Beyond Ex-Post Expediency –
An Ex-ante View of Rescission and Restitution.

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Abstract: It is commonly held, that if getting a contractual remedy was costless and fully compensatory, rescission followed by restitution would not exist as a remedy for breach of contract. This claim, we will demonstrate, is not correct. Rescission and restitution offers more than remedial convenience. Rational parties, we argue, would often desire a right of rescission followed by restitution even if damages were fully compensatory and costless to enforce. The mere presence of a threat to rescind, even if not carried out, exerts an effect on the behavior of parties. Parties can enlist this effect to increase their value of contracting.

I. INTRODUCTION

Why provide a remedy in restitution for breach of contract? A remedy in restitution makes sense in cases where the existence of the contract is defeated due to some incapacity, disability or other defect. The Draft Restatement (Third) of Restitution And Unjust Enrichment §§31-35 provides remedies to a party who renders performance under an agreement that is ultimately unenforceable due to indefiniteness or lack of formality, illegality or inconsistency with public policy, incapacity of a party or mistake by one or both parties, or due to some supervening condition or uncertainty of an obligation to perform nonetheless delivered under protest. In all of these cases, something prevented the agreement form receiving the adequate enforceability, as a matter of law, under contract. Restitution and Unjust Enrichment cleans up the mess associated with a legal defect under contract. But when the contract is not defective, why should a party have an option to elect a remedy in restitution following recession? Judicial economy and expediency is the usual answer. The distinguished and thoughtful Reporter for Restatement (Third) of Restitution, Professor Andrew Kull, has gone so far as to say that if getting a contractual remedy was costless and fully compensatory, rescission followed by restitution would not exist as a remedy for breach of contract. This claim, we will demonstrate, is not correct. Rescission and restitution offers more than remedial convenience.

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2“A party to a valid contract has no claim a priori to anything other than his contractual expectancy. If the enforcement remedies were fully effective and costless, rescission would not exist as a remedy for default.” Id. at 1499.
Rescission and restitution provide contractual parties a distinctive and valuable remedy even in the case where expectation damages are fully compensatory and costless to enforce. In demonstrating this claim, as we do below, we are not denying that the remedy of rescission and restitution often serves the function of economy to which commentators attribute to it. Rather, our aim is to expand the scope of motivation for the remedy. Indeed, we believe that the remedy’s long existence, dating back to the ancient markets of Rome and possibly even longer to the ancient law of Greece and Egypt, cannot be fully appreciated without the considerations we highlight here. Which is not to suggest that ancient jurist always freely promoted the remedy: they certainly did not. Medieval lawyers, in particular, saw value in the remedy but also limited its application because of anxieties—palpable but often unexpressed. By limiting the ease with which rescission may be elected, legal authorities responded to the century-old fear that rescission unsettles the commercial order or other normative values by threatening the stability of contracting. Chief among the concerns is the burden to the defendant of being compelled to reverse contractual exchange.

So what is our argument? We begin by reiterating the question why rescission should be available at all. Besides the case where rescission “extricates the claimant from a defective agreement” where “concern for the stability of the contractual exchange has no relevance”, the drafters of the Draft Restatement III of Restitution invoke the difficulty of compensating the claimant’s injury in damages and notions of “elementary fairness”:

“The justification for the rescission remedy combines remedial economy and elementary fairness to the plaintiff. So long as it is possible as a practical matter to order that the plaintiff's performance be restored in specie, it will usually be easier to do so than to calculate damages for breach or to compel the defendant to complete the interrupted exchange. From the plaintiff's viewpoint, rescission is attractive whenever the anticipated cost of proving damages (or obtaining specific performance) is greater than the profit element of the anticipated recovery. In such a case, a plaintiff who would rather unwind a partly-completed exchange than prove damages for breach is normally given the election to do so.”

Andrew Kull, the Reporter for the Restatement III of Restitution also mentions another motive while a plaintiff might want to elect rescission. “[R]estitution as an alternative remedy for breach of contract becomes interesting chiefly in cases where the aggrieved party has made an unfavorable bargain, a contract that he has been performing (or would have been obliged to complete) at a loss.” Expectation damages, after all, give the promisee the “benefit of the bargain”—the value that would have been realized had breach not occurred, which is ordinarily greater than the contract price. Only in those odd cases where realized value of performance is

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3 Draft Rest III §54, comment (d).
4 Draft Rest III §54, comment (b).
5 Kull, supra note 8, at 1469.
6 Expectation damages, v, also ordinarily exceed reliance damages, which include the price, p, and any incidental reliance, r, made on the contract. Hence the familiar chain of inequalities, that ex ante expectation is greater than reliance, which in turn is greater than restitution of benefits conferred to breacher: v > p + r > p. (Note that if the price has not been paid up-front this inequality would turn into v – p > r > 0.) See Restatement (Second) of Contracts § 344 & cmt. a (1981).
less than price—that is, in losing contracts—is the option to rescind and pursue restitution preferable to expectation damages. In these cases it is certainly convenient for the promisee to disaffirm the contract and get her money back when the promisor happens to have breached. But would the parties, when entering into the contract, ever agree to give the promisee such a fortuitous option? Not likely, says Andrew Kull “[R]ational parties would not bargain” for such a right. This conclusion is too hasty.

Rational parties, we argue, would often desire a right of rescission followed by restitution even if damages were fully compensatory and costless to enforce. The mere presence of a threat to rescind, even if not carried out, exerts an effect on the behavior of parties. Parties can enlist this effect to increase their value of contracting. To illustrate, consider the situation of a seller of goods who knows that the buyer has a right to rescind the contract if the goods are defective. Since rescission is generally disfavored by the seller, she will try to reduce its incidence. The seller knows that rescission occurs only when the contract price is more than value, as measured by expectation damages. That is, the buyer will want to rescind only when the contract is a losing one: when the value the buyer derives from the goods is less than the price paid for them. Moreover, rescission is only available to the buyer if the goods are defective, that is, when the quality of the goods falls short of the quality level specified or implied in the contract. But the seller is not without some control over the quality of the goods she produces and the price she charges for them. By lowering the price, the seller can reduce the likelihood that the buyer will want to rescind the contract, and by investing in the quality of the goods, the seller can reduce the probability that the buyer will have the legal right to do so.

Part II briefly reviews the traditional arguments for and against granting rescission rights. These arguments are all grounded in distribution and ex post transaction cost considerations. In Part III we make the case for efficiency and ex ante investment considerations. We argue that if parties can elect between rescission and expectation damages they can tailor incentives to efficiently invest in quality. Part IV we argue that the normative implications of our analysis are to have relatively generous access to rescission but to have limited ensuing remedies. This is the exactly opposite recommendation than the present trend in many modern reforms and reform proposals around the world.

7 Kull, supra note 8, at 1477.
8 Moreover, even in cases where parties would not voluntarily bargain for such a regime, we show that the availability of rescission might still be socially desirable. See infra Subsection III.C.2.
9 We assume that damages are fully compensatory and costless to enforce.
10 This is the case if the seller has some market power, which is very plausible in many markets where the seller has monopoly power with respect to his own (branded) product.