue ex-ante, in each and every contract they make. The Negotiation Costs under Expectation Damages are:

$$NC_{ED} = nc.$$

Expectation Damages creates $1/\beta$ more Negotiation Costs than Specific Performance. The smaller the chances are for an EB, the bigger the difference becomes[32].

Two reservations can be mentioned about the costs if negotiations. One is that the negotiation costs on the EB issue cannot be too high. The costs of negotiating the EB issue must not exceed the benefits from the EB gains ($NC < \beta(P_B - V_A)$. Otherwise, the parties will be reluctant to negotiate the EB issue ex-ante under

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[32] Expectation Damages will always create more Negotiation Costs because those these costs will equalize only when $\beta = 1$, but then when the EB is 100% certain, there is no gain to the original contract between Seller and Buyer A.

Expectation Damages, and will do so only under Specific Performance.[33] Another reservation is an alternative assumption, where the Negotiation Costs are not a fix amount, but are dependent to the surplus sum which is at stake. If the NC are a fixed percent of the surplus, then both remedies will create the same costs, $NC_{ED} = NC_{SP}$.[34] Although, it is more reasonable to believe that the increase rate of such negotiation costs is declining, so the costs under Specific Performance are lower.

9. Disagreement Costs

Let us define the costs created by the failure to reach an agreement ("**Disagreement Costs**" or "**DC**") as $DC = \gamma \cdot L$, where γ is the probability that the parties will fail to reach an agreement and L is the gains from said agreement that are lost.

Under Specific Performance, the parties will negotiate the EB issue only when B appears in probability β. If parties then fail to reach a new agreement to breach, then they will go back to their initial contract, resulting in the loss of only the EB gains of $P_B - V_A$. The Disagreement Costs are therefore: $DC_{SP} = \beta \cdot \gamma(P_B - V_A)$.

Under Expectation Damages, however, the parties have to negotiate the EB issue ex-ante, at the initial negotiation stage of t=0. If they fail to reach an agreement at this stage, they will lose all surpluses created from both the original contract with A and the alternative contract with B[35]. The Disagreement costs are: $DC_{ED} = \gamma[(V_A - c) + \beta(P_B - V_A)] = \gamma(V_A - c) + \beta\gamma(P_B - V_A)$.

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[33] Suppose that in our example, that the costs from negotiating the EB issue are 30. Under Expectation Damages, the parties will refuse to negotiate this issue because its costs are 30 and its marginal benefits are only 20. If the parties can settle this issue without negotiating, then they may prefer to do so under Expectation Damages. Otherwise, the parties will prefer Specific Performance, because the EB negotiations are held ex-post and by then the benefits from the EB are larger (200) so negotiating turn to be efficient.

[34] _____.

[35] An alternative possibility exist where after the disagreement between Seller and buyer A over the EB issue, Seller will take the β chance for a transaction directly with buyer B. Sometimes this possibility exists and sometimes it does not. For further discussion on these alternative circumstances, see Yarkoni (2015). With this possibility at hand, after the disagreement over the EB issue Seller could still capture the EB gains from buyer B ($\beta(P_B - c)$). The disagreement with A will cause Seller a loss of the original contract only if buyer does not show up in probability $(1 - \beta)$. The Disagreement costs will then be: $DC_{ED} = \gamma(1 - \beta)(V_A - c)$. In this scenario, which contractual remedy will create fewer Disagreement Costs? In most cases, Expectation Damages still creates greater Disagreement Costs. A situation where Specific Performance costs are higher is when: $\gamma(1 - \beta)(V_A - c) < \beta \cdot \gamma(P_B - V_A)$. But this will happen only when $V_A - c < \beta (P_B - c)$ meaning when the utility from the first contract with A (the left side) is smaller from the expected utility from a possible contract with B (right side).

The expression on the left represents the Disagreement Costs from the original contract with A. The expression on the right represents the Disagreement Costs from the alternative contract with B. Expectation Damages creates higher Disagreement Costs than Specific Performance. The additional Disagreement Costs that Expectation Damages creates are: $\Delta_{DC} = \gamma(V_A - c)$.

10. Complexity Costs

Another important element of negotiations costs is the complexity level of the negotiation and the number of variables that must be considered in negotiation. Complex negotiations generate more costs than simple ones. The complexity of a negotiation depends on the number of variables that must be evaluated during the deliberations. The more variables there are for the parties to consider, the more complex and costly the negotiation process gets. Each variable creates additional[36] information costs and negotiation costs.[37]

Let us assume Complexity Costs ("**CC**") for each additional variable needed for an agreement. Under Specific Performance, the contract price is $P_{SP} = V_A - \alpha(V_A - c)$. Here, there are **three** variables for the parties to consider: $(V_A; \alpha; c)$. The Complexity Costs at t=0 will be: $CC(V_A) + CC(\alpha) + CC(c)$. If Buyer B appears (in probability β) , then the parties will renegotiate at t=2 over the EB issue. In this second negotiation, the Seller will pay buyer A $\alpha(P_B - V_A)$ for her permission to breach. This second negotiation presents only 1 more additional variable (P_B) for the parties to negotiate, and this one additional variable will be added in only β of the cases. The Complexity Costs under Specific performance are: $CC_{SP} = CC(V_A) + CC(\alpha) + CC(c) + \beta * CC(P_B)$.

However, under Expectation Damages, the parties will have to negotiate ex-ante about the EB issue and consider all the EB variables in each contract. The contract price is: $P_D = V_A - \alpha(V_A - c) - \alpha\beta(P_B - V_A)$. The parties must consider

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[36] Note that is assumes that only new variables complicates the negotiation process and a variable that the parties have already considered and evaluated does not create additional Complexity Costs.

[37] Usually the parties do not negotiate the variables themselves but negotiate a total price. Nevertheless, the number of variables needed to be considered and evaluated by the parties will affect the information costs and the negotiations costs of the parties. Additional variables mean more information to gather and evaluate, a prolonged and complicated negotiation process with greater risk for disagreement.

all **five** variables $(V_A; c; \alpha; \beta; P_B)$, and therefore Complexity Costs will be: $CC_{ED} = CC(V_A) + CC(\alpha) + CC(c) + CC(P_B) + CC(\beta)$

Specific Performance causes fewer Complexity Costs than Expectation Damages. The additional difference (Δ) in Complexity Costs created by Expectation Damages is: $\Delta_{CC} = (1 - \beta)CC(P_B) + CC(\beta)$. Note that Expectation Damages creates two kinds of additional Complexity Costs:

β $-$ Probability of Buyer B appearing: this variable is very relevant under Expectation Damages and will create costs in every contract (100%). However, under Specific Performance, the parties can ignore this variable completely. Parties will save large costs of evaluating this factor and of negotiating over it.

P_B $-$ Buyer B's offer: under Expectation Damages, this variable is relevant and creates costs in every contract (100%). However, under Specific Performance, this variable creates costs only in β of the times.

11. Uncertainty Costs

Let us define Uncertain Variable ("**UC**") as a variable that is unknown to the parties at the time of agreement. Uncertain Variables are much more costly to negotiate because they make parties invest extra time and effort into gathering information, making estimations, performing calculations of probabilities and expectancies, and negotiating the various valuations.

In this model, at t=0 two variables **β** (probability of a buyer B) and **P_B** (expected price offered by B) are Uncertain Variables.[38] However, at t=2, these two variables are no longer uncertain. At t=2, the parties know where Buyer B appeared, $\beta = (0,1)$, and they know the actual amount of Buyer B's offer (P_B).

Let us assume that each Uncertain Variable needed for the agreement will create an Uncertainty Cost of μ. Under Specific Performance, parties negotiate over the initial contract regardless of any Uncertain Variables. Furthermore, when B appears and the parties renegotiate the EB, all of the EB variables are already known. At that time, there is no need to estimate β because he already appeared or not. Similarly, there is no need to evaluate P_B—the second buyer's expected offer—because a specific offer had been already offered to the Seller. Under Specific Performance, the parties negotiate the EB issue when a second party had
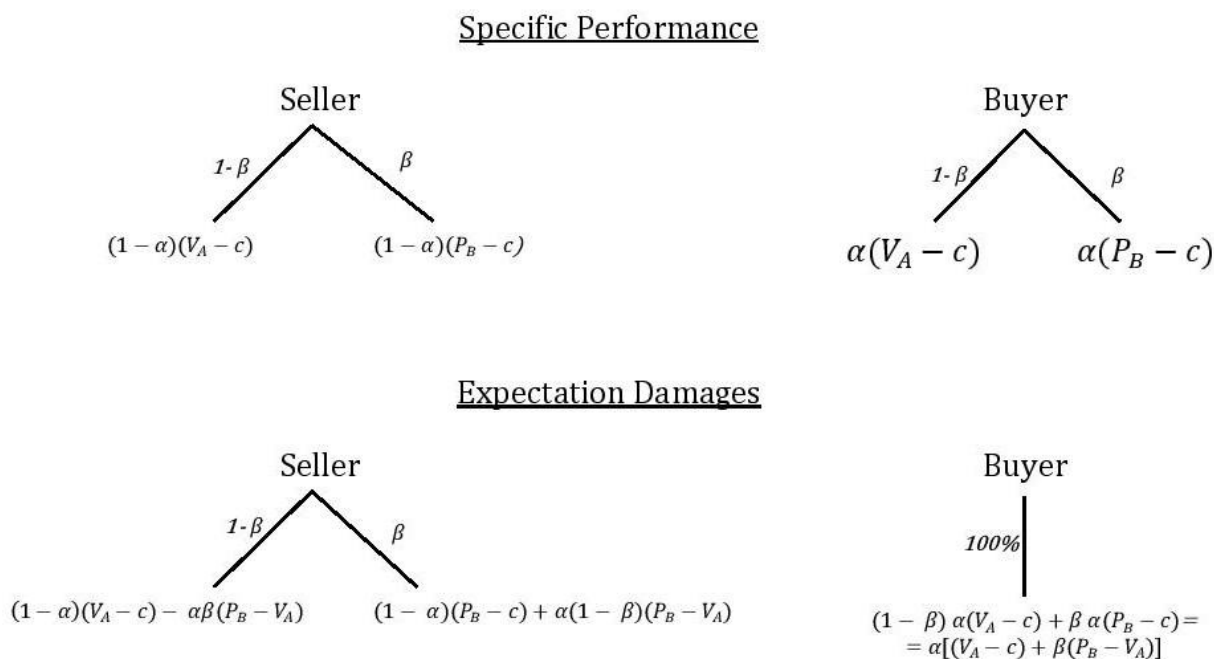
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[38] As opposed to c (costs to the Seller) of V_A (value for Buyer A) and α (their bargaining powers) which are internal variables, known to the at least one of the parties, so usually theses certain variable are much easier to negotiate, especially under an assumption of symmetric information.

already appeared and made a specific offer, so there are **zero** Uncertainty Costs when negotiating. $UC_{SP} = 0$.

In comparison, under Expectation Damages, the parties negotiate the EB issue in the initial stage of bargaining and before such an offer materialized. The parties are uncertain about the probability of such an offer (β) and about the expected value of such an offer (P_B).The Uncertainty Costs under Expectation Damages are: $UC_{ED} = 2\mu$. Since $0 < 2\mu$, then $UC_{SP} < UC_{ED}$; this makes Uncertainty Costs generated under Specific Performance lower than those generated under Expectation Damages.

12. Risk Sharing

Let us assume both parties are similarly risk averse, and their utility from risk is negative and convex. Under Specific Performance, both parties share the risk of the transaction. However, under Expectation Damages, only the Seller bares all the risk. The following chart illustrates:

Specific Performance

Seller

1-β / β

$(1-\alpha)(V_A - c)$ $(1-\alpha)(P_B - c)$

Buyer

1-β / β

$\alpha(V_A - c)$ $\alpha(P_B - c)$

Expectation Damages

Seller

1-β / β

$(1-\alpha)(V_A - c) - \alpha\beta(P_B - V_A)$ $(1-\alpha)(P_B - c) + \alpha(1-\beta)(P_B - V_A)$

Buyer

100%

$(1-\beta)\,\alpha(V_A - c) + \beta\,\alpha(P_B - c) =$
$= \alpha[(V_A - c) + \beta(P_B - V_A)]$

Under Specific Performance, the risk $\beta(P_B - V_A)$ is shared by both parties, according to α. However under Expectation Damages, the Seller alone bears all the risk and the Buyer is entirely immune from it.

The tendency towards risk in naturally convex, so dividing it between two parties will lower its costs and increase efficiency.

 [to be completed]

Although, the ability to control for the parties' risks by setting the contractual remedy can be used by the parties to choose between Expectation Damages or Specific Performance, depending on the parties specific risk preference:

(i)   If the Promisee is more risk-averse or the Promisor is more risk-seeking, then the parties may prefer Expectation Damages which reduces the risk for the Promisee and increases the risk for the Promisor;

(ii)   If however, the Promisee is more risk-seeking or the Promisor is more risk-averse then the parties may prefer Specific Performance, thus reducing risk for the Promisor and increasing risk for the Promisee.[39]

13. Incentive to Find a Second Buyer

Finding a second Buyer that will be willing to offer more than Buyer's value($P_B > V_A$) can be a costly. Let us assume that the parties start from a point where there is no probability to an EB (β =0) and then they each contemplate on whether or not to invest costs to find a second buyer and raise this probability to β.

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[39] However, I argue that this type of thinking is irrelevant to our discussion for two reasons: *First*, usually the law cannot tell in advance which party will be more sensitive to risk than the other. Sometimes it could be the Buyer is more risk-averse and other times it could be the Seller. The law usually cannot distinguish ex-ante between specific characteristics of specific individuals. Contract law sets the legal rules for the general public and ignores any risk preferences of specific parties. In our case, the law cannot tell which side, the Seller or the Buyer, is more likely to be more sensitive to risk. Therefore, the law must assume general preferences and homogeneous risk sensitivity. *Second*, we must remember that the Efficient Breach problem swings to both sides: the Seller can be the Promisor (when a second buyer approaches him) or the Seller might be the Promisee (when an alternative seller approaches the Buyer). Even if we assume that one side has a specific risk preference, we might still not know if that side will be the Promisor or the Promisee. Say, for instance, that a Seller knows ex-ante that he is risk averse, but he does not know which side would want to breach efficiently. He could himself as either the Promisor or the Promisee: If Seller will be the Promisor then he will prefer sharing the risk with Specific Performance. But if Seller will be the Promisee, then he might prefer a fix gain with Expectation Damages. Moreover, many contracts include reciprocity in their contractual terms. Meaning, one contractual remedy will be chosen to govern breaches from either side. If a party is in a situation where ex-ante he cannot tell if he will be a Promisor or a Promisee, then under such a veil of ignorance this party will be inclined to choose an overall efficient remedy.

Under Expectation Damages, Seller is the only one who will gain from an EB, so he alone has full incentive in finding such a Buyer. Under Specific Performance, both parties share the gains from the EB according to α, so both parties have a partial incentive to invest in finding a second Buyer.

If we assume that the productivity of each party's search efforts are independent, similar and decreasing, then letting two parties search will be efficiently better that letting only one party (Seller) to do so. [to be completed]

Part III - Discussions

I will briefly discuss some arguments and reservations to the model.

14. Constant Bargaining Powers

14.1 The Criticism

The model assumes that the respective bargaining powers of the parties do not change throughout the different stages of the model. The bargaining powers of the parties (α) at the initial stage of bargaining (at t=0) are the same bargaining powers at the later stage when the parties renegotiate the EB issue (at t=2).But one can argue that it is unreasonable to assume that the parties' bargaining powers will remain constant.

For instance, during the initial stage of bargaining, at t=0, the parties are engaged in a **market negotiation**, where there are many alternative buyers and sellers for the parties to choose from. However, during the second stage of bargaining, at t=2, the negotiating parties are stuck with each other in a **bilateral monopoly**. That is, the Promisor must get the Promisee's permission in order to breach and the Promisee needs the Promisor participation in order to contract with the third party. The bargaining powers of each party in a market negotiation in t=0 are expected to be different from these powers in a bilateral monopoly in t=2.

If we assume that parties do change their bargaining powers in t=2, then the parties under Specific Performance will be forced to negotiate the issue of Efficient Breach both ex-ante and ex-post, and their negotiations will be much more complicated and costly.

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14.2 A Model with Two Bargaining Powers

To understand why, let us examine a model with two bargaining powers. At t=0 the parties have one bargaining power (α_1) and at t=2 they have a different bargaining power (α_2), $\alpha_1 \neq \alpha_2$.

Note that the parties know this in advance, so they will bargain ex-ante at t=0 and set a contract price that will make sure that the end result, their expected utilities will be in accordance to the initial bargaining power (α_1). Only α_1 determine the parties' final allocation of profits.

Under Expectation Damages, the contract price will remain as before in eq. (7)[40].

$$P_{ED} = V_A - \alpha_1[(V_A - c) + \beta(P_B - V_A)] \tag{31}$$

However the price under Specific Performance will be much more complicated[41]:

$$P_{SP} = V_A - \frac{\alpha_1[(V_A - c) + \beta(P_B - V_A)] - \beta\alpha_2(P_B - c)}{(1 - \beta)} \tag{32}$$

Under an assumption of two different bargaining powers, most costs aspects that were discussed earlier in the paper are expected to be higher under Specific Performance.

14.3 Why We Should Assume a Constant Bargaining Power

However, there are many reasons to reject the mentioned argument and realistically assume that the parties do not change their bargaining powers:

(i)   Parties' bargaining powers are usually constant and exogenous factors[42].The bargaining powers are set by the Parties' personal negotiation skills, their sophistication, their business experience, legal experts, reputation, liquidity and so on, are all these are constant factors that are not expected to change.

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[40] Under Expectation Damages there are no ex-post renegotiations, so there is no importance to α_2.

[41] In stage t=0 Buyer A's utility is the difference between the Price and the value of the asset to her $V_A - P_{SP}$. This utility will be available only in $(1 - \beta)$ probability, because in β probability Buyer B appears, the original contract is breached and Buyer A will demand from Seller α_2 of the gains from breach ($P_B - c$). So Buyer A's total utility is: $U_A = (1 - \beta)(V_A - P_{SP}) + \beta\alpha_2(P_B - c)$. This utility must be equal to Buyer A's total utility described in eq. (2), only now Buyer's α is α_1. Both equations put together are: $\beta\alpha_2(P_B - c) + (1 - \beta)(V_A - P_{SP}) = \alpha_1[(V_A - c) + \beta(P_B - V_A)]$ and now P_{SP} can be extrapolated.

[42] See Markovits & Schwartz (2011): "_____" page ___.

(ii)   The parties may play a repeating game. They may transact in many similar transactions between them or they may have other kinds of transactions with one another. The parties may want to maintain an ongoing business relationship. In this state of the world, Thus, the bargaining powers in this specific transaction are already fixed and have been determined by the overall relationship.

(iii)   The parties may be repeating players in the market. Their bargaining powers may depend on their position in the general market. Reputation considerations can also retrain parties to not change their behavior at t=2 and remain with their original bargaining powers.

(iv)   There are many cases where parties negotiate solely with only one counterpart. The asset negotiated can be unique[43] or that the negotiation process forbids them to consider other sides[44]. If the negotiation in t=0 already resembles a bilateral monopoly, then there is now reason to expect the negotiation in t=2to be different.

(v)   Note that the model allows for additional buyers, in probabilityβ. There are many cases where Seller currently has only one buyer to negotiate with, but there is a β chance for him to find additional buyers.

(vi)   In order for the alternative model in Section 14.2 to work, the parties must know ex-ante, in t=0, that their bargaining power will change in t=2. In particular, they need to know that for one of them, his bargaining power will decrease. However, parties might be unable to anticipate or estimate correctly the possible future change in their bargaining powers. It is hard to anticipate in advance, what will be the future bargaining powers in t=2, when both parties are in bilateral monopoly.

(vii)   A Party may be myopic or optimistic in estimating a future change in his bargaining power. Keep in mind that both parties will get a veto power in t=2 on the EB issue, so it is hard for a party that knows he will get a veto power to realize and anticipate a decrease in his bargaining power.

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[43] Note that in the model's example described above, the asset discussed was Seller's land, am asset which might be unique for both of them.

[44] For example, a customary no-shop provision prevents a party to negotiate or silicate other counterparts.

(viii)   The hidden assumption in the basic Efficient Breach scenario is that the parties share the entire surplus available (120 in our example) between them. But there is an alternative story, where the parties share only the surplus available from a direct contract between them (80) and all the EB gains (40) are entitled solely to Seller. This alternative scenario might apply when Seller can transact directly with Buyer B and capture the EB gains by himself, and therefore the parties may decide to share only the additional surplus created by the direct contract between them.

Therefore, in considering this model where the parties share the entire surplus, a situation that fits this model can be one that the Seller is unable to transact directly with Buyer B and Seller must first transact with Buyer A in order to get the opportunity to transact with Buyer B[45]. This kind of a scenario, where Seller basically 'needs' the original Buyer, may also lead the parties to a situation resembles a bilateral monopoly[46].

15. The Number of Negotiation Processes

A counter argument to this model is that although Expectation Damages creates a much more complicated and costly negotiation process, it has a substantial benefit of reducing the number of negotiation processes. Under Expectation Damages, the parties collect and gather all their disputed issues into one single negotiation process and solve them all ex-ante, at t=0 (i.e., at the start of the relationship). Although this single negotiation process is much more complex and involves many more issues, variables and projections, it has the strong advantage of being one single process. On the other hand, the Specific Performance remedy forces the parties, in some cases (β), to enter into two separate negotiation processes: first regarding the initial contract and second regarding the EB issue. Under Expectation Damages, there is only one (1) single negotiation process while under Specific Performance there are (1+β) negotiation processes.

Specific Performance actually divides the negotiation process into two separate stages, and this might create some additional costs: (i) the costs of coordinating and assembling together all the parties and the parties' lawyers for the second

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[45] These situations can arise when_____ from 2nd paper

[46] But it is not necessarily so, because it might be that there are many such Buyers A which Seller can contract with, and then get a chance to a Buyer B.

time; (ii) the costs of re-learning and re-familiarizing the relevant material needed for the talks; (iii) the lost opportunity to bundle and connect the issues while negotiating[47]; and (iv) the economy of scale created by resolving many issues at once.

A number of responses can be made to address this counter argument: First, two issues bundled together might be easier to handle than the same two issues separately, but it is very hard to argue that two issues bundled together will be easier to handle than only just **one** issue. It is important to mention once again that Specific Performance allows parties to avoid altogether unnecessary discussions and negotiations about the EB issue and therefore saves substantial transaction costs.

Second, most contracts are not efficiently breached and the chances for an EB event (β) are usually slim. Therefore, whenever an Efficient Breach is indeed a fairly rare event, parties under Specific Performance are not exposed to a major risk of a second negotiation process. However, parties under Expectation Damages are always exposed to high transaction costs over the EB issue, even if such an EB is extremely rare. For example, let us imagine that there is a **1%** chance of an Efficient Breach. Under Specific Performance, there will only be a 1% chance for a second negotiation process and the costs associated with it. But under Expectation Damages there is a 100% chance for the high transaction costs generated by the need to settle the EB issue in advance. So in general terms, the larger the chances are for an EB, the more likely is that the parties will choose Expectation Damages and the parties will want to settle the EB issue in advance. The lesser the chances are for an EB, the more likely it is for the parties to prefer postponing their negotiations on this issue, by choosing Specific performance

Third, this argument assumes a desire among practitioners to reach a "complete agreement" that will cover all issues and settles all differences in all possible contingencies. In real life, parties and lawyers are not so eager to discuss and resolve every possible or hypothetical issue. In practice, a truly full and complete agreement is inefficient because of the costs of negotiating all these issues exceed the benefits. Many times parties wish to avoid negotiating controversial issues and inclined to leave these volatile issues to the final stages of the negotiation, especially considering hypothetical issues like the EB issue. This desire to

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[47] The ability to connect and bundle together different issues can arguably contribute to solving negotiated issues. One issue can be used as leverage for solving another. The counter argument is that it is preferable to separate between different issues of the negotiation. See also Section ___.

postpone and avoid controversial issues is aligned with the Specific Performance remedy, which allows parties to postpone and avoid negotiating the EB issue.

16. "Loss-Avoiding" Efficient Breaches

I will shortly address the Second type of an efficient breach, the "loss-avoiding" efficient breach. In this type of an EB, there is a possibility of rise in Seller's costs or a drop in Buyer's value of the asset, and this change will turn the performance of the original contract to be inefficient and a thus a breach of contract to be efficient.

Shavell (_)[48]and Markovits & Schwartz (2011) showed that for this type of breaches, the Expectation Damages remedy is the preferable remedy which creates less transaction costs.[49] The basic reason for this is… [to be completed]

17. Literature Review

[to be completed]

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[48] Schwartz (___) argues that courts should respect and enforce parties' agreement for Specific Performance. This is not the question here, when the parties have not specifically expressed their wishes. Shavell (2006) deals with this question (which he refer to as a "contract to produce goods") and reaches a conclusion that the Expectation Damages is the preferable remedy____ because ___.

[49] Markovits & Schwartz (2011) do not distinguish between a "loss-avoiding" EB (when the original contract turns to be an onerous one) to a "gain-seeking" breach EB (when there is an opportunity to make a better contract). But the transaction costs analysis on these two very different types of EB must be separate. As this model shows, we reach two very different conclusions in each type: the "loss-avoiding" EB type does indeed favor the Expectation Damages remedy. However, in the "gain-seeking" type of EB, the Specific Performance remedy is the one that creates the least costs.

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