Remedies in Public Contract Law: Apt to Encourage Efficient Breach?

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Abstract

The ordinary common law of contracts prefers to protect the promisee's entitlement to contractual performance through a liability-rule remedy in the form of expectation damages. This preference is generally justified by reference to the theory of efficient breach, according to which the repudiation of contractual obligations should be encouraged where the promisor is able to profit from a repudiation after placing the promisee in as good a position as the promisee would have occupied had performance been rendered. A question that arises in turn is whether, as the theory of efficient breach teaches us, government suppliers of goods and services should also be encouraged to breach public contracts. In view of the peculiar nature of public contracts, this article's analysis suggests that the theory of efficient breach has no place in public procurement. The article's main argument is that the courts of competent jurisdiction in the legal systems concerned should be more receptive to remedies (such as specific performance and punitive damages) that discourage suppliers from breaching public contracts, not least in cases where a public contract specifically provides for such remedies.

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Introduction

Many regulatory instruments, and thus much of the scholarly discourse pertaining to legal remedies in the field of public procurement focus on remedies for breach of procurement rules by the government procurer, including government's procuring agencies.[1] The question of remedies for breach of public contracts on the other hand is often treated as the province of ordinary contract law. Even the UNCITRAL Model Law on Public Procurement, a template that reflects extant international best practice in the field of public procurement, does envisage the award of damages for breach of procurement rules but stops short of recommending procurement-specific remedies for breach of public contracts.[2] Many common law systems, in particular, typically focus on regulating the process leading up to the award of public contracts,[3] leaving as the default standards for resolving disputes related to suboptimal performance or nonperformance of public contracts the ordinary rules of contract law. But why is this the case? Why are there procurement-specific rules governing the contracting phase of the public procurement cycle while the question of performance of the ensuing contracts is treated as "private business" between the parties? Should this be the case, anyway?

Granted, existing definitions of public procurement may be muddled.[4] But it is undeniable that public procurement, however defined, involves more than just the process through which a government supplier of goods or services is identified and a contract awarded to that supplier. Adequately understood, public procurement is a series of processes involving no less than three different but interrelated phases: the planning phase, the contracting phase, and the execution or performance phase.[5] The planning phase involves the process of budgeting and deciding *what* goods or services (including construction services or works) to procure and *when* to procure them. These are strategic

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[1] See e.g. D. Fairgrieve and F. Lichère (eds), *Public Procurement Law: Damages as an Effective Remedy* (Bloomsbury Publishing, 2011); A. Reich and O. Shabat, "The Remedy of Damages in Public Procurement in Israel and the EU: A Proposal for Reform" (2014) 2 P.P.L.R. 50; R. Caranta, "Remedies in EU Public Contract Law: The Proceduralisation of EU Public Procurement Legislation" (2015) 8 *Review of European Administrative Law* 75; H. Schebesta, *Damages in EU Public Procurement Law* (Springer, 2016).

[2] UNCITRAL Model Law on Public Procurement 2011, art. 67(9)(i)

[3] G. Quinot and S. Arrowsmith, "Introduction" in: G. Quinot and S. Arrowsmith (eds), *Public Procurement Regulation in Africa* (Cambridge University Press, 2013), ch.1, p.1. Civil law systems can be seen as something of an exception insofar as they tend to regulate both the process of contracting and contractual performance as part of their public procurement regimes. See, in this connection, P. Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (Oxford University Press, 2004), pp.38–40; S. Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in S. Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), ch.1, p.2.

[4] E. Prier and C.P. McCue, "The Implications of a Muddled Definition of Public Procurement" (2009) 9 *Journal of Public Procurement* 326.

[5] Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), p.2; C. Léon de Mariz, C. Ménard, and B. Abeillé, *Public Procurement Reforms in Africa: Challenges in Institutions and Governance* (Oxford: Oxford University Press, 2014), pp.15–16. See also United Nations Commission on International Trade Law, "United Nations Convention Against Corruption: Implementing Procurement-Related Aspects", (Submitted to Conference of the States Parties to the United Nations Convention against Corruption, Nusa Dua, Indonesia, January 28–February 1, 2008), p.14.

decisions which are—or at least ought to be—informed by public policy. The contracting phase involves the process of selecting a supplier from whom to procure goods or services and deciding the terms upon which those goods or services are to be procured. This is the phase which existing public procurement rules tend to focus on. The performance phase involves the process of managing and overseeing the execution of the contract, to ensure efficient and effective performance of the contract by the selected supplier.[6]

The interconnectedness of these phases is self-evident. Public procurement law defines the general principles and objectives of public procurement.[7] There are, of course, differences in terms of the specific goals and objectives of different procurement regimes. Even so, as an instrument of public policy, all law is purposive.[8] Every legal system thus uses public procurement law to achieve certain policy objectives for the benefit of society. These objectives, whatever they may be, may not be achieved unless *all* actors in *all* the three phases of the public procurement cycle perform their respective roles in a manner that is consistent with the desired policy outcomes.[9] It follows that the achievement of the objectives of public procurement law does not depend only on how public contracts are awarded but on the proper alignment of *all* the three phases of the procurement cycle with the relevant objectives.

First, public procurement plans must be strategically designed to fulfil the objectives set by the law. Secondly, public procurement officials must be strategic not only in crafting the terms of public contracts but also in selecting suppliers. To be more specific, the terms of public contracts must be strategically designed to achieve the stated objectives, and procurement officials must strategically select suppliers that are able and willing to perform public contracts in accordance with those terms. Thirdly, the selected supplier must render nothing short of the promised performance. Failure to do so could defeat the very essence not only of procurement planning but also of the procurement rules governing the contracting phase.[10] In short, the public procurement system as a whole must be "strategic in vision and purpose, focusing not on procurement transactions, but on acquisition processes and *outcomes* that contribute to accomplishing the mission".[11] The emergence of the field of public procurement law itself signifies the distinctiveness of public procurement from private

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[6] Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), p.2; Léon de Mariz, Ménard, and Abeillé, *Public Procurement Reforms in Africa: Challenges in Institutions and Governance* (2014), pp.15–16.

[7] See e.g. UNCITRAL Model Law on Public Procurement 2011, preamble.

[8] Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), p.47.

[9] See also generally J. Bartle and R. Korosec, "A Review of State Procurement and Contracting" (2003) 3 *Journal of Public Procurement* 192.

[10] G.M. Racca, R.C. Perin, and G.L. Albano, "Competition in the Execution Phase of Public Procurement" (2011) 41 *Public Contract Law Journal* 89.

[11] Per Warren and Welch, as quoted by Prier and McCue, "The Implications of a Muddled Definition of Public Procurement" (2009) 9 *Journal of Public Procurement* 326, 332 (emphasis added).

sector procurement in terms of the desired policy outcomes.

Against this backdrop, this article questions the wisdom of applying to public contracts the ordinary common law of contracts. More specifically, the article critically examines—in the context of public procurement—the appropriateness of the common law's preference for expectation damages as a remedy for breach of contract. Since existing scholarship justifies this preference by reference to the *theory of efficient breach*, a theory predicated on economic analysis of law, the article draws largely on law and economics scholarship. So far as the incentives of private economic operators are concerned, the theory of efficient breach has been extensively explored in literature. The question of remedies for private suppliers when government breaches a public contract, in particular, has also already been considered in existing scholarship.[12] This article thus focuses only on government's remedies when a private supplier breaches a public contract.

To provide context, the article begins by highlighting the key distinctive features of public contracts. The article then provides an overview of the theory of efficient breach and in turn applies that theory to public contracts, to establish the extent to which the theory accounts for the idiosyncrasies of public contracts. All in all, in view of the peculiar nature of public contracts, the analysis suggests that the theory of efficient breach has no place in public procurement. The article's main argument, therefore, is that the courts of competent jurisdiction in the legal systems concerned should be more receptive to remedies (such as specific performance and punitive damages) that discourage suppliers from breaching public contracts, not least in cases where a public contract specifically provides for such remedies.

Peculiarities of Public Contracts

The contracting phase of the public procurement cycle, as already noted above, culminates in the award by government—including government agencies—of a contract to a private economic operator for the supply of goods or services. The ensuing contract is referred to as a *government* or *public* contract because one of the parties thereto is government or a government agency. A valid public contract, like a valid private-to-private procurement contract, is legally binding and thus enforceable. It binds the government or the government agency concerned as purchaser or procurer and the selected private supplier of goods or services. There are, however, considerable differences between public contracts and purely private-to-private procurement contracts. These differences are predicated on at least two main reasons. First, government's participation in the market is not motivated purely

[12] See generally D.R. Fischel and A.O. Sykes, "Government Liability for Breach of Contract" (1999) 1 Am. L. & Econ. Rev. 313; J. Echeverria, "Public Takings of Public Contracts" (2012) 36 Vt. L. Rev. 517; B.D. Black, "Remedies for Government Breach: Lessons from the United States and a Zone of Appealable Remedies for Southeast Asia" (2021) 86 Brook. L. Rev. 1003.

by self-interest or profit maximization.[13] Secondly, given the complex nature of the government procurer and its reliance on public funds, agency problems tend to be more acute in public procurement than in private sector procurement,[14] thus increasing the risks of opportunism.[15]

Reasons for public procurement

Government plays a major role in every economy.[16] To be able to function, government itself needs inputs. Government thus purchases goods and services for its own consumption. Importantly, such operational consumption is but designed to enable government to provide goods and services to the public as part of its functions. Indeed, government enters into public contracts in order to deliver "a wide range of public services,"[17] including the very law and order upon which the existence of an organized political society depends. This holds good even in the so-called "market economies". There are certain goods and services which cannot be efficiently or sufficiently produced, consumed and/or distributed without the involvement of government.

First, one of the key functions of government is to provide *public goods* (otherwise known as *collective goods* or *social goods*[18]) such as public order, public defence, and the like. These goods may not be efficiently provided by private means because they are both *non-rival* and *non-excludable* in consumption, resulting in market failure.[19] They are non-rival goods in that one individual's consumption or utilization of a public good does not diminish the consumption possibilities of others. And they are non-excludable in that individuals cannot be costlessly excluded from consuming or utilizing a public good. While outlays for exclusion may themselves be a source of inefficiency, in most cases the production of public goods is so capital intensive that private economic operators

[13] J.G. Murray, "Local Government Demands more from Purchasing" (1999) 5 *European Journal of Purchasing & Supply Management* 33; Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), p.129; P.D. Larson, "Public Vs Private Sector Perspectives on Supply Chain Management" (2009) 9 *Journal of Public Procurement* 222; J.S. Arlbjørn and P.V. Freytag, "Public Procurement Vs Private Purchasing: Is there any Foundation for Comparing and Learning Across the Sectors?" (2012) 25 *International Journal of Public Sector Management* 203.

[14] Fischel and Sykes, "Government Liability for Breach of Contract" (1999) 1 Am. L. & Econ. Rev. 313, 326–32.

[15] P.T. Spiller, "An Institutional Theory of Public Contracts: Regulatory Implications" in C. Ménard and M. Ghertman, *Regulation, Deregulation, Reregulation: Institutional Perspectives* (Edward Elgar Publishing, 2009); J. Beuve, M.W. Moszoro, and S. Saussier, "Political Contestability and Public Contract Rigidity: An Analysis of Procurement Contracts" (2018) 28 J. Econ. Manage. Strat. 316, 317.

[16] I. Irvine and D. Curtis, *Principles of Microeconomics* (Lyryx Learning, 2021), Ch.14.

[17] Arlbjørn and Freytag, "Public Procurement Vs Private Purchasing: Is there any Foundation for Comparing and Learning Across the Sectors?" (2012) 25 *International Journal of Public Sector Management* 203, 204.

[18] M. Desmarais-Tremblay, "The Normative Problem of Merit Goods in Perspective" (2019) 48 *Forum for Social Economics* 219, 220.

[19] W.H. Oakland, "Theory of Public Goods" in A.J. Auerbach and M. Feldstein (eds), *Handbook of Public Economics* (Elsevier Science Publishers, 1987), Vol. II, pp.485–533; N.R.G. Baird, "Public Goods" in M.T. Gibbons (ed), *The Encyclopedia of Political Thought*, 1st edn (John Wiley & Sons, 2015); G. Mankiw, *Principles of Microeconomics*, 8th edn (Cengage Learning, 2018), pp.212–218; R.D. Kneebone, N.G. Mankiw, and K.J. McKenzie, *Principles of Microeconomics*, 8th edn (Nelson Education, 2020), p.243–249.

cannot rely on market prices to finance production.[20] The characteristic of non-excludability also creates an incentive for free-riding behaviour, since people can access and utilize a public good without paying for it.[21] Thus, private economic operators do not have economic incentives to produce public goods, the result being underproduction or complete nonproduction.[22] This is what engenders the need for government to step in and provide public goods for the benefit of the citizenry.

Secondly, government may engage in procurement activities in order to provide some *merit goods* (or *merit wants*[23]) to the public such as health, education, roads, and other services. These may be provided privately as they do not possess the characteristics of public goods. It may nevertheless be socially desirable for government to complement the private sector. This is so not least because the positive externalities of merit goods depend largely on their distributional and demographic characteristics.[24] Moreover, some merit goods may be underconsumed by the citizenry due to imperfect information about their benefits.[25] Therefore, although some may see it as a form of paternalism, it is generally accepted that a responsible government should provide and, where appropriate, compel individuals to consume or utilize certain merit goods (for example, inoculations), not only for the affected individuals' own benefit but also for the benefit of society as a whole.[26]

Thirdly, government participates in the market in order to promote *equity* or *economic equality* through income redistribution.[27] This is regarded as one of the most important functions of government even if the economy may be generally Pareto efficient (that is, even if resource allocations in a competitive market economy "have the property that no one can be made better off without someone being made worse off"[28]), since competitive markets can leave some individuals with insufficient or no resources at all on which to live. Indeed, income redistribution is said to be "the express purpose of welfare activities, such as food stamps and Medicaid."[29] Government also uses the procurement of goods and services from the market as a tool to promote social policies such

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[20] Oakland, "Theory of Public Goods" in Auerbach and Feldstein (eds), *Handbook of Public Economics* (1987), p.486.

[21] Mankiw, *Principles of Microeconomics*, 8th edn (2018), p.214; Kneebone, Mankiw, and McKenzie, *Principles of Microeconomics*, 8th edn (2020), p.245.

[22] J.A. Tatom, "Should Government Spending on Capital Goods be Raised?" (1991) 73 *Federal Reserve Bank of St. Louis Review* 3, 5.

[23] R.A. Musgrave, *The Theory of Public Finance: A Study in Public Economy* (McGraw-Hill, 1959).

[24] R. Fioritoa and T. Kollintzas, "Public Goods, Merit Goods, and the Relation Between Private and Government Consumption" (2004) 48 *European Economic Review* 1367, 1368.

[25] N.G. Mankiw and M.P. Taylor, *Economics* (Cengage Learning, 2020), pp.197–199. See also generally Desmarais-Tremblay, "The Normative Problem of Merit Goods in Perspective" (2019) 48 *Forum for Social Economics* 219.

[26] J. Stiglitz, *Economics of the Public Sector*, 3rd edn (W.W. Norton, 2000), pp.86–88; J. Stiglitz and J. Rosengard, *Economics of the Public Sector*, 4th edn (W.W. Norton, 2015), pp.95–97.

[27] Stiglitz, *Economics of the Public Sector*, 3rd edn (2000), pp.86–88; Stiglitz and Rosengard, *Economics of the Public Sector*, 4th edn (2015), pp.95–97.

[28] Stiglitz, *Economics of the Public Sector*, 3rd edn (2000), p.57; Stiglitz and Rosengard, *Economics of the Public Sector*, 4th edn (2015), p.64

[29] Stiglitz, *Economics of the Public Sector*, 3rd edn (2000), p.86; Stiglitz and Rosengard, *Economics of the Public Sector*, 4th edn (2015), p.95.

as gender and racial equality as well as the protection of minority groups.[30]

In sum, government enters into contracts to procure goods and services not only for its own operational consumption but in order to provide public goods and merit goods, to redistribute income in the economy, and to implement various social policies which may not necessarily be consistent with the goal of economic efficiency or profit maximization. In principle, therefore, citizens or members of the public in whose interest government exists are the ultimate beneficiaries of all public contracts. This means that citizens, including those who do not actively participate in public procurement, have a stake in public contracts. The "interest of citizens"—or, simply, the "public interest"—itself, it must be acknowledged, is difficult to ascertain as individual citizens' needs and preferences tend to be divergent. Even so, from a legal standpoint, the assumption is that the general objectives of public procurement law represent the public interest or the general aspirations of society as a whole.

Agency problems in public procurement

Government as such is not a legal person. Rather, government is a complex organization made up of a group of public officials, both elected and appointed, who act for and on behalf of the modern state and thus the citizenry. As we have already noted, government conducts public procurement using public funds.[31] These funds are raised mainly, albeit not exclusively, through both direct and indirect taxes paid by citizens.[32] Thus, the provision of public services for the benefit of citizens is not a mere gratuitous act on the part of government. As "owners" of the funds used to finance public procurement in general and as taxpayers in particular, citizens have a legitimate interest in the effective performance of public contracts.[33] The public interest in public procurement is thus predicated not only on the fact that citizens are the ultimate beneficiaries of public contracts but also on the fact that public procurement itself is conducted using public funds.

Securing the public interest in public procurement is, however, a complex affair. First, citizens "are often far removed from the procurement process and are unlikely to be active watchdogs" of government discretion,[34] since they must surmount collective action problems to be able to monitor the conduct of government officials (including politicians and career public servants). Secondly,

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[30] See Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), Ch.4.

[31] See also Léon de Mariz, Ménard, and Abeillé, *Public Procurement Reforms in Africa: Challenges in Institutions and Governance* (2014), p.15 (defining "public procurement as the purchase of goods, works, and services, mainly from the private sector, that uses public funds or guarantees from the government").

[32] Note that even borrowed funds used to finance public procurement are ultimately repaid by citizens through taxation. Other sources of public funds include non-tax government revenues and donations.

[33] J.J. Laffont and J. Tirole, *A Theory of Incentives in Procurement and Regulation* (MIT Press, 1993), p.9; C. Phiri, "Arbitration of Public Procurement Disputes: What is Amiss About it?" (2021) 30 P.P.L.R. 188, 204.

[34] Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), p.56.

procurement officials—the individuals who conduct procurement under the banner of "government"—are not directly accountable to the citizenry. Under a democratic system of government, in particular, it is elected officials or politicians who are most directly accountable to the people primarily through the ballot box. Yet, generally, politicians have neither the time nor the expertise to deliver public services.[35] They thus rely on nonelected procurement officials to conduct public procurement on their behalf.

This engenders what, in the economics lexicon, may be termed *three-layered* "agency problems".[36] First, citizens qua principals elect and "instruct" politicians as their agents to formulate procurement policies that seek to maximize the wellbeing of society as a whole. Secondly, politicians qua principals delegate the citizens' instructions to procurement officials as their agents to implement those policies on their behalf. Thirdly, procurement officials qua principals in turn rely on private suppliers as their agents to actualize those policies. Asymmetric information between each of these three sets of principals and their respective agents allows the agents to engage in opportunistic behaviour. This is so, in particular, because agents may hide information about their self-serving motives for entering into the agency relationship (*adverse selection*) and about their self-interested actions during the performance of their duties as agents (*moral hazard*). Each set of agents may thus feather their nests to the detriment of citizens as the ultimate principals.

For their part, politicians may have incentives to capture a rent from public procurement, in the form of both pecuniary and nonpecuniary advantages. This may lead politicians to undermine the public interest in public procurement, for example, by promoting patronage in the award of public contracts or by receiving kick-backs and illegal commissions from suppliers.[37] They may easily achieve this with the "help" of procurement officials. The desire for re-election may also lead politicians to deprioritize the public interest while prioritizing their own interests.[38] They may, for example, secure campaign financing in exchange for a promise to influence the award of public contracts in favour of certain businesspeople. Thus, politicians must "be given incentives to seek social welfare as they themselves have their own goals and... [are] not perfect agents for the voters."[39]

Even if politicians were seen as trusted agents, the relationship between politicians qua principals and

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[35] O. Soudry, "A Principal-Agent Analysis of Accountability in Public Procurement" in G. Piga and K.V. Thai (eds), *Advancing Public Procurement: Practices, Innovation and Knowledge-Sharing* (PrAcademics Press, 2008), p.434; J-E. Lane, "The Principal-Agent Approach to Politics: Policy Implementation and Public Policy-Making" (2013) 3 *Open Journal of Political Science* 85, 89.

[36] Cf. Lane, "The Principal-Agent Approach to Politics: Policy Implementation and Public Policy-Making" (2013) 3 *Open Journal of Political Science* 85 (discussing what the author calls "the double principal-agent relationships").

[37] Lane, "The Principal-Agent Approach to Politics: Policy Implementation and Public Policy-Making" (2013) 3 *Open Journal of Political Science* 85, 86–87.

[38] J.M. Buchanan, "Rent Seeking and Profit Seeking" in J.M. Buchanan, R. D. Tollison, and G. Tullock (eds), *Towards Theory of the Rent-Seeking Society* (Texas A & M University Press, 1980).

[39] Laffont and Tirole, *A Theory of Incentives in Procurement and Regulation* (1993), p.6.

procurement officials as their agents is not naturally immune to moral hazard. Whatever politicians can do in collusion with procurement officials, procurement officials can also do it on their own. Capitalizing on information asymmetries, procurement officials may disregard express procurement policy guidelines, discriminate against suitable suppliers in favour of family or friends, or even accept bribes,[40] and get away with it. This is a real possibility because, quite apart from their lack of expertise, politicians cannot costlessly or easily monitor the actions of procurement officials as the volume of government procurement transactions tends to be large.[41] Moreover, the large amounts of public funds involved in public procurement makes it easier for procurement officials to find ways of concealing their corrupt and unethical actions, making detection difficult.[42] This explains why public procurement law seeks to curtail the discretion of procurement officials.

Procurement rules that focus only on the contracting phase of the procurement cycle, however, leave room for opportunism during the contract performance phase.[43] First, a private supplier in collusion with procurement officials—and possibly politicians—could make a favourable bid and win a public contract in accordance with the law. Procurement officials could then allow the supplier to undermine the terms of the contract, for example, by "failing to enforce deliveries or quality standards under the contract, or allowing price revisions that are favourable" to the supplier.[44] Secondly, even in the absence of such collusion, the supplier itself could engage in manipulative or opportunistic behaviour during the performance phase. It could, for example, seek to change the terms of the contract in its favour and demand for extra payments as a precondition for performance.[45] To avoid being inconvenienced, and to protect the public interest, procurement officials may yield to the demand. Or the supplier could simply breach the contract either through delayed/suboptimal performance or complete nonperformance. Such post-award manipulative and opportunistic behaviour, whether by the supplier alone or in collusion with procurement officials and/or politicians, is even "harder to monitor than violations of rules that govern the contract award phase, since other suppliers will not

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[40] Soudry, "A Principal-Agent Analysis of Accountability in Public Procurement" in Piga and Thai (eds), *Advancing Public Procurement: Practices, Innovation and Knowledge-Sharing* (2008), p.434.

[41] Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), p.56.

[42] Soudry, "A Principal-Agent Analysis of Accountability in Public Procurement" in Piga and Thai (eds), *Advancing Public Procurement: Practices, Innovation and Knowledge-Sharing* (2008), pp.434–435.

[43] See V. Auricchio, "The Problem of Discrimination and Anti-competitive Behaviour in the Execution Phase of Public Contracts" (1998) 7 P.P.L.R. 113; Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), pp.1–2; Racca, Perin, and Albano, "Competition in the Execution Phase of Public Procurement" (2011) 41 *Public Contract Law Journal* 89.

[44] Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), pp.1–2.

[45] Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), p.2.

be policing the process in the same way as during a tendering procedure."[46] It should therefore be clearer now why, as noted above, the achievement of the objectives of public procurement law such as efficiency or value for money, competition, and equality of treatment does not depend only on the conduct of procurement officials or politicians. Suppliers, too, can undermine those objectives and thus the public interest in public procurement.

In sum, the main supply-side risks envisaged here are two-fold. First, suppliers often have private information on their supply/production costs which they have incentives not to fully disclose during the contracting phase. Secondly, suppliers have incentives to hide information and to behave opportunistically once the contract is awarded. The result of such information asymmetries between the government procurer and private suppliers is adverse selection and moral hazard during the contracting and performance phases of the public procurement cycle, respectively.[47] These problems are exacerbated by the rigid "take-it-or-leave-it" form in which most public contracts are awarded, which necessitates post-award renegotiations in favour of suppliers, as well as by the large size of government transactions/projects and the large amounts of public funds involved in public procurement.[48] Thus, it is not only politicians and public procurement officials who should be given incentives to respect public procurement rules; suppliers should also be given incentives to fulfil their contractual undertakings in keeping with the underlying objectives of public procurement law. Absent such incentives, competitive bidding and stringent regulation of the contracting phase of the procurement cycle could exacerbate both adverse selection and moral hazard and thus undermine—rather than facilitate—the achievement of the desired procurement outcomes.[49]

Remedies for Breach of Contract and the Theory of Efficient Breach

The law, according to the Calabresi-Melamed framework,[50] can protect legal rights or entitlements through either *property rules* or *liability rules.*[51] Property rules represent the policy of *prohibition* or *sanctions* and liability rules the policy of *internalization* or *pricing*.[52] A property rule is one that

[46] Arrowsmith, "Public Procurement: Basic Concepts and the Coverage of Procurement Rules" in Arrowsmith (ed), *Public Procurement Regulation: An Introduction* (2011), p.2.
[47] P. Bajari and G. Lewis, "Moral Hazard, Incentive Contracts, and Risk: Evidence from Procurement" (2014) 81 Rev. Econ. Stud. 1201.
[48] See also generally Beuve, Moszoro, and Saussier, "Political Contestability and Public Contract Rigidity: An Analysis of Procurement Contracts" (2018) 28 J. Econ. Manage. Strat. 316; N. Fugger, E. Katok, and A. Wambach, "Trust in Procurement Interactions" (2019) 65 *Management Science* 5110.
[49] I. Chakraborty, F. Khalil, and J. Lawarree, "Competitive Procurement with Ex Post Moral Hazard" (2021) 52 RAND J. Econ. 179.
[50] G. Calabresi and A.D. Melamed, "Property Rules, Liability Rules and Inalienability: One View of the Cathedral" (1972) 85 Harv. L. Rev. 1089.
[51] For more details about this framework as further developed by subsequent scholarship, see C. Phiri, "Criminal Defamation Put to the Test: A Law and Economics Perspective" (2021) 9 U. Balt. J. Media L. & Ethics 49, 51–54.
[52] R. Cooter, "Prices and Sanctions" (1984) 84 Colum. L. Rev. 1523, 1523; K.N. Hylton, "Property Rules and Liability Rules, Once Again" (2006) 2 Rev. L. & Econ. 137, 137.

prohibits others from taking or destroying an entitlement without the entitlement-holder's consent.[53] Thus, the holder is at liberty to decide whether and at what price to sell to, or otherwise modify the entitlement in favour of, an interested "buyer". A liability rule on the other hand allows others to deprive the holder of his entitlement but imposes an obligation on those who do so to pay or compensate the holder for the loss suffered.[54] When the law accords a liability-rule protection, the price of the entitlement is fixed *ex post* by a third party—typically a court or an arbitral tribunal—following a nonconsensual taking or deprivation of the entitlement, rather than *ex ante* by the holder in a voluntary transaction between the holder and a buyer.

It can thus be said that the common law of contracts protects the promisee's entitlement to contractual performance primarily through a liability rule. Indeed, although there may be some differences across common law systems with respect to specific types of contract, the ordinary common law of contracts "does not put the promisee in the position of receiving the promised performance but rather puts him 'in as good a position' by requiring the promisor to pay money damages that equal the benefit of the promisee's lost bargain."[55] These damages are termed "compensatory" or "expectation" damages because the promisor is required to fully internalize the costs of his breach by paying the monetary value of the promised performance. The common law thus affords the promisee a liability-rule protection as opposed to prohibiting, or otherwise punishing the promisor, for breaching a contract.[56] The remedy of specific performance on the other hand affords the promisee a property-rule protection.[57] This should be obvious because, unless the promisor has a valid defence or the promisee decides to "give away" his entitlement to performance, an order for specific performance compels the promisor to render the promised performance. The promisor, it is true, may attempt to go back on his promise. But, where the remedy of specific performance is available, the promisor may not be able to avoid an order for specific performance unless by renegotiating the contract and repurchasing the entitlement from the promisee.

By the same token, the remedy of exemplary or punitive damages protects as property the promisee's entitlement to contractual performance.[58] It does so by punishing and thus deterring nonconsensual modifications or complete deprivations of the entitlement. The availability of the remedy of punitive

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[53] A. Porat, "Economics of Remedies" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (Oxford: Oxford University Press, 2017), Vol.2, p.309.

[54] Porat, "Economics of Remedies" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (2017), p.309.

[55] D. Markovits and A. Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939, 1940.

[56] E.J. Weinrib, "Punishment and Disgorgement as Contract Remedies" (2003) 78 Chi.-Kent L. Rev. 55.

[57] R. Craswell, "Property Rules and Liability Rules in Unconscionability and Related Doctrines" (1993) 60 U. Chi. L. Rev. 1, 4; Markovits and Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939, 1941.

[58] W.S. Dodge, "The Case for Punitive Damages in Contracts" (1999) 48 Duke L.J. 629, 667.

damages, in other words, compels the promisor to either perform the contract or to renegotiate the terms thereof and repurchase—in whole or in part—the promisee's entitlement to performance. A liquidated damages clause in a contract that operates as a penalty also has the same effect,[59] especially where the courts are likely to uphold it. Given the common law's preference for expectation damages, however, common law courts tend to annul liquidated damages clauses as penalties and instead award expectation damages unless it is shown that the amount fixed is a reasonable estimate of the damages resulting from the breach at issue.[60] It should also be noted that a liquidated damages clause fixing damages at a value that is *equal to* or *lower* than expectation damages does *not* afford the promisee a property-rule protection. Rather, it affords the promisee a liability-rule protection by allowing the promisor to breach the contract and pay damages and thus may *encourage* rather than discourage breach.[61]

The policy choice between property rules and liability rules can be informed by various considerations, ranging from economic efficiency to purely social and moral considerations. However, in keeping with the Calabresi-Melamed framework as modified by Hylton,[62] existing scholarship tends to focus on efficiency considerations, particularly the distribution of transaction costs and the parties' subjective valuations of entitlements. The transaction costs envisaged here include the *costs of meeting* and the *costs of reaching an agreement* to transfer or modify an entitlement. Moreover, a distinction can be drawn between *low* transaction-cost settings (where both the costs of meeting and the costs of reaching an agreement are low), *intermediate* transaction-cost settings (where the costs of meeting are low but the costs of reaching an agreement are high), and *high* transaction-cost settings (where the costs of meeting are prohibitive).[63] It therefore behoves policymakers to decide which of the two types of rules would maximize socially desirable transfers and modifications of entitlements under each of these three transaction-cost settings.

Property-rule remedies such as specific performance, punitive damages, and liquidated damages that operate as penalties give rise to transaction costs, since they require the promisor to renegotiate the contract when performance subsequently becomes undesirable. To avoid these transaction costs, so the "efficient breach" argument goes, the common law prefers to protect the promisee's entitlement

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[59] L.A. DiMatteo, "A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages" (2001) 38 Am. Bus. L. J. 633.

[60] See C.J. Goetz and R.E. Scott, "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Colum. L. Rev. 554; Porat, "Economics of Remedies" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (2017), pp. 325–327.

[61] T. Wilkinson-Ryan, "Do Liquidated Damages Encourage Breach? A Psychological Experiment" (2010) 108 Mich. L. Rev. 633.

[62] Hylton, "Property Rules and Liability Rules, Once Again" (2006) 2 Rev. L. & Econ. 137.

[63] For more details in this connection, see Phiri, "Criminal Defamation Put to the Test: A Law and Economics Perspective" (2021) 9 U. Balt. J. Media L. & Ethics 49, 51–54.

to contractual performance through a liability rule in the form of expectation damages. The first scholarly expression of this theory of efficient breach is credited to Birmingham. In his article published in 1970, Birmingham contends that the repudiation of contractual "obligations *should be encouraged* where the promisor is able to profit from his default after placing his promisee in as good a position as he would have occupied had performance been rendered."[64] According to Birmingham, the promisor's failure "to honor an agreement under these circumstances is a movement toward Pareto optimality".[65] Essentially, therefore, the theory of efficient breach teaches us that the promisee's entitlement to contractual performance should generally be vindicated through expectation damages so as to give the promisor an incentive to breach the contract whenever performance becomes inefficient or otherwise less profitable.

This means that the theory of efficient breach can be invoked whenever the promisor is able and willing to fully internalize the costs of his breach by compensating the promisee *and*, taking into account any sunk costs (that is, any irrecoverable costs that the promisor has already incurred under the contract), the promisor himself would not make a loss from the breach. Given that none of the parties would be worse off in that event, the assumption is that the promisor will have an incentive to breach the contract only when he is certain that he will make a profit from doing so. This is likely to be the case when the promisor breaches the contract in order to redirect his resources or services to a higher valuing user than the promisee. Breaching the contract in such circumstances could thus not only result in Pareto efficiency (that is, the promisor would be better off after breaching the contract and paying damages without making the promisee or anyone else worse off[66]) but also maximize social welfare.

A belief in this assumption has seen common law courts, most notably in the U.S., repeatedly turn to the theory of efficient breach to justify their preference for expectation damages for breach of contract while denying other remedies such as specific performance and punitive damages,[67] including punitive damages prescribed by contractual agreement. Some courts have even gone so far as to explicitly recognize a common-law *right* "to breach a contract and pay a rightful amount of compensatory damages."[68] Invoking the theory in the majority opinion in *Lake River Corp. v.*

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[64] R.L. Birmingham, "Breach of Contract, Damage Measures, and Economic Efficiency" (1970) 24 Rutgers L. Rev. 273, 284 (emphasis added).

[65] Birmingham, "Breach of Contract, Damage Measures, and Economic Efficiency" (1970) 24 Rutgers L. Rev. 273, 284. See also generally J.H. Barton, "The Economic Basis of Damages for Breach of Contract" (1972) 1 J. Legal Stud. 277.

[66] See Stiglitz, *Economics of the Public Sector*, 3rd edn (2000), p.57; Stiglitz and Rosengard, *Economics of the Public Sector*, 4th edn (2015), p.64.

[67] For a detailed discussion of some of the cases, see Dodge, "The Case for Punitive Damages in Contracts" (1999) 48 Duke L.J. 629; R.A. Posner, "Let Us Never Blame a Contract Breaker" (2009) 107 Mich. L. Rev. 1349; R.A. Posner, *Economic Analysis of Law*, 9th edn (Wolters Kluwer, 2014), Ch.4.

[68] *Miller Brewing Co v Best Beers of Bloomington, Inc*, 608 N.E.2d 975, 984 (Ind. 1993).

Carborundum Co, the leading efficient-breach theorist in literature Posner, then speaking as judge of the U.S. Court of Appeals for the Seventh Circuit, provided the following explanation against the award of contractual punitive damages in favour of expectation damages:

> "A … penalty clause may discourage efficient as well as inefficient breaches of contract. Suppose a breach would cost the promisee $12,000 in actual damages but would yield the promisor $20,000 in additional profits. Then there would be a net social gain from breach. After being fully compensated for his loss the promisee would be no worse off than if the contract had been performed, while the promisor would be better off by $8,000. But now suppose the contract contains a penalty clause under which the promisor if he breaks his promise must pay the promisee $25,000. The promisor will be discouraged from breaking the contract, since $25,000, the penalty, is greater than $20,000, the profits of the breach; and a transaction that would have increased value will be forgone. On this view, since compensatory damages should be sufficient to deter inefficient breaches (that is, breaches that cost the victim more than the gain to the contract breaker), penal damages could have no effect other than to deter some efficient breaches."[69]

It must also be noted that the theory of efficient breach does not draw a distinction between breaches motivated by the promisor's desire to avert a loss from performance (purely loss-avoiding breaches) and breaches motivated by the promisor's desire to gain a larger profit and keep it for himself (purely gain-seeking breaches). Even judge Posner himself justifies purely gain-seeking breaches. In this connection, Posner provides the following illustration in his *Economic Analysis of Law*:

> "Suppose I sign a contract to deliver 100,000 custom-ground widgets at 10¢ apiece to A for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to close his pianola factory at great cost, and offers me 15¢ apiece for them. I sell him the widgets and as a result do not complete timely delivery to A, causing him to lose $1,000 in profits. Having obtained an additional profit of $1,250 on the sale to B, I am better off even after reimbursing A for his loss, and B is also better off. The breach is therefore Pareto superior. True, had I refused to sell to B he could have gone to A and negotiated an assignment to him of part of A's contract with me. But this would have introduced an additional step, with additional transaction costs—and high ones, because it would be a bilateral-monopoly

[69] *Lake River Corp v Carborundum Co*, 769 F.2d 1284, 1289 (7th Cir. 1985). See also *Patton v Mid-Continent Sys*, 841 F.2d 742, 750 (7th Cir. 1988) (Posner, J.) (holding that if the promisor is forced to pay a penalty over and above compensatory damages then "an efficient breach may be deterred, and the law doesn't want to bring about such a result").

negotiation."[70]

For efficient-breach theorists, therefore, the maximization of Pareto efficiency or *total* surplus is all that matters. The promisor's failure to honour his promise is immaterial,[71] and so is the fact that the surplus generated from the breach is redistributed from the nonbreaching party (promisee) to the breaching party (promisor). Nor does it matter whether or not the promisee would for some personal reasons otherwise prefer contractual performance to monetary compensation. Markovits and Schwartz take the argument a step further, positing that failure to render the promised performance when it is efficient to do so should not even be seen as amounting to a breach.[72] According to them, in default of a valid agreement to the contrary, a valid contract should be seen as imposing "alternative obligations on the promisor: *either* to supply goods or services for a specified price *or* to transfer to the promisee the gain the promisee would have made had those goods or services been supplied."[73] On this view, the promisor breaches the contract only if he "*neither delivers nor pays.*"[74]

Along with the general social welfare argument, the main reasoning behind the theory of efficient breach or, what Markovits and Schwartz call, the "dual performance hypothesis" finds more specific support in the notion of incomplete contracts.[75] Since long term contracts are essentially incomplete contracts, so the argument goes, "contract law provides the parties with default rules that apply to their contracts unless they opt out of those rules. The default rules save the parties transaction costs (in terms of negotiation and drafting costs), which they would have incurred but for the default rules."[76] The promisor's option to breach the contract and pay damages thus allows him to opt out of the default rules when doing so becomes efficient during the performance phase, thereby obviating the need for renegotiation.

In sum, the normative guidance the theory of efficient breach provides is that the law should as a general rule afford a liability-rule protection to the contractual promisee in order to encourage

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[70] Posner, *Economic Analysis of Law*, 9th edn (2014), §4.10. See also generally Posner, "Let Us Never Blame a Contract Breaker" (2009) 107 Mich. L. Rev. 1349.

[71] See C. Fried, *Contract as Promise: A Theory of Contractual Obligation*, 2nd edn (Oxford: Oxford University Press, 2015), p.133.

[72] Markovits and Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939, 1948; D. Markovits and A. Schwartz, "(In)Efficient Breach of Contract" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (Oxford: Oxford University Press, 2017), Vol.2.

[73] Markovits and Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939, 1948.

[74] Markovits and Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939, 1948. See also D. Markovits, "Contract and Collaboration" (2004) 113 Yale L.J. 1417, 1504 (asserting that a "promisor who pays expectation damages continues to collaborate with her promisee, in spite of her breach").

[75] S. Shavell, "Is Breach of Contract Immoral?" (2006) 56 Emory L.J. 439; S. Shavell, "Why Breach of Contract May Not Be Immoral Given the Incompleteness of Contracts" (2009) 107 Mich. L. Rev. 1569; Markovits and Schwartz, "The Myth of Efficient Breach: New Defenses of the Expectation Interest" (2011) 97 Va. L. Rev. 1939; D. Markovits and A. Schwartz, "The Expectation Remedy Revisited" (2012) 98 Va. L. Rev.1093.

[76] Porat, "Economics of Remedies" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (2017), p.314.

efficient breach in appropriate cases. By prioritizing expectation damages quantifiable in monetary terms, the theory favours the policy of internalization or pricing as opposed to the policy of prohibition or sanctions. It thus disfavours remedies that afford the promisee a property-rule protection such as specific performance and punitive damages, including punitive damages fixed by a contractual clause. The theory has since become so familiar and so influential that it now appears in textbooks meant for first-year law students.[77]

The theory of efficient breach is, however, quite infamous outside the lawyer/economist community.[78] Empirical research suggests that most laypeople's intuition is that breach of contract is morally wrong even when the promisor pays expectation damages or indeed damages at a level higher than expectation value.[79] Research has established that laypeople are particularly more averse to purely gain-seeking breaches than to loss-avoiding breaches and that they would prefer the remedies of specific performance and punitive damages for intentional, purely self-enriching breaches.[80] Empirical studies further suggest that businesspeople see deliberate breach as unethical[81] and that even the economic argument for efficient breach is stronger with respect to loss-avoiding breaches than with respect to purely gain-seeking breaches.[82] Moral philosophers, too, are somewhat tolerant to breaches resulting from a desire to avoid losses but find to be reprehensible breaches resulting from the promisor's desire to gain extra profits and keep them for himself.[83] In any event, "when people make contracts, they usually contemplate...performance rather than…breach. The express language used does not generally go further than to define what will happen if the contract is fulfilled."[84]

It would therefore appear that even Markovits and Schwartz's attempt at reformulating the theory of efficient breach as the "dual performance hypothesis" is unlikely to persuade critics. Any such hypothesis, one would argue, is both counterintuitive and at variance with existing empirical findings. It would thus be difficult to justify Markovits and Schwartz's assumption that the contractual

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[77] Markovits and Schwartz, "(In)Efficient Breach of Contract" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (2017), p.21. See e.g. J.T. Ferriell, *Understanding Contracts* (2nd edn, LexisNexis, 2009), pp.715–17.

[78] Markovits and Schwartz, "(In)Efficient Breach of Contract" in F. Parisi (ed), *The Oxford Handbook of Law and Economics* (2017), p.21. See also R.R. Anderson, "The Compensatory Disgorgement Alternative to Restatement Third's New Remedy for Breach of Contract" (2015) 68 SMU L. Rev. 953, 957.

[79] J. Baron and T. Wilkinson-Ryan, "Moral Judgment and Moral Heuristics in Breach of Contract" (2009) 6 *Journal of Empirical Legal Studies* 407.

[80] Baron and Wilkinson-Ryan, "Moral Judgment and Moral Heuristics in Breach of Contract" (2009) 6 *Journal of Empirical Legal Studies* 407.

[81] D. Baumer and P. Marschall, "Willful Breach of Contract for the Sale of Goods: Can the Bane of Business Be an Economic Bonanza" (1992) 65 Temp. L. Rev. 159, 164–67.

[82] M. Bigoni, S. Bortolotti, F. Parisi, and A. Porat, "Unbundling Efficient Breach: An Experiment" (2017) 14 *Journal of Empirical Legal Studies* 527.

[83] E. Zamir and B. Medina, *Law, Economics, and Morality* (Oxford: Oxford University Press, 2010), p.265.

[84] O.W. Holmes, *The Common Law*, G.E. White (ed) (Harvard University Press, 2009), p.273.

promisee would, in default of an express agreement to the contrary, willingly agree to receive monetary compensation as a substitute for contractual performance. As some commentators have pointed out, it is unlikely that at the time of entering into the contract the promisee would authorize the promisor to unilaterally decide not to render the promised performance whenever the promisor finds it more profitable to do so, even if the promisee were in turn promised to be given a share of the extra profits.[85] Rather, the parties would likely agree "that if such an opportunity comes up, they would *renegotiate* nonperformance and sharing of the extra gains."[86]

Application to Public Contracts

The theory of efficient breach is particularly unattractive in the context of public procurement. Recall that public procurement law addresses agency problems arising in this context primarily by restricting the discretion of procurement officials to ensure that their selection of suppliers aligns with the public interest.[87] Where bidding is deemed appropriate, in particular, the law limits the ability of procurement officials to transfer rents to their own favoured suppliers, by requiring procurement officials to award public contracts to the most competitive bidder. Moreover, the law normally requires procurement officials to award public contracts in a rigid "take-it-or-leave-it" form, leaving little to no latitude for negotiation of the terms by the promisee: in this case, the selected supplier.[88] In principle, therefore, the terms of a public contract represent a firm commitment which the selected supplier must honour following the award of the contract.[89] Any material deviation from the promised performance is essentially a deviation from the very public interest that public procurement law seeks to protect. Any such deviation also infringes the rights of losing bidders by undermining the very purpose of competitive bidding, since the supplier's "lower-than-promised performance makes it *as if* the selecting agency failed to choose the best tender."[90] This holds good regardless of whether government engages in procurement for its own operational consumption or for the purpose of providing public or merit goods, redistributing income, or delivering other public or social services. Taxpaying citizens as funders and ultimate beneficiaries of public procurement expect government, through the selected supplier, to deliver the desired goods or services. They do not expect the supplier to pay monetary damages to government in lieu of those goods or services. Indeed, no amount of

[85] Zamir and Medina, *Law, Economics, and Morality* (2010), p.265, fn.19.
[86] Zamir and Medina, *Law, Economics, and Morality* (2010), p.265, fn.19 (emphasis added).
[87] Cf. E. Bosio, S. Djankov, E.L. Glaeser and A. Shleifer, "Public Procurement in Law and Practice" (2022) 112 Am. Econ. Rev. 1091 (providing evidence suggesting that procurement regulation may be detrimental in countries with high public sector capacity as it may inhibit the socially optimal exercise of discretion).
[88] Phiri, "Arbitration of Public Procurement Disputes: What is Amiss About it?" (2021) 30 P.P.L.R. 188, 202–203.
[89] Racca, Perin, and Albano, "Competition in the Execution Phase of Public Procurement" (2011) 41 *Public Contract Law Journal* 89, 89–90.
[90] Racca, Perin, and Albano, "Competition in the Execution Phase of Public Procurement" (2011) 41 *Public Contract Law Journal* 89, 90.

damages paid to government may be adequate to atone for the loss that the public may suffer as a result of the supplier's failure to render the promised performance. The supply of goods and services for purposes of social welfare, public health, and emergency relief, for example, can be literally a matter of life and death for many people. Failure to perform a public contract for the supply of inputs needed to provide such services can result in the loss of lives which no supplier would possibly adequately atone for in monetary terms or at all. This may be the case regardless of whether the failure in question takes the form of delayed/suboptimal performance (for example, where the goods or services supplied do not meet the required standards) or complete nonperformance.

In any event, given that government does not generally engage in procurement in order to make quantifiable monetary profit but to discharge its functions for the ultimate benefit of citizens; and given that government also engages in public procurement in pursuit of social policies which may not necessarily be consistent with the goal of economic efficiency or profit maximization; it would appear that the theory of efficient breach has no place in public procurement. Indeed, even efficiency considerations in this context weigh heavily in favour of performance or at least a negotiated release when performance becomes too costly for the selected supplier. The public interest in public procurement means that we must, at least as a general rule, attach a higher social welfare weight to government's payoff than to the supplier's profit.[91]

True, if a supplier need only pay compensatory damages whose value may have to be determined by some form of judicial guesswork anyway, a decision to breach a public contract—whether to a loss-avoiding or purely opportunistic end—may turn out to be highly profitable for the supplier. The incentive to abandon a government project or otherwise to breach a public contract when the costs of performance turn out to be higher than anticipated or when the supplier finds a new and more lucrative opportunity is particularly high in the construction industry. "Because most of the work is subcontracted and firms…are [often] small, it is relatively easy to shut down and then open a new business under a different name; contract breach is not very costly for contractors",[92] even when sunk costs are taken into account. But given the public interest in public procurement, whatever its specifics may be, no amount of damages paid to government by the breaching supplier would generally be equal to or indeed outweigh the loss the public is likely to suffer as a result of the breach. Worse still, a liability-rule remedy that allows the supplier to breach a public contract—subject only to the requirement to pay compensatory damages—leaves the public interest at the mercy of private

[91] O. Chillemi and C. Mezzetti, "Optimal Procurement Mechanisms: Bidding on Price and Damages for Breach" (2014) 55 Econ. Theory 335, 338.

[92] Chillemi and Mezzetti, "Optimal Procurement Mechanisms: Bidding on Price and Damages for Breach" (2014) 55 Econ. Theory 335, 336.

suppliers. An opportunistic/manipulative supplier may demand for additional and even economically unjustified payments, knowing that—in a bid to protect the public interest, especially in an emergency situation—government will be "forced" to make those payments to entice the supplier to perform the contract.[93]

Many commentators favour the remedy of specific performance where, as in the case of public contracts, damages are likely to be undercompensatory. For example, contrary to Markovits and Schwartz's dual performance hypothesis, Kronman contends that economic considerations suggest that contracting parties would prefer to contract into such a property-rule remedy when the subject matter of the contract is unique.[94] The gist of Kronman's argument is that the liability-rule remedy of expectation damages always imposes a risk on the promisee of undercompensation, since the court may err in calculating damages and that risk is but higher when the subject matter of the contract has no close market substitute. While some of the goods and services supplied under public contracts may not be unique in the sense that Kronman speaks about, we now know that public contracts themselves are unique. The uniqueness of public contracts lies not only in the peculiarly higher risks of opportunism discussed above but also in the fact that the breaching supplier may be neither willing nor able to adequately atone for the loss the public for whose benefit government engages in public procurement may suffer as a result of the breach.

Schwartz, one of the advocates of the dual performance hypothesis, too, believes that the remedy of specific performance should be more generally available than efficient-breach theorists suggest.[95] He contends, like does Kronman, that the remedy of expectation damages is often undercompensatory. Importantly, Schwartz adds that the promisee does not normally have economic incentives to seek specific performance unless damages are likely to be undercompensatory. Schwartz thus recommends that "the remedy of specific performance should be as routinely available as the [expectation] damages remedy."[96] If Schwartz is right in arguing that parties will normally desire specific performance only when damages are undercompensatory, the theory of efficient breach cannot be relied upon to deny the specific performance of a public contract. Indeed, on Schwartz's view, the case for specific performance is even more compelling in the context of public procurement, since monetary damages are typically undercompensatory in this context.

The case for specific performance of public contracts finds further support in existing scholarship that disfavours the theory of efficient breach. Ulen, for example, contends that, absent a valid agreement

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[93] See also Bigoni, Bortolotti, Parisi, and Porat, "Unbundling Efficient Breach: An Experiment" (2017) 14 *Journal of Empirical Legal Studies* 527, 545.
[94] A.T. Kronman, "Specific Performance" (1978) 45 U. Chi. L. Rev. 351.
[95] A. Schwartz, "The Case for Specific Performance" (1979) 89 Yale L. J. 271.
[96] Schwartz, "The Case for Specific Performance" (1979) 89 Yale L. J. 271.

to the contrary, the remedy of specific performance is more likely to achieve economic efficiency than any form of damages.[97] According to Ulen's analysis, any transaction costs arising from the negotiations that may be necessitated by the remedy of specific performance are likely to be low because the contracting parties would have already established a relationship and any litigation costs (including the risk of judicial error) are likely to be much less than under a liability-rule regime that requires the court to make an estimation of expectation damages.

Ulen's argument, too, is even more persuasive in the context of public procurement. Empirical research has consistently shown that public contracts are renegotiated more often than comparable private-to-private contracts, particularly in politically contestable jurisdictions.[98] Contrary to the postulates of efficient-breach theorists, this has been attributed not to the choice of remedies but to the rigid manner in which public contracts are awarded in keeping with public procurement rules.[99] Thus, post-award contract negotiations in this context tend to be at the instance and in favour of suppliers.[100] The fact that there is at least one other factor to which these *successful* negotiations can be attributed substantiates the claim that the transaction costs of such negotiations—*both* the costs of meeting and of reaching an agreement—are *low* and also somewhat pre-empts any need to encourage the so-called "efficient breaches", since negotiations are likely to take place anyway.

It would appear that the theory of efficient breach also fails to provide a convincing case against prioritizing the remedy of punitive damages in public contract law. An award of damages at a level that is so high as to operate as an incentive for the supplier to perform or to renegotiate a public contract when performance becomes inefficient is likely to produce more efficient results than the litigation (or other process of dispute resolution) that may be necessitated by the supplier's breach. The costs of post-award negotiations cannot generally be expected to be higher than the costs of litigation, which include not only the costs resulting from the problem of the parties' strategic behaviour in litigation but also those attendant to hiring lawyers, preparing court documents and witnesses to inform the court about the dispute, and judicial error in determining damages.[101] Moreover, the mere prospects of punitive damages being awarded, whether as determined by the court or by government through a contractual clause, would provide an incentive for the supplier to

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[97] T.S. Ulen, "The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies" (1984) 83 Mich. L. Rev. 341, 366–**3**71.

[98] See generally J. Beuve, M.W. Moszoro, and P.T. Spiller, "Doing It by the Book: Political Contestability and Public Contract Renegotiations" (2021) J. L. Econ. & Org., *https://doi.org/10.1093/jleo/ewab039*.

[99] Beuve, Moszoro, and Spiller, "Doing It by the Book: Political Contestability and Public Contract Renegotiations" (2021) J. L. Econ. & Org. See also Spiller, "An Institutional Theory of Public Contracts: Regulatory Implications" in Ménard and Ghertman, *Regulation, Deregulation, Reregulation: Institutional Perspectives* (2009); Beuve, Moszoro, and Saussier, "Political Contestability and Public Contract Rigidity: An Analysis of Procurement Contracts" (2018) 28 J. Econ. Manage. Strat. 316, 317.

[100] J.L. Guasch, *Granting and Renegotiating Infrastructure Concessions: Doing it Right* (World Bank Publications, 2004).

[101] Dodge, "The Case for Punitive Damages in Contracts" (1999) 48 Duke L.J. 629.

timely notify government of any impending failure by the supplier to perform the contract, thereby enabling government to take timely remedial action in the public interest.

These claims find considerable support in existing scholarship related to private-to-private contracts. Dodge, for example, argues on economic grounds that the promisor should be given an incentive to negotiate for a release when performance becomes inefficient.[102] The promisee's entitlement to contractual performance, Dodge contends, should thus be protected by a property rule in the form of the remedy of punitive damages in order to "force" the promisor to negotiate for a release under such circumstances. Consistent with the foregoing argument, Dodge argues that this would be a more efficient way of avoiding inefficient performance as opposed to allowing the promisor to unilaterally decide not to render the promised performance, thereby breaching the contract and giving rise to a dispute which may necessitate inefficient litigation. Dodge notes, as argued above with respect to public contracts, that the costs of negotiating such a release are likely to be lower than the costs of litigation.

In the same vein, as regards *contractual* punitive damages, Goetz and Scott argue that such damages "represent, under many circumstances, the most efficient means by which parties can insure against the otherwise non-compensable consequences of breach."[103] DiMatteo similarly argues that, subject to the doctrine of unconscionability, liquidated damages clauses that operate as penalties should be presumed to be enforceable.[104] According to DiMatteo, full enforcement of such clauses is consistent with the intentions of the parties and obviates the need for lengthy and inefficient litigation to determine the issue of liability and the amount of damages to be awarded to the promisee. Further economic analyses by Edlin and Schwartz[105] and by Chillemi and Mezzetti[106] suggest that, in the face of information asymmetries and the resultant problems of adverse selection and moral hazard, the promisee's optimal contract requires penalties in the form of liquidated damages above expectation damages.

This perhaps explains why liquidated damages clauses are a common feature in public contracts.[107] Consistent with existing law and economics scholarship, the principal purpose of these clauses is said

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[102] Dodge, "The Case for Punitive Damages in Contracts" (1999) 48 Duke L.J. 629.

[103] Goetz and Scott, "Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach" (1977) 77 Colum. L. Rev. 554, 557–58.

[104] DiMatteo, "A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages" (2001) 38 Am. Bus. L. J. 633.

[105] A.S. Edlin and A. Schwartz, "Optimal Penalties in Contracts" (2003) 78 Chi.-Kent L. Rev. 33.

[106] Chillemi and Mezzetti, "Optimal Procurement Mechanisms: Bidding on Price and Damages for Breach" (2014) 55 Econ. Theory 335.

[107] P.H. Gantt and R.C. Breslauer, "Liquidated Damages in Federal Government Contracts" (1967) 47 B.U. L. Rev. 71; W.F. Pettit and G.K. Gleason, "Liquidated Damages in Government Contracts: A Comment on Defenses" (1971) 25 Sw. L. J. 264; Trepte, *Regulating Procurement: Understanding the Ends and Means of Public Procurement Regulation* (2004), p.35.

to be twofold: (1) to induce government suppliers to deliver the promised performance on time; and (2) to provide a simple method of fixing the amount of liability for breach, since it is normally difficult to prove the amount of actual damages when a supplier breaches a public contract.[108] The U.S. Supreme Court, too, recognizes that liquidated damages clauses "serve a particularly useful function when damages are uncertain in nature or amount or are unmeasurable, as is the case in many government contracts".[109]

However, as already noted above, common law courts may not enforce a liquidated damages clause even where it can be shown that the actual damages that accrue to government as a result of a breach are difficult or, as is normally the case, impossible to determine. Contrary to repeated findings by different scholars, the prevailing common-law rule that liquidated damages cannot exceed expectation damages means that common law courts will uphold such a clause only where it can also be shown that the liquidated amount is not a penalty but a reasonable estimate of just compensation for breach.[110] Yet the effect of this rule when applied in practice is to *encourage*—rather than to discourage—suppliers to breach public contracts,[111] since a contractual clause fixing damages at a value that is *equal to* or *lower* than expectation damages affords government a liability-rule protection and thus effectively allows the supplier to breach the contract and pay damages.

Conclusion

The choice of legal remedies for breach of contract plays an important role in public procurement and in private sector procurement alike. Contrary to what efficient-breach theorists tell us, the efficiency of any given contract remedy does not depend solely on the transaction costs of renegotiating a contract. Contract remedies, as Craswell points out, also serve to allocate risks between the parties and thus affect the parties' incentives not only whether or not to take precautions to prevent breaches before they occur but also whether to enter into the contract in the first place and with whom and at what price.[112] This holds good even when one assumes that the transaction costs of renegotiating a given contract are zero.[113] Indeed, at least in the context of public procurement, the analysis conducted in this article strongly suggests that we must be less concerned about any such transaction costs when

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[108] Pettit and Gleason, "Liquidated Damages in Government Contracts: A Comment on Defenses" (1971) 25 Sw. L. J. 264.
[109] *Rex Trailer Co v United States*, 350 U.S. 148, 153 (1956).
[110] Gantt and Breslauer, "Liquidated Damages in Federal Government Contracts" (1967) 47 B.U. L. Rev. 71, 72; Pettit and Gleason, "Liquidated Damages in Government Contracts: A Comment on Defenses" (1971) 25 Sw. L. J. 264, 266; Chillemi and Mezzetti, "Optimal Procurement Mechanisms: Bidding on Price and Damages for Breach" (2014) 55 Econ. Theory 335, 336.
[111] Wilkinson-Ryan, "Do Liquidated Damages Encourage Breach? A Psychological Experiment" (2010) 108 Mich. L. Rev. 633.
[112] R. Craswell, "Contract Remedies, Renegotiation, and the Theory of Efficient Breach" (1988) 61 S. Cal. L. Rev. 629.
[113] Craswell, "Contract Remedies, Renegotiation, and the Theory of Efficient Breach" (1988) 61 S. Cal. L. Rev. 629.

selecting remedies for breach of contract.

First, given that public contracts are often renegotiated anyway,[114] the transaction costs of renegotiating a public contract cannot generally be said to be prohibitive. Secondly, given that suppliers have an economic incentive to abandon government projects or otherwise to breach public contracts when the costs of contractual performance turn out to be higher than anticipated or when they find new and more lucrative opportunities, the need to secure the public interest in public procurement dictates that the law should protect *as property* government's entitlement to contractual performance. Government's entitlement to contractual performance, in other words, must be protected by a property-rule remedy that prevents a private supplier from abandoning a government project or otherwise deviating from the terms of a public contract unless with the consent of the government procurer. Any post-award contract negotiation costs that may be necessitated by such a property rule cannot generally be so high as to outweigh the public interest in ensuring that government, through the selected supplier, discharges its functions in a timely and effective manner for the ultimate benefit of citizens.

This article thus casts doubt on the wisdom of applying to public contracts the common-law rule that prefers to protect the entitlement to contractual performance through a liability-rule remedy in the form of expectation damages. The justification for this preference offered by the theory of efficient breach does not appear to have a place in public procurement. It would therefore appear that many public procurement regimes are deficient insofar as they stop short of providing for government's remedies for breach of contract. For as long as this regulatory deficiency remains unaddressed, it is incumbent upon the courts of competent jurisdiction in the legal systems concerned to be more receptive to property-rule remedies such as specific performance and punitive damages, not least in cases where a public contract specifically provides for such remedies. After all, the use of liquidated damages clauses that operate as penalties and other contractual arrangements (such as performance bonds[115]) that protect as property government's entitlement to contractual performance should be encouraged in the public interest.

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[114] See generally Guasch, *Granting and Renegotiating Infrastructure Concessions: Doing it Right* (2004); Spiller, "An Institutional Theory of Public Contracts: Regulatory Implications" in Ménard and Ghertman, *Regulation, Deregulation, Reregulation: Institutional Perspectives* (2009); Beuve, Moszoro, and Saussier, "Political Contestability and Public Contract Rigidity: An Analysis of Procurement Contracts" (2018) 28 J. Econ. Manage. Strat. 316; Beuve, Moszoro, and Spiller, "Doing It by the Book: Political Contestability and Public Contract Renegotiations" (2021) J. L. Econ. & Org.

[115] See L.M. Giuffrida and G. Rovigatti, "Supplier Selection and Contract Enforcement: Evidence from Performance Bonding" (2022) 31 J. Econ. Manage. Strat. 980.