

## Compensation for Breach of Contract

1. **General Rule:** Not to breach; implying specific performance.
2. **Exception:** When the situation has changed, it 'might be' better off to breach.
3. **Condition for Efficient Breach:** Breach of contract is efficient if and only if it satisfies Kaldor-Hicks Criterion. I.e. the breaching party must be better off sufficiently to compensate for the innocent party making him/her indifferent between the breach + the compensation and the performance of contract.

*\*Damage = Injury from the breach incurs to or the worse-off-ness of the innocent party; Damages = Compensation for the damage*

### 4. Compensation Rules

#### 4.1 Perfect Expected Damages or Liquidated Damages

This rule based on the Kaldor-Hicks criterion to create Pareto improvement by transferring the wealth from the breaching (better-off) party to the innocent (worse-off) party sufficiently to make the innocent one *indifferent* between *i) being breached + receiving compensation* and *ii) the performance of the contract*. Thus, it will make the innocent party to feel as if the contract is performed. In other words, the innocent party feels nothing.

It is alternatively called '*liquidated*' because it releases both contracting parties from obligations under the breached contract. In other words, it is the payment from the breaching party to the innocent one in order to free themselves from any obligation of the original contract.

#### 4.2 Problems of 4.1

Effectively, the use of perfect expected damages makes the innocent party thoughtless about the chance of being breach and insensitive the possibilities of any better contractual opportunity that may arise. Subsequently, even though there is a better chance for the innocent party to take and cancel the original contract (or to have simultaneous breaches), the innocent party has no incentive to do that because the innocent party believes whatever happened with the contract (s)he would never be made worse-off, providing the transaction cost to any contract is positive and contracting parties are risk-averse. Thus, there is *ex ante* economic inefficiency.

It is apparent that perfect expectation damages is *ex post* efficient since it restores the status of the innocent party. But being immune to the breach, the innocent party's behaviour is *ex ante* inefficient. Alternative compensation rules are called for.

#### 4.3 Reliance Damages or Negative Damages

Essentially, we need to understand what 'reliance' means. *Reliance* is any cost incurred to the innocent party due to his/her belief that the contract would be performed. For instance, the bride quits her job because she wholeheartedly believes that her groom-so-to-be-husband will support her living in the marriage; or she went to the beauty spa in preparation of the wedding. But at the end, the wedding is cancelled. Another example is that you built the garage in preparation for the delivery of your new car but the car is never delivered.

The key to this rule is whatever you have invested by *relying* on the belief in the existence of the contract would be used to calculate the compensation. The more you believe, the more compensation you will be paid. This rule owes to the fact that no one will pay his/her reliance more than the real valuation of the contract worth. If the car is worth 1 million baht to you, you will pay

up to 1 million for the construction of the garage. If your soon-to-be-husband cannot afford to pay your living allowance more than your monthly salary, you will not quit your job. This is the upper bound of compensation.

However, you might think you may exaggerate your reliance to get high compensation. In fact, the court will award you only what you have paid; so you will gain nothing by doing so and you are limited by that upper bound.

Calculating reliance is a way for the court to get around information cost that could be too prohibitive to ascertain how much the innocent has been made worse-off. It is easier and more objective (less subjective) to gauge the damage.

This rule, therefore, transfers the wealth from the breaching party to the innocent party in such a way that the innocent party is indifferent between *no formation of the original contract ex ante* and the *breach of that original contract ex post*.

#### 4.4 Opportunity Cost Damages

This rule employs a simple fundamental economic concept of opportunity cost. Once you are engaged in one contract, you sacrificed all other possible contracts. Rational choice will dictate you to choose the best contract available. In case that contract is breached, your real lost is not the breached contract but the second best alternative that you did not engage in.

Under the opportunity cost damages, the breaching party transfers his/her wealth to the innocent party to make the innocent party indifferent between choosing the *second best contract from beginning* and the *breach of the chosen contract*.

It can be summarised in the table below.

Rule	Compensation is the difference between (I – II)	
	I	II
<i>Perfect Expectation Damages</i>	Breach of original contract	Performance of original contract
<i>Reliance Damages</i>	Breach of original contract	No formation of original contract
<i>Opportunity Cost Damages</i>	Breach of original contract	Performance of next-best contract

**5. Examples:** see PPT

**6. Conclusion:** Different rules for calculating damages or compensation are trying to balance between *ex ante* and *ex post* economic efficiency resulting from the breach of contract. Perfect expected damages is *ex post* efficient but *ex ante* inefficient; while two others are less *ex post* efficient but more *ex ante* efficient. The amount of compensation is highest for perfect expected damages and less for two others depending on reliance and the second best option. Different rules also are balancing between the ability to avoid costs of breach between the breaching and innocent parties. The innocent has no burden but the breaching party takes all burden of breach under perfect expected damages. Under two other rules, the innocent party responsible more for the cost of damage, depending on the level of reliance and the next best option.