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## RIGHTS AND OBLIGATIONS OF THIRD PARTIES

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### Abstract

Three different issues, related to third-party involvement in a contractual relationship, are examined. The first two (assignment of contractual rights/delegation of contractual duties and third-party beneficiary contracts) are examined in a unified way. After pointing to the striking similarity between beneficiary and assignment contracts, we discuss the non-simultaneous assent argument, the danger of creating open classes of beneficiaries without the intention of the contracting parties, and other problems. In a second part, we deal with the controversial issue of efficient breach due to inducement by a third party. After reviewing the literature, we briefly consider the use of liquidated damages as an instrument that is better-suited than a tort for the protection of the subjective valuation and the risk aversion of the promisee.

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### 1. Preface

The ‘two-parties bargaining’ dimension of contract is so prominent that some tend to perceive it as a *sine qua non* condition of a contract, as part and parcel of its very definition and as a unique characteristic which differentiates it from other areas of the law, such as tort. The bargaining model is prevalent in common law countries and quite influential in many civil law countries. Thus, it is no coincidence that the entanglement of third parties in contracts concluded by two other persons is theoretically considered an ‘anomaly’ - an exception to the rule, a problem that is difficult for a theory to accommodate without adulterating itself.

We will deal with three different problems concerning third parties involvement in a contract. The first two, ‘third-party beneficiaries’ and ‘assignment-of-rights/delegation-of-duties’, are well-known to contract scholars. Even though they are seemingly two separate themes and are often treated dissimilarly, they revolve around the same issue: the assumption by a

third person who is not a participant to the contract of the rights (third-party beneficiary, assignment) or duties (delegation) of one of the contracting parties. We contend that the key to the question of the third party's role in a contract is, first of all, approaching the problem in a unified way.

In the second part of this chapter, we will discuss another problem (in the literal sense), namely the inducement to breach by a third party. This is not a topic that distinctly falls within contract law, since the inducement is tortified in many jurisdictions. However, it leans heavily on contract law and especially on a sacrosanct subject for law and economics scholars: efficient breach.

### A. The Transfer of Rights and Duties to a Third Party

#### 2. Introduction

In a contractual relation, the basic question concerning third parties is whether or not it is desirable for the law to facilitate and enforce the substitution of either party by a third person, not a party to the original contract.

Several theories have provided us with answers to the above question, although these answers are often contradictory with each other. The will theory, championing the enforcement of the will of the parties, acquiesces to any transfer provided that the latter is the goal of both parties (however see Fried, 1981, pp. 44-45, but also Collins, 1993, pp. 287-288). The bargain theory, by contrast, especially in its strictest form that includes a hard-bitten 'privity' doctrine (Collins, 1993, pp. 283-300) could create insurmountable obstacles by refusing to acknowledge any rights to a third person who is a beneficiary of a contract for which he has not offered consideration, that is *quid pro quo* (see generally Atiyah, 1995, pp. 355-394). Economic theory is usually closer to the will theory (Kronman and Posner, 1979, p. 5) and this is also true for the problem of third parties.

Thus, the question of the desirability of third parties involvement has puzzled legal theory and practice, in both civil and common law countries, for a reason that does not seem obvious today: even though the law's enforcement of this transfer was an indispensable condition for the unbridled functioning of a modern market economy (Fuller and Eisenberg, 1990, pp. 795-796, 819-824), legal scholars and judges proved extremely reluctant to follow society and economy. According to Calamari and Perillo (1987, p. 724), '[t]he history of the law of assignments is an interesting illustration of the struggle between commercial needs and the tenacity of legal conceptualism' (see also Simpson, 1975, pp. 475-485; Farnsworth, 1990, pp. 744-748; Fuller and Eisenberg, 1990, Appendix E; Karsten, 1991; Eisenberg, 1992, pp. 1360-1374; Nicholas, 1992, pp. 182-187).

After the developments in the financial sector of the economy, the transfer of money, and entitlements in general, assumed an unprecedented variety of different forms (Dupré, 1981); as a result, the needs for overcoming the privity requirement became pressing. But even then, courts in some jurisdictions were reluctant to recognize the rights of third parties in many respects (Speidel, 1987). A classic example is English courts which, even today, do not recognize the rights of third party beneficiaries (see Atiyah, 1995, pp. 360-362, 364-365, 367-369; Collins, 1993, pp. 284-285). By contrast, the United States was the first common law country to recognize these rights as early as 1859 (*Lawrence v. Fox*, 20 N.Y. 268 (1859), see also Hoeflich and Perelmuter, 1988).

### **3. The Economic Approach**

The economic rationale underlying the enforcement of a clause for the benefit of a third party by the beneficiary resembles the one used by economists to justify the existence of contract law, but also freedom of contracts in general. The economic role of contract law is to facilitate transactions, to help parties realize their goals (thus creating value through exchange) and to encourage rational planning by the parties (Eisenberg, 1992, p.1374). An economic theory of contract law should construct legal rules which will accommodate rather than interfere with existing business practices (Hay, Shleifer and Vishny, 1996). The role of contract law is, therefore, initially to enforce people's promises, since these promises are by default value-enhancing (and utility-enhancing), that is to maximize the wellbeing of the members of society. Consequently, if the will of the parties is to confer benefits to a party outside the contract, this must be satisfied by being enforced by law. As Stephen (1988, p. 157) put it, 'contract law can be seen as ensuring that the optimal number of contracts is entered into' (see also Kronman and Posner, 1979, pp. 1-2; Cooter and Ulen, 1988, pp. 226-227). Any approach to the problem, other than the legal enforcement of third party rights, would lead to insuperable problems of opportunism, and consequently to inefficiency (Goetz and Scott, 1980).

There is no apparent reason for the courts to create legal rules that hinder the will of the parties, as long as there is no market failure. In fact, there is a specific business practice, the 'objectification' of the promise, that is increasingly becoming a kind of intangible property (Waters, 1985, p. 1189; Farnsworth, 1990, p. 745), which must be transferable '[O]wnership without the privilege of transferability is only a limited form of ownership' (Goetz, 1984, p. 38).

The only issue which needs special consideration is finding a way to detect the true will of the parties. Especially in a contract for the benefit of a third party, it is essential to discover if the parties did or did not want the beneficiary to obtain a direct right. But this is a general problem in contract formation.

Another problem is the transferability to a third party of the rights and duties created in a contract, without the explicit or the implicit consent of the promisor. Before we proceed to a more detailed discussion of the aforementioned problems in the light of an economic perspective, we should take a closer look at the relationship between the two 'different' procedures for the transfer of contractual rights.

#### 4. The Paradox of the Transfer of Rights

In most textbooks, the issues of third party beneficiaries and 'assignment and delegation' are independently discussed. However, we cannot help but notice the striking similarity between the two (Calamari and Perillo, 1987, p. 723; Roszkowski, 1989, pp. 289-307; Tsai, 1985). The clauses of the contract which establish a third party as a beneficiary often have similar economic effects with the clauses of an assignment contract that transfers the rights arising from a contract to a third person, with no synchronous delegation of the duties (if they exist). The only difference is that in the first case we have an *ex ante* transfer of rights and in the second case an *ex post* transfer with a second contract (often regulated by different rules).

It is apparent that the existence of two different ways of transferring contractual rights are due to the desire of the parties to economize on transaction costs (see, for example, the example used by McGaha, 1985, pp. 797) to illustrate the basic format of a third-party-beneficiary contract]. A contract which confers rights to a third party is economizing on transaction costs by reducing the number of deeds necessary for the transfer of these rights from the promisee to the third party. At the same time, it creates a greater sense of security for the third party whose claim against the promisor may not be attacked as non-assignable.

Thus, with a third-party beneficiary clause, there is no need for an additional assignment contract. The third party may obtain the rights of the assignee without the extra transaction costs. Evidently, this is only possible when all information is available before the contract for the benefit of the third party is concluded, and the promisor expressly agrees to the substitution. The *ex ante* agreement of the promisor is an indication that the transaction is efficient and that the relations among the three parties are well-functioning.

It is obvious that the unenforceability of third-party clauses in a given legal order seems rather anomalous (Atiyah, 1995, p. 359) when it is accompanied by the enforcement of assignment contracts. This anomaly results in making more costly, with no apparent reason or benefit, the transfer of contractual rights to a third party (since an assignment contract will be the only alternative). The differentiated treatment of the two issues seems pointless if we view *the third-party beneficiary contract as a type of cost-reducing assignment*

*contract* (in some jurisdictions, for example Louisiana, assumptions of obligations were often considered as third-party-beneficiary contracts, see Tsai, 1985, p. 819). The only essential difference between the two is that in the *ex-ante* transfer for the benefit of a third party, the promisee has the privilege of in-advance information in relation to his duties towards third parties. He knows that he should 'transfer' the rights of the contract to a third person (it does not make a difference if this transfer is necessary for the payment of a debt or for a gift) and he prefers to make a contract for the benefit of this third party directly. He thus frees himself from the extra costs of a separate performance or of a new contract for the assignment of rights. He also minimizes the danger of opportunistic behavior on the part of the promisor. At the same time, he maintains control of the tripartite relationship and reserves the right to revoke the transfer before the establishment of rights.

The promisor is also better off when a third party clause is available and preferred by the promisee. This is so because the promisor can control the assignment of rights (that is his duties) to a third person, unknown to him. The fact that he has concluded the contract with the promisor demonstrates that he doesn't have any problem with the transfer (or that he has been compensated enough to accommodate it).

The third party is also better off, since he economizes on transaction costs (there is no need for an assignment contract) and always has the option of accepting or refusing performance by the promisor. Additionally, in a number of jurisdictions, he can free himself from opportunistic objections by the promisor to an assignment contract (such as the objection of the non-assignability of the contract).

### **5. De Geest's Non-Simultaneity Argument**

The issues that arise from the substitution of either one of the parties by a third person have not yet attracted the interest of economists. The only significant attempt to treat these problems from an economic perspective is Gerrit De Geest's (1995) ambitious effort (also see De Geest, 1994, ch. 5). De Geest treats the transfer of rights to a third party as a problem of contract formation by 'non-simultaneous assent'.

According to De Geest, in some cases it is efficient to permit non-simultaneous assent since a requirement of simultaneity in all cases could lead to additional transaction costs and problems of opportunism. Non-simultaneity implies that the assent of the first party is 'frozen' or 'fixed' for a specific time period. Thus, in the case of a third-party beneficiary clause in a contract, another contract is implicitly concluded after the acceptance of the benefit by the third party. The promisor of the original contract assents to

the transfer of rights to the third party (a kind of 'offer' for the implicit contract) and the third party's acceptance to become a beneficiary (even after many years, as in life insurance contracts) is the necessary requirement for the formation of the new contract (De Geest, 1995, p. 11). Additionally, in any other type of contract, the promisor declares that he is willing to perform in the hands of a third party in case of a later assignment (given that a default contract rule allows for the assignment of contractual rights).

De Geest's theory is similar to the 'theory of offer' that developed in France in the middle of the nineteenth century and was soon abandoned because of doctrinal and practical difficulties (Nicholas, 1992, p. 188; Fried, 1981, p. 45). His main target is opportunism created by the temporal element which is an essential part of the definition of contract (Kronman and Posner, 1979, p. 3; De Geest, 1995, pp.18-19).

The construct of De Geest is an interesting and quite useful attempt to objectify contract law (and consent) by remaining inside its boundaries. Even though De Geest's idea of a 'frozen' assent is engaging (see however Fuller and Eisenberg, 1990, p. 745), I do not see any reason for labeling the acceptance of a 'frozen' (by law) assent as a contract - not only because there was no bargaining and meeting of the minds, but also because this legal fiction could create many other problems, when it is treated as just another contract. For example, what is the role of the promisee in this relation (for example, De Geest, 1995, pp. 19-20) and especially, what is the import of the relation between promisor and promisee? Whose intent should prevail? How should we acknowledge the contract defenses of the promisor against the third party based on the promisor-promisee relation? Or shouldn't we? The problematic nature of the non-simultaneous assent, however, is underscored by the impasse that it could create when the two original contracting parties wish to modify their contract, especially given the differences in the nature of third party involvement (donee or creditor beneficiary) in the contract (Summers, 1982, p.885-886).

The problem with De Geest's construct is its effort to stretch the notion of contract beyond its connotation in business life. This stretching is more than apparent in the treatment of assignment. According to De Geest, the promisor, when signing the original contract, 'declared that he was willing to perform in the hands of a third party, in case of a (later) assignment' (De Geest, 1995, p. 11). It is quite difficult to imagine such an intention in most contracts, with the exception of certain special transactions and cases where there is use of commercial paper. Even when there is an acceptance of the probability of assignment, even then, this acceptance is far from being an 'offer' for the creation of a new contract. The problem is more apparent in delegation cases, where (in De Geest's opinion, 1995, p. 21) 'there should be no regulation which forbids the clause according to which the debtor can assign contractual obligations without the (ex post) assent of the creditor'.

De Geest's approach calls to mind the phenomenon of the expansion of contractual liability during the nineteenth century, when an endeavor of common law judges and theorists to characterize a number of varying and different obligations as deriving from fictitious (Ott, 1995, p. 30) implicit contracts, failed (Gilmore, 1974). This reasoning is followed by De Geest, especially when he declares: 'From an economic point of view, an accepted testament is a contract' (De Geest, 1995, pp. 11, 20).

Having discussed the economic role of third party beneficiaries, assignment and delegation contracts, we note that there are several issues that require further clarification, like the conditions under which the transfer of rights is enforceable by the courts, and the nature and extent of the rights and duties of the three parties involved. Space constraints limit going into all these problems analytically, but we will touch upon those that are important for the well-functioning of the mechanism of substitutability in a relation of obligation.

## 6. Assignment and Delegation

A fundamental question relating to the assignment of contractual rights is the extent of the promisee's power to assign his rights. Should there be limits to this power of the assignee? Should the law associate the validity of the assignment with the promisor's assent?

There is general consensus that the promisor's state of mind should not affect the validity of the assignment. However, all jurisdictions have established conditions on the power of the promisee to transfer his rights. These conditions range from typical requirements (like a simple notice from the promisee to the promisor) to more substantive guarantees of the non-material change in the promisor's duties. For example, in American contract law the assignment should not materially increase the burden of performance or the risk imposed by the contract, should not impair the promisor's likelihood to obtain the return performance in the case of bilateral contracts and should not reduce the value of this performance to the promisor (UCC §2-210(2), *Restatement (Second) of Contracts* §317(2)).

There is no doubt that these conditions have been established in order to safeguard freedom of contract (and freedom not to contract) of the parties, as well as economic efficiency. Nevertheless, they require further elaboration, from an economic point of view:

*i. The problem of the promisor's assent.* Theoretically, the promisor's assent to the transfer of contractual rights should best guarantee the efficiency of the transfer, since an 'assent requirement' would be closer to the principle of freedom of contracts (see generally Epstein, 1975, pp. 431-432). But in practice

this is not desirable, since this transfer is crucial to economic life and not just an exception to the rule. The transfer of rights is so common and the need for the transferability of rights so pressing in many situations of business life, that a contrary rule (even when it is not part of *jus cogens*) could create many problems to the parties due to opportunism. It is more efficient for the law to allow these transfers to take place and to let the parties decide if they want to restrict them (Ott, 1995, pp. 32-33). A different rule could substantially increase transaction costs before or after the contract.

*ii. The problem of the material change of the promisor's duty.* From the standpoint of legal and economic certainty, a more objective standard and the courts' scanty use of the concept of material change would enhance efficiency since, after all, there is always the possibility of a contrary agreement between the parties. As cases of material change we should consider those that can be objectively characterized as causing substantial deterioration of the promisor's situation - a deterioration that alters the character or substantial terms of the agreement and goes against business ethics and trade usage. It goes without saying that the claims and defenses of the promisor against the assignor must also be made available against the assignee.

The same problem arises in cases of delegation of contractual duties, especially those which involve contracts for personal services. Here, the concept of material change is crucial (see generally DiMatteo, 1994) and the discussion can be associated with the problem of economic rent. A classic example is employment contracts, especially the contracts of members of the entertainment industry, professional athletes, artists and other professionals (lawyers, physicians, and so on), whose expertise is the most important reason they are chosen by the other contracting party.

However, a main problem in delegation cases is the liability of the delegating party. Should the delegator remain liable after the delegation? In most legal systems, the answer is positive. Otherwise, it would be very easy for a person to avoid a contractual obligation by simply delegating it (Roszkowski, 1989, p. 293; Ott, 1995, p. 33). The performance of a duty (especially when this duty is not the payment of money) usually involves personal services. In the typical contract relationship, where one party pays another a sum of money in exchange for the other's performance, the buyer is usually the one who chooses among many sellers and prefers one over the others, for a number of advantages that are not usually delegated, especially in conditions of monopolistic competition (De Geest, 1995, p. 20). Subsequently, a rule according to which the delegator remains liable is more efficient, since the need for its modification by the parties will seldom arise.

This 'objective', *'per se'* approach has been criticized as applying nineteenth-century rationale to modern economic relations. According to DiMatteo (1994, p. 410), delegation should be allowed when the subjective

expectations can be satisfied even without the use of personal services, that is when the delegatee's performance meets the expectations of the promisee or the performance of the delegatee is equivalent to the performance that would have been rendered by the promisor/delegator.

Aside from these qualifications, the assignment of rights and the delegation of duties should be readily available to the parties if they so choose (the same holds for the clauses prohibiting assignment or delegation). Assignment should be less restricted given its economic role, and delegation more restrained because of the great danger of opportunism.

Finally, there is one more question that needs to be considered. Should all rights and duties be transferable? This is a matter of public policy, since there is no apparent economic reason for the prohibition of the transfer of any particular right or the delegation of any particular duty. In many jurisdictions, there are various prohibitions which reflect public policies, such as the proscription of the assignment of rights against the state, the assignment of future wages, the assignment of political rights or rights that are too personal and the delegation of debts which are not subject to execution. In most of these cases, economics are (at least at first blush) irrelevant and other considerations should be weighed as more important (Allcock, 1983; Radin, 1987).

### **7. Third-Party Beneficiaries**

We have already stressed the importance of this device to economic life (Ott, 1995, p. 32) and called attention to its cost-saving function, which renders it an ancillary tool that serves the needs of the parties. If we approach the problem in this perspective, there will not be any difficulties in answering the question of the third party's ability to enforce a contract that confers a benefit upon him.

The rights of beneficiaries have been recognized in nearly all jurisdictions, with variations in the default rules and the extent of the beneficiaries' powers. However, a host of other problems emerge after accepting the rights of the beneficiary. The most significant is the possible confusion between positive externalities and third-party rights created by a contract.

A contract concluded by two parties does not create legal and economic results solely for the two parties involved. It creates, almost necessarily, effects for third parties either intentionally or accidentally. These external effects can be either positive or negative. The problem is which externalities should be regulated by law. More generally, a broader problem in economic (as well as political) theory is the definition and delineation of an externality (see Trebilcock, 1993, pp. 58-77; Parisi, 1994, pp. 216-218) and more generally (Papandreou, 1994).

The law has provided its own solutions to the problems created by externalities. Negative externalities are treated mainly by property,

environmental and tort law. But what about the third-party beneficiary problem? (Collins, 1993, pp. 289-292). Is this an example of a positive externality?

Holderness (1985) provided the most satisfactory answer to the problem, emphasizing that the mere definition and assignment of property rights is not sufficient. A necessary foundation for exchange is that the law assigns all rights in any resource to a closed class of clearly identifiable persons, each of whom is able to contract at any moment. A class is closed when persons can enter the class - and thus obtain the right - only by first purchasing the right from a current class member (Holderness, 1985, p. 322). The rights, therefore, must lend themselves to voluntary transfer and this is not possible when the rights are assigned to open classes (a class is open when entry to it is unrestricted). If they are, then no voluntary transactions can take place and resources are blocked from moving to higher-valued uses.

Thus, a legal policy which treats a positive externality stemming from a contract as an enforceable right by a third party creates open classes, since there are at least some individuals who can enter the class and obtain usage rights, without the intention of the owner of those rights. The denial of rights to third parties, even when they rely upon the formation of a contract or benefit from its completion, in both common and civil law, should be viewed under this prism as an endeavor to maintain the closedness of the class of contracting parties (Holderness, 1985, pp. 328, 330). Otherwise, the class of rights-holders would be open and large, impairing alienability and making exchange very costly.

In any case, the problems associated with the rights of a third party from a contract are not externality problems, if we define externality as an unintended consequence or, better yet, as a consequence that was not specifically intended by the contracting parties and is obviously not the result of another contract. We cannot characterize a benefit to a third party as a positive externality when this benefit was the objective of the contracting parties, even when the third party was not informed or asked about it. Assigning enforcement rights only to named beneficiaries closes the class by identifying all the class members (Holderness, 1985, p. 332).

Therefore, a contract's unintentional beneficial effect for a third party should not be the source of enforceable rights for third parties who benefit from it. The law must not recognize vested interests in this case. This is so for two reasons:

(i) When the parties have no intention (that is intention by the promisee and assent by the promisor) of conferring a benefit upon a third party by means of their contract, an opposite legal rule could be an infringement of the freedom of contracts, and according to the established mainstream view in economic analysis of law, paternalistic intervention in a contract must be justified by a market failure (Cooter and Ulen, 1988, pp. 232-242).

(ii) A rule which would endow third parties with rights deriving from a contract when there is no corresponding intention of the parties, could be so inefficient as to dramatically augment transaction costs, without any benefit to society. Obviously, such an imprudent rule could destroy economic life altogether, since entry into transactions would become very costly (see Holderness, 1985, 1989; Metzger and Phillips, 1989, pp. 968-969, and more generally Posner, 1992, pp. 126-128, and the economic literature on the related issue of consequential damages).

As a result, in all jurisdictions the marginal case for the creation of rights for a third party in a contract is when the beneficiary was not expressly mentioned by the parties, but it was their clear intention, manifested in the contract, to confer a *legally enforceable right* upon him (Summers, 1982, pp. 898-899). However, the courts or the legislators have sometimes attempted to extend these rights to cases where there is no intent to benefit third parties, but only positive externalities from government contracts (for the intended beneficiaries of public programs in which funding contracts are employed, see Adelson, 1985; Waters, 1985). But as we saw, this direction can create severe economic problems (Metzger and Phillips, 1989, p. 974).

We should approach the other problems created by the third-party beneficiary contractual rights by treating them in similar fashion with assignment of contract problems. This is reasonable since we should treat the beneficiary as an assignee. For example, the principle that a person cannot avoid a contractual duty by transferring it to a third party is valid here, as in the assignment. Consequently, the promisor can employ any defenses that he has against the promisee.

Another issue we should consider is the exact point in time when the rights of the beneficiary are vested. There are basically four alternatives (apparently, a contract clause that explicitly or implicitly deals with the matter, should prevail): (a) immediately after the formation of the contract which establishes someone as a beneficiary, (b) after a simple notice to the beneficiary, (c) after acceptance by the beneficiary, (d) after reliance by the beneficiary. We believe that the acceptance of rights by the beneficiary should be the point at which these rights are vested. Acceptance signifies that there is consensus among the three parties concerning the transfer of rights, that is all parties regard it as efficient. At the same time, the danger of impairing alienability by creating rights in unidentified persons is reduced (Holderness, 1985, p. 331) and even De Geest's non-simultaneous assent is satisfied.

## **B. Tortious Interference in a Contractual Relationship**

### **8. Efficient Breach and Tort Law**

Another problem which involves third parties and has preoccupied law and economics scholarship for many years, is 'efficient breach' induced by a third party. We will not get into the problem of efficient breach as such in this entry. The literature on efficient breach is perhaps the most important contribution (in terms of impact) of economic analysis to contract law (but first see Holmes, 1881, p. 301, 1897, p. 463; see also Birmingham, 1970; Posner, 1992, pp. 118-120, 128-129; Cooter and Ulen, 1988, pp. 289-292; Craswell, 1988; and for critiques, Macneil, 1982; Friedmann, 1989; Harrison, 1995, pp. 126-130). We will examine efficient breach as the result of a third party's interference in a contractual relationship, an interference which takes the form of a better offer by the third party to the promisor (after all, a better deal is the essence of a competitive order). This interference has been characterized as tortious by American law and the law in many other countries. This 'criminalization' of the better offer by a third party has been widely disputed by lawyers and economists as creating inefficiency.

The essential legal question appears to be the following: given the practical problem of calculating expectation damages, the corresponding high administrative costs and the parallel appearance of opportunism, in most situations, should we accept efficient breach or should we adhere to a theory which sanctifies promise, assent (De Geest, 1994, pp. 318-322) and/or good faith (and which, supposedly, will substantially reduce transaction and administrative costs)? The ethical dilemma which surfaces is that the two regimes can lead to quite different distributive outcomes. In an injunction regime, the new surplus will be shared by the three parties, but in a damages/efficient-breach regime the surplus will be divided between the third party and the promisor.

### **9. Review of the Literature**

The first papers that questioned the soundness of the tort of interference appeared in the early 1980s, greatly influenced by the dissemination of law and economics and efficient breach theory in particular. A tort which criminalizes the better offer, necessary for the efficient breach, would be inefficient, as far as it disrupts the process which leads to efficient breaches, discourages the optimum number of breaches and distorts incentives. As a result, in a number of arguments articulated in a series of papers, written mostly by economically-minded lawyers, the authors tried to point out the problems created by the tort of interference and to limit it (if not abolish it entirely) to a

few cases where there is another economic or public policy reason for tortious treatment of the breach.

Dobbs (1980) is the first in this line of authors to acknowledge the need for the availability of efficient breach (pp. 360-363), that is impaired by tortification, but he bases his opposition on rather doctrinal and philosophical arguments (challenging the 'property conception' of contract rights and the relevancy of mental states).

Two years later, two important papers fortified the case for limiting the tort, based entirely on economic arguments. In the first paper, Rizzo (1982), without much acknowledging the aspect of wealth maximization through the reallocation of resources to higher-valued uses (not totally unexpected from a leading 'Austrian'), limits tort-based recovery to those cases where contracting costs are high and the relevant economic losses are concentrated on a few persons, that is essentially when the litigation costs are fewer than the expected value of recovery, making the latter socially beneficial (Rizzo, 1982, pp. 283-285).

The second paper, written by Harvey Perlman, defined (and refined) the economic approach and became the point of reference for friends and foes since then. Perlman (1982, pp. 83-85), recognizing the delicate balance of a tort which essentially overrides the terms of a private relationship, tracks two different sources of inefficiency created by an unrestricted tort of interference: (a) prevention of efficient breaches and (b) augmentation of transaction, negotiation and salvage costs. He then categorizes interference cases into (a) those in which the act of interference is independently unlawful (fraud, antitrust violation, and so on) or malicious and, (b) those in which the behavior of the third party is otherwise lawful. An unlawful means test could restrict tort liability to cases of the first category. In the second category of cases, contract remedies promote efficiency which can be inhibited by a subjugation to a tort regime.

However, this is essentially an abolition of a tort of interference as a self-sufficient independent base for liability (but see also Chutorian, 1986). For Perlman, if there is a problem with the current remedies and full-compensation is untenable, the tortification of breach is not the solution.

Dowling (1986) notes the promisor's counterintuitive opportunistic incentive (created by the tort) to breach inefficiently (*ibid.*, pp. 507-508) and the throwing off balance of the delicate contract damage system produced by the 'spectrum' of double recovery (*ibid.*, p. 509, see also Wexler, 1994, p. 281). He expands Perlman's limitation beyond the unlawful means test, making the conceptual distinction between interference with contract and tortious interference with business relations. For Dowling, the latter deserves stronger protection than the former. The protection of the promisee in a contractual relationship is superfluous, given his pre-existing contractual right to collect damages (*ibid.*, pp. 514-519) (for the importance of the distinction, see also Feltham, 1988, and Gergen, 1996, pp. 1180-1181).

The problem of 'double recovery' is treated primarily by Landes and Posner (1987), who look upon the issue as mainly a problem of joint liability where the injured party can sue the promisor for breach of contract or, alternatively, the third party for tortious interference. The third party is the lower-cost avoider of the harm most of the times (but see Dowling, 1986, p. 508) and should be liable in cases of undercompensation of plaintiff (insolvency, litigation costs, and so on). Indeed, even though the liability of the promisor is a strict liability and that of the third party is based on negligence (which should be proved in court), a rational promisee may choose to sue the third party and get an award of punitive damages as a bonus (see the (in)famous *Pennzoil Co. v. Texaco Inc.* case and also Austin, 1996).

BeVier (1990) reconsiders inducement, agreeing with much of the abovementioned criticism and the need for reconciliation with efficient breach. However, she defends a limited tortious liability for the protection of the creditor and his incentives to collect information and invest (reliance), especially in cases where specific performance and damages are unavailable (*ibid.*, 1990, p. 905) or inapplicable (p. 910), that is when contract remedies under-protect contract rights. Relational contracts constitute the typical example. In such complex relations, the assumption of a perfect replication of performance is often unrealistic; additionally, the tort of interference can differentiate freeriders from those who truly value performance more than the promisee (*ibid.*, p. 890, for similar views, see also Partlett, 1992, p. 775).

Myers (1993) correctly observes that the law of tortious interference has been carried along in the tide of liability expansion in recent years in the USA, with considerably less attention given to concerns of efficiency than antitrust law (compare Lao, 1997). This conflict with now-accepted antitrust reasoning is due to the considerable doctrinal confusion of tortious interference law which leads to unfortunate results: tort law gives excessive protection to tenuous contractual relationships at the expense of competition and efficiency. Further, the availability of punitive damages may deter efficient breaches of contract, thereby heightening the doctrinal conflict. Thus, tort protection for existing contracts (from unlawful acts and especially antitrust law violations) is economically defensible, but only with the burden of proof to the plaintiff, without the availability of punitive damages and with limitation to actual damages. In antithesis to Dowling, he believes there is no economic reason for the protection of prospective business relations.

De Geest (1994), after reviewing previous work and criticizing the requirement of prior information (notice) for the liability of the third party as leading to inefficient results, classifies the cases of inducement into four different categories with various criteria (the availability of damages or specific performance, the economic situation of the debtor, and so on) and examines the alternatives that do not support an extensive use of tortious liability.

Finally, in the most unequivocal full-scale attack to the tort of interference, Wexler (1994), charges it as frustrating the underlying policies of the law of contracts and antitrust, deterring efficient breaches of contract and procompetitive conduct, and even intruding into basic individual rights (for a similar argument, that the imposition of tort liability for the mere communication of truthful information is a violation of fundamental First Amendment principles, see Tucker, 1997). Thus, it places an unnecessary burden on the legal system and commerce (for similar views, see also Grothe, 1989).

Until recently, Richard Epstein had posited the most (if not the only) authoritative defense of the tort (after the attack by economists). Although many theoretical ('corrective justice-based') arguments against the tort of interference were grounded in an earlier much-discussed Epstein (1975) paper, Epstein (1987) himself dealt directly with the problem, supporting the soundness of tortious liability and 'following' the path of a former student of his (see Fine, 1983, who 'read' Epstein, 1975, quite differently than others and more compatibly with Epstein's later views), finding analogies in property law. However, he bases his defense on novel ground.

According to Epstein (who essentially equalizes contractual rights with property rights), '[t]he tort of inducement of breach of contract is best understood as an unsuspected manifestation of the problem of ostensible ownership', and inducement is a form of taking of this property right to promisor's performance (Epstein, 1987, p. 2 and Friedmann, 1989, pp. 20-23, who agrees; see also Epstein, 1997, pp. 51-53). Nonetheless, the third party must be liable only when he knows the preexisting contractual relationship. After a notice informing the third party of the existence of a prior contract (Epstein, 1987, pp. 24-26), the inducer should be liable in tort in order to 'regularize business transactions among trading parties' (Epstein, 1987, p. 41, however, see Epstein, 1985, p. 42 and Macaulay et al., 1995, vol. 2, pp. 186-187 for side-effects). Other defenders of the tort (based on philosophical/dogmatic grounds but discussing extensively economic arguments) include Gergen (1996) who uses it to bolster the argument for allowing a contract claim for breach of the duty of good faith.

Recently, the doctrine of tortious interference was strongly advocated by three scholars who disputed the economic analysis based on the efficient breach theory. For Woodward (1996), the tort stands for a community's interest in the maintenance of contracts and the relationships they embody. The supporters of efficient breach are essentially based on a quantity of unknown empirical information with the major problem of efficient breach theory being the unrealistic nature of its requirement of 'full compensation' principle, due to transaction costs and proof problems (Woodward, 1996, pp. 1155-1163). Lao (1997) discusses the growing use of tortious interference law in what were traditionally antitrust cases (see Myers above) and the ensuing criticism that

such use is inefficient and irreconcilable with federal antitrust policy. She supports this use employing similar arguments with Woodward.

A mainstream economist, McChesney (1998), begins by questioning the usefulness of the efficient-breach model in the typical interference case. The concept of efficient breach may make sense in a two-person world when costs of performance rise *ex post* and the parties have not specifically allocated risk of that event *ex ante*, but does not in the three-party setting in which contractual interference actually occurs. In a two-party Coasean situation (and as long as there can be recontracting once costs change) the result is the same, regardless of the initial allocation of property rights (ignoring wealth effects). However, initial allocation is important when subsequent transaction costs effectively prevent recontracting.

Moreover, in a three-party tortious interference case, the situation is quite different. The breach deprives the promisee not only of the 'use value' of the performance, but also of its 'exchange value'. The issue thus comes down to the question of who owns or should own the increased exchange value. McChesney points to the promisee, since expectation damages are difficult to calculate and this difficulty dramatically increases litigation costs, not to mention the additional negotiation costs (see *contra* Posner, 1992, p. 119). Thus, efficient breach entails two sets of transaction costs (negotiation and litigation costs) and tortious interference involves only one (negotiation costs). A liability rule would be similar to reverting to the efficient breach model and thus the default option for asset protection should be a property rule, that is a mandatory rule of promisee ownership of promisor's performance. And that is exactly what the tort of interference does.

McChesney's endeavor has many problems, the most important among them being the rigidity of the tort (that is of a property rule) itself. However, his paper offers the best case against efficient breach and for the tort of inducement, based principally on the increase of litigation costs and the difficulty in measuring expectation damages. The problem boils down to statistical evidence, which McChesney offers at a preliminary stage.

#### **10. Efficient Breach with a Simultaneous Protection of Idiosyncratic Values**

Efficient breach is a peculiar transfer. Here the promisor 'transfers' his promise from the promisee to the third party, without the acceptance of the former, because the third party has offered a better deal. This transfer seems unorthodox. The promise, after the formation of contract, has been transformed into a kind of property and no longer belongs to the promisor. However, if we embrace Holme's intuition that this property can have an exact monetary equivalent, that is a user value (even a purely subjective value), then we can

condone such a transfer. We can then say that the new property is an entitlement to the monetary equivalent of the promisee's expectations (user value) or his subjective valuation of the promisor's promise.

There is no reason for the enactment of a rigid mandatory rule for the protection of the promisee, since the manipulation of the remedies by the judges could prove more useful. Judges can discern the cases where administrative costs are high and order specific performance instead of damages (Kronman, 1978). When the administrative costs are low, they can order expectation damages. Thus, the dangers of unfairness and perhaps inefficiency which an 'efficient breach' regime could induce, can be mitigated in every particular case by the judge's discretionary power to award damages or specific performance (and by letting the Coase theorem do the work, automatically taking into account the promisee's expectations-subjective value).

Promisees can always ask for penal clauses or high liquidated damages, reflecting their subjective valuation of the contract or their risk aversion. Those who are risk averse or value performance higher than its market price can insure themselves or can ask for either a penal or a 'liquidated damages' clause to be included in the contract (for the pattern of incentives that can be created in a legal system with 'free efficient breach' and enforcement of penal clauses, inferences can be drawn from Ayres and Gertner, 1989 and 1992; but see *contra* Schwartz, 1996, p. 37). This way, the promisee who has concluded an ordinary contract in a competitive market would be protected less than the one who struck a deal that he considers unique for personal reasons (see also BeVier, 1990, p. 898).

In a seminal paper, Goetz and Scott (1977) emphasized the proof problems inherent in fully recovering idiosyncratic values. These problems prevent the non-breaching party from recovering his subjective expectations, if recovery is limited to legally determined 'objective' remedies. Accordingly, efficiency will be enhanced, under many circumstances, by the enforcement of liquidated damage clauses that represent the most efficient means by which parties can insure against the otherwise non-compensable consequences of breach (Goetz and Scott, 1977, pp. 557-558).

These clauses prohibit breaches that are not efficient, since their presence usually signifies a difference between market price and subjective value (a spacious consumer surplus). Even in cases where the penalty clause was redundant, purely gambling, or opportunistic, the Coase theorem is at work and should lead to the same result that specific performance would lead to (Hatzis, 1997, p. 15, 1998, ch. 5).

To 'criminalize' this anomalous transfer by punishing the third party through tort law is very often a mistake. The fear of punishment and tort liability can stop many efficient transactions, not because the promisee is actually hurt but because of opportunism and strategic behavior. This does not

signify that in some extreme cases certain actions should not be characterized as torts, since their basic purpose is to willfully damage the promisee (as in the case of the 'paulian claim', that is defraud of creditors). But this tort liability is actually based on behavior that should be in any case punished as unfair (or extremely inefficient).

The essence of the free market is competition and this includes offering someone a better deal. The criminalization of competition can bring about only distorted effects, since the incentives to search would be diminished and the outcome cannot be Pareto optimal. Contract is a mechanism devised for better allocating resources. If this allocation can be improved with the non-performance of a contract and without injury to anyone, that is if there is a way (with no damage to contract stability) to a Pareto improvement, then the purposes of contract law have been served.

## **11. Conclusion**

Rigid legal doctrines and philosophies have created many problems to the third parties involved in contractual relations. The privity requirement can be economically explained as the law's attempt to assign the rights of any resource to a closed class of clearly identifiable individuals. However, the non-enforcement of third-party beneficiary clauses has rather been the result of dogmatic adherence to a principle without the parallel reconsideration of its economic rationale, thus augmenting opportunism. The simultaneous enforcement of assignment contracts has created an anomaly in the relation between the third parties, augmenting transaction costs. The same can be said for the tortification of efficient breach. Based more on the theory of 'sanctity of contract' rather than on an economic rationale, it frustrates the most important process in a free market, namely competition. The issues discussed here have once again demonstrated the need for a coherent and scientific theory of contract law, grounded in economic science and business practice.

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