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Remedies for breach of contract under the CISG

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Abstract

In this essay, I survey the three main remedial categories of the Convention on the International Sale of Goods (CISG) [specific performance, money damages, and goods-oriented remedies such as rejection and cure] from the vantage point of the economic literature on contract remedies, and discuss whether the rules set by the CISG are economically suitable for the particular transactions it governs—that is, long-distance and cross-border transactions, which are characterized by a different configuration of relative transaction costs than purely domestic exchanges. The central theoretical premise of the essay that is that while the economically optimal arrangement with respect to contract remedies is a second-best matter about which it is difficult to generalize, it is possible to draw some distinctions between long-distance and short-distance transactions and between in-border and cross-border transactions, and to develop generalizations about which remedies are relatively best suited to which contracts. A subsidiary premise is that CISG remedial rules are only default rules; and that private parties engaging in these transactions can and should contract into the remedial arrangements that are best suited to their particular arrangements. At the end of the paper, I draw some comparisons to issues raised by the burgeoning practice of electronic contracting.

Keywords: Remedies for breach of contract; Contract law; Sales law

1. Introduction

The remedial provisions of the Convention on the International Sale of Goods (CISG) reflect a deliberate balancing among the remedial approaches of the civil law, the common law, and other various legal systems of the Convention's signatory nations. Much discussion of these provisions, accordingly, has proceeded from the vantage point of comparative law, and has focused on the question of which rules are better or fairer as a matter of overall

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policy or as an international compromise. This essay takes a different approach; it instead evaluates CISG remedies from the vantage point of the economic analysis of law, in order to determine whether those remedies maximize contractual value for international traders or, conversely, whether such traders would do better to contract out of the Convention's default rules and into their own arrangements.

From the vantage point of a central planner, the economic approach might appear to offer no clear-cut conclusions in this regard, for the main lesson that can be drawn from the law-and-economics literature on contract remedies is that no remedial rule is perfect in the sense of providing efficient incentives along all relevant dimensions of contractual behavior. Rather, there are always economic tradeoffs to be drawn among the various elements of contractual efficiency: efficient ex post performance, efficient mitigation of losses, efficient reliance, efficient risk allocation, and so on. Furthermore, while it is hard enough to generalize about the efficiency of contract rules within a single legal system, it is even more problematic to make such an attempt in the transnational setting, where parties, business settings, and legal transaction costs are highly heterogeneous.

Fortunately, we do not have to undertake such an effort, since the law of contracts leaves the specification of remedies to the parties to a very considerable extent. This freedom of contract is not unlimited, of course. Under US sales law, for instance, the parties lack power to set damages at a punitive level, to bind a court to award specific performance, or to limit remedies in such a way to deprive an aggrieved party of the substantial value of the bargain.[1] But subject to such outer limits, and to the limits imposed by general doctrines such as unconscionability and public policy, parties retain substantial freedom to choose their remedies. They may liquidate damages in a particular amount, specify a method for calculating damages, limit damages to a specific amount, or exclude certain types of damages (such as consequential damages or economic loss) entirely. Similarly they can restrict a buyer's right to reject goods, a seller's right to cure defective performance, or either party's right to demand assurances of performance or to declare a contract repudiated, provided they do so in a way that is not manifestly unreasonable.[2]

All these options are also available in international sales contracts under the CISG. In particular, CISG Article 6 explicitly authorizes contracting parties to exclude the application of the Convention to their agreement, or to derogate from or vary the effect of any of its provisions.[3] Again, this authority does not confer absolute freedom of contract, because the parties will still be restrained by domestic legal rules relating to the contract's validity,

[1] See UCC §§2-718 (holding unreasonably large liquidated damages void as a penalty); 2-716 (specific performance is discretionary and courts may condition its award on whatever terms and conditions are deemed just); 2-719, comment 1 (requiring "at least a fair quantum of remedy for breach").

[2] UCC 1-102(3) (provisions of the UCC variable by parties' agreement; obligations of good faith, diligence, reasonableness and care may not be disclaimed, but parties may determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable).

[3] The Convention does impose some minor limitations on this general rule. Specifically, where one of the parties to the contract is located in a state that has made a reservation under article 96 relating to the question of whether a contract must be formally evidenced by a writing, the parties may not agree to dispense with the writing requirement that the home state has retained. In addition, the parties are not empowered to derogate from the public international law provisions of Articles 89 through 101, as these provisions cover issues relevant to contracting States rather than private parties.

which are not governed or superseded by the CISG.[4] (And as discussed below, the CISG does not require a domestic court to award specific relief in situations where this would be contrary to their usual local practice.) But the overall spirit of the Convention, and the fact that most disputes under it are heard by private arbitral tribunals, plainly encourages parties to choose remedial options that best suit the needs of their transaction.

In addition, the option of contracting around legal defaults is more salient in the transnational setting, where in order to contract with one another at all, the parties must address the question of how each party will have to adjust their standard contractual practices in order to conform to the practices and the legal system of the other, or to any compromises offered by the CISG. Thus, it is less likely that the parties will just fall back on legal default rules out of habit or inertia, and more likely that they will consciously make use of their leeway for contractual freedom.

For this reason, in this essay I focus primarily on what remedial arrangements private parties should make when contracting around the CISG default rules, and only secondarily on whether the CISG rules themselves set the appropriate defaults. I have argued elsewhere that the economic approach to contracting is more usefully applied to transactional planning than to the design of public legal texts, both because private actors designing their own transactions are likely to be more receptive to efficiency concerns than are public jurists or legislators, and because private lawmakers are more likely to be in possession of the detailed information that is necessary to apply economic analysis usefully.[5] In the international sales area in particular (and when working under uniform laws and conventions more generally), this emphasis on transactional design is even more strongly warranted because the institutional difficulties of amending a multilateral treaty make changing its articles extremely unlikely. Thus, it is only through private transactional design that economic analysis is likely to have much effect on international sales.

Of course, parties operating in different markets and across different borders or trading different kinds of goods will face different economic tradeoffs, and it is not feasible to offer general advice here to all such parties. CISG transactions do have certain common characteristics, however, that distinguish them from the more general transactions governed by domestic sales law. Most importantly, they are all merchant-to-merchant transactions; they are all transnational transactions in which the parties must contend with the reach of multiple legal systems; and they typically involve shipment of goods across national borders and, on average, over longer distances. As a result, it should be possible to draw useful generalizations regarding the arrangements that are best suited to this subset of commercial contractual transactions and this configuration of relative transaction costs. Such generalizations will be useful both for ex ante transactional design (i.e. as a starting point for individual renegotiation around the legal default rules in specific instances) and for ex post dispute resolution (i.e. as a guide to interpretation and application that can be applied by transnational tribunals deciding cases).

[4] See Article 4(a) (the CISG is not concerned with the validity of the contract, of any of its provisions, or of any usage).

[5] See Avery W. Katz, Taking Private Ordering Seriously, 144 U. Pa. L. Rev. 1745 (1996); Avery W. Katz, An Economic Analysis of the Guaranty Contract, 66 U. Chi. L. Rev. 47 (1999); Avery W. Katz, The Economics of Form and Substance in Contract Interpretation, 104 Colum. L. Rev. 496 (2004).

The organization of this essay proceeds as follows: Section 2 essay discusses the economic tradeoffs that are posed by the choice of remedial provisions, and how these tradeoffs interact with the distinctive features of CISG transactions. Section 3 discusses the CISG provisions that deal with specific performance of contracts—the standard remedy for contractual breach under both the civil law and CISG. Section 4 discusses the CISG provisions dealing with monetary damages, and also discusses liquidated damages negotiated by the parties ex ante—a topic that the CISG does not explicitly address. Section 5 discusses CISG provisions dealing with those party-administered remedies arising in the course of contractual performance: including rejection, cure, *nachfrist*, and avoidance. Finally, Section 6 draws some parallels between the legal arrangements most appropriate in CISG transactions and those arrangements best suited to electronic contracting transactions; and Section 7 concludes.

2. The economic perspective on contract remedies as applied to international sales

The economic analysis of contract remedies starts from the basic premise – perhaps unconventional from a non-economic standpoint – that remedial terms are just one of the terms of the contract. That is, the choice of remedy has substantive incentive and risk allocation effects just as other contract terms do, and the parties can and should choose among remedial terms and trade them off against more traditionally conceived substantive terms as suits their joint interests.[6] For example, a buyer might reasonably agree to a less expansive remedy in event of breach in exchange for a lower price, in the same way that she might agree to a limited warranty that defines downward what counts as a breach.

From this perspective, we are naturally led to ask what substantive effects are produced by various remedial terms. And as mentioned above, these effects operate along various dimensions of behavior including whether to perform ex post or to breach the contract, versus or breach, what efforts should be taken by both sides to mitigate losses in the event of breach, what should be the level of pre-performance reliance and relational investment, how the various risks of non-performance and fluctuations of costs and benefits should be allocated between the parties, how must information should the parties develop and exchange before contracting, and how much effort should the parties spend searching for contractual partners and entering into contracts in the first place.[7]

Because of this multiplicity of substantive considerations, it is not possible to generalize about which remedial term is best over all contractual situations. Expectation damages, for instance, provide good incentives to choose between performance and breach as well as good incentives for precautionary investment by the promisor, but they do not provide good incentives for promisee reliance, promisee mitigation, transmission of information from promisee to promisor, or risk allocation in situations when the promisor is more risk-averse

[6] Steven Shavell, Damage Measures for Breach of Contract, 11 Bell J. Econ. 466 (1980); Steven Shavell, The Design of Contracts and Remedies for Breach, 99 Q.J. Econ. 121 (1984); Steven Shavell, Contracts, in The New Palgrave Dictionary of Economics and the Law, ed. Peter Newman (New York: Stockton Press, 1998).

[7] See generally Steven Shavell, Foundations of Economic Analysis of Law (Cambridge, MA: Belknap Press of Harvard University Press, 2004), ch. 13.

than the promisee. Using more complicated rules that condition liability on both parties' behavior, it is in theory possible to promote multiple substantive incentives simultaneously. For instance, imposing a duty to mitigate as a condition of receiving expectation damages can promote efficient performance together with efficient mitigation[8]; and limiting expectation damages to the level that was foreseeable at the time of contracting can promote efficient performance together with efficient disclosure from promisee to promisor.[9] But such conditional rules impose additional informational demands on judicial factfinders that they may not always be able to meet: for example, determining in hindsight what level of reliance was reasonable.[10]

The difficulty of balancing various dimensions of efficiency in heterogeneous circumstances suggests two general institutional responses: choosing legal default rules that are second best, and permitting freedom of contract so that individual parties can use their local knowledge to improve on the general defaults that public lawmakers have set. For example, if we think that private bargaining is relatively costly due to bilateral monopoly or other transaction costs, we should choose default rules to implement the tradeoff that best suits majority preference; conversely, if we think that private bargaining is relatively cheap, we should select default rules that encourage such bargaining.[11] This could mean penalty default rules if parties are asymmetrically informed, or bright-line rules if they are symmetrically informed.[12]

Which of these various potential responses is proper depends on what we know about the universe of transactions involved, and also about the relative competence of judicial tribunals and private parties. In the area of consumer contracts, for instance, many of the standard rationality and informational assumptions of the economic approach are not met. Different contractual policies may thus be appropriate, has been recognized by most legal systems and legal commentators. But in the business-to-business context, and in the international commercial context in particular, different generalizations and different kinds of default rules are in order, and private parties exercising their freedom of contract will want to make different kinds of arrangements still.

In applying the economic analysis of contract remedies to CISG transactions in particular, we return to the distinctive features mentioned in the previous section. First, as we have noted, the CISG is restricted in scope to mercantile transactions.[13] Merchants generally have access to good legal and business information, who can spread many risks over the course of multiple transactions, and who can more easily establish reputations that make repeat business (or litigation on the other hand) more credible. They also have good access

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[8] Robert D. Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. Rev. 1 (1985).

[9] Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989).

[10] See, e.g. Jeffrey J. Rachlinski, A Positive Psychological Theory of Judging in Hindsight, 65 U. Chi. L. Rev. 2 (1998).

[11] Charles J. Goetz and Robert E. Scott, The Limits of Expanded Choice: An Analysis of the Interactions between Express and Implied Contract Terms, 73 Cal. L. Rev. 261 (1985).

[12] Ayres and Gertner, supra, note 11 (advocating penalty default rules); Robert E. Scott and George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law, 104 Colum. L. Rev. 1428 (2004).

[13] See Article 2(a) (the Convention does not apply to sales of goods bought for personal, family or household use).

to mass market institutions and devices – such as private arbitration, commercial letters of credit, and trading of financial derivatives – that can be used to spread risk and hedge against disputes.

Second, and most obviously, the CISG is restricted to international transactions.[14] This implies that CISG transactions cross national boundaries and require the parties to incur the costs of dealing with separate systems of law, procedure, regulation, and commercial custom. And perhaps less significantly, CISG transactions are more likely to occur across larger physical distances (although this last generalization obviously need not hold in every specific case, only on average).

The international nature of CISG transactions affects relative transaction costs in a number of overlapping ways. It is more costly, relative to the value of the goods themselves, to transport goods across borders and over long distances, more costly to communicate information before and during exchange (especially when the greater risk of miscommunication is counted as a cost), more costly to monitor the performance and reliability of contractual partners, and more costly to litigate and settle disputes. All these factors advantage domestic relative to international trade; and to the extent that international transportation, communication, monitoring and disputing costs increase less than proportionately to the value of the underlying goods, they also imply greater economies of scale in international trade than in domestic trade.[15]

In addition, the importance of these various transaction costs relative to each other are also different in international settings. While both disputing costs and monitoring costs are higher in the international arena, the relative increase in disputing costs is probably greater than the relative increase of monitoring costs, given the availability of transnational monitoring agents such as inspectors, certification agencies, and corresponding banks. Similarly, the relative increase of monitoring costs in the international setting is probably greater than the relative increase in the costs of transmitting information, especially given recent innovations in information technology. And the relative increase in the costs of disputing and monitoring may well be greater than the relative increase in the cost of physically transporting goods. These relative cost factors explain why litigation is infrequent in the international setting, as well as why 3d-party guaranty devices such as letters of credit are widely used—especially in cases where the parties have not yet developed a sufficient commercial relationship to make reputation and repeat dealing a binding incentive for collectively rational behavior.

In sum, all these factors combine in the international setting to advantage reputational remedies over legal ones, party-administered legal remedies over court-administered ones, and monetary remedies over possessory ones—other things being equal. Of course, such general rules of thumb do not themselves explain how relative transaction costs play out

[14] See Article 1 (the Convention applies only to contracts of sale of goods between parties whose places of business are in different States).

[15] Cf. Avery W. Katz, The Relative Costs of Incorporating Trade Usage into Domestic versus International Sales Contracts, 5 Chi. J. Int'l L. 181 (2004), at 189. ("Because many [litigation] expenditures are fixed in amount and do not depend on the intensity of litigation, however, the incremental cost of considering additional evidence given that there is already going to be litigation is relatively low in comparison. More generally, it makes sense to litigate more intensively in litigation that is characterized by higher stakes or higher overhead costs, and in the international setting it is these cases that are typically brought before arbitrators or courts.")

in terms of specific statutory provisions. In the succeeding sections of this paper, accordingly, I sketch out implications of the foregoing framework over three broad divisions of remedial law: specific relief, the calculation of monetary damages, and the recissionary remedies that arise during the course of performance and that can be applied directly by the parties without immediate judicial supervision. In my discussion, I will analyze the CISG provisions simultaneously and in comparison with the sales law regime that is in force in the USA—Article 2 of the Uniform Commercial Code (UCC). I adopt this comparative focus for two reasons: first, to connect this essay up to the existing work on the economics of remedies, most of which has been developed in the context of US law; and second, to highlight more clearly the transactional approach I emphasize throughout. In teaching sales law to law students, and in designing sales transactions for use by international traders, one is constantly faced with the choice between competing legal provisions. The optimal choice of legal terms in such contexts can only be made comparatively, in a second-best manner. Readers more familiar with other regimes of sales law are invited to extend and apply my suggested framework to the legal arrangements they know best.

3. Specific relief under the CISG

It is a truism of comparative law scholarship that civil law systems tend to favor specific relief as a remedy for breach of contract, while common law systems tend to favor monetary damages. In practice, however, this dichotomy is probably overstated. Some civil law scholars have suggested that specific relief is much less often used in fact than the official doctrinal sources would indicate[16]; and at least in the US, doctrinal developments have made it easier for plaintiffs to get specific relief.[17] But viewed as a difference in degree rather than a difference in kind, the conventional wisdom remains valid.

In this regard, the CISG sides with the civil law and establishes a preference for specific relief.[18] This preference is not absolute; it yields to the discretion of a court to deny a remedy that it would not apply under its own domestic law.[19] But such denials are discretionary, and many courts that would incline against specific relief in domestic cases may incline toward it in CISG cases, out of a sense of international comity or of the desire to establish a favorable environment for international business. Most CISG disputes, furthermore, are heard by private arbitral tribunals with no such compunctions. Is this preference for specific relief appropriate, then, on efficiency grounds?

[16] See Henrik Lando and Caspar Rose, On The Enforcement Of Specific Performance In Civil Law Countries, 24 Int'l Rev. L. & Econ. 473 (2004).

[17] See Farnsworth on Contracts (2001), §12.4 ("the modern trend is clearly in favor of the extension of specific relief at the expense of the traditional primacy of damages").

[18] Article 46 sets up a general rule of specific performance in cases of seller breach. In non-conforming goods cases, the buyer has a right to demand delivery of substitute goods if the lack of conformity constitutes a fundamental breach, and to demand repair unless such a demand is unreasonable. Article 62 provides an analogous rule in the case of buyer breach.

[19] Article 28 provides that "a court is not bound to enter a judgement for specific performance unless the court would do so under its own law in respect of similar contracts of sale not governed by this Convention."

The law and economics literature regarding specific performance has gone through three stages of development. The first wave of commentators suggested that the traditional common law distinctions that governed availability of the remedy were generally efficient. For example, Kronman argued that specific relief was efficient only in contracts for unique or specialized goods or services, on the grounds that the transaction cost of cover in such cases are relatively high.[20] The second wave of commentators suggested that the efficient remedy instead depended on a comparison of relevant transaction costs: buyers could have a comparative advantage covering even in thin markets, and sellers could have a comparative advantage in covering even in thick markets.[21] The third wave of commentators built on the analysis of the second in order to argue that no general conclusions about the remedy's efficiency could be drawn. On this most recent view, contractual parties should be encouraged to make the choice on their own (or to liquidate damages instead) because courts are not in a good position to evaluate the relevant comparative transaction costs. For example, Ulen has argued that a default rule of specific performance provides the best starting point for such bargaining (in part because courts are probably more willing to honor attempts to contract out of specific performance than attempts to contract in).[22]

This argument for decentralized contractual choice has been further reinforced by subsequent literature that has emphasized the value of specific relief in encouraging unobservable relational investment.[23] Thus, in the current received law-and-economics view, the main arguments against specific relief are the administrative cost it imposes on the courts and the cost it imposes on parties who should contract out of such relief ex ante, but for some reason cannot or fail to do so.[24] In the unusual case in which specific relief is clearly socially wasteful and the parties have failed to contract out, the court's discretion, exercised sparingly, provides a useful safety valve.

In light of these arguments, the CISG's treatment of specific relief appears to accord with modern thinking. Specific relief is available as a default rule under Articles 46 and 62. Parties can contract out of this default by using Article 6, or by explicitly granting the promisor an option to pay a liquidated sum in lieu of performance. Finally, in cases where specific relief is too burdensome, courts are extended an escape hatch under Article 28.[25]

Turning to a comparative transaction cost perspective, several specific features of the international sales context are relevant to the choice between specific and monetary relief. First, because transportation costs are relatively high, resale and cover transactions are less likely to be available following breach, and market differentials are likely to be harder to calculate due to underdevelopment of local markets in the relevant commodity (such

[20] See Anthony T. Kronman, Specific Performance, 45 U. Chi. L. Rev. 351 (1978).

[21] See, e.g. Alan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271 (1979).

[22] Thomas S. Ulen, The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies, 83 Mich. L Rev. 341 (1983).

[23] See, e.g. Aaron S. Edlin and Stefan Reichelstein, Holdups, Standard Breach, and Optimal Investment, 86 Am. Econ. Rev. 478 (1996).

[24] Cf. Aaron S. Edlin and Alan Schwartz, Optimal Penalties in Contracts, 78 Chi.-Kent. L. Rev. 33 (2003).

[25] This analysis is only a first cut at the problem. Private parties must also decide whether to exercise their freedom under Article 6 to avoid specific performance; and we have not considered how the special features of transnational contracts bear on their choice whether to do so.

thinness of markets being a significant motivation for the transaction to begin with). This factor would favor increased use of specific performance relative to damages, other things being equal. Similarly, to the extent that successful transactions require parties to engage in up-front cross-border search and to become expert in foreign legal and commercial systems, this will lead them to make greater relationship-specific investments. In general, greater relational investment, by reducing the substitutability of alternative contractual partners, also favors the greater use of specific performance.[26]

On the other hand, the greater distance between the parties and the extra lag time required for transporting goods may make it more difficult for a court to oversee an award of specific relief. An award of money damages, in contrast, is more easily enforced against local assets or against an issuer of a letter of credit or a guarantor. This increased difficulty of enforcement suggests that in many cases, aggrieved parties may prefer to seek and domestic courts may prefer to grant money damages in preference to specific relief. Similarly, the commercial letter of credit device, and the third party certification this provides, will often prove a more effective way to motivate performance than would the injunction of a distant court.[27]

In the end, however, these countervailing factors do not undermine the case for having a default rule of specific performance under the CISG. Nothing in the CISG prevents aggrieved parties from choosing the alternative of money damages if they prefer; indeed, Article 73 explicitly grants them the option of doing either.

4. Monetary relief under the CISG

As with the question of specific relief, the conventional economic wisdom on money damages has moved through multiple stages. The first wave of commentary concluded (as summarized above) that expectation damages were the most desirable measure of monetary relief because they encouraged efficient performance and breach.[28] Admittedly, the expectation measure did not encourage efficient promisee mitigation or reliance, but such behavior could be controlled imperfectly through doctrines like the duty to mitigate damages and by using objective measures of lost expectation like market differentials, as opposed to subjective measures like lost profit.[29] With regard to risk allocation, expectation damages would also be inefficient if the promisee were the least cost insurer,[30] but moral hazard and adverse selection made this an unlikely occurrence with regard to the risk of promisor non-performance, except in cases where performance became impossible or commercially

[26] Cf. Laclede Gas Co. v. Amoco Oil Co., 522 F.2d 33 (8th Cir. 1975) (existence of relational investment in form of dedicated pipelines a determining factor in award of specific performance in otherwise homogenous commodity).
[27] See Ronald J. Mann, The Role of Letters of Credit in Payment Transactions, 98 Mich. L. Rev. 2494 (2000); Clayton P. Gillette, Letters of Credit as Signals, 98 Mich. L. Rev. 2537 (2000); Avery W. Katz, Informality as a Bilateral Assurance Mechanism, 98 Mich. L. Rev. 2554 (2000).
[28] Shavell, supra, note 8.
[29] See Cooter, supra, note 10; See, e.g. Robert E. Scott, The Case for Market Damages: Revisiting the Lost Profits Puzzle, 57 U. Chi. L. Rev. 1155 (1990).
[30] A.M. Polinsky, Risk Sharing through Breach of Contract Remedies, 12 J. Legal Stud. 427 (1983).

impracticable due to unforeseen events.[31] Thus, expectation damages were viewed as probably second-best in most cases.

This first wave of scholarship also tended to endorses the common-law suspicion of liquidated damages in excess of the expectation interest, on the grounds that such damages deterred efficient breach.[32] To this argument against contractual penalties, scholars writing from the perspective of antitrust economics added the objection that such penalties were inefficient because they assisted the promisee in foreclosing entry by competitors.[33]

A subsequent wave of economically influenced legal scholarship, however, has resulted in a shift of conventional wisdom at least with regard to liquidated damages. Most economically influenced commentators tend to think that liquidated damages should be regulated for fairness and defective process on the same basis as other contractual terms, under doctrines such as fraud, duress, unconscionability, or mutual assent, but should not be subject to any special restrictions such as the penalty doctrines of the common law and UCC 2-718.[34] This is so for two reasons: first, courts policing liquidated damages under the penalty doctrine have often mistakenly characterized damages as excessively penal when a fuller economic understanding would have revealed them as merely compensatory.[35] Second, under many circumstances, supracompensatory damages can increase the parties' expected surplus from trade, even if they give inappropriate signals with regard to the performance/breach margin.[36] This new view of liquidated damages, however, has not yet displaced the majority view in favor of expectation damages as a default rule, although it is possible that it may in the future.[37]

In the main, the CISG's money damage provisions accord with the recommendations of earlier economic scholarship. As a general matter, the CISG adopts expectation damages as its primary measure of monetary relief in Articles 74 through 78. It tracks the UCC in providing both objective market measures of expectation (Article 75 on cover and

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[31] Richard A. Posner and Andrew M. Rosenfield, Impossibility and Related Doctrines of Contract Law: An Economic Analysis, 6 J. Legal Stud. 83 (1977).

[32] See, e.g. Samuel A. Rea, Jr., Efficiency Implications of Penalties and Liquidated Damages, 13 J. Legal Stud. 147 (1984).

[33] Philippe Aghion and Patrick Bolton, Contracts as a Barrier to Entry, 77 Am. Econ. Rev. 388 (1987); Tai-Yeong Chung, On the Social Optimality of Liquidated Damage Clauses: An Economic Analysis, 8 J.L. Econ. & Org. 280 (1992).

[34] Edlin and Schwartz, supra, note 24. Although this point of view has become dominant only more recently, it has important precursors in the earlier literature, including most influentially Charles J. Goetz and 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).

[35] Alan Schwartz, The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures, 100 Yale L.J. 369, 383–387 (1990).

[36] For example, supracompensatory damages could serve to compensate for a positive probability of non-detection (as with punitive damages in tort), or to encourage relational investment that, while observable by the parties, is unverifiable by a third-party tribunal. Aaron S. Edlin, Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages, 12 J.L. Econ. & Org. 98 (1996); Edlin and Reichelstein, supra, note 23, Eric Maskin and Jean Tirole, Unforeseen Contingencies and Incomplete Contracts, 66 Rev. Econ. Stud. 83 (1999).

[37] Two recent articles that discuss contract damages from the viewpoint of real option theory may signal a potential shift in this regard: Scott and Triantis, supra, note 14, and Avery W. Katz, The Option Element in Contracting, 90 Va. L. Rev. 2187 (2004).

resale transactions and Article 76 on market differentials) as well as more subjective measures of lost profit (Article 74). And it also adopts a foreseeability limitation in Article 74, which places limits on subjectively measured damages, thus better encouraging ex ante disclosure.

Furthermore, the CISG measures expectation damages more accurately than the UCC in at least three respects. Article 77 provides an explicit duty to mitigate damages, in contrast to the implicit and incomplete treatment afforded under UCC §§2-706 and 2-712. Interest on unpaid obligations – plainly a part of lost expectation – is available by default under Article 78. And in cases where contracts are avoided or repudiated before performance and damages are measured by the difference between contract and market price, market price is measured as of the time of avoidance. Under the current version of UCC §2-708, and arguably also under the current version of §2-713, market price is measured as of the time of performance, thus granting the aggrieved party an undeserved an inefficient speculative opportunity, and giving potential breachers an excessive incentive to perform.[38]

On the other hand, there is one respect in which the CISG falls short of the UCC in assessing expectation damages: in its formula for measuring damages for breach of warranty on delivered goods. Under UCC §2-714, such damages are measured in terms of the difference in value between the goods that were received and the goods that were promised; this formula is a straightforward implementation of expectation damages. CISG Article 50, on the other hand, applies a subtly different test: instead of difference in value, it applies a ratio measure.[39] In cases where the contract price is equal to the market value of the goods that should have been delivered, accordingly, these two formulas yield identical results, but when contract price exceeds market value (i.e. when buyer has overpaid ex post), the CISG measure overcompensates the buyer relative to her expectation. Conversely, when contract price is less than market value (i.e. when the buyer has underpaid ex post), the CISG measure undercompensates the buyer relative to her expectation.[40]

Effectively, the CISG measure sacrifices efficient incentives for performance in order to achieve some additional amount of risk sharing between the seller and buyer. Since the parties have presumably chosen market price to allocate risk as they see fit, however, it is unclear why a breach of warranty should be an occasion to disturb this allocation. Thus,

[38] See Thomas H. Jackson, Anticipatory Repudiation and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, 31 Stan. L. Rev. 69 (1978) (explaining relationship between time of measuring damages and the expected value of damages payable). Note that proposed revisions to Article 2-708, recently promulgated by the ALI and NCCUSL but not yet adopted as the law of any state, would eliminate the current asymmetric treatment of buyers and sellers in this regard, measuring damages at repudiation for either party in accordance with Jackson's argument. See revised §2-708(1)(b), comment 4 (2003).

[39] Article 50 provides: "If the goods do not conform with the contract and whether or not the price has already been paid, the buyer may reduce the price in the same proportion as the value that the goods actually delivered had at the time of the delivery bears to the value that conforming goods would have had at that time." From a formal perspective, this remedy is styled as an adjustment in the contract terms (namely, the price) rather than as damages, but from the economic viewpoint it is equivalent to damages in cost-benefit terms.

[40] To see this, let the contract price be denoted as P, the market value of the goods as they should have been delivered as V, and the shortfall in value due to defective performance as ΔV. Under UCC §2-714, damages are calculated as ΔV. Under CISG Article 50, the buyer's can set off a portion of the price, ΔP, in an amount equal to $\Delta V(P/V)$. When $P=V$, $\Delta P=\Delta V$; but when $P>V$, $\Delta P>\Delta V$.

the economic perspective would reject the rule of Article 50 in favor of the rule of UCC §2-714.[41]

With regard to liquidated damages, the CISG appears to anticipate the new wisdom of the law and economics literature in that it adopts a more liberal approach than the UCC. Section 2-718 of the UCC incorporates the common-law penalty doctrine, albeit with a few variations and exceptions. Under the CISG, however, there is no specific provision dealing with liquidated damages, and thus no penalty doctrine. Indeed, CISG Article 6 on its face authorizes departures from expectation damages to the same extent that it authorizes departures from any other default term of the Convention.

To be sure, the CISG states explicitly in Article 4 that it takes no position on the issue of contractual validity—a category that includes the standard common-law defenses to liability such as fraud, duress, mistake and unconscionability.[42] Domestic defenses of this sort, accordingly, could if applicable limit the availability of liquidated damages. But this is exactly the recommended approach of the modern law and economic scholarship. The current prevailing view is not that liquidated damages should be subject to no regulation at all—rather that it should be regulated neutrally on the same basis as other contract terms. This is just what Article 4 provides.[43]

What can we add to the foregoing analysis to account for the special circumstances and transaction costs of international sales contracts? Three additional factors are relevant in this regard. First, the extra costs of disputing cross-border cases may render expectation damages inadequate to motivate efficient performance. This outcome is most likely under the American system of litigation finance, where attorneys' fees are not compensable as an ordinary part of expectation damages, but most probably the same is true to a lesser extent under the loser-pays system followed by the rest of the world. The practical inadequacy of expectation damages justifies a relatively more liberal attitude toward liquidated damages, along the lines of the civil law's approach. Similarly, the special difficulties of collecting monetary judgments in transnational settings may justify a more liberal attitude toward supracompensatory damages, assessed either as quasi-punitive measures or as informational signals of reliability.

Second, relatively high transportation costs tend to make cover and resale less feasible than in comparable domestic transactions. Just as this factor argues in favor of specific performance where available and feasible, it also justifies a more liberal inquiry into lost profit and other subjective measures of damages. And third and finally, the higher transaction

[41] Note that in cases involving risk of loss, the UCC adopts an analogous risk-sharing policy to Article 50. Under UCC §§2-509, the risk of loss to identified goods passes to a merchant buyer upon tender of delivery, but under §2-510, where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of their loss remains on the seller until cure or acceptance. Thus, seller breach results not just in the obligation to pay expectation damages, but also in an additional reallocation of risk. The rule of §2-510 is similarly overcompensatory and accordingly creates inefficient incentives for the seller to perform.

[42] This approach follows that of the civil law, where penalties are permissible up to the point where they are deemed extravagant. Aristides N. Hatzis, Having the Cake and Eating It Too: Efficient Penalty Clauses in Common and Civil Contract Law, 22 Int'l Rev. L. & Econ. 381 (2002).

[43] There is a caveat to this analysis. Conceivably, UCC §2-718 could be viewed as such a validity provision under US law; this would allow the regulations of 2-718 to come into CISG transactions via the route of Article 4. This could only happen, though, if US validity rules were deemed to apply to the contract under the rules of private international law.

costs present in the international setting may similarly favor a more contextual inquiry into the issues of lost profit and mitigation. As I have argued elsewhere in the context of discussing the CISG's interpretative rules, such costs, while rendering litigation a less attractive alternative, create economies of scale that make it worthwhile to litigate more intensively those disputes that do make sense to pursue.[44]

5. Privately administered remedies under the CISG

In many cases, especially those in which breach is incomplete or uncertain, the high transaction costs of pursuing ex post legal relief make it a relatively ineffective remedy in practice. Under such circumstances, an aggrieved party may prefer simply to escape from the contract, throwing the resultant losses on the breacher—or less drastically, to suspend its own performance as a means of putting pressure on its counterparty to comply with contractual obligations. This is so for reasons of both compensation in the immediate case, and deterrence in the longer run. With regard to compensation, abandoning the contract may offer early mitigation opportunities that are more valuable than either the net expected damages that could be recovered through litigation or the grudging performance of a counterparty who performs under threat of litigation. With regard to deterrence, conversely, the potential losses resulting from a rescinded bargain (or from the aggrieved party's withholding its own performance) may impose a larger effective penalty on a potential breacher.

For these reasons, contractual doctrines dealing with rejection of goods, suspension of performance, avoidance of the contract, insecurity, and repudiation should be understood to provide a separate set of remedies that operate both as complements to and substitutes for traditional monetary and injunctive relief. In particular, these remedies, which have received relatively less attention in the law-and-economics literature, have the distinctive advantage that they can be applied by the parties themselves in the course of contractual performance, requiring only after-the-fact supervision by legal authorities. For this reason, I refer to them as privately administered remedies.[45]

Privately administered remedies can be superior to conventional monetary and specific relief in at least three related respects. First, they directly encourage parties to negotiate and exchange information during the period in which performance is pending, since if they wait until litigation to do so their positions may be irrevocably disadvantaged. Second and relatedly, they encourage early mitigation of damages in cases where breach is likely or inevitable; and third, they reduce the scope for of rent-seeking over the costs of litigation. More specifically, an aggrieved party's rights to demand assurances of performance, to

[44] Katz, The Relative Costs of Incorporating Trade Usage into Domestic versus International Sales Contracts, supra, note 15.

[45] Other writers have sometimes labeled them as "self-help" remedies, on an analogy to the property-oriented remedies that are sometimes available under the law of security interests and mortgages. See, e.g. Richard E. Speidel, Buyer's Remedies of Rejection and Cancellation under the UCC and the Convention, 6 J. Contract L. 131 (1993). It should be noted, however, that any remedies that turn on property interests, such as foreclosure and repossession, are excluded from the coverage of the CISG. See Article 4(b) (providing that the Convention is not concerned with any effect the contract may have on the property in the goods sold).

suspend its own performance in the event of insecurity, and ultimately to put the contract to an end, limit its counterparty's ability to speculate with regard to the fact of performance.

Absent the doctrines of insecurity and anticipatory breach, for instance, a party contemplating breach lacks incentive to cut the contract short at the appropriate time because the damages payable in the event of breach do not track the counterparty's expected losses, or compensate for the loss of mitigation opportunities. In such instances, the promisor has an incentive to speculate inefficiently at the promisee's expense, and can extract a payment or other concession in exchange for clarifying the situation. But the buyer's rights to demand assurances of performance, and to declare a repudiation if they are not forthcoming, limit the seller's incentives in this regard.[46]

Similarly, absent the remedies of rejection and revocation, a seller of goods has an incentive to provide less than full performance, because he knows that if he breaches to an extent that is just less than the buyer's cost of litigation, the buyer's threat to bring suit will not be credible. Rejection and revocation limit a seller's ability to extract rents from the buyer by lowering the available rents to be extracted and by granting the buyer a credible counter-threat.[47]

On the other hand, all of these remedies can also be asserted oppurtunistically by the buyer. A buyer who can cover for rejected goods at relatively low cost, for instance, and who knows that the seller's resale costs are relatively high, can use the threat of rejection to extract a modification or to induce the seller to take excessive precautions against the risk of not being able to perform.[48] And a party may declare insecurity or trigger repudiation or rescission of the contract at a point that is privately rational for the rescinding party,

[46] For instance, suppose that B fears that S will fail to deliver promised goods, and if this happens B will suffer 100 in uncompensable losses. Suppose also that if the contract is rescinded, B can take mitigating actions that will reduce his losses to 50, but if the contract remains in force and is performed, these actions will result in losses to B of 150. (This could be because B's mitigation efforts are wasted in the event of delivery, or because they will cause B to breach the contract and to owe damages to S). In this case, mitigation does not pay unless the probability p of S performing is less than 25%.

Suppose finally that S earns 50 profit in the event of delivery, and loses 50 (including any damage payments) in the event that she breaches. In this case, the social costs of breach are 150; and it is socially optimal to call off the contract whenever $p < 75\%$. But because S does not pay the entire social cost of breach, she will prefer to go forward with the contract whenever her chances of performance are at least 50%. In this case S will either go forward inefficiently, or extract a payment from B (in an amount up to 100p–50, B's expected savings from mitigation) in exchange for calling off the contract. But if B has the right to put the contract at an end whenever his risk of going forward is too high, S loses this hold-up power.

See generally Richard Craswell, Insecurity, Repudiation and Cure, 19 J. Legal Stud. 399 (1990).

[47] For example, suppose that a seller fails to apply a promised chemical treatment that costs 500, and which increases the value of the goods by 2000. This failure is plainly inefficient and the 2000 is available as damages. But if it costs 2500 to bring suit, the threat of suit is not credible and S lacks incentive (apart from any loss of reputation) to treat the goods. On the other hand, if the buyer rejects the defective performance, it will have to go out and cover with substitute goods at a cost of 500, and the seller will then have to dispose of the goods at reduced market value. In this case, rejection is credible (because it is cheaper to pay 500 in cover costs than suffer a 1500 diminution in value of the goods) and the seller will be induced to complete performance (because the prospect of disposing of unfinished goods in a spot market internalizes the costs to the seller of incomplete performance). See generally George L. Priest, Breach and Remedy for the Tender of Nonconforming Goods Under the Uniform Commercial Code: An Economic Approach, 91 Harv. L. Rev. 960 (1978).

[48] For example, suppose it costs 2000 for S to finish the goods, and this increases their value by only 500; so it is not worth finishing and the parties should settle on a price adjustment. But because the goods are specially

but inefficient from the viewpoint of the two parties together. These countervailing types of opportunism are a particular concern when market prices have moved against the party threatening self-help, so that that party wishes to escape the contract for reasons entirely unrelated to the counterparty's uncertain performance.

The CISG provisions relating to privately administered remedies make it harder for buyers to use these provisions for strategic purposes. Though the buyer's rejection rights are limited in various ways under the UCC, they are limited to a greater extent under the CISG, which contains no analogue to the "perfect tender" rule of UCC §2-601. Instead, the CISG adopts a materiality standard that is closer to UCC 2-612's special rule applying to installment contracts.[49]

Conversely, the CISG provisions relating to cure are somewhat more flexible than those of the UCC, mitigating the seller's incentives for strategic under-performance. Under some instances, a buyer may require cure under Article 46 or can specify an extension of the period for performance (a variant of the German *nachfrist* procedure) under Article 47; there is no analog to these provisions under the UCC. And the seller's right under Article 48(1) to cure after delivery is somewhat stronger than under UCC §2-508(2).[50] But there is a price to be paid for this flexibility. The contextual nature of the CISG standards for avoidance and cure leads to greater uncertainty, and to concurrent difficulty in predicting the outcome of disputes.

Do these CISG provisions simply reflect a different normative perspective than underlies the UCC, or do the special transaction costs present in the transnational setting justify a different set of default rules? It is at least plausible that the latter is the case. Disputing costs are higher than monitoring or communication costs in international settings, making ex post remedial proceedings less attractive. Transport costs make last-minute mitigation in the form of cover or resale relatively expensive. Simple substitution on the margin, accordingly, suggests that privately administered self-help remedies should play a larger role in international sales contracts than in purely domestic ones. Indeed, this substitution effect may be sufficient to account for the greater case load in this area, even apart from the contextual standards that are used.

On the other hand, the same transaction costs make it more costly to cover from alternative suppliers or to re-route goods to alternative buyers, implying that the rejection and avoidance remedies are particularly costly in an international setting. Optimal mitigation may thus more often take the form of adjusting the original agreement. If so, the CISG's more restrictive approach to avoidance and more liberal approach to cure may make economic sense.[51] And the uncertainty arising from contextual standards may be less of a problem in the international setting, where economies of scale in dispute resolution militates in favor of greater use of standards relative to rules.

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suited to the particular buyer or the market has turned against the seller, S's cost of resale is 3000 and B's cost of cover is 500. In this case B can credibly threaten rejection, allowing him to hold up S for the lesser of the cost of completion and the cost of resale.

49 Compare UCC §§2-601, 2-612 to CISG Articles 35–44.

50 See Speidel, supra, note 45.

51 There is some indication that these economic considerations operated as part of the actual motivation of the CISG's drafters. See, e.g. John Honnold, Uniform Law for International Sales Under the 1980 United Nations Convention, 3rd ed. (Cambridge, MA: Kluwer Law International, 1999).

6. Parallels to electronic contracting

The comparative transaction cost approach set out in the preceding sections can be applied beyond the specific question of how legal arrangements should vary between domestic and international settings; in particular, it can be applied to the burgeoning topic of electronic contracting. Just as there is a significant change in the configuration of transaction costs when one moves from the domestic to the transnational setting, there is an analogous change when one moves from traditional to electronic methods of contracting. Indeed, the key economic feature of electronic contracting is the qualitative reduction in the costs of processing information relative to other costs of contracting. The costs of communication fall relative to the cost of transporting physical items; and given current technology, the costs of contract formation fall relative to the costs of dispute resolution.

A systematic discussion of the connections between electronic and transnational contracting is beyond the scope of this paper[52]; but it is both possible and instructive to sketch out a few illustrative comparisons. First, in electronic settings, as in transnational settings, public enforcement of contracts becomes relatively expensive and private enforcement of contracts becomes relatively cheap.[53] This cost shift makes it efficient to make more use of arbitration, of third-party certification mechanisms such as letters of credit, and of privately administered self-help remedies such as rescission, avoidance and suspension of performance.

Similarly, the private remedies of rejection and revocation are relatively costly in the electronic setting, just as they are in the international setting, but for reasons that are more complicated. For contracts that require the shipment of physical items, the electronic and international situations are analogous; relatively high transport costs make cover and resale more expensive than monetary relief. In contracts for the sale or licensing of information goods, conversely, transportation is cheap, but rejection and rescission are costly for a different reason: namely, the difficulty of verifying that the buyer has not improperly retained a copy of information received under the rescinded agreement. This pattern of costs may be temporary, however, in that further development of digital rights management systems may mitigate this problem in the future.

Second, the law should be more liberal in allowing penal bonds as enforcement devices in electronic as opposed to traditional settings, and parties should be more liberal about using them. This is so for three reasons, one of which is also relevant in the setting of transnational non-electronic contracting, and two of which are not. First, the higher costs of disputing and of collecting judgments favor greater tolerance of damage clauses that are potentially supracompensatory, just as they do in the international setting. Second, reductions in the cost of processing text – a factor not present in ordinary international contracts – lessens the

[52] For a more extensive discussion of the special transaction cost structure in the electronic setting, see Avery W. Katz, Vertragsrecht im Zeitalter des Internets: Eine Ökonomische Perspektive (Contract Law in the Age of the Internet: An Economic Analysis), in Ökonomische Analyse des Sozialschutzprinzips im Zivilrecht (Economic Analysis of the Social Protection Principle in Civil Law), ed. Hans-Bernd Schäfer and Claus Ott. (Tübingen: Mohr Siebeck, 2004).

[53] See David D. Friedman, Contracts in Cyberspace, 6 J. Internet L. 12 (2002); Clayton P. Gillette, Reputation and Intermediaries in Electronic Commerce, 63 La. L. Rev. 1009 (2002); Henry H. Perritt, Jr., Dispute Resolution in Cyberspace: Demand for New Forms of ADR, 15 Ohio St. J on Disp. Resol. 675 (2000).

chance that liquidated damage terms will be overlooked at the bargaining stage. Third, the greater availability and lower cost of reputational networks in the electronic setting makes opportunistic use of penal clauses less likely, as a party who invokes a penalty in bad faith is more easily disciplined through non-legal sanctioning than in traditional settings. Again, it is unclear that this last factor has any particular importance in international contracts.

Finally, in contrast to the transnational case, monetary remedies become more important relative to specific relief. This is so for two reasons: first, to the extent that electronic contracting increases the average physical distance between the parties, supervising performance at a distance becomes relatively more difficult. Second, reduced informational costs make it easier and cheaper to search for market alternatives to performance; by the same token, market-oriented damage measures such as cover and difference-in-value should be relatively easier to assess.

To repeat, these general conclusions should be understood as illustrative, not general, and should be interpreted in other-things-being-equal terms. The claim here is not that specific relief should not be available at all in electronic settings or that there should be no restrictions on penal damages; rather, it is that specific relief is relatively less attractive and penal damages more so as a result of relative differences in transaction costs. It is less important that legal default rules change in this regard, than that the parties themselves – themselves who are in a better position to assess the various transactional considerations – take such factors into account in planning the remedial provisions of their agreements.

7. Conclusion

In judging the economic rationality of the CISG's remedial provisions, one should attend to the differences in relative transaction costs and institutional constraints between international and domestic sales contracts. Because of these different costs and constraints, it makes sense to impose different legal arrangements in the international setting, and thus to set up different statutory default rules. Because of the difficulty of generalizing about these costs and constraints, however, we should not spend so much time worrying about what the default rules should be, but instead should make it easier for the parties to choose the regime for themselves that best suits their individual needs. For example, the law should defer liberally to parties' ex ante contractual choices between money damages and specific performance, between liquidated and court-calculated damages, and between privately administered and court-imposed remedies.

Ultimately, it is economics that drives the demand for international trade, and international trade that drives the demand for transnational contract law. International legal institutions should accordingly attend to the economic underpinnings of the transactions they govern, in order to facilitate their underlying purposes.

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