11  Impossibility and impracticability

Donald J. Smythe

1. Introduction

Once parties have made a contract, should they ever be excused from the performance of their obligations? This is the question addressed by the doctrines of impossibility and impracticability. These provide affirmative defenses to complaints seeking specific performance or damages for alleged breaches of contract. They may be interpreted as default rules that provide an implied term in every contract excusing the parties from their obligations in the event that some contingency causes their performances to become impossible or impracticable. As such, they are often referred to as excuse doctrines. This chapter will survey the law and economics literature on the role of excuse doctrines in contract law.

The doctrine of impossibility is usually only applied in circumstances in which a party’s performance has become physically impossible, such as when a painter dies before fulfilling a contractual promise to complete a painting. The doctrine of impracticability, on the other hand, may be applied in circumstances in which a party’s performance is physically possible but will cause severe hardship, such as when the costs of building a bridge rise so much that the party that contracted to build it will be forced into bankruptcy if compelled to perform. These two doctrines are closely related to the doctrine of frustration of purpose, which may apply in circumstances in which the essential purpose of a contract has been frustrated, such as when a party rents rooms specifically to view a coronation procession that is subsequently cancelled.

It is widely believed that until the middle of the nineteenth century the common law almost always required that contractual obligations be performed (see Gordley 2004 for a skeptical discussion). The doctrine the courts most commonly applied was the ‘rule of absolute liability’. This rule was relaxed, however, in *Taylor v. Caldwell*, an English case in which the court excused both parties from their performances when the music hall one had contracted to rent from the other was destroyed by a fire, thus establishing the doctrine of impossibility. The doctrine of frustration was established in *Krell v. Henry*, another English case in which a party was excused from paying for a room it had contracted to rent to view King Edward VII’s coronation when the coronation parade was cancelled due to the King’s illness. This case, and others, expanded the range of
circumstances under which the common law would excuse performances beyond those which made them physically impossible.

A number of American cases have further expanded the range of circumstances in which contractual performances may be excused. In Mineral Park, for instance, the defendants were excused on the grounds that their performances were ‘impracticable’. Mineral Park and similar cases thus established the doctrine of impracticability. The Restatement (Second) of Contract Law now devotes more attention to this doctrine than to either impossibility or frustration of purpose, and the Uniform Commercial Code (UCC) has made it the principal excuse doctrine for American sales contracts. The modern trend in the common law has clearly been in the direction of expanding the grounds on which excuse will be granted.

In the civil law tradition, the doctrine of impossibility can be traced back to Roman law (the common law doctrine of impossibility also has important roots in Roman law; see Gordley 2004 for an overview). A separate doctrine allowing excuse because of changed circumstances evolved out of Canon law. Although European jurists and scholars struggled with these separate strands of doctrine with varying degrees of success, and although their legal systems borrowed in different ways from the two legal traditions, most civil legal systems have ended up with excuse doctrines similar to those in the major common law systems. This is probably more than mere happenstance. In any modern market economy, it is inevitable that parties will occasionally seek to be excused from their contractual obligations. All modern legal systems have therefore established rules or principles to govern when parties should be excused from their contractual obligations and when they should be required to perform. Practical considerations appear to have influenced both common and civil law systems to adopt similar excuse doctrines (Zweigert and Kotz 1998).

The earliest contributions to the law and economics literature on excuse doctrines emphasize their role in promoting efficient risk-bearing. These early contributions have been widely cited and are therefore discussed in the next section of this chapter. The contributions immediately subsequent to these generally elaborated on the analysis of how the excuse doctrines might affect the efficiency of contractual risk allocations. These subsequent contributions are discussed in the third section of this chapter. Another set of contributions analyzed the potential for damage limitations and price adjustments to enhance justness and efficiency. These are discussed in the fourth section. The most recent contributions to the literature have analyzed the role of the excuse doctrines in long-term or relational contracts. These are discussed in the fifth section. The sixth section offers some concluding comments.
2. **The Early Literature: Efficient Risk-Bearing**

The first modern economic analysis of excuse doctrines was by Posner and Rosenfield (1977). Posner and Rosenfield assume that one of the central purposes of contract law is to reduce the costs of transacting by providing economically efficient default rules to fill the gaps in contracts. They argue that efficiency generally requires assigning contractual risks to the party that is the least-cost risk-bearer. Thus, in the face of changed circumstances that give rise to an impossibility or impracticability claim, a party should be excused from its contractual obligation if the other party is the superior risk-bearer; the party should not be excused if it is the superior risk-bearer. As Posner and Rosenfield conceive of the problem, a party can be a superior risk-bearer if it is better able to prevent the risk from materializing, or if it is able to insure against the risk at lower cost. Some parties may be able to insure against risks using portfolio diversification strategies, others may have to purchase an insurance policy or simply self-insure. Posner and Rosenfield argue that from an economic efficiency standpoint, a promisor should be excused from performing if it could not reasonably have prevented the event that makes its performance impossible or impracticable, and if the promisee could have insured against the risk of its nonperformance at lower cost.

As a practical matter, however, Posner and Rosenfield note there are judicial costs to undertaking particularized inquiries. Thus, applying the economic efficiency standard in every case would create legal uncertainties; at the ex ante stage of their transaction, parties might not be able to predict how courts will reallocate the risks in their contracts through the application of excuse doctrines. They argue therefore that the economic efficiency standard should be used to establish rules to apply to categories of cases rather than the circumstances of individual cases. Indeed, they argue that this is essentially how American courts have applied the excuse doctrines. In contracts between a corporation and an employee for personal services, for instance, both parties are able to assess the risks of the employee’s death and each is best able to evaluate how it would impact them (or in the employee’s case, her estate) and thus insure against the death in the most appropriate way. Thus, when an employee dies, courts typically discharge the employee’s estate from any obligation for damages, as well as the corporation from any obligation for payment. Similarly, in contracts for the supply of specialized equipment, the supplier is best able to evaluate the degree to which the equipment is specialized and the costs of converting it to alternative uses. Thus, in cases where a buyer seeks an excuse from an obligation to purchase specialized equipment because its performance has become impossible, courts have granted discharges. This is efficient because the supplier can spread the risks of such discharges across its contracts with all buyers.
Although they acknowledge that courts have not always been consistent, Posner and Rosenfield argue that similar tendencies may be found in other categories of cases. They thus argue that their analytical framework is a useful guide to the case law. In that respect, they offer not only a normative economic analysis but a positive one. Indeed, in their view, the application of excuse doctrines by courts generally illustrates the ‘implicit economic logic of the common law’ (Posner and Rosenfield 1977, p. 84).

A paper by Paul Joskow (1977), published simultaneously with Posner and Rosenfield’s, focused on the application of the impracticability doctrine in the Westinghouse case. Westinghouse had contracted with several utilities to deliver uranium fuel for their nuclear power plants at fixed prices. The costs of the uranium ore used to produce the uranium fuel rose much more rapidly than Westinghouse expected and it was faced with the prospect of large financial losses if forced to honor its fixed price contractual commitments. Joskow argues that uranium costs were driven upwards by the failure of the industry to increase its long-term supply capacity enough to meet demand. In fact, Westinghouse itself unwittingly contributed to the failure by contracting to supply utilities with uranium fuel at unrealistically low and essentially fixed contract prices, while maintaining a short position in the market for uranium ore. Uranium ore suppliers were unwilling to invest in new capacity unless buyers such as Westinghouse were willing to commit to long-term purchase contracts. When the demand for uranium eventually drove the spot prices of both uranium fuel and uranium ore higher, Westinghouse was trapped between contractual obligations to supply uranium fuel at low and essentially fixed prices and the need to buy uranium ore at high spot market prices.

Joskow estimates that as of January 1, 1975 Westinghouse had obligations to supply about 60,000 tons of uranium fuel at base prices between $8 and $10 per pound with minor cost escalation adjustments (primarily for certain labor and materials costs) over the period from 1975–88; over the same period it had contractual commitments from suppliers for only 14,000 tons of uranium ore and only about 6,000 to 7,000 tons of uranium ore inventories. By June, 1975 the spot price of uranium ore had risen to $22 per pound; by December, 1975 it had risen to $35 per pound. Thus by the middle of 1975 Westinghouse was short about 40,000 tons of uranium ore that it would need to purchase over the next ten or twelve years at spot prices that were prospectively three or four times the prices at which it had contracted to supply uranium fuel. On September 8, 1975 Westinghouse announced that it would not honor its commitments, on the grounds that its performance had become impracticable under the UCC.

As Joskow notes, the truly puzzling aspect of the case is why Westinghouse placed itself in this position. One possibility, of course,
is that it was behaving strategically and hoping the Atomic Energy Commission would forestall any significant price increases by releasing some of its stockpile of uranium reserves. Or it might have hoped that import restrictions would be lifted and it would be able to obtain uranium ore at cheap prices from foreign suppliers. While it is possible Westinghouse was pursuing a rational strategy, Joskow suggests it was more likely that Westinghouse simply made a mistake. At the time it made its commitments to supply uranium fuel, it was focused primarily on nuclear power plant construction and not on securing uranium ore supplies. The resulting debacle may thus have been a consequence of a failure at Westinghouse’s corporate level to exercise adequate command and control over the nuclear division.

Joskow’s economic analysis focuses on the relative costs of risk-bearing, much like Posner and Rosenfield’s. He notes that in a case such as Westinghouse, a narrow interpretation of impracticability places the burden of risks on the promisor, thus encouraging the promisor to insure against the risks; a wider interpretation places the risks on the promisee, thus encouraging the promisee to insure against the risks. If the scope of the doctrine is appropriately defined, the costs of transacting will be reduced. Joskow interprets the test for impracticability under the UCC to require several conditions: (1) that an underlying condition of the contract must fail, (2) the failure must have been unforeseen at the time of contracting, (3) the risk of the failure must not have been assumed by the party seeking excuse, (4) the performance must have been made impracticable, and (5) the seller must have made all reasonable attempts to ensure that the source of supply would not fail. He conjectures that as it is currently applied, the test probably reduces transaction costs on the whole and promotes economic efficiency.

In Joskow’s view, an appropriate application of the impracticability test would preclude Westinghouse from qualifying for an excuse. First of all, he argues that well-informed industry participants should have expected uranium prices to rise. Thus, the failure of uranium prices to remain stable could not have been reasonably unforeseen. Moreover, the purpose of a fixed price contract is to assign the risk of price increases to the seller; thus, Westinghouse assumed the risk by committing itself to a fixed price contract. And Westinghouse certainly failed to do everything possible to insure itself an adequate source of supply. Even if all the other requirements were met, Joskow doubts whether Westinghouse should be able to meet the impracticability requirement given the size of its prospective losses. In all these respects, Joskow’s analysis accords with Posner and Rosenfield’s. Both of these early contributions focus on efficient risk-bearing and argue for narrow applications of excuse doctrines.
3. Extensions of the Efficient Risk-bearing Theories

Bruce (1982) seeks to refine Posner and Rosenfield’s approach to the economic analysis of excuse doctrines by elaborating on the role of imperfections in information in the optimal assignment of liabilities and the manner in which it could affect parties’ incentives to mitigate damages. He assumes, additionally, that the rules should also be constructed taking the legal costs of resolving disputes and parties’ negotiation costs into account. In cases where parties are equally knowledgeable about a risky event and neither can mitigate its consequences, he argues that excuse doctrines should be applied using a negligence standard with a contributory negligence defense. This would require courts to determine whether the promisor took the appropriate precautions to mitigate damages and whether the promisee failed to take precautions that could have avoided them. Bruce argues that where parties have asymmetric information, the logic of Posner and Rosenfield’s argument for assigning the liability to the better-informed party falls apart if the parties are able to contract around their rule. Thus, where the promisor is less well informed about the prospective size of the promisee’s damages and would be discharged under Posner and Rosenfield’s analysis, the promisee could pay the promisor to accept responsibility for a breach of contract.

Perloff (1981) attempts to answer a question that Joskow (1977) had raised: Why would somebody make a commitment to buy under a long-term fixed price contract other than to insure against fluctuations in the price? He notes that in an Arrow-Debreu world of full information and complete contingent claims markets, there would be no need for excuse doctrines, but that in a second-best world of asymmetric, limited information, incomplete futures markets, and other imperfections, contractual discharge might be able to improve economic welfare. To illustrate this, he constructs a model in which transaction costs preclude risk-averse sellers from hedging against price fluctuations by executing futures contracts. In this context, a discharge of the seller’s obligations if the spot price at the time for performance exceeds the ex ante expected price by a sufficient amount could serve as a substitute for the kind of contingency clause the seller might have negotiated in a contract with a risk-neutral buyer to hedge against price fluctuations.

Perloff notes that some of his results conflict with Posner and Rosenfield’s. In his model, for instance, it may be efficient for a risk-averse seller to pay damages to a risk-neutral buyer under particular market conditions. Whereas it is always optimal for the risk-neutral party to bear the risks in Posner and Rosenfield’s model, it is not necessarily so in Perloff’s model because a court’s decision to grant an excuse will have general equilibrium effects not captured in Posner and Rosenfield’s analysis. He argues that
Posner and Rosenfeld’s analysis is a special case of his own in which different sellers’ outputs are never positively correlated. He concedes that there are significant costs to judicial inquiries and that courts may not be able to ensure that excuses will always improve welfare, but argues that since courts are only rarely asked to intervene, they may nonetheless be able to apply excuse doctrines in ways that improve welfare overall, especially if they follow relatively simple legal rules.

White (1988) analyzes excuse doctrines using principles from the economic analysis of contract breach (Shavell 1980; Polinsky 1983). She argues that courts should forego a separate analysis of whether a discharge from contractual obligations is justified and focus instead on the appropriate damages remedy for the party’s breach. In some cases, the appropriate damages would be zero, but in most cases positive damages should be levied on a nonperforming party. She further argues there are three ways in which breach of contract rules can enhance economic efficiency: by providing incentives to perform if performance is efficient; by discouraging the promisee from making inefficient reliance expenditures; and by minimizing the costs of risk-bearing. Since the amount of damages necessary to ensure efficient risk-bearing is always positive, regardless of whether the buyer and seller are risk-neutral or risk-averse, discharging a contract will increase the risk faced by both parties overall. Moreover, since it is equivalent to zero damages, it will also encourage inefficient breach.

White thus argues that judges should treat discharge cases as breach of contract cases, and assess damages according to the risk preferences of the parties, the amount of the contract price paid in advance, and the degree to which the parties can influence whether or not the adverse event occurs. She argues that in cases where performance becomes impossible, courts will often look to whether or not the contract price was paid in advance. She claims that in *Krell v. Henry*, for instance, the lessee made a partial payment in advance; when the lessee sought an excuse, the court granted it, but did not require the lessor to return the advance payment. This implicitly assessed damages against the lessee. In cases where performance has merely been made impracticable because of a significant cost increase, such as the Suez canal cases, the efficient amount of damages will always be positive.

Sykes (1990) analyzes conditions under which contractual discharge will be efficient given that an event occurs that makes a party’s performance impracticable. He assumes that contracting parties can anticipate the contingencies that might give rise to impracticability claims and make rational decisions ex ante about whether to incur the transaction costs of negotiating customized contract clauses or to bear the expected costs of having the excuse doctrines apply by default. Sykes notes that the impracticability
doctrine can be characterized as a two-tier damages rule since zero damages will apply if the defense is accepted, but positive damages will be awarded if it is rejected. He thus treats the impracticability defense as a two-tiered damages rule and compares it to the expectation damages rule that would otherwise ordinarily apply.

In Sykes’s model, uncertainty arises from the promisor’s costs. With zero transaction costs, the parties would negotiate a Pareto-efficient contract that allocates the risk of price fluctuations optimally. If transaction costs are positive, on the other hand, the parties’ contract will be second best. He assumes the parties negotiate a fixed price contract. If the promisor’s realized costs exceed the fixed contract price, the promisor may then seek to be discharged from its contractual obligations. Under an expectation damages rule, the promisor would perform if and only if its costs were less than the value of the performance to the promisee. But of course this places all the risk on the promisor, which may be suboptimal. The question thus is whether and when a discharge of the promisor’s obligations will improve the efficiency of the risk allocation enough to offset the inefficiencies of encouraging breach when performance would be optimal. This treats contractual excuse as a second-best solution to the contracting problem in the presence of transaction costs.

Sykes’s analysis suggests that if the promisor is risk-neutral, the expectation damages rule will always be at least as efficient as the impracticability defense. This follows from the simple observation that if the promisor is risk-neutral (and the promisee is not a risk-preferer), there can be no efficiency gains from shifting risks from the promisor onto the promisee by accepting an impracticability defense. If the promisor is sufficiently risk-averse and the promisee is risk-neutral, however, accepting the impracticability defense may improve efficiency. If the promisor and the promisee are both risk-averse, then it becomes difficult to draw any general conclusions. Whether accepting the impracticability defense will be second-best depends on a host of factors, including the parties’ relative degrees of risk-aversion, their wealth, the probability distribution of the promisor’s costs, etc. Given the information that courts would require to ensure that they accepted the impracticability defense only when it would be welfare-increasing, Sykes concludes that it is difficult to conceive of a discharge rule that would reliably increase economic efficiency. Although he does not argue for the abolishment of excuse doctrines, he suggests they should be applied only in particular cases, such as those involving supervening illegality or crop failures.

Triantis (1992) provides an analysis of the doctrine of impracticability as a problem in the allocation of risks under uncertainty. He extends the traditional model of decision-making under uncertainty to explain the
contractual allocation of unknown risks. In this respect, he challenges
the conventional assumption that parties are unable to allocate the risks
of unanticipated events contractually. To this end, he applies behavioral
models of decision-making under uncertainty rather than the more con-
ventional models of decision-making under imperfect information. The
behavioral theories he applies are based on models in which individuals
cannot assign unique probability distributions to given risks, but must
contemplate that random events could be generated by more than one
probability distribution. It is worth noting that this approach to uncer-
tainty is less radical than some others because it assumes that decision-
makers can at least define the universe of possible random events. There
are, in that sense, no truly unforeseeable contingencies.

In this framework, contractual risks are allocated through an implicit
price for risk-bearing. Although Triantis notes that some risks are inevi-
tably unanticipated, they generally can be folded into broader categories
of risk that are allocated contractually. For instance, a party might not
be able to foresee the risk of a terrorist attack that closes an important
shipping route, but they probably will be able to foresee the possibility
of the closure of the shipping route, if for some other, undefined reasons.
Thus, the contract may allocate the risk of the closure to the shipper for
some implicit price, and the shipper should then bear the risk regardless of
whether the specific event which causes the closure was itself foreseeable.
The risks of unforeseen contingencies are thus allocated at a broader level
of aggregation. Although Triantis acknowledges that this aggregation
of risks may not always be optimal, he argues that unknown risks are
typically remote and exogenous. Moreover, he cites empirical research by
behavioral theorists to argue that contracting parties can and do address
the risks of truly unforeseeable contingencies by making adjustments in
their assessments of the broader risks associated with their contractual
obligations.

Triantis argues that the same cognitive limitations that plague the
individual parties to contracts also impede the courts. Thus, he argues it
is unlikely that any court could allocate contractual risks more efficiently
than the parties themselves. Since excuse doctrines are more like muddy
standards than bright line rules, courts must apply them on a case-by-case
basis under diverse facts. This makes the outcomes of the cases difficult to
predict and only adds to the uncertainty inherent in the contracting envi-
nronment. Given most parties’ aversion to risk, the application of excuse
doctrines by courts increases the ex ante costs of contracting. Moreover,
because of the courts’ cognitive limitations, they will often fail to identify
the superior risk-bearer and their interventions will generally not improve
ex post efficiencies or redress inequities either. Triantis concludes that the
continued existence of the doctrine of impracticability ‘only serves to pre-
serve the confusion and uncertainty as to its application and scope’ and
that ‘[t]he role of contract law should be limited to the interpretation and
enforcement of the parties’ risk allocations’ (Triantis 1992, p. 483).

4. Arguments for Damages Limitations or Price Adjustments

Some authors have argued that unforeseen circumstances may warrant
damage limitations or price adjustments even if a full discharge is not
warranted and that price adjustments may be preferable to discharge
even when it is warranted. Walt (1990), for instance, argues that a party
should only be liable for losses attributable to risks it was compensated
to bear under the terms of the contract. For example, if 20 percent of
an increase in costs was foreseeable at the time of contracting, and if the
seller was compensated for bearing that risk under the contract, in the
event the seller breaches, its liabilities should be limited to 20 percent of
the cost increase. In principle, the same reasoning could be used to argue
for a price adjustment, although Walt does not develop that line of argu-
ment. Walt contends that such an approach would be consistent with the
Uniform Commercial Code and within the competence of the courts.

Trimarchi (1991) develops a case for price adjustments based on a cri-
tique of the efficient risk-bearing theories and using a transaction costs
argument. As he points out, the efficient risk-bearing theory does not suit
all circumstances in which a party might seek an excuse. In some cases,
certain risks, such as those associated with inflation or international crises,
may be systematic and thus affect the economy as a whole. Trimarchi
argues there may be no efficient risk-bearer of such systematic risks.
Efficient insurance in these contexts would require hedging, but because
futures markets are incomplete, hedging will in many cases be impossible.
Self-insurance, on the other hand, is merely a form of gambling. In other
cases, a risk of a loss to one party may correspond to a windfall gain to the
other. Suppose, for instance, that the seller’s costs increase, but the buyer’s
benefits under the terms of the contract increase even more. The seller’s
loss would be the buyer’s windfall. Trimarchi argues that requiring the
seller to insure against such a loss would not only be unjust but also inef-
ficient because the seller’s planning and organization would be disrupted
(presumably causing a loss of organizational rents), even if it was not
forced into bankruptcy (and if it was, valuable goodwill would be lost).

Trimarchi’s alternative analysis is based on a conception of incom-
plete contracts. He argues, for instance, that parties would rarely intend
that a fixed price clause assign all the contractual risks associated with
price fluctuations. Indeed, he observes that most of the risks that might
give rise to an impossibility or impracticability claim are so improbable
that they would normally be overlooked. Even if the parties did foresee the risks, they would probably ignore them anyway since psychological considerations normally impede parties from negotiating explicitly over highly unlikely contingencies that might give rise to significant contractual difficulties.

Trimarchi contends that a discharge of the seller’s obligations or an adjustment of the contract price might be warranted when a contractually unallocated risk arises in the face of an unforeseeable risk. If the risk was unforeseeable, then it was incalculable and efficient risk-bearing was impossible. In theory, a discharge would allow the parties to renegotiate the contract price and complete their transaction. In some respects, this would be preferable because it would respect the parties’ autonomy and allow them to adjust the contract price using their private information and based on their own preferences. Trimarchi observes, however, that transaction costs might be saved if the price was adjusted by the courts or if some procedural rule was used to facilitate the parties’ adjustment of the price.

Renner (1999) analyzes the contractual risks posed by inflation and reaches similar conclusions. Since parties may not anticipate the true rate of inflation, an excuse would benefit the seller if the contract price increased more than the inflation rate and it would benefit the buyer if the contract price rose more than the inflation rate. If courts granted excuses under these circumstances, the parties would bear the risks of relative price fluctuations they had contracted to avoid. If courts adjusted the contract price to accommodate the inflation rate, on the other hand, then the risks of relative price fluctuations that the parties agreed upon in their contract would not be disturbed. Renner thus contends that when unanticipated inflation disrupts parties’ agreements, price adjustments are always preferable to excuses. Renner recognizes that individualized court adjustments would be costly and so she argues that these are justified only when the risk of loss at stake is particularly large, but that a standard rule governing price adjustments should apply when the risk at stake is small.

5. Impossibility and Impracticability in Long-term Contracts
Most of the analyses of excuse doctrines in long-term contracts have eschewed a focus on risk-bearing. In an early contribution, Williamson (1985a) extends his transaction cost theory of the firm to the analysis of contracts and uses transaction cost theory to analyze the role played by excuse doctrines. In Williamson’s transaction cost theory of the firm (see Williamson 1979), actors are assumed to be boundedly rational, in the sense that Herbert Simon explains as ‘intentionally rational, but only limitedly so’ (Simon 1961), and also opportunistic, in the sense that they...
are ‘self-interest seeking with guile’ (see Williamson 1985b for a thorough discussion). Williamson argues that transaction costs depend on the frequency with which transactions recur, the degree of uncertainty inherent in the environment, and the asset specificity of any investments the transactions require. In principle, his transaction cost theory applies to short-term contracts as well as long-term ones, but the most interesting implications are for long-term contracts.

High transaction costs preclude parties from negotiating long-term contracts that are complete. Since long-term contracts frequently require significant investments in specific assets, it will often be in the parties’ best interests to make adaptations in the face of unanticipated contingencies because the failure of their transaction will generally mean a failure to recoup a return on specific investments. They might include an arbitration clause in their contract to facilitate such adaptations. If they do not do so, Williamson suggests that this is likely because they considered the contingency that warrants an adaptation too unlikely or the costs of arbitration too high, or the impairment of other incentives too severe. One could conclude, then, that strict enforcement should be preferred over an excuse. Williamson argues, however, that this would generally operate to the advantage of the party that is better able to calculate the risks and costs of remote events in advance. It would certainly encourage the parties to engage in more detailed negotiations and thus incur greater transaction costs at the bargaining stage of their contracts. Moreover, as Macaulay (1963) observed, such detailed negotiations might impede some agreements from being reached.

Williamson argues that contract excuse doctrines could help to mitigate some of the ex ante transaction costs, particularly if one party is more sophisticated than the other. He distinguishes two cases: one in which the contract is silent regarding potentially problematic contingencies; the other in which the contract attempts to cover some, but not all, problematic contingencies. He argues that in the latter case, the less sophisticated party should have been alerted to the risks of the contract, and since it made no effort to broaden the protections, it should be subject to strict contract enforcement (as should the more sophisticated party). In the former case, however, contract discharge is easier to justify since neither party was put on alert by the other’s negotiation of special protections from some remote contingency. In addition, he argues that since the excuse doctrines encourage parties to be adaptive in the execution of their contracts, they may provide additional benefits. But since there are significant judicial costs to applying the excuse doctrines, he concludes that the case in their favor is limited.

Goldberg (1985, 1988) addresses excuse doctrines in two separate articles. In the first, like Perloff (1981), he seeks to answer the question Joskow
(1977) posed: Why would anyone commit to a long-term fixed price contract? Goldberg (1985) argues that parties have many ways of adjusting prices to changed conditions both ex ante and ex post. They can, for instance, include price acceleration clauses in their contracts; alternatively, they can renegotiate prices even in a fixed price contract. This latter option might be attractive to both parties if it prevents the aggrieved party from ‘working to the rules’ and undermining the value of the contract to the other without breaking the letter of the contract. Although the options are imperfect, they do not necessarily argue for courts to grant an excuse.

Goldberg (1988) argues that parties would not normally agree to excuse one another’s performances because of changed market conditions at the ex ante stage of their contract. Although he concedes that price concessions are common, he argues that they are usually only given for consideration. In his view, parties are much more likely to agree to excuse the other’s performance if the supervening events giving rise to the request are unrelated to market conditions. An excuse in the face of an unanticipated price increase, for instance, would only redistribute income between the parties. An excuse in the face of some supervening event that would otherwise dramatically increase the costs of performance for one without significantly increasing the benefit for the other would, on the other hand, alleviate a serious moral hazard problem. As a general matter, such moral hazard problems increase transaction costs for both parties at the ex ante stage of a long-term contract.

Goldberg argues that this distinction helps to explain much of the case law. The Suez cases, for instance, involved an event which affected market conditions and courts generally declined to grant excuses. Goldberg notes that the closing of the Suez canal was not subsequently added to the force majeure clauses in most shipping contracts. In the coronation cases, such as Krell v. Henry, excuses were granted but in at least one (Chandler v. Webster), the discharged renter was denied reimbursement of a deposit. He argues that this Solomonic solution is now common in the hotel industry and generally agreeable to most parties. It essentially treats a hotel reservation as an option contract. Since the modern practice is consistent with the application of the doctrine of frustration in the coronation cases, he argues the courts in those cases probably applied the doctrine of frustration appropriately.

Scott (1987) analyzes the role of excuse doctrines in long-term contracts using a game-theoretic conception of parties’ strategic interactions. In his theory, parties negotiate an assignment of risks in their contracts, but since they cannot allocate all the risks ex ante – either explicitly or implicitly – they may seek adjustments during the course of their agreement in order to accommodate unanticipated contingencies. Once the contract has been
made, however, they have less incentive to accommodate the other’s requests for adjustments than they did ex ante. They are thus inevitably confronted during their contract with the choice between adjusting the contract cooperatively or behaving non-cooperatively and resisting the adjustment. He argues the parties’ interactions can be analyzed using a repeated prisoner’s dilemma game in which they must decide whether to behave cooperatively or non-cooperatively each time there is an unanticipated contingency. The parties will generally rely on tit-for-tat strategies and social norms to regulate their behavior, but if either of them responds non-cooperatively they may decide to enforce the contract legally. The question then is whether the courts should enforce the contract as written or grant an excuse.

The parties’ difficulties in enforcing their contract will usually be exacerbated by imperfect information. They will usually only have limited understandings about how an unanticipated contingency will affect the other. They may also have imperfect information about the actions of the other party in the preceding period. In addition, they may have high discount rates and they may face significant uncertainty about the duration of their transaction. This increases the costs of enforcing their contract through the usual cooperative and retaliatory interactions that comprise tit-for-tat strategies. Reputation effects and extra-legal enforcement mechanisms may help the parties maintain a cooperative equilibrium, but these may themselves be costly and may not be as effective in contracts between commercial actors as they are between family members.

Scott argues that contract law offers two valuable mechanisms for reducing errors in the initial assignment of contractual risks. The first is the implied contract term. These are typically provided by many common law doctrines, such as impossibility and impracticability. The problem is that these doctrines can only be constructed through carefully adjudicated cases over a long period. Custom and usage of trade may offer some guidance to the courts in constructing these implied terms, but not enough to eliminate all uncertainty over judicial interpretations. Scott thus argues that particular circumstances will usually require that express contract terms supersede any terms implied by the courts. The second mechanism for reducing errors in the assignment of contractual risks is the ‘express invocation’ – a term that carries an unambiguous meaning that the courts can then apply. Scott argues that certain force majeure clauses can evoke such meanings. The usefulness of standardized terms, however, is limited to standardized contractual arrangements. Parties will have difficulty in establishing terms for more innovative arrangements.

Scott argues that even if the costs of judicial inquiries are high, courts may nonetheless play an important role in resolving contract disputes. If one party seeks an adjustment and the other declines the request, the
parties may become involved in a series of spiteful and unproductive interactions. Judicial intervention may help to control these spiteful interactions because courts can serve as a neutral and legitimate arbiter of the parties’ dispute. Additionally, the power of an aggrieved party to invoke legal enforcement provides a credible threat of severe retaliation against the other party that has defected from a cooperative equilibrium. To this end, strict legal standards that can be applied clearly and decisively may help courts to enforce the initial assignment of contractual risks better than loose ones. Scott argues that this may explain why courts are so reluctant to apply the doctrines of impossibility and impracticability. Since the unanticipated contingencies that give rise to excuse defenses will usually involve contractual ambiguities and interpretative difficulties, courts may generally prefer to adhere to the principle of party autonomy instead, and force the parties to rely on their strategic interactions and social norms to resolve their disputes between themselves.

Smythe (2002, 2004) constructs a game-theoretic model of parties’ interactions over the course of a long-term – or ‘relational’ – agreement and uses it to analyze the roles of contractual enforcement and contract excuse doctrines. In his model, the parties must transact in the face of uncertainty about future contingencies. Since transaction costs are high and/or the parties are boundedly rational, they cannot allocate the risks of all possible contingencies in a complete contingent claims contract and so their agreements are necessarily incomplete. He argues that they therefore enter into long-term agreements, with the understanding that they will adapt the terms in the face of new contingencies as the need arises. In the face of an unforeseen contingency, one of the parties may then request an adjustment or an excuse from its obligation. The other must decide whether to comply with the request or deny it. This leaves open the possibility of two types of opportunism: the party requesting the excuse may have done so when under the spirit of their agreement the request was not justified, and the other party might deny the request for an excuse when under the spirit of their agreement the request should have been granted. In the face of such opportunism, the agreement will unravel. The prospect of the agreement unraveling increases the uncertainty faced by the parties at the outset of their transaction.

In Smythe’s model, the parties’ design their agreement to be largely self-enforcing. In the face of the uncertainty raised by the prospect of unforeseen contingencies, the parties may respond by making their agreement less than fully cooperative. Since their incentives to deviate from the agreement decline as the cooperativeness of the agreement declines, this may enable them to proceed with a mutually gainful transaction even in the face of significant uncertainty. In Smythe’s model, however, even a small
decrease in the cooperativeness of the agreement can have a significant impact on the profitability of their transaction. A relatively small decrease in their cooperativeness in any one period might not matter much, but a decrease in their cooperativeness in every period over the course of a long-term agreement might matter a great deal. Moreover, the decrease in the parties’ cooperativeness would usually be accompanied by a decrease in the size of any initial investments they might make towards the profitability of their transaction. This would, of course, compound the impact of the uncertainty on the profitability of their transaction.

The parties will attempt to reduce the uncertainty by adopting an effective governance structure for their transaction. The governance structure might rely on social norms and the parties’ business ethics, but it may also include the strictures of a formal contract. Executing a contract for the transaction is a means of opting in to the possibility of legal enforcement of the parties’ obligations. If, in the face of some problematic unforeseen contingency, one of the parties demands an excuse from its obligations and the other denies the request and demands performance, the former has the option of turning to the courts to enforce the contract. The courts will then have to decide whether to enforce the contractual obligation or grant an excuse. Courts can make two kinds of mistakes: if they enforce the contract when an excuse is justified, they will accommodate the enforcing party’s opportunism; if they grant the excuse when one is not justified, they will accommodate the excused party’s opportunism.

The possibility of both kinds of judicial mistakes increases the ex ante uncertainty faced by the parties if they execute a contract for their transaction. If courts apply the excuse doctrines inappropriately, therefore, this will increase the costs of contracting and possibly discourage parties from transacting altogether. Of course, if courts typically only enforce contracts when they should and grant excuses when they are justified, this will decrease the ex ante uncertainty faced by the parties and reduce the costs of contracting. This will increase the longevity and cooperativeness of their agreements, the size of their initial investments, and decrease their reliance on other, less efficient governance structures. Smythe (2004) argues that the manner in which the doctrine of impracticability has been applied by most American courts has probably helped to reduce the uncertainty and costs of contracting. Moreover, as long as courts allow parties to contract around the rule, any harm that it might do can at least be mitigated.

6. Conclusion

The earliest economic analyses of excuse doctrines focused on their role in promoting efficient risk-bearing. Subsequent studies extended the early
ones by incorporating the analysis of excuse doctrines into more general frameworks for the analysis of contract damages claims, by elaborating on other ways in which the courts might affect risk allocations through their applications of excuse doctrines, and by suggesting other ways in which the parties might allocate risks contractually. The most recent analyses have focused on the role of excuse doctrines in long-term contracts. The focus of these studies has been on whether the application of the excuse doctrines will generally impede or enhance the parties’ efforts to enforce their agreements autonomously. In light of the most recent studies, it seems reasonable to predict that future work in this area is likely to elaborate on the role of the excuse doctrines in long-term contracts, using theories and methods from behavioral law and economics.

Bibliography

Other References