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Impossibility and Related Excuses

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by

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0. *Introduction*

If conditions change after parties enter into a contract, one of them might want to be excused from performance, or at least have its obligations revised. Anglo-American law provides the disadvantaged party with a number of defenses which would extinguish that party's obligations – impossibility, frustration, impracticability, and mutual mistake. Although there are some technical distinctions between these, for analytical convenience I will hereafter lump them all together under the impossibility rubric. My purpose in this essay is to explore some problems that have arisen in determining the appropriate scope of the impossibility defense.

The importance of the impossibility defense is circumscribed by the ability of the parties to contract around the law. If the law were too liberal in excusing performance, the parties could narrow the range of acceptable excuses by explicit contractual language. Conversely, if the law were too niggardly, the parties could enumerate additional circumstances that would justify discharge of the contractual obligations. If the law were badly out of line in either direction, the problems could be vitiated by proper drafting of *force majeure* clauses. Such clauses, which are very common, will suspend or disscharge a promisor's obligations for "acts of God". [1]

* Part of the research for this paper was conducted while the author was a visiting professor at Washington University (St. Louis) and Columbia University. Helpful comments were provided by Christopher Bruce, Janis Powell, and participants at workshops at Washington University, Columbia University, and the Wissenschaftszentrum Berlin, as well as by participants at the Conference.

[1] Most of the acts of God that are enumerated in such clauses are beyond the control of the contracting parties. There is one significant exception to this generalization. The clauses typically include strikes by the employees of either party. The purpose of this strike exception is, clearly, to protect the contracting parties from the threat of hold up in their dealings with labor. Thus, in the absence of such a clause the possibility that a firm would be liable for damages for breach of contract would weaken its bargaining position vis a vis the union.

Indeed, it should not really matter whether we frame the problem of excuse in terms of implementing the parties' decision ("Does the fire constitute an act of God that excuses performance as per the initial agreement?") or of identifying the conditions that would justify excusing performance ("Does the fire make performance impossible?"). Even if a contract had no *force majeure* clause, a court might infer that the parties would have included one had they thought of it.[2] That is, instead of recognizing an impossibility defense, the courts could achieve the same result by interpretation of a *force majeure* clause, express or implied.

Regardless of how the doctrine is labelled, courts, when considering a plea to excuse performance, should be constrained by the fundamental question: what would the parties have chosen? I will argue that, as a general rule, parties would not agree to excuse performance because of changed market conditions (neither supply nor demand shocks). The fact that market prices have doubled or tripled would be irrelevant.[3] Parties are more likely to excuse performance if the supervening events adversely effect the costs of performing this particular contract for reasons that are essentially unrelated to overall market conditions.

This argument implies that relative risk aversion as such has nothing to do with the question. Analyses which center on this concept – PERLOFF [1981] and POLINKSY [1987] – would be largely beside the point. Other analyses in which relative risk aversion plays a less central role – POSNER and ROSENFIELD [1977], JOSKOW [1977], BRUCE [1982], and NARASIMHAN [1986] – are, to a lesser degree, similarly tainted.

The paper is organized as follows. In the first section I present an explanation of why reasonable businessmen would choose to excuse performance for some changed circumstances, but not others. In the remainder of the paper I will analyze specific problems that have arisen in the impossibility case law and literature. The explanation forwarded in Section 1 will play a prominent role in much of that discussion. Largely because their paper stimulated my thoughts on the problem, I will contrast my analysis of some of the specific cases to that

[2] POSNER and ROSENFIELD [1977, p. 107] provide an example of such creative interpretation in an impossibility decision. In Snipes Mountain Co. v. Benz Bros. & Co., 162 Wash. 334, 298 P. 714 (1931), the contract was for delivery of a crop that was destroyed prior to delivery. The contract did not mention that the crop should be grown on a specific piece of land. Nonetheless, the court allowed an equitable action to reform the contract so that the land was mentioned. The court then discharged the contract. (For a discussion of why courts discharge contracts for crops grown on specific land, see below Section 2.2) It would have been just as easy to say: despite the fact that there was no *force majeure* clause in the contract, we presume that the parties meant to include one and that such a clause would have excused performance.

[3] This is not to say that parties would never adjust the contract price. Price concessions in the face of changed market conditions are commonplace. But the grantor of the concession often expects a quid pro quo, either express (e.g., an increase in the term of the contract) or implied (e.g., enhanced good will). The grantor, that is, maintains the right to make (or not make) price concessions.

of POSNER and ROSENFIELD [1977]. I will not, except in passing, critique the case law, the reasoning underlying the case law,[4] or the other scholarship.

1. Why Excuse Performance?

Many contracts include a *force majeure* clause which would discharge a seller's obligation if, for example, his factory were to burn down. If he did not want to deliver for other reasons, perhaps because he could get a better price elsewhere, he would not be excused. Why would reasonable businessmen agree to excuse performance for the first reason but not the second? It is useful to note first that not all contracts would discharge the seller's obligation even in the first situation. If the subject matter of the contract were fungible, the contract would be less likely to provide for discharge. For example, suppose that Smith agrees to pay $ 1000 for an item. His wallet, with $ 1000 in it, is consumed in flames. It is unlikely that the parties would want to excuse his performance on this ground since there is no reason to presume that this $ 1000 was connected in any way with performance of this contract. The loss of his wallet makes Smith poorer, but does not otherwise impair his ability to perform the contract. He simply substitutes other dollars for those destroyed in the fire. If, instead of cash, Smith had lost a ton of a fungible commodity or his factory for producing that fungible commodity had burnt down, the same story holds. He does not need to produce the commodity; he can meet his contractual obligation by buying it on the open market.

Let us consider, then, a contract for delivery of something other than a fungible commodity from the seller, Smith, to the buyer, Brown. If the seller does not perform and remains liable for damages, then the court must assess damages and ascertain the reasonableness of buyer's cover. These tasks present some of the same problems that arise with monitoring specific performance.[5] Because the good is not fungible, the buyer has some leeway in choosing the goods with which to cover. If Brown bears the costs, he will have an incentive to choose the most efficient substitute. If, however, Smith must bear the costs, Brown's incentive to economize is weaker. For example, suppose that Brown was purchasing a computer system. His choice of alternatives to the original system that Smith had promised include one provider with somewhat better hardware and somewhat inferior software and aftersale services. A second alternative has the opposite features and is considerably more expensive. If Brown had to pay out of his own pocket, he would choose the superior hardware at the lower price. If, however, the costs were to be borne by Smith, Brown would choose the latter.

[4] As POSNER and ROSENFIELD [1977, p. 118] suggest, the decisions are often more satisfactory than the justifications.

[5] A common ground for denying a request for specific performance is that supervision or enforcement would be difficult; see FARNSWORTH [1982, p. 822].

This is a routine moral hazard problem. The greater the moral hazard, the greater the *joint* costs of the parties. It might appear that non-discharge would be good for Brown – he receives more than he initially bargained for. While this would be correct if we begin the analysis at the time at which Smith is no longer able to perform, it is not correct if we begin at the contract formation stage. Since in the long run the sellers must cover their costs, the costs of moral hazard will be reflected in the price of the goods. In this indirect way do the buyers share in the costs.

If not excusing the seller would result in these increased costs, why would flush right contracting parties ever fail to excuse? The reason is that there are benefits from holding sellers to agreements. While these benefits will generally outweigh the costs, they are likely to be much lower in the event of the occurrence of a condition covered by a *force majeure* clause. If the plant for building a particular machine burns down or a farmer's entire carrot crop is destroyed, the overall market conditions do not change, although the costs of the individual producer do. If the occurrence of the particular event is uncorrelated with market conditions, then the expected value of the change in price between the date of contract formation and the date of the occurrence is zero. If the seller were excused, the buyer would gain when the market price fell and lose when it rose; leaving consequential damages aside, those two effects should roughly wash out.[6] That is, the buyer's *expected* damages from this source at the contract formation stage are low. The *actual* damages could turn out to be very high, however.[7]

The crucial point is this. If the occurrence of a *force majeure* condition is not correlated with market conditions, the expected change in market price is zero, and therefore, the benefits anticipated at the contract formation stage from holding the promisor liable are likely to be low. However, if the seller refuses to perform because events subsequent to the formation of the contract have shown that the contract price is too low, the buyer does suffer. If the seller could perform, but would prefer not to, we can reasonably infer that the reason is that the contract price is too low; the seller could do better selling elsewhere. The changed conditions affect the market for the good or service involved. There is a widespread drought, the Suez Canal closes, etc. Discharging the contract in this instance carries a greater cost. If a seller could be excused simply because the contract price was below the market price, the substantial benefits from

[6] If the buyer could have recovered consequential damages that would arise because a substitute performance could not be completed until after the original performance was due, then discharge could be expensive for the buyer. The analysis is cleaner where it is clear that consequential damages would not be granted. When damages from delay are anticipated, a *force majeure* clause would be likely to suspend the seller's obligation, rather than terminate it.

[7] One cost of excusing performance is that the existence of a *force majeure* condition is a question of fact which could be costly to litigate. The greater the contract versus market differential, the greater the incentive to allege the existence of such a condition.

entering into a contract in a timely manner are sacrificed. While this sacrifice might be acceptable in some cases, it is clear that the costs of excusing a seller's performance when the contract price is too low are greater than excusing its performance in the event of a fire or other act of God.

Thus, it is at least plausible that contracting parties would find it efficient to excuse a seller in the event of a fire or similar seller-specific occurrence, but not on other grounds. It should be emphasized that discharge does not allow the seller to get off scot-free. If a fire destroys the seller's factory and its contract is discharged, it still bears all the costs of the destruction. The buyer bears the risk of a subsequent price change and any consequential damages. It should also be noted that the "impossibility" label is misleading. It might be impossible for the seller to perform what had been promised, but it is not impossible for him to pay the expectation damages. All he'd have to do is write a check. The justification for discharge is that the expected value of the check at the contract formation stage is likely to be low compared to the costs associated with holding the seller liable.

2. *The Cases*

In the remainder of the paper, I want to consider four problems discussed by Posner and Rosenfield. While we generally agree on the outcomes, we differ on the rationale. I rely on the analysis in the previous section to determine whether performance should be excused in three of the cases. The one exception is the *Coronation* cases which are most usefully analyzed as option contracts. The one outcome on which I part company with both Posner and Rosenfield and modern Anglo-American law is not a matter of whether performance should be excused. Rather, it concerns problems that arise if performance is excused – restitution of payments made by the buyer and compensation for costs incurred by the seller in reliance on the contact.

2.1 The Suez Cases

In 1956 and again in 1967, military operations in the Middle East closed the Suez Canal to shipping traffic. Parties that had entered into contracts before the canal was closed found that completing performance would be considerably more expensive. Carriers and sellers who had promised to deliver goods at a fixed price attempted to avoid their contractual obligations. In most instances, the courts enforced the contracts. In *Transatlantic Financing Corp. v. United States*,[8] for example, a shipowner argued that its contract with the United States to transport wheat from the U.S. to Iran was discharged by the closing

[8] 363 F.2d 312 (D.C. Cir. 1966).

of the Suez Canal. POSNER and ROSENFIELD [1977, pp. 103–105] argue that the court's refusal to discharge the contract was correct:

> ... [T]he decision on whether to discharge the contract turn[s] on an examination of the key economic parameters that we have identified. The shipowner is the superior risk bearer because he is better able to estimate the magnitude of the loss (a function of delay, and of the value and nature of the cargo, which are also known to the shipowner) and the probability of the unexpected event. Furthermore, shipowners who own several ships and are engaged in shipping along several different routes can spread the risks of delay on any particular route without purchasing market insurance or forcing their shareholders to diversify their common-stock portfolios. And the shipping company could, if it desired, purchase in a single transaction market insurance covering multiple voyages. Of course, the shipper in the particular case – the United States Government – was well diversified too, but decision should (and here did) turn on the characteristics of shippers as a class, if an unduly particularistic analysis is to be avoided.

Perusal of current shipping contracts indicates that the basic shipping form contracts were not altered after the *Suez* decisions. Closing of the Canal is not an enumerated excuse in *force majeure* clauses. Hence, it would appear that the courts got it right. The Posner-Rosenfield explanation, however, does not work. To see this, consider a closely related problem. How would the parties to a shipping contract deal with the possibility that the port of destination would be closed by a blockade? The reasons given in the previous paragraph would apply at least as well to this problem. Nevertheless, ocean shipping contracts routinely include language that would discharge the carrier in this instance.

Why would the parties agree to excuse the carrier in the event of a blockade of the port of destination, but not excuse in the event that the Suez Canal was blockaded? To make the analysis even crisper, suppose that in both instances these are executory contracts. That is, the parties entered into the agreement before the supervening event had occurred, but had not loaded the goods on the ship. Consider first the blockade of the single port. The costs of getting the goods to the original destination increase. If the carrier were to attempt to deliver by sea it incurs the increased risk of loss due to destruction of the ship or cargo. If it attempted to get the goods to the port by other means (shipping over land or substituting other goods for the goods named in the original contract) it would also incur additional costs. It is not at all clear that the promisee would want these additional costs to be incurred if it had to pay the costs out of its own pocket. Discharging the contract puts that question to the promisee directly. The supervening event raises the costs of performing this particular contract. But there is no reason to believe that there would be any effect on the market price of ocean shipping generally. This is a classic instance of the case discussed in the previous section in which the occurrence of a supervening event is uncorrelated with market conditions. Since at the contract formation stage the expected change in the market price of shipping services due to the blockade of a destination port is approximately zero, the benefits of holding the promisor liable should be low.

This is not true for the closing of the Suez. The closing of the Canal had a substantial impact on the market price for ocean shipping services. There was a large increase in the short-term demand for ocean shipping services which, when coupled with the short-term inelasticity of supply of vessels, resulted in prices more than doubling. The fact that the journey is longer and more costly than originally anticipated is irrelevant. The key factor is that the opportunity cost of the ship has increased. Excusing the promisor in this case where the supervening event is correlated with market conditions carries a greater cost for both parties.

It is worth noting in passing that the non-discharge of the contracts does not mean that all the contracts will be performed. The changed circumstances do not affect all shippers equally. There will be a reallocation of shipping services with the ships tending to go to the highest bidders. Non-discharge means that the beneficiaries of the windfall are those who happened to sign contracts before the Canal closing was anticipated. Discharge would give the windfall to the owners of the vessels.

2.2 Agricultural Goods

Suppose a farmer promises to deliver carrots. The crop is destroyed by a flood and the farmer asks that the contractual obligation be discharged. The general rule has been that if the contract called for delivery of crops from this particular farm, then the farmer would be excused. Otherwise, he would not. Posner and Rosenfield [1977, pp. 106–107] suggest that the explicit identification of the crops with a particular plot of land is irrelevant by itself; however, it generally leads to the right decision since it serves as a proxy for the distinction between a farmer and a wholesaler, the latter being better able to diversify risks.

> The result is both consistent and efficient; it places the risk of extreme weather conditions on the superior risk bearer. The purchaser from the grower can reduce the risk of adverse weather by diversifying his purchases geographically; there is empirical evidence to suggest that in some climatic regions geographical separation of only a few miles can dramatically reduce the risk of a large loss. When the seller is a wholesaler or large dealer there is no reason to allow discharge since he can diversify his purchases and thereby eliminate the risk of adverse weather.

To see why the seller's ability to diversify is not the critical factor, let us assume initially that the farmer is producing a homogeneous product. (This assumption is implicit in the Posner-Rosenfield analysis; as we shall see, a proper resolution of the matter requires that we drop the assumption.) If his crop were destroyed, he could purchase a substitute on the open market and meet his obligations in that way. Regardless of whether or not he is excused, the farmer bears the entire risk of the destruction of his crop. The impossibility defense only concerns the additional risk of a price rise occurring between the time the contract was entered into and when performance was due. If the farmer had assumed this risk in the initial contract, why should the risk be shifted when his crop was destroyed?[9] Why should the parties distinguish between the case in which the farmer produces the goods and then must sell them at a contract price less than the market price and the case in which the farmer fails to produce the goods and must buy them on the market at a high price and resell at the contract price?

Posner und Rosenfield have concentrated on the wrong factor. Differential attitudes toward risk do not explain why performance is more likely to be excused when the contract specifies the land on which the crop is to be grown. A simple question to ask is: why would a contract specify that the crop be produced on a particular piece of land? A plausible answer would be that the parties are doing this to distinguish the crop from others. That is, carrots are not homogeneous; by specifying that the carrots be grown on a particular piece of land, the parties are conveying some information about the expected quality of the carrots.

My knowledge of agricultural markets is meager and unsystematic, and I do not want to become embroiled in a debate over the extent of quality variation in various markets. But I think it is quite clear that quality does vary and that the identity of the supplier can be quite important in some instances. This is obviously true for wine grapes. And it is also true for many fruits and vegetables. Indeed, in some instances canners will provide seeds for certain varieties to selected growers.[10]

Thus, if the carrots are destroyed by an act of God and such acts are expected to be uncorrelated with changes in market prices, we have the type of situation described in the previous section. The anticipated rewards to holding the promisor to the contract are low while the costs of holding him to the contract given the difficulties in reckoning damages and evaluating the reasonableness of the buyer's mitigation (cover) can be high.[11]

Notice that it is not even necessary for the contract to include an explicit excuse clause. If the contract quantity depends upon the amount actually grown, then any shortfall from the expected crop is automatically excused. That is, if the buyer agrees to take all the carrots produced (or a pro rata share) and

[9] BRUCE [1982, pp. 331–32] hints at this; his discussion gets bogged down in some extraneous considerations of insurance.

[10] See FLATH [1980, p. 183]. In some instances courts might find that, if a grower breaches, the lack of close substitutes would force the buyer to incur consequential damages. In Campbell Soup Co. v. Wentz, 172 F. 2d (1948), a grower of a special variety of carrots (grown from Campbell's seeds) breached his supply contract. The court held that the carrots were sufficiently unique to merit granting Campbell specific performance. (Specific performance was denied, however, since the court misunderstood the *force majeure* clause and held it unconscionable; the court then argued that a party that included such a nasty clause in a contract did not deserve specific performance.)

[11] The *force majeure* clause in *Campbell v. Wentz* did excuse the grower if the carrot crop was destroyed.

bad weather results in fifty percent of the crop being destroyed, the grower is, in effect, excused from delivering the remaining fifty percent.[12]

At the opposite extreme, consider a wholesaler who intermingles the product of many farmers and then sells a product of a defined quality. The moral hazard problem in this instance is trivial. Even if his crops were destroyed, he could meet his obligations by buying and tendering warehouse receipts. The costs of having the promisor cover or of reckoning damages in this instance are likely to be outweighed by the benefits of providing assurance that the contract will be enforced. Thus, in this instance it is less likely that the parties would include a *force majeure* clause in the contract.

When I presented an earlier version of this paper at Columbia University, I uncautiously characterized the preceding argument in the form of a prediction. In contracts in which the particular supplier's quality was important, we should expect to find *force majeure* clauses. Where goods of the same quality are easily available, we should not find the clauses. Professor E. Allan Farnsworth pointed out that a number of form contracts for fungible agricultural products did include *force majeure* clauses, and he graciously provided me with some.

Careful consideration of one of these contracts will, I think, lend support to my argument, so long as the conclusions are not presented in such overbroad terms. The North American Export Grain Association agreement concerns the delivery of fungible grain from an elevator to the buyer's vessel.[13] The contract contains a number of interesting features. First, it specifies liquidated damages in the event that the buyer fails to take delivery;[14] since there can be no dispute over the accuracy of damage measurement or the adequacy of cover, this eliminates the moral hazard problem. Second, if the contract is one that is being traded like a futures contract rather than one for which delivery is to be

[12] In *Campbell v. Wentz,* Campbell agreed to take all the carrots produced (up to twelve tons per acre). The open-ended quantity clause creates an incentive problem. Suppose that at harvest time the contract price is well below the market price. If the marginal cost of harvesting is upward sloping, the farmer will have an incentive to underspend in harvesting because he does not fully capture the rewards. This would also be the case if the contract was for a fixed quantity but included a *force majeure* clause. Consider a farmer whose fields are flooded. He might be able to salvage some of the crop and the amount salvaged will depend upon the amount he spends. If the market price exceeded the contract price, the farmer has an incentive to underspend on salvage (or mitigation) and invoke the excuse. If monitoring of the farmer's efforts is difficult, then the availability of the excuse can result in the farmer making an inadequate response to the flood because the bulk of the rewards to his salvage effort go to the promisee.

[13] The contract is described in detail in SLABOTZKY [1984].

[14] Clause 18 sets the damages at the difference between the contract and market price plus daily carrying costs (a blank term to be filled in at the time of contracting). "It is further expressly agreed that carrying charges as provided herein are to be construed in the nature of liquidated damages and, as such, that no further proof of damages shall be required in substantiation thereof."

expected, the excuse clause does not apply.[15] Third, the excuse clause is operative only for a few specified causes which make it difficult for the parties to ship the grain: strikes, exceptional impediments to transportation, and actions by governmental authorities.[16] A fire in the seller's warehouse would not excuse performance. In sum, the grain contract is consistent with the picture I have sketched. The contract is not excused under any circumstances if delivery had not been anticipated. Even if delivery had been anticipated, the contract is not excused if fungible grain is destroyed. It would, however, be excused if the costs of loading at a particular location increase just as the contract to transport the grain would be excused if the port of delivery was closed.[17]

2.3 *The Coronation Cases*

In anticipation of the procession to be held in connection with the coronation of Edward VII, rooms were rented along the route at high prices. Edward's appendicitis forced the cancellation of the procession and considerable litigation ensured. In *Krell v. Henry*[18] it was held that the cancellation of the procession frustrated the purpose of the contract and that the renter was discharged from the contract. He did not have to make payments that were due after the procession had been cancelled. Since he had withdrawn his cross-claim for restitution of funds already paid before the cancellation, the court did not have to deal with that issue. In *Chandler v. Webster*[19] the court ruled that there could be no recovery for money that had been paid before the cancellation; furthermore, the renter would be liable for any money due before the cancellation but not yet paid. This result has been subjected to considerable criticism. Professors DAWSON and HARVEY [1969, p. 636], for example, state that "the absurdity of this solution is apparent."

I think that the decisions are not absurd. Before I begin the analysis, I should point out that the Coronation cases are one-shot deals between amateurs. These are the sorts of cases that law professors love. One can play a lot of games attempting to divine how the parties might have dealt with the problem had they thought about it. There are few constraints upon the imagination. As such, these are terrible cases on which to build a commercial jurisprudence. There are, however, many commercial situations in which similar problems arise and in which it would be possible to observe how parties routinely deal with the problem. If, for example, the Chicago Cubs lose in the playoffs, hotel reserva-

[15] In trade usage, a "circle" is a series of contracts in which each seller is also a buyer of the same quality goods at the same port in the same time period; each party to the circle "may agree to forego actual delivery and to participate in a clearing agreement for the settlement of contract price differences." (Clause 16) See SLABOZKY [1984, pp. 56–62].

[16] Clause 20.

[17] See the discussion of the *Suez* cases, above.

[18] [1903] 2 K.B. 740.

[19] [1904] 1 K.B. 493.

tions in Chicago for the World Series will be worth considerably less; how would the contract treat the guest's obligation? If I make reservations at a ski lodge and when the time comes there is no snow, can I have the contract discharged? and will I get a refund for any money already paid? I will discuss *Krell* and *Chandler* on the assumption that the contracting parties were acting as reasonable businessmen. This will be a useful prelude to consideration of the World Series and ski lodge type of problem.

It is useful to view the owner of the flat, Krell, as selling an option. By agreeing to make a series of payments at specified dates, Henry was in a position to exercise or not exercise the option. If after he had made one payment he decided that he did not really want to see the procession or that he would rather see if from a different location, he could refuse to make the subsequent payment, thereby allowing the option to expire. In this interpretation all money that was due prior to the supervening event should be paid to Krell for performance of the contract. The cancellation of the procession does not require that the contract be discharged; rather, the option contracts are performed with Henry simply allowing all the subsequent options to expire.

Now, the contract did not say that Henry had an option; nor did it explicitly state that, in the event that the coronation had taken place as scheduled, Henry could refuse to make the payment due prior to the event and escape without liability. Nonetheless, I think it is reasonable to infer that this is how parties would treat the problem if they dealt with it explicitly. Suppose that a skier is contemplating a vacation at a popular ski lodge. She might make reservations six months in advance. If she changed her mind the following day and the contract was silent on the matter, she would be legally liable for the full amount.[20] But the contract would probably not be silent on this point. The lodge would probably ask for a modest initial deposit and require some additional non-refundable deposits at later dates. In the event that she changed her mind, her liability would only be for the non-refundable deposits. It might well be that she could walk away from her reservations two weeks before the planned vacation date at a cost of only ten per cent of the contract price.

Posner and Rosenfield [1977, pp. 110] agree that the contract should not be discharged because of the lack of snow. Their argument hinges on the relative ability of the contracting parties to diversify risks. The ski lodge, they claim, is less able to diversify the risks than are the customers who could ski elsewhere. I doubt that the argument is correct since it would probably be difficult for the skiers to book alternate accomodations on short notice. But we need not worry about whether their assertion is correct; the ability to diversify is a red herring. The contract would most likely include a schedule of payments. When it be-

[20] There are some complications as to whether the reletting of the room by the lodge would constitute mitigation of damages or whether the lodge could argue that it was a lost volume lessor. For analysis of the lost volume problem, see Goldberg [1984] and Goldberg [1988, Part IV].

comes clear to the skier that snow conditions will be inadequate, she stops paying. There would be neither a breach nor a discharge. The magnitude of the payments made by the skier will depend upon the timing of the decision, the popularity of the lodge, and so forth. If the contract did not require that the skier make any payments prior to showing up, then she would bear no liability.

I have not collected any systematic information on how ski lodges, hotels, and others handle these problems. Anecdotal evidence suggests that the options are routinely sold. Hotels frequently require that someone booking a room pay for the first night in advance to assure reservations.[21] Restaurants rarely charge a price for reservation, although some high-priced restaurants have established a policy of billing no-shows. I am reasonably confident that a more systematic canvassing would show that the use of options is very common and that the judicial disposition of *Krell* and *Chandler* is consistent with what is routinely done in the hotel business.

2.4 Customized Machinery

If a contract involves a machine that is to be constructed by the seller and installed in the buyer's factory and that factory is destroyed by fire prior to delivery, the contract would be discharged. The Anglo-American case law and the Uniform Commercial Code both would excuse performance. *Force majeure* clauses would also generally excuse the performance. There is less agreement on what should be done after the seller has been excused. Should the seller be compensated for costs incurred prior to the fire? Should the seller be required to return payments made by the buyer prior to the fire?

Let us begin with the simplest case. The fire occurred before the seller has started to perform and the buyer has made no payment. If the buyer was not excused, for what damages would he be liable? He would be liable for the change in the market value of the machine between the date at which the contract was formed and the instant at which he breached.[22] Since the fire at the buyer's factory is likely to be unrelated to overall market conditions for the machinery, the expected value of the price change is likely to be zero. By the argument of the previous section, it is unlikely that the benefits of holding the promisor to the contract would outweigh the costs. POSNER and ROSENFIELD [1977, pp. 92–93, 105–106] and BRUCE [1982, pp. 330–331] reach a similar

[21] Most of my readers have, I suspect, booked hotel reservations over the phone, given their credit card number, and agreed, in effect, that if they do not show up for any reason, they are still liable for the cost of a one-night stay. Fewer, I suspect, had an inkling that this routine practice is in any way related to commercial impracticability and other arcane corners of contract law.

[22] Some courts might hold B liable for "lost profits" as well. This, I think, would largely be the result of a misunderstanding of what it means to make the non-breaching party as well off as it would have been had there been no breach. I develop this point in GOLDBERG [1988, Parts III B and IV].

conclusion. They note that the seller is generally in the better position to salvage[23] and that courts have correctly discharged the contracts in such circumstances.

Curiously, BRUCE [1982, pp. 323–324] argues that *Taylor v. Caldwell*[24] was wrongly decided. That case, the "fountainhead of the modern law of impossibility" (FARNSWORTH [1982, p. 673]) concerned a contract to perform in a music hall which was destroyed by fire less than a week prior to the scheduled performance date. But there is no practical distinction between that case and one in which the fire disrupted a contract for delivery of a machine rather than the delivery of a service. Bruce emphasizes the incentives for the music hall owner to control the likelihood of the occurrence of the fire. Note, however, that the music hall owner bears the direct costs of that fire; it is his music hall that burns down. The only damage issues in *Taylor v. Caldwell* concern the post-contractual change in the price of music hall services and the performer's reliance costs, consequential damages, and incidental damages. By excusing the music hall, the decision put the entertainer in exactly the same position as the manufacturer of machinery in the hypothetical.[25]

If the fire occurred after the seller had begun to perform, and if only some of the costs of performance were salvageable, then responsibility for these additional costs must be assigned. In the absence of specific contractual language, this raises two new damages issues: (a) Should there be restitution of any payments made by the party invoking the excuse? and (b) Should the innocent party be compensated for expenditures made in reliance on the contract? Reliance would include the costs of acquiring inputs necessary for performance of this contract, costs incurred in performing the contract up to the point at which the breach occurred, and costs incurred in anticipation that the contract would be performed (e.g., establishing a network of retailers or initiating an advertising campaign).[26]

Both of these issues present difficulties even in the case in which the buyer's failure to perform resulted from a deliberate decision on its part rather than an act of God that was presumably beyond its control. Thus, American courts

[23] If the seller has not begun to perform or if salvage value were zero, then the relative ability to affect salvage would be irrelevant. There is a bit of confusion in the Posner-Rosenfield analysis in that they assume "the machine has no salvage value" (p. 92) and then argue that the "loss depended not only on the salvage value of the machine if the fire occurred after its completion but also on its salvage value at various anterior stages." (p. 93)

[24] 3 B. & S. 826, 122 Eng. Rep. 309 (1863).

[25] In the machinery hypothetical the costs of reliance and the consequential and incidental damages were assumed to be zero. The assumptions are relaxed in the next paragraph.

[26] In a case like *Taylor v. Caldwell*, the frustrated entertainer might have incurred travel expenses; he might also have foreclosed alternative employment opportunities for the period he had been scheduled to perform at the music hall.

have in some instances ordered restitution to the breaching party of money paid even where the breach was willful, rather than accidental or negligent.[27] Surely, if restitution were appropriate in the face of a willful breach, it should be paid when a contingency beyond either party's control arises. Whether the law *should* award restitution to a willful breacher is a different question. In most reasonable commercial contexts economics and common sense suggest that the answer should be: No. I will return to this shortly,

If the buyer breached, it is not at all clear that the manufacturer would be compensated for expenses incurred in anticipation of the sales contract being performed. The law does not generally look kindly upon reliance losses and/or consequential damages. Indeed, I argue elsewhere (GOLDBERG [1988], Part III B) that American law has probably become too liberal in compensating these losses. I will not pursue that argument here. For my purposes it is sufficient to acknowledge the existence of a tradeoff. On the one hand, compensating the seller weakens his incentives to control costs before the contract is terminated.[28] On the other hand, a failure to compensate reliance expenditures might result in the seller's doing too little. How can these competing interests best be taken into account? A priori, we can't say. The question is too situation-specific. But that means that, to the extent possible, we should leave the balancing decision in the hands of the contracting parties. There are numerous contractual devices by which the seller could achieve some protection of its reliance. In particular, it could require interim payments from the buyer. The arrangement could be formalized with progress payments, as they are usually called, being required as the seller successfully completes particular phases of the project. If the contract was terminated prematurely (either deliberately or by an act of God) there would be no need to order restitution or to reckon the compensable reliance damages. By appropriately phasing their performance, the parties manage to balance their respective interests and to avoid wasteful litigation.

The questions of restitution and reliance are, therefore, interrelated. Prepayment should not be viewed as a mere happenstance. In serious commercial transactions, prepayment is a device for providing some protection of the reliance interest.[29] If customized goods are involved, phased payment should

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[27] See FARNSWORTH [1982, pp. 600–605, 8.14].

[28] POSNER and ROSENFIELD [1977, pp. 93] emphasize the seller's control of costs in their argument that the contract should be discharged in the event of a fire in the buyer's plant. Implicitly, at least, they are arguing that the relevant damages are reliance damages and they should be borne by the seller.

[29] That is, of course, not the only purpose. As noted in the discussion of the Coronation cases, prepayment can be an effective way of creating options. POSNER and ROSENFIELD [1977, p. 116] argue that because there are so many reasons for prepayment we should not presume that prepayment is related to the possible occurrence of an event which would result in discharge of the contract. Therefore, they favor a rule which provides restitution of prepaid money.

be expected; the more unique the goods, the greater the protection. Contracting parties might find any particular contingency too remote to worry about. Nonetheless, a sensible rule for them to adopt is that there are a large number of reasons why a particular contract might not be completed and one way to protect one's interests is to assure that at each point in time, the performance rendered and compensation received are not too far out of whack.[30] By ordering restitution or attempting an independent assessment of reliance losses, courts undo the balancing of interests achieved by the parties.

Anglo-American law appears to be moving in the wrong direction.[31] *Chandler v. Webster*, after being subjected to a considerable amount of criticism, was overturned in England in *Fibrosa Spolka Akcyjna v. Fairbairn Lawson Combe Barbour, Ltd.*[32] In that case, the Polish plaintiff ordered machines that were to be manufactured in England and delivered to Poland. The plaintiff had made a down payment and the manufacturer had partially completed performance when Germany invaded Poland, a condition which resulted in discharge of the contract. The House of Lords held that the plaintiff was entitled to a refund of the down payment, but that the defendant was not entitled to compensation for the costs it had incurred; that issue, it asserted, was a matter for the legislature to deal with. Shortly thereafter Parliament passed the Law Reform (Frustrated Contracts) Act[33] which allowed for some recovery of reliance expenditures. The net result of the decision and subsequent legislation seems to be that if courts do their job well, they will manage, at considerable expense, to put the parties in roughly the same position the parties were in before the courts became involved. That does not seem to be a happy outcome.

3. *Concluding Remarks*

The first tentative conclusion I want to draw from this exercise is a methodological one. Because uncertainty over the future is a central element of the impossibility problem, there is a great temptation to invoke attitudes toward risk (relative risk aversion) and the ability to diversify risks in analyzing the problem. I hope that I have demonstrated the fruitlessness of that approach. This is one more piece of evidence in the case I have been trying to make over

[30] KLEIN [1980] notes that the parties might have rational reasons for having the benefits and costs diverge over time. If one party can use the threat of imposing high costs by terminating the contract, the parties might be better off because that threat can be used to discipline the potential loser. This possibility makes it even less likely that a court could intelligently determine how much restitution and reliance damages would be appropriate.

[31] On American law, see Restatement Contracts 2d 272 and FARNSWORTH [1982, pp. 702–704].

[32] 1943, A.C. 32.

[33] 1943, 6 & 7 Geo. 6, c. 40.

the last few years against relying upon risk aversion to explain most contracting behavior or economic institutions generally.[34]

The second conclusion is that the distinction between supervening circumstances which affect market conditions and those which affect the costs of performing this particular contract is the key to understanding the case law and the decisions of the parties as to when performance should be excused. Market fluctuations, even beyond the range that reasonable men might have foreseen, are not a ground for discharging a contract. That does not mean that the parties will set the price term and accept any subsequent price changes as part of their bargain. They have a number of devices at their disposal for adjusting the contract price to changed market conditions – indexing being the most obvious.[35]

The third conclusion is that private parties are pretty clever.[36] They do not use *force majeure* clauses indiscriminately. As the discussion of the grain contract indicated, the grounds on which a contract would be excused can be nicely tailored to industry conditions. Moreover, *force majeure* clauses are only one aspect of the private response. Business firms can set up their affairs to take into account the possibility that the contract might be terminated for any reason. Phasing performance with devices like progress payments can effectively protect the reliance interest of the performing party.

Finally, these points suggest that courts should be cautious when confronted with demands for discharge or demands for restitution in the event that a contract has been discharged. This does not mean that courts should never succumb to the demands. There is room for interpretation of ambiguities in *force majeure* clauses and of the intentions of the parties in the absence of such a clause. This is especially true as we move away from commercial contracts between repeat players toward contracts between amateurs. Courts should not, however, take the existence of ambiguities, real or contrived, as license to remake deals in pursuit of ex post fairness. The preceding analysis suggests the principles that should be used to fill the gaps in these contracts.

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[34] See GOLDBERG [1988]. I am not alone in my aversion to risk aversion for analyzing institutions; see also BARZEL [1982], KLEIN [1983], p. 370, and WILLIAMSON [1987].

[35] In GOLDBERG [1985, pp. 531–534], I discuss the benefits of price adjustment and the mechanisms for achieving it.

[36] Actually, individuals might be rather foolish and most people in the industry could probably not tell us what the excuse clause looked like and why it took the form that it did. The cleverness is in part that of a few lawyers and in part (I suspect a greater part) the result of market forces rewarding the good contracts and penalizing the bad.

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