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Virtue Ethics and Efficient Breach

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Virtue Ethics and Efficient Breach

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Preliminary draft, March 19, 2011

Abstract:

The concept of “efficient breach” – the idea that a contracting party should be encouraged to breach a contract and pay damages if doing so would be more efficient than performance – is probably the most influential concept in the economic analysis of contract law. It is certainly the most controversial. Efficient breach theory has been criticized from both within and without the economic approach, but the most prominent criticism is that it violates deontological ethics --- that the beneficiary of a promise has a right that it be performed, so that breaching the promise wrongs the promisee.

This essay argues that this criticism is misplaced, and that efficient breach theory, properly understood, is entirely consistent with parties’ complying with their deontological obligations. Instead, the intuitive resistance that most people experience to the concept may be better explained by aretaic concerns --- specifically, that failing to complete a contractual relationship is not conducive to virtuous character or to the maintenance of a flourishing community. While efficient breach can be squared with deontological ethics, it cannot be squared with virtue ethics unless one is prepared to argue that seeking efficiency is a virtue, or at least that it is not a vice.

Virtue Ethics and Efficient Breach

Avery Katz*

Draft, March 17, 2011

Contracts scholars have been arguing over the concept of “efficient breach” for over thirty years. The issues at stake in this argument are well known, yet the arguments fail to subside. Supporters of the concept contend that allowing a promisor to escape the obligation to perform by paying a money substitute increases the potential gain from contractual exchange, and corresponds to the arrangement that most contracting parties would have wanted. Critics of the concept respond that allowing promisors to get out of performance without securing the promisee’s actual ex post consent works an injustice in the individual case, and undermines the social practice of contracting more generally.

These arguments are thoroughly familiar to anyone who teaches and writes about basic contract law, because they have been rehearsed again and again in the literature.¹ Indeed, the debate has proliferated in recent years.² Why do the

* Vice Dean and Milton Handler Professor of Law, Columbia University School of Law. A revised version of this essay will appear in “Contract as Promise at 30,” a festschrift in honor of Charles Fried on the occasion of the 30th anniversary of the publication of his *Contract as Promise*. I am grateful to colleagues at Columbia and to workshop participants at the University of Toronto and Case Western Reserve School of Law for helpful comments and encouragement on this project.

¹ See, e.g., Robert L. Birmingham, *Legal and Moral Duty in Game Theory: Common Law Contract and Chinese Analogies*, 18 *Buff. L. Rev.* 99 (1969), Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 *Rutgers L. Rev.* 273 (Winter 1970), Richard Posner, *Economic Analysis of Law* (1973), pp. 55-59; Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 *Colum. L. Rev.* 554 (1977); Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 *Calif. L. Rev.* 1432 (1985); Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 *S. Cal. L. Rev.* 629 (1988); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 *J. Legal Stud.* 1 (1989); Steven Shavell, *Contracts*, in *The New Palgrave Dictionary of Economics and the Law* 436, 439 (Peter Newman ed., 1998). It is generally acknowledged that the specific phrase “efficient breach” was coined by Goetz and Scott in their 1977 Columbia article; but the essence of the concept is plainly manifest in Birmingham’s and Posner’s formulations.

² See, e.g., Louis Kaplow and Steven Shavell, *Fairness Versus Welfare* (2002), pp. ___; Steven Shavell, *Specific Performance Versus Damages for Breach of Contract: An Economic Analysis*, 84 *Tex. L. Rev.* 831, 867 (2006); Steven Shavell, *Is Breach of Contract Immoral?*, 56 *Emory L.J.* 439, 439 (2006); Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 *Cal. L. Rev.* 975 (2005); Richard R.W. Brooks, *The Efficient Performance Hypothesis*, 116 *Yale L.J.* 568 (2006); Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 *Harv. L. Rev.* 708 (2007), Jody S. Kraus, *A Critique of the Efficient Performance Hypothesis*, 116 *Yale L.J. Pocket Part* 423 (2007), Barry E. Adler, *Efficient Breach Theory Through the Looking Glass*, 83 *N.Y.U. L. Rev.* 1679 (2008) Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 *Colum. L. Rev.* 1603 (2009); Steve

leading writers in the discipline continue to revisit a debate in which the main positions have long been staked out? One possibility might be that they are contending for the hearts and minds of their students, who encounter the concept anew each year as they are introduced to the expectation principle and its normative underpinnings. Efficient breach remains a contested issue in contracts for the same reason that the fault principle remains a contested issue in torts; it is a locus for conflict between values that are inherently in tension, yet both deeply rooted in our political and moral culture, so that the issue will never go away. An alternate possibility, however, is that the debate remains active because there are important normative concerns that have still not been adequately clarified by efficient breach's critics or addressed by its defenders.

The purpose of this essay is to explore this latter possibility, and to suggest that the debate over efficient breach has focused on deontological concerns (specifically, whether contract breach is equivalent to promise-breaking, and whether promise-breaking in the contractual context is necessarily wrong) to the exclusion of aretaic ones (specifically, that failing to follow through a contractual relationship is not conducive to virtuous character or to the maintenance of a flourishing community). It argues that the standard deontological objections to efficient breach do not substantially undermine its basic concept, because they can generally be addressed by reinterpreting or revising the underlying contract so that paying a money substitute in lieu of specific performance is explicitly authorized. On such a reinterpretation, paying money when performance becomes inconvenient is neither a breach nor a wrong; it is just an alternate way of discharging one's contractual duties.³ In this way, "efficient breach" (perhaps

Thel, Peter Siegelman, *Willfulness Versus Expectation: A Promisor-Based Defense of Willful Breach Doctrine*, 107 Mich. L. Rev. 1517 (June 2009); and Alan Schwartz and Daniel Markovits, "The Myth of Efficient Breach" (2010). Faculty Scholarship Series, Paper 93. http://digitalcommons.law.yale.edu/fss_papers/93.

³ A point recognized early on and reiterated with regularity. See, e.g., David Simon and Gerald A. Novack, *Limiting the Buyer's Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts*; 92 Harv. L. Rev. 1395, 1436 -7 (1979) ("As we see it, where both parties to a market transaction are market traders who are dealing with commodities of fluctuating value, the contract should be treated as equivalent to a bet which the parties are making against the future market price. Payment of market damages mounts to specific performance of the bet."); Shavell, *Contracts*, supra, note ___ ("The view that a contract breach is the breaking of a promise overlooks the point that the contract that is breached is generally an incomplete contract, and that the breach is what the parties want and would have specified in a complete contract. In the example of the simple incomplete contract calling for a desk to be produced, the seller who finds that his production cost would be \$2,000 will commit breach under the expectation measure. But in so doing, he will be acting precisely as would have been set out in a complete contract, and it is that contract which is best regarded as the promise between the parties that ought to be kept.")

relabeled “efficient performance” or “efficient cancellation option” in the interest of more favorable marketing⁴) can easily be squared with deontological ethics.

I suggest that the intuitive resistance that many people experience to the concept of efficient breach may be better explained by aretaic concerns — that is, by virtue ethics. The aretaic objection, unlike the deontological objection, cannot be disposed of by reinterpreting the promise so that paying money counts as performance rather than breach, because it is not fundamentally based on the morality of keeping promises. Rather, it is based on the morality of making promises. On this objection, a promise that can be satisfied with a cash substitute is a cheap and superficial one, and not the kind that the good society should valorize.

While the concept of efficient breach can be squared with deontological ethics, accordingly, it cannot be squared with virtue ethics unless one is prepared to argue that seeking efficiency is a virtue, or at least that it is not a vice. The balance of this essay elaborates on this specific claim.

The consensual basis for efficient breach

The practical problem that motivates the whole debate is that circumstances change over time and so contracting parties’ plans must change too, even if those plans have been made the subject of a promise. For example, a farmer may promise to sell crops, but the crops may fail. A company that sells ice blocks for purposes of refrigeration may find itself unable to obtain supplies at a sustainable price due to an unexpectedly warm winter.⁵ A coal company may promise to restore a parcel of land to its original condition after strip mining, but the cost of restoration turns out to be prohibitively expensive.⁶ A consumer may promise to buy a boat, but then suffer health or financial reverses that make it unattractive

⁴ Compare Brooks, *supra*, note 1 (suggesting terminology of “efficient performance” as opposed to efficient breach); Schwartz and Markovits, *supra*, note 1 (suggesting terminology of “dual performance” as opposed to efficient breach.)

⁵ *Goebel v Linn*, 47 Mich. 489, 11 N.W. 284 (1882).

⁶ *Peevyhouse v. Garland Coal & Mining Co.* 382 P.2d 109 (Okla. 1962).

to go through with the deal.⁷ In each of these cases there are substantial social gains to be achieved [or losses to be avoided] by adjusting the parties' plans.⁸

In the law and economics literature, this problem has generally been addressed from an ex post perspective. On this perspective, the contract has been formed, the parties are deciding what to do, and the options are performance or breach [assuming that the changed circumstances do not rise to the level of an excuse.] At this point, performance is efficient if (and only if) the benefits of performance to the promisee exceed the costs to the promisor.⁹ If conversely the costs of performance exceed the benefits, both parties can be made better off by cancelling the performance and by having the promisor compensate the disappointed promisee by paying properly measured expectation damages. In this instance, the promisee is no worse off than if the promisor had specifically performed, and the promisor is better off [because paying damages is less costly than specifically performing]. The resultant cost savings represent a net increase in social welfare.¹⁰

⁷ *Neri v. Retail Marine Corp.* 334 N.Y.S.2d 165, 285 N.E.2d 311 (N.Y. 1972).

⁸ The news that motivates such adjustment does not have to be bad news; it could also be good news — for instance if a new buyer arrives who places a much higher value on the items being exchanged and is willing to pay a much higher price (or a new supplier who can deliver at lower cost, and thus lower price.). See TAN ___, *infra*.

⁹ The definition of efficiency used here, and in the law and economic literature, is potential Pareto superiority, also known as the Kaldor-Hicks criterion, also known as cost-benefit analysis. According to this criterion, an action [in this case breach of contract] is economically efficient when the gains resulting from the action, aggregated over all parties who are affected, exceed the losses. In this case it is possible in principle, and often in practice, to make all parties better off by arranging a side payment from the winners to the losers [in the case of breach of contract, a payment from the breacher to the aggrieved promisee in the amount of expectation damages.]

This formal definition of efficiency should be contrasted with one common meaning of the term in informal discourse, where it is often used interchangeably with the term “advantageous”. On this colloquial usage, an unscrupulous businessperson might say that it is efficient to dump industrial waste in a public waterway, because it is personally cheaper to do this than to pay the costs of ecologically secure disposal. This is not what economists mean by efficiency, however, because it excludes the costs suffered by the other users of the polluted water. The economist’s view would be that dumping industrial waste could sometimes be efficient, but only if it is the cheapest alternative considering the interests of all parties put together. If the costs of ecologically secure disposal (or of abstaining from the activity that generates the industrial waste) are greater than the costs of pollution, only then would pollution be the efficient (least costly) alternative.

¹⁰ See Posner, *supra*, note ___, at 57 (“[I]n some cases a party would be tempted to breach the contract simply because his profit from breach would exceed the expected profit to the other party from completion of the contract, and if damages are limited to a loss of expected profit, there will be an incentive to commit breach. *There should be. . . If [the potential breacher’s loss from performance] is greater than the gain to the other party from completion, it is clear that commission of the breach would be value maximizing and should be encouraged.* And because

Presenting the issue in this way suggests that there is a conflict between economic efficiency and deontological justice, because the cost savings are apparently achieved at the expense of the promisee's rights. From a deontological perspective, a promisor who breaches a contract in order to achieve a larger profit or avoid a larger loss has appropriated something that belongs to the promisee — the right to performance — and used it for his own personal ends. On this view, the efficient breacher is no better than a thief who steals and resells a car on the theory that he knows where to get a price that is higher than the owner's reservation value. Both the thief and the breacher have profited from converting something that is not their own; and any surplus that has been created is properly the entitlement of the rightholder (in the case of the car theft, the owner; and in the case of the broken contract, the promisee.)¹¹

But there is another way to look at the matter, by shifting perspective from the later point at which the parties are deciding whether to perform to the initial point where they are entering into the contract and specifying their duties. At this initial point, the parties have the opportunity to decide who will hold the right to decide whether the promisor specifically performs. As a matter of principle if not of law, they could allocate that right to the promisee, by stipulating their advance consent to injunctive relief.¹² They could alternatively allocate that right to the promisee, by providing for an explicit option to pay, in lieu of specific performance, an amount of money representing the value of the promisee's expectation. One way to do this is through a liquidated damages clause; but if the parties do not or cannot agree on a liquidated amount, another method is to leave it up to a court or arbitrator after the fact.

This *ex ante* perspective prompts us to ask the question: when is it value-increasing to give parties the option to buy their way out of a contract at a court-determined price, and when not? The advocates of efficient breach argue that, in general, it is value-increasing and in the interest of both parties to allow such an

the victim of the breach is made whole for his loss, he is indifferent; hence encouraging breaches in these circumstances will not deter people from entering into contracts in the future.”)
[emphasis supplied]

¹¹ See, e.g., Friedmann, *supra*, note ____.

¹² In principle but not in law, because under most common-law regimes, an equity court is not bound by the parties' agreement to specific performance. See, e.g., *Stokes v Moore*, 77 So. 2d 331 (Ala. 1955) (denying effect to parties' agreement, but the existence of the agreement can serve as nonconclusive evidence for the proposition that money damages are inadequate.)

option; and therefore, the default rule for contracts that leave the matter silent is to presume that they have done so.¹³

Here is a concrete example that illustrates the point: imagine a homeowner who wants her driveway repaved and is shopping for a contractor. The homeowner places some reservation value on the new driveway; without loss of generality, call it \$2000. It does not matter for our purposes whether the homeowner's reason for wanting a new driveway is commercial (i.e., it will increase the potential resale value of her home by \$2000) or personal (it will be more pleasant to look at, and will make the driveway easier to shovel in winter). In either event, the homeowner does not wish to spend more than \$2000 on the driveway; if the driveway is going to cost more than \$2000, she would prefer to take the same amount of money and spend it on her wine collection.

Suppose the homeowner looks in the online Yellow Pages and finds three possible contractors. The first, which operates under the trade name of Reliable Contractors, promises to finish any job it undertakes, no matter what. The second, Efficient Contractors, does not promise to finish any job it undertakes, but does promise to pay a sum equal to the customer's lost expectation if it does not finish. The third, Manhattan Contractors, does not promise to finish its jobs and does not even promise to pay the customer's lost expectation, but it does promise that it will give its full deliberation in deciding whether to show up to work, and to cheerfully refund any deposit if it does not show up. All three contractors have excellent Better Business Bureau ratings; they always keep their promises, or at least have so far.

It should be obvious that in a competitive market, the three contractors cannot charge the same price and all stay in business, because it is more costly to promise to finish a job, no matter what, than to promise to finish or pay expectation, whichever is less; and it is more costly to promise to finish or pay

¹³ Note that ex ante agreement is not the only way to achieve the benefits of efficient non-performance. The parties could alternatively wait for the new information to arrive and then agree on a mutually satisfactory modification ex post. Whether this alternative is preferable depends on whether the costs of ex ante agreement (primarily, errors in anticipating what allocation of rights is best, and the marginal transaction costs of negotiating an extra term that in most cases will never come into application) exceed the costs of ex post agreement (primarily, costs arising from haggling, delays, holdup, and bargaining failure). The advocates of efficient breach argue that in many and perhaps most cases, ex ante agreement on a cash buyout is preferable to waiting for an ex post modification; the main reasons are that waiting for an ex post modification imposes extra risk on the parties, and creates incentives for wasteful expenditure of resources in anticipation of hold-up. See Shavell, *Specific Performance Versus Damages*, supra, note ____.

expectation than it is to promise to show up to work if one feels like it. In particular, there is some possibility that the contractor will turn out to have performance costs of more than \$2000 [either because the cost of labor and materials has risen, or because some other job comes along that would pay more than \$2000 and it is not possible to undertake both.]

The standard logic that implies that expectation damages lead to efficient breach also implies that the homeowner is strictly better off hiring Efficient Contractors than she is hiring Reliable Contractors. A full exposition of this logic is available elsewhere,¹⁴ but the intuition is straightforward. If she hires Reliable Contractors she gets her new driveway, and its \$2000 value, with certainty. If she hires Efficient Contractors, she gets either the driveway, or enough cash to substitute for the anticipated appreciation in the value of her house (if she is buying the driveway as an investment) or (if she is buying the driveway for its consumption value) to buy a quantity of wine that will make her just as happy as she would be having the driveway (though perhaps happy in a different way). She gets \$2000 worth of value either way, but Efficient Contractors charges a lower price and accordingly offers a better deal.¹⁵

Similarly, one can show that the homeowner is better off in expected terms hiring Efficient Contractors than she is hiring Manhattan Contractors. The reason is that Manhattan Contractors will only perform if its cost of performance is less

¹⁴ See Louis Kaplow and Steven Shavell, *supra*, note ___, at ___.

¹⁵ For example, suppose that the contractor's usual cost of performance is 1000, but one time out of ten it turns out to be 6000 [because materials and preparation costs are unexpectedly high due to unforeseeable ground conditions, or alternatively because an extremely lucrative job that would yield 6000 in extra revenue comes up at the last minute and it is not possible for the contractor to undertake both.] In this case, the reliable contractor would have to charge at least 1500 in order to break even on the deal: $1500 = (90\% \times 1000) + (6000 \times 10\%)$. The homeowner would receive 2000 in benefits from entering into this agreement, and would enjoy a net surplus of 500 (=2000-1500).

The efficient contractor's costs are lower than this, however, because it does not have to incur 6000 in performance in the high-cost contingency; instead it makes cash payment of 2000. Accordingly, to break even it only needs to charge 1100 [$1100 = (90\% \times 1000) + (2000 \times 10\%)$]. The homeowner would again receive 2000 in benefits from entering into this agreement, but would now enjoy a net surplus of 900 (=2000-1100). Note that the 400 increase in consumer surplus corresponds to the avoidance of inefficiently costly performance, ten percent of the time. Inefficient performance wastes 4000 (the difference between the 6000 cost of performance and the 2000 benefit it produces for the homeowner); this 4000 discounted by the one in ten chance of incurring it equals 400.

Note also that even if the homeowner attaches some subjective psychic value to performance, above and beyond its pecuniary value, the efficient contractor is still the more desirable partner so long as this psychic value is less than or equal to 400.

than the price it quotes, and will fail to perform otherwise. But there will sometimes arise circumstances in which Manhattan's cost is greater than the quoted price, but still less than the homeowner's \$2000 value of completion, so that Manhattan inefficiently fails to complete.

It follows that if the homeowner has strictly instrumentalist motives for entering into the paving contract (that is, all she cares about is what she receives when the parties' interaction is complete), she should choose to do business with Efficient Contractors. Similarly, if she is not facing three different contractors, but one contractor offering to do business under three alternative contractual arrangements, differing only with respect to the availability of specific performance or the amount of money to be paid if it does not occur, she should prefer to do business under the efficient, expectation-protecting contract.

One might object that the homeowner, or at least some homeowners, would be willing to pay the price premium to hire the reliable contractor, in order to have the satisfaction of knowing that the job will be done no matter what. But such a preference simply means that the \$2000 buyout payment does not fully compensate for the homeowner's losses. It needs to be increased by some additional amount sufficient to compensate for the disutility associated with the mental adjustment of receiving the expectation in the form of wine instead of in the form of a driveway. Unless the homeowner places an infinite value on getting the driveway as promised, there will be some amount of cash that will make her happier than the driveway, and she will be better off dealing with a contractor who promises to pay this amount of cash in lieu of the driveway, than with the reliable contractor who promises to specifically perform no matter what.¹⁶

If it is the case that most promisees do not really place an infinite value on having their promises enforced, then a rule of law that provides for expectation damages (including an appropriate premium for the mental and other costs of adjusting to the fact that the promise is being discharged by cash payment instead of the originally anticipated non-cash performance) will make most promisees better off than a rule requiring specific performance. Expectation damages are therefore justifiable as a default rule, providing the remedy that most parties would prefer, and that, in a world of costless and complete contracting, they would have

¹⁶ Note that even the most reliable contractor will encounter situations in which it is physically or practically infeasible to perform, and the parties must specify, explicitly or implicitly, what amount of money is available as a substitute for performance in that instance. The ultimate contract price will depend on the amount that is chosen, just as it depends on the amount payable under contracts that do not require specific performance.

explicitly chosen.¹⁷ To this extent this argument is sound, awarding expectation damages is not only efficient, but consistent with both consent and party autonomy.¹⁸

Indeed, on this line of argument the term “efficient breach” is actually a misnomer, since paying money in place of specific performance, if the promisor finds it advantageous to do so, is entirely consistent with the best understanding of the parties’ agreement, and not a breach at all. Rather, it is just an alternate way of discharging one’s duties under the contract. Instead of efficient breach, we might equivalently (and perhaps more clearly) speak of “efficient performance” or “efficient cancellation option” or “efficient rescission.” And if there is no breach of promise, then there is no (promissory) wrong.

Objections to the argument for efficient breach

The literature on efficient breach has identified a number of straightforward and well-known objections to the argument laid out in the previous section. These overlapping objections include:

- That the argument above depends on empirical presuppositions that are not borne out in practice, such as the assumption that expectation damages are routinely available and well measured by courts;¹⁹
- That renegotiation ex post in the shadow of a specific performance remedy, or ex ante assessment of damages in the form of a liquidation clause, would more effectively protect parties’ expectation interest and promote efficient performance than ex post assessment of money damages in an adversarial proceeding;²⁰

¹⁷ See Shavell, supra note __ (1998) (“The seller who finds that his production cost would be [greater than the buyer’s reservation value] will commit breach under the expectation measure. But in so doing, he will be acting precisely as would have been set out in a complete contract, and it is that contract which is best regarded as the promise between the parties that ought to be kept.”)

¹⁸ See Richard Craswell, Contract Law, Default Rules, and the Philosophy of Promising, 88 Mich. L. Rev. 489 (1989) (arguing that consent-based arguments have no purchase when choosing a default rule of interpretation.)

¹⁹ See, e.g., Eisenberg, supra, note 2.

²⁰ See, e.g., Alan Schwartz, The Case for Specific Performance, 89 Yale Law Journal. 89: 271-306 (1979); Thomas S. Ulen, The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies, 83 Mich. L. Rev. 341 (1984).

- That even if money damages protects the parties' expectation interest under the contract in question, they create a negative externality by undermining the certainty of future bargains by third parties;²¹
- That the argument at most establishes hypothetical consent to a rule of money damages, but only actual consent is morally relevant;²²
- That many and perhaps most contracting parties attach a distinct non-instrumental interest to specific performance that is incommensurable with money, so that damages can never truly be compensatory;²³
- That ordinary contracting parties do not in fact subjectively understand their agreements to contain an implicit buyout option; but in fact believe that they have agreed to specific performance;²⁴
- That ordinary contracting parties are boundedly rational and do not adequately consider the prospect of non-performance when they enter into agreements, and thus do not bargain for the price adjustment that would correspond to that prospect under full information;²⁵
- That a system in which contracting parties were free to choose ex ante between expectation damages and specific performance might be morally acceptable, but our own legal system does not offer that choice — in that we do not allow parties to contract into specific performance, or even to set liquidated damages above the level that a court regards as a fair estimate of lost expectation.²⁶

For the purposes of this essay, it is important to classify these objections according to their membership in three families of normative argument. The first type of objection arises from the consequentialist tradition, which assesses the morality of actions and institutions based on whether they produce good or bad consequences.²⁷ This tradition includes both utilitarian theories of morality as well as the concept of economic efficiency itself; it is the normative mode in which contemporary economists are primarily schooled and acculturated.

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25 Eisenberg

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27 See Walter Sinnott-Armstrong, "Consequentialism," The Stanford Encyclopedia of Philosophy (Fall 2008 Edition), Edward N. Zalta (ed.), URL = <<http://plato.stanford.edu/archives/fall2008/entries/consequentialism/>>.

For instance, the objection that courts do not actually award true expectation damages (because they are difficult to measure, or because some losses are excluded as a matter of legal doctrine, or because it is costly to bring suit, or because there is some chance the court will err or the aggrieved party will be unable to prove his claim) forms the basis of a consequentialist objection. To the extent these concerns are empirically relevant, actual promisors will have an inadequate incentive to perform and an excessive incentive to breach. In this situation, attaching moral opprobrium to breach of contract might be an effective way of increasing the sanction for nonperformance, leading to a more efficient outcome.

Similarly, the claim that the expectation interest is more cheaply and effectively promoted by ex post renegotiation, undertaken in the shadow of a legal right to specific performance, also provides a consequentialist objection to efficient breach. To the extent the claim is valid, specific performance provides equally good incentives for efficient performance, at lower transaction costs and with a lower incidence of error.

A second type of objection arises from the deontological normative tradition, which assesses the morality of actions and institutions based on whether they respect rights, fulfill duties, and promote autonomy.²⁸ For a deontologist, the fact that an act leads to good consequences is irrelevant if it is wrongful; wrongfulness depends on whether a choice conforms with a primary moral norm (for example, do not lie or kill, treat other persons as ends in themselves rather than means to an end). This is the mode of argument that most closely corresponds to the normative vocabulary of the law; and it is this tradition to which the preceding argument is primarily directed.

For instance, the objection that ordinary contracting parties do not in fact understand their agreements to contain an implicit buyout option, but in fact regard themselves as having agreed to specific performance, forms the basis of a deontological objection. Imposing upon them an arrangement to which they have not agreed, even if it is more efficient, deprives them of autonomy and fails to respect their freedom to contract. Similarly, if they agreed to specific performance but the law only requires payment of money damages, the legal system has countenanced a violation of the promisee's moral rights and the promisor's moral duties.

²⁸ See Larry Alexander and Michael Moore, "Deontological Ethics", The Stanford Encyclopedia of Philosophy (Fall 2008 Edition), Edward N. Zalta (ed.), URL = <http://plato.stanford.edu/archives/fall2008/entries/ethics-deontological/>.

Finally, a third set of objections arise from a third normative tradition that today is commonly referred to as virtue ethics. This tradition assesses conduct based on whether it is grounded in or promotes the development of good moral character, and is commonly denoted as “aretaic”, deriving from the ancient Greek word for virtue or excellence, *arete*.²⁹ The aretaic tradition is less commonly invoked in legal scholarly circles than either consequentialist or deontological arguments, but it has grown in influence in the philosophical literature in the last fifty years and has more recently begun to influence legal scholarship as well.³⁰

By distinguishing among these categories of normative argument I do not mean to suggest that they are wholly disjoint, or that any particular objection to efficient breach must fall into a single category. On the contrary, all three types of argument are embedded in our moral traditions, though perhaps not to the same extent at all times and places³¹; and as a result various accommodations among them have developed. For example, consequentialist theories all depend on some account of the good, but they vary depending on what this account consists of. One consequentialist might take the position that the good consists of human happiness but that happiness depends critically on the exercise of autonomy within clearly delineated boundaries — in which case the good is promoted by articulating an intelligible set of rights and duties and establishing institutions that protect their observance. A different sort of consequentialist might argue that happiness derives from the satisfaction of developing one’s talents and capacities —that is, by pursuing excellence.

Similarly, all deontological theories depend on some account of rights, but they vary in what rights they consider fundamental. One deontologist might take the position that all persons have a right to certain basic goods (e.g., food, shelter, health care, education) that enable them to formulate and pursue their individual goals, whatever those goals may happen to be. Alternatively one might argue that the right to develop one’s human potential is most important. These theories might overlap considerably in what specific rights they prescribe (for example, the rights to life and liberty would figure prominently under either of these

²⁹ See Rosalind Hursthouse, "Virtue Ethics", The Stanford Encyclopedia of Philosophy (Winter 2010 Edition), Edward N. Zalta (ed.), URL = <http://plato.stanford.edu/archives/win2010/entries/ethics-virtue/>.

³⁰ See, e.g., Anthony T. Kronman, *The Lost Lawyer: Failing Ideals of the Legal Profession* (1995); Lawrence B. Solum, *Virtue Jurisprudence: An Aretaic Theory of Judging* (2003).

³¹ Hursthouse, *supra*, note __, suggests that virtue ethics provided the dominant approach to Western moral philosophy up through the beginning of the Enlightenment, but was eclipsed by deontology and utilitarianism in the 19th and the first half of the 20th centuries.

theories) but their substantive groundings – and the rhetoric used to defend them – could be quite different.

Because all three traditions are part of our common moral culture, furthermore, and each of them have developed internal accounts of each other, few authors can be wholly pigeonholed within a single tradition. Daniel Friedmann, in what is generally considered to be the most prominent early attack on efficient breach theory, deploys both utilitarian and deontological arguments, though he presents the latter as more fundamental to his overall critique. Seana Shiffrin, perhaps the most vigorous critic of efficient breach theory in the recent legal literature, systematically combines deontological and aretaic rhetoric, sometimes even within the same sentences.³² And even the early Richard Posner, who is identified more than any other legal commentator with the pursuit of economic efficiency, relies on aretaic values in defending his concept of wealth maximization against the rival consequentialist theories of utilitarianism and efficiency.³³

Notwithstanding this theoretical overlap, in this essay I wish to maintain the distinction between these three kinds of arguments as ideal types, in order to better understand the ways in which the major participants in the debate have been talking past one another.

To be clear, I do not mean to claim that taking a deontological or aretaic position on ethics necessarily commits one to defending specific performance as the primary remedy for breach of contract, any more than taking a consequentialist or utilitarian position commits one to defending expectation damages. As we

³² See Shiffrin, *supra*, note ___, at pp. 18-20 (“A virtuous agent can surely accept that there may be good aspects to wrongful breach on certain occasions. Yet, if such breach is indeed all-things-considered wrong, I do not see that a virtuous agent could accept that this fact could constitute a reason for the law’s content; the challenge would be all the greater if the particular shape the reason took was that it would be better if the law were to have that certain content in order to encourage the wrongful conduct. If that were the reason, then it and perhaps even the resulting legal content would imply a prescriptive recommendation to act wrongfully and it is hard to see how a virtuous agent could embrace such an implication.” Ultimately, however, I read Shiffrin as drawing more on the aretaic than the deontological tradition.

³³ Richard Posner, *The Economics of Justice* [1983], p. 68-9 (“To summarize, the wealth-maximization principle encourages and rewards the traditional ‘Calvinist’ or ‘Protestant’ virtues and capacities associated with economic progress. It may be doubted whether the happiness principle also implies the same constellation of virtues and capacities, especially given the degree of self-denial implied in adherence to them. Utilitarians would have to give capacity for enjoyment, self-indulgence, and other hedonistic and epicurean values at least equal emphasis with diligence and honesty, which the utilitarian values only because they tend to increase wealth and hence might increase happiness.” [emphasis in original])

have just seen, it is possible to favor specific performance on economic grounds, given the particular configuration of empirical factors at work; and conversely, one can hold a deontological view of contracting while still favoring the rule of expectation damages. Indeed, our honoree Charles Fried takes this very position in the book that is the focus of our festschrift.³⁴ But in general, those who have criticized efficient breach on moral grounds have tended also to argue in favor of specific performance, and have viewed expectation damages as at most a second-best remedy, perhaps tolerated for pragmatic reasons, but never to be condoned, let alone celebrated.³⁵

The aretaic argument against efficient breach

To summarize: the deontological objection to efficient breach is that it licenses wrongdoing, in the specific form of promise-breaking, in the service of consequential ends. The consequentialist response to this objection is that people enter into contractual promises not for the sake of the promises themselves, but in order to accomplish instrumental goals, most commonly economic ones: to exchange material commodities, to induce investment, to provide insurance against economic risk, and so on. Given such purposes, promises that can be escaped by paying a sufficient money substitute are more useful than those that cannot. Accordingly, agents who enter into contracts for instrumental purposes should agree that their contracts should be based on the former kind of promise, and not on the latter. Similarly, in cases where the parties have not explicitly stated what type of promise they are making, the default rule of interpretation should be that they have entered into the former kind of contract.

³⁴ C. Fried, *Contract as Promise* (1981), at 17-21 (“What a Promise is Worth”). Note that Fried does not offer any defense of expectation damages as opposed to specific performance; this is because his primary concern is to defend the promissory principle against reliance-based theories of contract such as those offered by Patrick Atiyah and Grant Gilmore. See Fried at 18 (“The assault on the classical conception of contract, the concept I call contract as promise, has centered on the connection. . . between contract law and expectation damages. As the critics recognize and as I have just stated, to the extent that contract is grounded in promise, it seems natural to measure relief by the expectation, *that is, by the promise itself*. If that link can be threatened, then contract itself may be grounded elsewhere than in promise, elsewhere than in the will of the parties.”) [emphasis supplied]

³⁵ See Daniel Friedmann, ‘Economic Aspects of Damages and Specific Performance Compared’, in Djakhongir Saidov & Ralph Cunnington eds., *Contract Damages: Domestic and International Perspectives*, Hart Publishing (2008) (conceding that specific performance may not be warranted in cases where the promisor’s cost of performance exceeds the promisee’s benefit, but insisting that in such cases breach is tolerated, but never condoned). Friedmann’s theory of “tolerated” breach, however, would apply only to the case where the promisor’s cost is an out-of-pocket cost as opposed to an opportunity cost. In cases where the promisor breaches in order to achieve a gain, Friedmann would view this gain as belonging to the promisee.

Even if paying money as an alternative to performance is not deontologically wrong, however, and even if it is consented to, it does not necessarily follow that it is a virtuous act. From the perspective of virtue ethics, indeed, the concept of efficient breach may be objectionable because it establishes and endorses a norm under which contracts are casually entered into and casually abandoned — in which contractual partners are treated instrumentally and superficially.³⁶

To be precise, the objection is not that without a strong level of commitment, the contracting parties will lack sufficient incentive to invest in relationship-specific assets. That would be a purely consequentialist argument. From an efficiency perspective, sacrificing some degree of efficient reallocation of resources *ex post* could be economically worthwhile in order to achieve more efficient investment incentives *ex ante*; this is a consequentialist reason for commitment that might lead some or even most parties to prefer specific performance over expectation protection. But the argument I am unpacking here is a non-instrumental one: it is that a legal regime in which commitment is respected and valorized will better promote virtuous moral character, civic solidarity and a flourishing community. We may call this the aretaic argument against efficient breach.³⁷

To make the point concrete, consider an example drawn from social rather than commercial life. Imagine that a law student arranges to meet a group of friends for dinner, to be followed by a trip to the theater. At a late afternoon extracurricular event, lubricated by alcohol, the student meets a charming person and perceives the possibility of mutual romantic interest. On an impulse, the

³⁶ Cf. Schwartz and Markovits, *supra*, note 2, at 63 (“One of the basic, formal features of promising is that a promisor makes the promisee distinctive for her – she takes the promisee out of the general sea of humanity and becomes particularly attentive to the promisee’s person. As Joseph Raz observed, promises establish a special relationship between promisors and promisees, and the value of this special relationship plausibly explains why it is not a sufficient reason for breaking a promise that doing so is best overall. Perhaps, then, the unilateralism associated with the expectation remedy wrongly eliminates such promissory solidarity, while other remedies (including, but not limited to, traditional specific performance) might better make room for it.”)

³⁷ This argument is closely related to that presented in Daniel Markovits, *Contract and Collaboration*, 113 *Yale L. J.* 1417 (2004), although he does not explicitly draw the connection of his theory to virtue ethics, and also endorses the idea that the parties might legitimately contract into a regime of efficient breach. 113 *Yale L.J.* at 1497-99 (“The prospect that an opportunity for efficient breach might arise, and the value associated with this prospect, therefore count among the benefits generated by the contract. And the parties may allocate this benefit, by means of the contract, just as they allocate any other. . . The law’s generally encouraging stance toward efficient breaches should be read . . . as establishing a principle of contract interpretation under which contracts that are silent are interpreted to exclude from a promisee’s expectation the gains from possible efficient breaches (and in this way also rendering restitution for such gains unjustified on its own terms”).

student abandons the dinner and theater plans and instead spends the evening with the charming new acquaintance. Indeed, the new acquaintance is so captivating that the student never even bothers to send a text message to the group of waiting friends.

We can stipulate that there is no contractual liability entailed in standing up one's friends for dinner (although there may be a duty for the student to repay the friends for the cost of the unused theatre ticket.) Still, has the student behaved wrongly, to the extent that an apology is due? Most people would probably say yes; and their moral intuitions would be reinforced if we added in the factor that the friends delayed the beginning of dinner in hopes of the student's late arrival, leading them to rush through their meal and to arrive at the theatre after the first act has begun.

On the other hand, suppose that all the friends are young and unattached and all seeking romantic partners. Suppose that they have an agreed understanding (it could even be explicit) that if the opportunity to spend the evening with a charming potential romantic partner comes along, it should be taken up without hesitation, with explanations to follow later. In their unanimous view, the potential disruption to the group's plans is more than outweighed by the potential rewards of an exciting new paramour. All the other facts are the same; no text message is sent, the friends initially delay and then rush through a hurried dinner, and they arrive at the theatre late. Now has the student behaved wrongly?

Some will alter their judgment in this situation and say no; but others will still say yes. To the extent that the student's behavior remains objectionable in the second situation, however, it is not because any promise has been broken. The friends have authorized the student's frolic, and consented in advance to be stood up. They may have suffered a loss by having to bolt their dinner and miss the beginning of the play, but they understood that this was a risk of their agreement and accepted that risk willingly and gladly in order to obtain similar opportunities for themselves. What is objectionable in the second case — if there is something objectionable — is that this is no way to treat friends, and no way for friends to accept being treated. On such a view, the second group, even if they agree that these are the ground rules for their relationship, shares an impoverished view of friendship. In their willingness to subordinate their

relationship to a casual fling, they exhibit their shallowness and lack of mutual commitment.³⁸

Can a similar objection be leveled at ordinary commercial contracts enforced by expectation damages? In form, it plainly can. A contracting party who breaks off a relationship and offers money in compensation is treating the relationship as alienable and disposable. A counterparty who accepts this understanding as the price of doing business (or, in exchange for a more favorable price) is collaborating in this alienability. The question, however, is whether the objection resonates in substance in the ordinary case.

Arguments of this sort have commonly been put forward in the property and constitutional law literature in furtherance of the claim that particular rights and duties should not be alienated, particularly in exchange for money.³⁹ They have been most influential, however, when applied to rights that are deemed fundamental to personal integrity: most particularly those related to family formation and reproductive choice.⁴⁰ Do such arguments have any force in contracts generally? Do they apply when parties trade away their entitlement to specific performance, explicitly or implicitly, by contracting *ex ante* into expectation damages?

One possible answer is that they do not, that market and non-market interactions represent separate spheres of human activity that involve separate ethical obligations. On such a view, human flourishing may require the existence of some thick relationships in which commitment and solidarity are constitutive elements, but it does not require all relationships to be similarly thick. Indeed, we might worry that attempting to extend aspirations of solidarity to market relationships will, by spreading our emotional attention too thinly, undermine our ability to maintain our more intimate relationships with the same intensity.

On the other hand, the majority of citizens in modern capitalist societies, perhaps save retirees, students, and homemakers, spend the largest part of their social

³⁸ Cf. Ethan J. Leib, *Contracts and Friendships*, *Emory Law Journal*, Volume 59, Issue 3, pp. 651-726 (2010); *Sex and the City* (2008) (“They say nothing lasts forever; dreams change, trends come and go, but friendships never go out of style.” --- Sarah Jessica Parker as Carrie Bradshaw). *Aficionados of the SATC* television series will recognize the value conflict outlined in this paragraph as a running theme in the characters’ dramatic and comedic interactions.

³⁹ Most famously by Margaret J. Radin, *Market-Inalienability*, 100 *Harv. L. Rev.* 1849 (1987).

⁴⁰ See generally Frances Olsen, *The Family and the Market*, 96 *Harv. L. Rev.* 1497 (1983); Elizabeth Anderson, *Value in Ethics and Economics* (1995); Michael Trebilcock, *the Limits of Freedom of Contract* (1997).

interactions in market-related activities. In both large and small-scale enterprise, productive activity is increasingly undertaken in teams. And as we have learned from the relational contracts literature, in all but the simplest exchanges (and perhaps even in those as well) the parties' interactions rest on and reinforce a web of social and cultural relations. Accordingly, excluding norms of solidarity from market settings may undermine our ability to maintain them in other aspects of our lives.⁴¹

Additionally, individual choices, as they are observed and interpreted by others, affect the development of social norms. Parties who behave according to the recommendations of efficient breach theory, and commentators who urge them to do so, establish models of social behavior that others may be induced to follow.⁴²

This effect is magnified when these social models are enshrined in the law. Most critics of expectation damages would probably not be prepared to forbid contracting parties from agreeing *ex ante* to forego the remedy of specific performance, at least not across the board. But they generally do object to establishing a default rule to that effect. One important reason for this objection is that default rules are not just a matter of head-counting of contracting parties' preferences. They establish a norm and put the stature of legal institutions and the legal community behind it.⁴³

⁴¹ Cf. James Boyd White, *Economics and Law: Two Cultures in Tension*, 54 *Tenn. L. Rev.* 161 (1986).

⁴² This potential for spillover to social norms helps explain the otherwise puzzling argument that even if money damages fully protects the parties' expectation interests, breach of one contract creates a negative externality by undermining the certainty of future bargains by third parties. From a purely consequentialist perspective, this argument makes no sense; if expectation is fully protected even in the event of breach, there is no reason for third parties to be deterred from entering into their own contracts. Whether their counterparties breach or perform, they will still get their expected gains.

If on the other hand parties attach non-instrumental value to contractual performance, because they value solidarity for its own sake, then they do have reason to be concerned about other contractors' breaches. By exhibiting and modeling independent, impersonal economic behavior, and prioritizing material gains over personal connection, they may encourage others to adopt similar normative commitments, which will make it harder for people who do value contractual solidarity to find corresponding partners. Formally, this is an externality that operates through the mechanism of preference formation.

⁴³ As Richard Craswell has argued, default rule arguments are not easily susceptible to deontological objections. See Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 *Michigan Law Review* 489 (1989). But they are susceptible to aretaic objections.

For all these reasons, lawyers concerned about virtue will have misgivings about the concept of efficient breach that are quite different from any misgivings they may have that arise from their concerns about justice. Indeed, from an aretaic perspective, the rhetoric of efficient breach is at least as objectionable as its substance. I have suggested above that the concept would have generated less controversy if it had been articulated in terms of efficient performance or efficient termination options. But the point of articulating the concept in terms of breach was, at least in part, deliberately transgressive.

In this way, the advocates of efficient breach have followed in the footsteps of Oliver Wendell Holmes, who delighted in tweaking his more moralistic contemporaries, and savored the thought that his legal positivism and moral skepticism would stink in their nostrils.⁴⁴ Indeed, Posner, Goetz and Scott, and their cohort went Holmes one better, by arguing not just that the law was indifferent to whether a person kept his contractual promise, but that promise-breaking was actually desirable. A theory of efficient performance would not have had the same effect or influence.⁴⁵

The defenders of efficient breach have not yet joined issue with the aretaic objection, in part because the nature of the objection has rarely been made explicit. This not does mean that no response can be made. An effective response, however, would have to defend an alternate account of virtue that competes with the relational account, in the same way that efficient breach theorists have defended an alternate account of consent that competes with the account offered by the deontologists.

Such an account can easily be imagined, although this essay does not attempt to develop it. It would need to derive from virtues compatible with the efficiency

⁴⁴ Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 *Harvard Law Review* 457 (1897) (“The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it — and nothing else. If you commit a tort, you are liable to pay a compensatory sum. If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can.”)

⁴⁵ It should be appreciated that such transgressive formulation are a standard rhetorical move in welfare economics and the economic analysis of law, where writers routinely talk of the efficient amount of crime, corruption, or pollution as opposed to the efficient amount to be spent on law enforcement or environmental. Even deontologists and virtue ethicists accept that it is not feasible to spend unlimited resources to combat such social ills, but it rankles to hear such ills described with the affirmative valence of efficiency or optimality —which is of course part of the point. Another way of saying this is that it is a standard piece of economic (and law-and-economics) rhetoric to purport to make a virtue out of vice.

norms, and with the positivist methodology of modern neoclassical economics.⁴⁶ The possible candidate virtues would include prudence, thrift, diligence, self-reliance, candor, practicality, and the like. These are admittedly unromantic virtues, and few of us would wish to aspire to them exclusively. But it is plausible that they are an essential subset of those broader set of virtues comprised by practical wisdom.⁴⁷

Additionally, the virtues of solidarity and community stand in some tension with the values of autonomy and liberty. Inalienable commitment to a relationship, whether commercial or personal, necessarily limits one's ability to act independently. Impersonal trade can be alienating in one sense, but it is liberating in another, in that it frees people from the obligation of unwanted social relationships as the price of economic survival.⁴⁸

Conversely, one might defend efficient breach in aretaic terms by stressing the ethical obligations of the promisee, where the relevant virtues would include clemency and magnanimity. From such a perspective, a promisee who insists on receiving full specific performance when monetary compensation would fully protect his expectation interest, and when specific performance would impose an avoidable loss on his counterparty, would be behaving vengefully and spitefully. Graciously accepting the substitute of expectation damages, conversely, could be a way of expressing solidarity, and of strengthening a partnership that holds the promise of reciprocal magnanimity on a future occasion.

Conclusion

The ongoing debate over efficient breach theory is not just a debate between consequentialists and deontologists; it is also — and perhaps even primarily — a

⁴⁶ Cf. Avery W. Katz, *Positivism and the Separation of Law and Economics*, 94 Mich. L. R... 2229 (1996).

⁴⁷ As Hursthouse remarks, "It is part of practical wisdom to know how to secure real benefits effectively; those who have practical wisdom will not make the mistake of concealing the hurtful truth from the person who really needs to know it in the belief that they are benefiting him." Hursthouse, *supra*, note ____.

⁴⁸ See Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) at ____ ("Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want, is the meaning of every such offer; and it is in this manner that we obtain from one another the far greater part of those good offices which we stand in need of. It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own to their humanity but to their self-love, and never talk to them of our own necessities but of their advantages. Nobody but a beggar chooses to depend chiefly upon the benevolence of his fellow-citizens.")

debate between partisans of competing virtues. The aretaic aspects of the debate, however, have rarely been conducted openly, or explicitly distinguished from the deontological aspects. As a result, while the critics of efficient breach have been offering both deontological and aretaic objections (or deontological objections with an aretaic grounding), the defenders of efficient breach have only been recognizing and responding to the deontological elements of the criticism.

I conclude by returning to the focus of this symposium: Charles Fried's celebrated and influential *Contract as Promise*. The reader may be asking: what does efficient breach, or the connection between efficient breach and virtue ethics, have to do with Fried's book? The connection, I think, is as follows. Fried has famously argued that the law of contracts is best understood and best morally justified if we take its primary purpose to be the promotion and protection of promise-keeping. The debate over efficient breach, however, and the aretaic objection to efficient breach in particular, suggests that Fried's account is incomplete. It is not enough to keep one's promises; in addition, it is also important to make the right kind of promises – or perhaps in some circumstances, not to make promises at all.

The economic analysis of contracts, as a first cut, holds that promises that help to maximize exchange value are the right kind of promises, and promises that reduce exchange value are not. For virtue ethicists, promises that assist in the development of good moral character or that enact flourishing relationships are the right kind of promises, and promises that interfere with moral development or that enact dishonorable relationships are not. The law of contracts takes a stand on this issue by making it easier to enter into some contracts and harder to enter into others. Accordingly, those who care about the substantive content of promises, as well as whether they are kept, have reason to care about the law of contracts.