Damages for repudiation: an ex ante *perspective on the Golden Victory*

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Abstract

The remedy of damages for repudiation modifies not only the parties' behaviour after the contract is repudiated (*ex post* behaviour), but also their behaviour in making and performing the contract (*ex ante* behaviour). In this article, a law-and-economics approach is adopted to analyse the majority decision in *The Golden Victory*, arguing that this decision is economically justified because: (1) it encourages the parties to solve the uncertainty of measuring damages; (2) it enforces the parties' contractual allocation of risks; and (3) it encourages the early disclosure of their intention to breach. This article differs from the existing literature in two ways. Firstly, rather than examining the impact of *The Golden Victory* on *ex post* behaviour, it focuses on *ex ante* behaviour. Secondly, unlike most existing literature, which criticises the majority's decision, this article supports it from a law-and-economics perspective.

I Introduction

Professor Reynolds remarked in a recent article that *Golden Strait Corp v Nippon Yusen Kubishika Kaisha* ('*The Golden Victory'*)[1] had been described by a former Commercial Judge as 'the worst decision on any aspect of English commercial law, and certainly shipping law, that has come out of the House of Lords in my entire career in the legal profession'.[2] The case involves a time-charterparty contract. The appellant (the owners) time-chartered a tanker to the respondent (the charterers) for a period of seven years ending on 6 December 2005. Clause 33 of the contract provided that both the owners and the charterers could cancel the charter if war or hostilities broke out between two or more of a number of named countries, including the United Kingdom, the United States and Iraq. On 14 December 2001, the charterer repudiated the contract by returning the ship to the owners, who accepted the repudiation on 17

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1 [2007] 2 AC 353 ('*The Golden Victory'*).

2 Sir Anthony Colman, (Speech delivered at the London Maritime Arbitrators Association, August 2008) quoted in Francis Reynolds, 'Commercial Law' in Louis Blom-Cooper, Brice Dickson and Gavin Drewry (eds), *The Judicial House of Lords 1876–2009*, (Oxford University Press, 2009) 700, 710.Sir Anthony Colman, (speech delivered at the London Maritime Arbitrators Association) quoted in Francis Reynolds, 'Commercial law' in Brice Dickson and Gavin Drewry (eds), ibid 700, 710.

December 2001 and brought a claim to the arbitrator for damages which, they argued, should be measured as the difference between the market rate and the contract rate for the whole remaining period of 48 months. On 20 March 2003, before the arbitration award was granted, the second Gulf War broke out. The charterers then argued that they were liable for damages only until the time of the outbreak of the war because the contract would have been cancelled anyway had it been in force when the war broke out. Damages for the whole 48 months would overcompensate the owners for their losses. The arbitrator made an award in favour of the charterers. The owners appealed to the Queen's Bench Division, where the appeal was dismissed by Langley J, then to the Court of Appeal, where it was dismissed again. Finally, they brought an appeal to the House of Lords.

The House of Lords dismissed the appeal by three to two. Lords Scott, Carswell and Brown, in the majority, ruled that the fundamental principle of damages for breach is to use a financial remedy to put the non-breaching party in the position that they would have been had no breach been committed. The owners' claim exceeded the amount of damages to which they were entitled in accordance with this principle.[3] Lord Bingham and Lord Walker, in the minority, delivered a powerful dissenting opinion that the market price rule should apply. Damages ought to be assessed as the difference between the market price and the contract price at the date of the breach; no future contingency should be taken into account, unless it is 'predestined or inevitable'. This is a well-established principle in law.[4]

Not surprisingly, *The Golden Victory* has attracted much academic attention.[5] It is surprising, however, to see criticisms of the majority decision dominate the literature. These criticisms can be summarised in two points. First, the majority decision damages the certainty which is one of the major advantages of English commercial law.[6] Allowing a future contingency to discount damages will make it difficult for the parties to predict damages if one party commits a breach.[7] Second, the majority's decision encourages the breaching party to delay settlement or prolong litigation. Allowing a future contingency to discount damages will

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3 'The arguments of the owners offend the compensatory principle. They are seeking compensation exceeding the value of the contractual benefits of which they are deprived.' [2007] 2 AC 353, 383 (Lord Scott).

4 *Maredelanto Compania Naviera SA v Bergbau-Handel GmbH; The Mihalis Angelos* [1971] 1 QB 164.

5 GH Treitel, 'Assessment of Damages for Wrongful Repudiation' (2007) 123 *Law Quarterly Review* 9; Brian Coote, 'Breach, Anticipatory Breach, or the Breach Anticipated?' (2007) 123 *Law Quarterly Review* 503; Michael Mustill, '*The Golden Victory* — Some Reflections' (2008) 124 *Law Quarterly Review* 569; Francis Reynolds, '*The Golden Victory* — A Misguided Decision' (2008) 38 *Hong Kong Law Journal* 333; J W Carter and Elisabeth Peden, 'Damages Following Termination for Repudiation: Taking Account of Later Events' (2008) 24 *Journal of Contract Law* 145; David Capper, 'A "*Golden Victory*" for Freedom of Contract' (2008) 24 *Journal of Contract Law* 176; Michael Furmston, 'Actual Damages, Notional Damages and Loss of a Chance' in Djakhongir Saidov and Ralph Cunnington (eds), *Contract Damages: Domestic and International Perspectives* (Hart Publishing, 2008) 419; Anthony Mason, '*The Golden Victory*' (2008) 22(2) *Commercial Law Quarterly* 3; David McLauchlan, 'Some Issues in the Assessment of Expectation Damages' [2007] *New Zealand Law Review* 563; Jonathan Morgan, 'A Victory for "Justice" Over Commercial Certainty' (2007) 66 *Cambridge Law Journal* 263; David McLauchlan, 'Expectation Damages: Avoided Loss, Offsetting Gains and Subsequent Events' in Djakhongir Saidov and Ralph Cunnington (eds), *Contract Damages: Domestic and International Perspectives*, (Hart Publishing, 2008) 349.

6 *The Golden Victory* [2007] 2 AC 353, 367–8 (Lord Bingham).

7 Treitel, above n 5; see also Coote, above n 5; Mustill, above n 5.

create a perverse incentive for the breaching party to delay settlement in the hope that a contingency may arise to reduce damages.[8]

Compared with the overwhelming criticism in the literature, the supporters of the majority decision made only moderate responses.[9] They tried to justify the decision from a doctrinal perspective, arguing that the market price rule is only a prima facie rule and is not always adopted in the assessment of damages for repudiation. The judges could reject the market price rule if they believed it proper to do so.[10] Furthermore, it is well-established that a court must consider the possibility of future contingencies in the assessment of damages.[11] As such, the majority decision did not depart from precedent.[12]

All discussions in the existing literature examine *The Golden Victory* from an *ex post* perspective, with little consideration of its *ex ante* impact; in other words, the existing literature considers only how the parties responded to the law when the contract was actually repudiated, with no analysis of their responses at the time of making and performing the contract. The two criticisms of the majority decision are of course *ex post* problems, but they must not be exaggerated. Unfortunately, the supporters of the majority decision justify it on doctrinal grounds only, without sufficiently replying to the two concerns raised by its opponents.

In contrast with the existing literature, this article will consider the impact on the parties' *ex ante* behaviour and defend the majority decision against the criticisms levelled at it. It will show that, compared to the minority decision, the majority decision encourages the parties to solve the uncertainty of measuring damages through negotiation as well as enforcing the parties' agreement to the allocation of risk. Furthermore, the criticism of the majority decision on the incentive for delay is spurious. When deciding whether to settle or delay litigation, a rational party will choose to delay only if the expected payoff from the delay exceeds the payoff from immediate settlement. In fact, the majority decision, by reducing the party's expected payoff from the delay, deters the party from prolonging the litigation rather than encouraging it. More importantly, under the rule proposed by the majority, the breaching party has a stronger incentive to disclose their intention to breach. In brief, the majority decision can be justified from an economic perspective.

This article proceeds as follows. A response will be made in Section II to the criticism that the majority decision increases uncertainty; in Section III, it will be shown that the minority decision undermines the risk allocation function of contract. Responses to the criticism of the majority decision on the incentive to delay and the analysis of the breaching party's incentive to disclose the intention to breach will be made in Sections IV and V respectively. Section VI concludes the article.

8 Coote, above n 5, 511; Morgan, above n 5, 265; Reynolds, above n 5, 338.

9 Andrew Burrows, 'Lord Bingham and Three Continuing Remedial Controversies' in Mads Andenas and Duncan Fairgrieve (eds), *Tom Bingham and the Transformation of the Law: A Liber Amicorum* (Oxford University Press, 2009) 589; Qiao Liu, 'The Date for Assessing Damages for Loss of Prospective Performance Under a Contract: *The Golden Victory*' [2007] *Lloyd's Maritime and Commercial Law Quarterly* 273; Qiao Liu, 'Accepted Anticipatory Breach: Duty of Mitigation and Damages Assessment: *The Golden Victory*' [2006] *Lloyd's Maritime and Commercial Law Quarterly* 17; Carter and Peden, above n 5.

10 *Radford v De Froberville* [1977] 1 WLR 1262.

11 *The Bwllfa & Merthyr Dare Steam Collieries (1891) Ltd v Pontypridd Waterworks Co* [1903] AC 426.

12 Burrows, above n 9, 600.

II Uncertainty or resolution of uncertainty

Certainty is, of course, one of the most important values to be pursued and protected by commercial law. Plainly, the legal rules in relation to damages for breach of contract should be designed or modified to minimise uncertainty. Courts can significantly mitigate legal uncertainty by improving the clarity of the law, reducing legal gaps and minimising the risk of legal errors, so that parties know clearly the redresses which are available if others commit a breach. Yet, however hard the courts may try, absolute certainty is unattainable.

It must be acknowledged that the majority decision is associated with some level of uncertainty, because any consideration of future contingencies in the assessment of damages inevitably involves some level of prediction, which is of itself a source of uncertainty. However, the minority decision is not immune from the uncertainty problem. Its supporters argue that the market price rule is more certain, because if damages are measured as the difference between the market price and the contract price at the date of breach, the parties will immediately know the amount of damages as soon as the contract is repudiated. But this claimed merit is more imaginary than realistic, as the market price rule achieves certainty only at the level of rule formulation, not at the level of application.[13] When applying this rule in practice, it does not seem to be as certain and easy as it appears to be in theory.

First, it cannot be guaranteed that the market price can be ascertained, such as in the case of a contract for the sale of unique rather than generic goods, where no market price is available. In this situation, the court is left with no choice but to measure damages in accordance with other legal principles, such as the cost of acquiring the nearest equivalent substitute,[14] the difference between the contract price and the resale price[15] or the diminution in value.[16] For example, in *The Alecos M*,[17] the contract was for the sale of a second-hand ship with a spare propeller, but no propeller was delivered. There was no market for such a propeller and it would have cost US$121,000 to manufacture one. The court held that the buyer was entitled to damages equivalent only to the scrap value of the propeller at US$1,100. Damages were certainly not measured according to the market price rule.

Second, even if there is a market for the goods, it is still not easy for the parties to predict whether the court will apply the market rule. There have been various judicial definitions of 'market'.[18] One example is sufficient to illustrate the complexity of this issue. In *Charter v Sullivan*,[19] the court ruled that no market price was available for the contract to sell a new Hillman car, despite the existence of a market in which a large number of sales of such cars were going on, because the retail price was fixed by the manufacturers. Conversely, on similar facts in *Thompson (WL) Ltd v Robinson (Gunmakers) Ltd*,[20] the court ruled that the retail

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13 Carter and Peden, above n 5.

14 *Hinde v Liddell* (1875) LR 10 QB 265.

15 *The Arpad* [1934] P 189.

16 *Sealace Shipping Co Ltd v Oceanvoice Ltd; The Alecos M* [1991] 1 Lloyd's Rep 120 ('*The Alecos M*').

17 Ibid.

18 Roy Goode, 'The Concept and Implications of a Market in Commercial Law' [1991] *Lloyd's Maritime and Commercial Law Quarterly* 177.

19 [1957] 2 QB 117.

20 [1955] Ch 177.

price for the sale of the Vanguard car, although fixed by the manufacturers, could still be referred to as the market price for the measurement of damages. It is notoriously troublesome to define the market price and it would be harsh to conclude that in practice the market price rule confers more certainty than the majority decision in *The Golden Victory*.

Third, the purpose of the remedy of damages in contract law is compensatory. It is overtly demonstrated that to achieve this aim, courts do not always measure damages at the time of the breach.[21] Not infrequently, damages are measured at some later date.[22] This was explicitly summarised by Lord Wilberforce in *Johnson v Agnew*:

> The general principle for the assessment of damages is compensatory, i.e., that the innocent party is to be placed, so far as money can do so, in the same position as if the contract had been performed. Where the contract is one of sale, this principle normally leads to assessment of damages as at the date of breach — a principle recognised and embodied in section 51 of the *Sale of Goods Act 1893*. But this is not an absolute rule: if to follow it would give rise to injustice, the court has power to fix such other date as may be appropriate in the circumstances. In cases where a breach of a contract for sale has occurred, and the innocent party reasonably continues to try to have the contract completed, it would to me appear more logical and just rather than tie him to the date of the original breach, to assess damages as the date when (otherwise than by his default) the contract is lost.[23]

As illustrated above, the application of the minority decision would not in practice confer more certainty than that of the majority decision. It is true that, by taking account of future contingencies in the measurement of damages, the majority decision involves some degree of uncertainty, but the minority decision is not immune to this problem. The criticism that the majority decision brings uncertainty to commercial law must not be taken too far, since every legal rule is inevitably beset by some level of uncertainty. The more realistic question is not which decision or rule is more certain, but which can better mitigate the uncertainty.

The uncertainty raised in *The Golden Victory* relates to the measurement of damages for the wrongful repudiation of the contract. The cause of this uncertainty is that the method of assessing damages adopted by the majority is unpredictable by the parties, as Treitel argues:

> *The Golden Victory* seems to impair such certainty in two ways. First, it does so with regard to the outcome of the case itself: the shipowners, as it turned out, could not "know where they [stood]" when their right to damages accrued; the value of that right fluctuated in the light of later events for which they were not responsible and which, when the right accrued, were "merely a possibility" and not "inevitable or probable" … Secondly, the case seems to impair, in the sense of failing to promote, certainty with regard to

21 See generally Roy Goode, *Commercial Law* (Penguin, 2nd ed, 1995) 386–400; S M Waddams, 'The Date for the Assessment of Damages' (1981) 97 *Law Quarterly Review* 445.

22 *Miliangos v George Frank (Textiles) Limited* [1976] AC 443; *Worth v Tyler* [1980] AC 367.

23 [1980] AC 367, 400–1.

> future similar cases … it provides no firm guidance for the resolution of future disputes of a similar nature.[24]

There are two ways to abate this uncertainty. First, the court can improve certainty by ignoring or eliminating any uncertain element in the assessment of damages, thereby making the rule more precise, clear and observable to the parties, such as the suggestion in the minority decision that any future contingency must not be considered unless it is 'inevitable'. Second, uncertainty can also be mitigated by the parties themselves. Instead of relying on the measurement of damages by the court, they can agree on a liquidated damages clause for wrongful repudiation to prevent misunderstanding of the rule in relation to the measurement of damages or inconsistency between their prediction and the measurement adopted by the court. It seems that the minority decision favours the first option by assuming that the court, not the contracting parties, should play an active role in calculating damages for breach. It is this assumption which leads many legal scholars to favour the minority decision.

Ideally, damages for breach of a contract should be measured as the aggrieved party's expectation losses, placing the aggrieved party in the same situation in which they would have been had the contract been properly performed.[25] If the court knows better than the parties what the aggrieved party's expectation losses are, it will of course be reasonable to rely on the court's assessment, so ignoring future events in the assessment might then be justified. To calculate the aggrieved party's losses precisely however, the court requires key private information which it would not be easy to obtain, such as the party's subjective value of the contract, the cost to the party of making the contract, the party's expected profit from the contract and the price changes in the relevant market. This information problem means the court is not in a better position than the parties themselves to know the actual expectation losses. The market price rule is far from offering a precise calculation, but is just a proxy for the party's actual expectation losses.

The contracting parties can often measure expectation losses more accurately than the court because of their information advantage. No-one would challenge the contention that, in *The Golden Victory*, the owners knew better than the Court what their own expectation losses resulting from the charterers' wrongful breach was. Rather than relying on the court's assessment, the contracting parties can themselves decide the amount of damages to be paid in the event of breach. The rules for the measurement of damages in contract law are default rules. In other words, they apply only if the parties do not replace them with their own contractual terms. To opt out of the default rules, the parties can agree on a liquidated damages clause. If the contract has such a clause and one party commits a breach, the role of the court is to enforce the clause, without the need to assess damages. A liquidated damages clause can inform both parties more precisely than a default rule of the actual amount of damages to be paid if a breach occurs. A liquidated damages clause is therefore better than the default rule in resolving the legal uncertainty of the measurement of damages.

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24 Treitel, above n 5, 17.

25 *Robinson v Harman* (1848) 1 Ex 850, 855; 154 ER 363, 365.

From an economic perspective, if the cost of negotiating a liquidated damages clause is not unreasonably high, there can be no justification for relying on the court instead of the parties to assess damages. Therefore, when the negotiation costs are not prohibitively high, the legal rule should be designed to facilitate and encourage the use of liquidated damages clauses to resolve the problem of uncertainty.

The law can encourage the parties to negotiate a liquidated damages clause by modifying the default rules for the assessment of damages. Default rules fill the gaps in the contract left intentionally or unintentionally by the contracting parties. A default rule can be designed in two different ways:[26] either in the way preferred by the majority of contracting parties (the majority default rule), or as preferred by only a minority of contracting parties (the penalty default rule). The choice depends on a number of factors, but mainly on transaction cost and information. The majority default rule is preferable for the purpose of minimising transaction costs, because if the default rule is favoured by the majority of contracting parties, it can save most parties' negotiation costs. Consequently, the aggregate of transaction costs in society is minimised. However, if the parties enjoy an information advantage over the court and the goal is to induce them to use their information to improve the precision of the rule, the penalty default rule is preferred, because if the default rule disfavours the majority of the contracting parties, they will have an incentive to replace it with their own contractual terms, then the private information of most contracting parties will be disclosed and used.

Applying this analysis to *The Golden Victory*, the majority decision can be seen as a penalty default rule, inducing parties to negotiate a liquidated damages clause. According to the majority, the assessment of damages for repudiation must take into account any future contingency which will reduce the value of the contract. Under this rule, both parties are uncertain of how the future contingency will be taken into account and of the amount of damages to be awarded. This uncertainty diminishes their reliance on the default rule of damages, thereby creating a strong incentive for them to negotiate a liquidated damages clause.

One might reject the above proposition by arguing that the penalty default rule will not achieve an efficient outcome if there is unequal bargaining power between the parties. No doubt, bargaining power will influence the allocation of contractual rights and duties. If one party enjoys dominant bargaining power, it will be no surprise if the contract is more favourable to that party. However, unequal bargaining power is not a problem peculiar to the negotiation of liquidated damages clauses, but a general problem for all contractual negotiations. It does not seem that this problem is less serious under the market price rule than under the majority decision. As noted above, the rule of damages for breach of contract is a default rule that the parties can agree to displace. If one party has strong leverage, there will be no reason, under the market price rule, for them not to maximise their self-interest by forcing the other party to agree to opt out of the default rule.[27] It would thus seem both inappropriate and ineffective to rely on the default rule of damages to solve the problem of bargaining power. This important problem must be tackled

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[26] Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87.

[27] Thomas C Schelling, 'An Essay on Bargaining' (1956) 46 *American Economic Review* 281.

by other more effective legal techniques, such as the doctrine of duress, competition law and consumer regulations.

Nonetheless, transaction costs will be higher under the majority than the minority decision, because more negotiations may take place. This is an obvious drawback of the majority decision, but no legal rule is costless. The additional transaction costs can be seen as simply the price of achieving a better solution to the problem of certainty. The argument in this article is not that the majority decision in *The Golden Victory* is a perfect rule and absolutely superior to the minority decision, but that the criticism of the former that it generates more uncertainty than the latter is an exaggeration and questionable. Indeed, the majority decision will resolve the uncertainty more effectively and efficiently than the minority's approach. The real question is not which rule is more certain, but whether we intend to adopt a better solution to the problem of uncertainty at the expense of an increase in transaction costs.

III Contract as a risk allocation device

The fundamental difference between the majority and minority decisions in this case is that the minority insisted that the charterers could not rely on the cancellation clause to reduce damages for their wrongful repudiation. Harder supports the minority decision, saying:

> the real question raised by *The Golden Victory* is whether and when there ought to be a cut-off date by which a hypothetical opportunity of lawfully inflicting the victim's loss needs to arise in order to exculpate a wrongdoer. Arguably, the latest cut-off date is the time the victim incurs the loss, subsequent events not affecting liability. For instance, a passenger on a ship who wrongfully damages a part of the ship should arguably not escape liability only because the ship subsequently (but prior to the repair of the damage) gets into an emergency in which the passengers could have lawfully inflicted the same damage in order to save their lives. Likewise, a doctor who wrongfully removes the patient's spleen should arguably not escape liability for the ensuing pain and suffering only because the patient subsequently suffers unrelated injuries which would necessitate the removal of the spleen in order to save the patient's life.[28]

In discussing this issue, the distinction must be drawn between contract-based and non-contract-based cases. The excerpt above seems to be misleading. There are fundamental differences between the two examples given by Harder on one hand and *The Golden Victory* on the other: Harder's two examples are tortious wrongs, which are non-contract-based cases, whereas *The Golden Victory* is a contract-based case. In the former cases, there is no contractual allocation of risk by the parties, so making either the passenger or the doctor liable for the full damage resulting from their tortious wrongs does not affect the parties' incentive to allocate the risk. Conversely, in *The Golden Victory*, the parties intended to allocate the risk via the cancellation clause, so that refusal to consider the cancellation clause in the assessment of damages undermines the risk allocation of contracting.

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[28] Sirko Harder, 'The Exculpation of Repudiating Parties by a Right to Terminate the Contract' (2009) 7 *Journal of Business Law* 679, 688.

From an economic perspective, contract is a risk allocation device.[29] For instance, by agreeing to pay the current market price for goods to be delivered in the future, the buyer shifts the risk of a rise in market price to the seller, while the seller transfers the risk of a drop in market price to the buyer. It is always desirable to allocate the risk to the most efficient risk-bearer. Three criteria can be offered to identify an efficient risk-bearer. Firstly, it can be a person who can avoid the risk at the lowest cost. Secondly, if the parties have different attitudes to the risk, a person who is relatively less sensitive to the risk is a more efficient risk-bearer. Thirdly, the efficient risk-bearer can also be a person who will suffer the least cost from the materialisation of the risk.[30]

Contracting can generate mutual gain for the parties by allocating the risk to the efficient risk-bearer. If one party to the contract enjoys any of the three advantages outlined over the other party, he is the efficient risk-bearing party and his *ex ante* cost of bearing the risk will be lower than that of the other party. Thus, if the risk initially lies with the latter, that party will have the incentive to bribe the more efficient risk-bearing party to bear the risk by paying him an amount between that party's own *ex ante* cost of bearing the risk and that of the efficient risk-bearing party. Assuming away the bargaining problem and transaction costs, such an agreement will generate mutual gain to both parties and will finally be reached. For instance, assume that the parties to a contract for the sale of goods agree that the risk for the goods during delivery should be borne by the buyer and that there is one chance in a thousand that the goods (which are worth £1 million) will be totally lost during delivery. The *ex ante* cost of the risk to the buyer is £1000 ($£1\,000\,000 \times \frac{1}{1000} = £1000$). In other words, the buyer is willing to pay any amount below £1000 to purchase insurance to cover the risk. If it costs the buyer £800, but only £500 for the seller to arrange the identical insurance, the buyer will have an incentive to pay the seller any amount under £800 to bear the risk or, alternatively, to assign to the seller the duty of arranging the insurance. For the same reason, the seller will be willing to arrange the insurance for the buyer on receiving any amount higher than £500. Let us further assume that the seller agrees to bear the risk in return for a payment of £650 by the buyer. Accordingly, each party realises a gain of £150 (£800-£650=£150 for the buyer, and £650-£500=£150 for the seller) and the total gain to society is £300 (the seller's £150 plus the buyer's £150).

The allocation of risk can often take the form of a concession on contractual terms, rather than direct payment of money. Thus, in the above example, the seller, instead of requesting the additional payment of £650, may ask the buyer to arrange a more secure payment of the contract price. If the buyer values the extra cost of the secure payment at less than £800, the buyer will be willing to accept this in return for shifting the risk to the seller. The outcome is equally beneficial to both parties.

However, the effectiveness of risk allocation via contracting is subject to a crucial condition: that the arrangement by the parties must be enforced by the court.[31]

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29 Anthony Ogus, *Costs and Cautionary Tales: Economic Insights for the Law* (Hart Publishing, 2006) 147–51.

30 George G Triantis, 'Unforeseen Contingencies. Risk Allocation in Contracts' in Boudewijn Bouckaert and Gerrit De Geest (eds), *Encyclopaedia of Law and Economics* (Edward Elgar, 2000) vol 3, 100.

31 Schelling, above n 28, 290–1.

If such arrangements are seen as illegal or unenforceable, none of the parties will have an incentive to invest in them. Had the law mandated that the buyer must bear the risk during the delivery, the buyer in the above example would not have been willing to pay the seller in advance for transferring the risk, as the arrangement would not be enforceable. As a result, there would be no guarantee for the buyer that the seller would purchase the insurance or bear the loss if the risk materialised.

The facts in *The Golden Victory* do not suggest that there was duress or inequality of bargaining power during negotiations between the parties. It is reasonable to assume that the cancellation clause was a genuinely voluntary agreement. It is also appropriate to see the clause as a risk allocation arrangement by the parties. It provided that both the owners and the charterers could cancel the charter if war or hostilities broke out between two or more of a number of named countries including the United Kingdom, the United States and Iraq. Plainly, this was an allocation of risk in relation to price fluctuations. It was seen as possible that the outbreak of war would cause a fall in the supply of ships for the voyage to Iraq, leading to an increase in the market rate. In this case, the owners would have a strong incentive to terminate the charterparty and hire out the ship for a higher profit.[32] If, conversely, the outbreak of war led to a reduction in demand for ships because of a decrease in the international trade with Iraq, the market rate would decline. The charterer would then be motivated to terminate the contract and hire another ship at a lower rate. Thus, the cancellation clause allocated the risk of a price increase to the charterers and the risk of a price decrease to the owners. The clause can also be seen as an excuse for non-performance. In other words, both parties agreed that were a war to break out, either would be entitled to terminate the contract to pursue other more profitable alternatives without being liable for non-performance.[33]

The cancellation clause is a partial outcome of the parties' negotiations and must not be considered in isolation. Perhaps, at the time of making the contract, both parties envisaged that the outbreak of war would be likely to drive the market rate up, so the cancellation clause would favour the owners by excusing them from non-performance. In this case it is reasonable to believe that in return for accepting this clause, the charterers should have received some form of benefit, such as a reduction in the price or the inclusion of one or several contractual terms in their favour. Equally, if both parties believed that the outbreak of war would lead to a drop in the market rate, the cancellation clause would have favoured the charterers, so the owners would not have agreed without receiving something in return.

The minority decision amounts to a refusal to enforce such an arrangement. By prohibiting the charterer from relying on the cancellation clause to discount damages, the Court in fact refused to enforce the parties' risk allocation arrangements. The minority decision makes the charterers liable for the owners' losses occurring after the outbreak of the war, notwithstanding that by agreeing to the cancellation clause, each party intended to excuse the other's liability for non-performance if a war was to break out. At the time of making the contract, it is probable that both parties believed that the cancellation clause would benefit the charterers, and that the charterers agreed to increase the rate or to compromise on

32 Furmston, above n 5, 426; McLauchlan (2008), above n 5, 356–60.

33 The termination clause can also be seen as a call for options; see Robert E Scott and George G Triantis, 'Embedded Options and the Case Against Compensation in Contract Law' (2004) 104 *Columbia Law Review* 1428.

other terms in order to obtain the benefit of the clause. The minority decision undermines the parties' incentive to allocate risks in this way, as it makes the charterers' price increase or concession on the contractual terms worthless. Had the charterers known that the Court would not allow them to rely on the cancellation clause, they would not have agreed to the cancellation clause by paying extra or compromising on other contractual terms. The same reasoning applies equally to the situation where the cancellation clause would favour the owners. Clearly, the minority decision impairs the risk allocation function of contract.

IV Incentive to delay settlement: A spurious criticism

The second criticism of the majority decision in *The Golden Victory* is that it creates a perverse incentive for the breaching party to delay settlement.[34] If the court allows a future contingency to reduce damages for wrongful repudiation, the repudiating party may prolong the litigation in the hope that a contingency will materialise, reducing that party's liability. In fact, the same concern was addressed by Lord Carswell's speech, but he was confident that the courts could tackle this problem effectively:

> repudiating parties in future cases might attempt to delay the assessment of damages in order to see if such a suspensive condition might come into operation. I recognise that a risk of that nature may exist, but courts and arbitrators have the ability to prevent such abuse if application is made to them to proceed with dispatch.[35]

Although the risk of delay by a breaching party exists, it seems to be too remote to materialise for three reasons. Firstly, if the breaching party decides on a tactical delay, they must bear the risk that the suspensive event may not occur. Damages in the future may increase rather than decrease. The breaching party will be uncertain whether the delay will in fact reduce the damages to which they are liable, so it cannot be assumed that they have a stronger incentive to delay than to settle.

Second, tactical delay will generate a high cost in terms of legal fees, time and effort expended in waiting. Given the uncertainty and low probability that the suspensive event may occur, it is unlikely that these costs can be outweighed by the benefit derived from a tactical delay. A rational breaching party will not choose to delay settlement.

Third, the breaching party will have the incentive to delay settlement only if the expected value of damages in the future is lower than the actual damages now. For example, if the breaching party settles the litigation now, their liability in damages is £100. But if they delay, there is a 50% chance that damages will be only £50 due to the occurrence of the suspensive event. The expected value of future damages is £75 (£100 x 50% + 50% x £50 = £75), which is lower than the £100 damages for immediate settlement, so the breaching party is made better off by delaying the settlement. Yet, rather than encouraging delay, the majority decision in fact eliminates the breaching party's incentive to delay: by allowing the

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34 Coote, above n 5, 511; Morgan, above n 5, 265; Reynolds, above n 5, 338.

35 *The Golden Victory* [2007] 2 AC 353, 393.

future contingency to reduce damages for wrongful repudiation, it removes the gains to the breaching party from the tactical delay.

Lord Brown said that a future contingency must be taken into account in the assessment of damages, even though it has not yet occurred at the time of assessment. His Lordship said 'account should properly be taken of a contingency which would reduce the value of the contract lost even were the chance of it happening less than 50% …'.[36]

Lord Carswell took this a step further by considering how a contingency should be taken into account:

> If the second Gulf War had not broken out by the time the arbitration was held, the arbitrator would have had to estimate the prospect that it might do so and factor into his calculation of the owners' loss the chance that the charter would be cancelled at some future date under clause 33. *The loss which would have been sustained over the full period of the charter would then have been discounted to an extent which would have reflected the chance, estimated at the time of the assessment, that it would be so terminated.*[37]

The above passages show clearly that the courts are ready to reduce damages for a wrongful repudiation by considering any suspensive event which is agreed by both parties. If Lord Carswell's approach was applied to the above example, damages for which the breaching party is liable would be assessed as the expected value of their future damages, £75 (£100 x 50% + 50% x £50 = £75), rather than the actual damages of £100, thereby making the payoff from the settlement and the delay equal. As a consequence, there would be no incentive for the breaching party to delay. In addition, if we consider the high costs associated with the delay and the probability of the occurrence of the suspensive event outlined above, it is reasonable to expect that the breaching party would be more likely to settle the litigation than delay. In brief, the problem of delay is more theoretical than practical, or as Burrows remarked, 'this is a spurious concern'.[38]

V Encouraging disclosure of the intention to breach

Compared with the minority decision, the majority decision would encourage the breaching party to disclose their intention to breach early. Time is, without any doubt, one of the most valuable assets in the commercial world. In some volatile markets, such as those for stocks or commodity futures, the daily price fluctuations are considerable. Responding promptly to market changes is one of the prerequisites for business success. In a contractual relationship, if one party intends to default on their future obligations, it is always economically desirable for the other party to learn of this intention as early as possible. The earlier the party learns of the other party's intention to breach, the quicker that party can respond and mitigate the losses it will suffer from the breach.

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36 Ibid 395.

37 Ibid 392 (emphasis added).

38 Burrows, above n 9, 600.

According to English contract law, an anticipatory repudiation by one party cannot automatically bring the contract to an end. If one party repudiates the contract before the date of performance, the contract will not be terminated until the other party accepts the repudiation.[39] A game theory analysis will help us understand the economic problem with the law of anticipatory breach. As will be shown, the breaching party under the rule proposed by the majority in *The Golden Victory* has a stronger incentive to disclose its intention to breach than under the rule endorsed by the minority.

Assume that a seller contracts to sell goods to be delivered in the future for £100. It is also agreed that either party can cancel the contract if the United Kingdom declares war against Iraq. Before the date of delivery, the seller decides not to perform the contract. The seller must now decide whether they should inform the buyer immediately of their intention to breach and pay damages for the breach or keep silent until the delivery date and pay damages in the future. Behaving rationally, the seller will choose the course which generates the highest payoff. Let us further assume that the market price at the time of the anticipatory breach is £200 and that there is a 10% chance that the seller will not be liable if they wait, because of the possibility of war between the United Kingdom and Iraq.

According to the minority decision, damages for a wrongful repudiation should be measured as the difference between the market price and the contract price, no account being taken of any future contingency unless it is inevitable. If the seller repudiates the contract and the buyer accepts, damages for the breach will be £100 (£200-£100=£100), while if the seller waits, the expected value of future damages for the breach will be £90 ((£200 - £100) x 90% + £0 x 10% = £90). From the buyer's perspective, if the seller repudiates the contract and the buyer accepts the repudiation, the buyer will receive £100 in damages, but only £90 if the buyer does not accept the repudiation. Both parties' payoffs and strategies are shown in Figure 1.

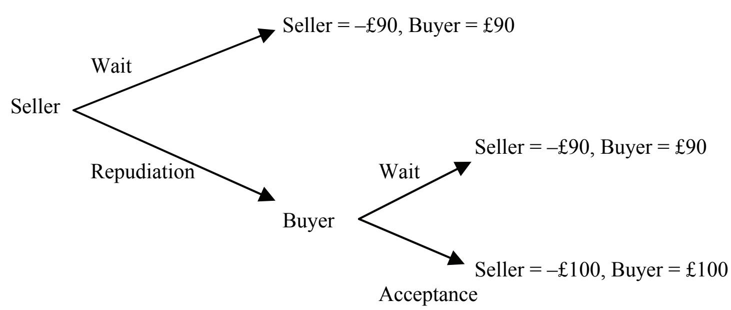

Figure 1

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39 *Fercometal SARL v Mediterranean Shipping Co SA* [1989] AC 788; Q Liu, 'Claiming Damages Upon an Anticipatory Breach: Why Should an Acceptance Be Necessary?' (2005) 25 *Legal Studies* 559; M Mustill, 'Anticipatory Breach of Contract: The Common Law at Work' in *Butterworth Lectures 1989-1990* (Butterworth, 1990) 41; E Tabachnik, 'Anticipatory Breach of Contract' (1972) 25 *Current Legal Problems* 149; A L Goodhart, 'Measure of Damages When a Contract is Repudiated' (1962) 78 *Law Quarterly Review* 263; J W Carter, Andrew Phang and Sock-Yong Phang 'Performance Following Repudiation: Legal and Economic Interests' (1999) 15 *Journal of Contract Law* 97.

Clearly, if the seller repudiates the contract, the best strategy for the buyer is acceptance, as this generates a payoff of £100, which is £10 (£100-£90=£10) more than if the buyer does not accept repudiation. Consequently, the seller's payoff is -£100. But if the seller chooses to wait, the payoff is -£90. Therefore, waiting is the best strategy for the seller. It is implied that under this legal regime the seller will not disclose their intention to breach before the delivery date.

Let us now turn to the analysis of both parties' responses under the rule proposed by the majority, whereby damages for repudiation should be discounted by the possibility that a suspensive event may occur to reduce the value of the contract.[40] Under this rule, if the seller repudiates the contract and the buyer accepts, damages will be £90 $((\pounds 200 - \pounds 100) \times 90\% + \pounds 0 \times 10\% = \pounds 90)$, which equals the seller's payoff from the strategy of waiting. From the buyer's point of view, if the seller repudiates the contract, there is no difference between accepting and not accepting. Both parties' payoffs and strategies are shown in Figure 2.

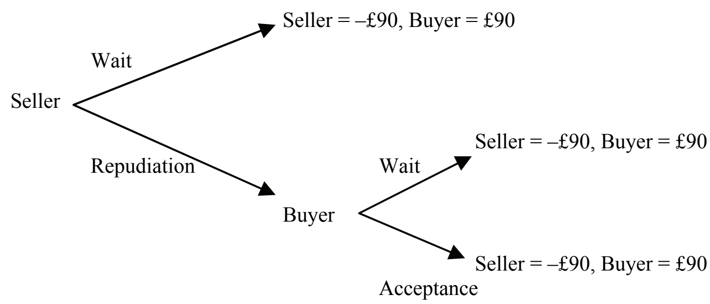

Figure 2

The difference between Figure 1 and Figure 2 is that in Figure 1 the payoffs of the seller and the buyer from the strategies of repudiation and acceptance are -£100 and £100 respectively, while in Figure 2, they are -£90 and £90. Figure 2 shows that, under the majority decision, there is no difference for the seller between repudiating the contract and waiting. Thus, it is reasonable to assume that under the majority decision, some sellers will repudiate the contract by informing the buyer of their intention to breach and some will not. The outcome is superior to the outcome under the minority decision, where no sellers will disclose their intention to breach. Thus, the majority decision is more efficient than the minority decision in terms of encouraging early disclosure of the intention to breach.

VI Conclusion

The remedy of damages for breach of contract modifies both the *ex post* and *ex ante* behaviour of parties. This article has shown that a law-and-economics approach can offer valuable insights into the impact on parties' *ex ante* behaviour of the legal change in damages for repudiation. As claimed in this article, from an *ex ante* perspective, the academic criticisms of the majority decision in *The Golden Victory* are overstated.

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40 *The Golden Victory* [2007] 2 AC 353, 392 (Lord Carswell), 395 (Lord Brown).

First, uncertainty is associated with every legal rule. While the majority decision gives rise to some level of uncertainty, so does the minority decision. But the former creates an incentive for the parties to resolve the uncertainty of damages assessment via negotiation, while the latter relies on the court to solve the problem. As shown in this article, this uncertainty can be mitigated more efficiently and effectively by the contracting parties than by the court.

Second, the majority decision is superior to the minority decision because the latter undermines the risk allocation function of contract. The cancellation clause can be seen as a risk allocation agreement by the parties. Prohibiting the discounting of the charterers' damages by the occurrence of the second Gulf War amounts to refusing to enforce the parties' agreement on risk allocation, thus impairing the risk allocation function of contracting.

Third, the suggestion that the majority decision encourages the breaching party to delay settlement is a spurious one. At least, this risk is too remote to materialise. In fact, by allowing the future suspensive event to discount damages, the majority decision deters, rather than encourages, the delay or prolongation of litigation. In addition, high costs associated with delay and uncertainty over future damages will undermine the breaching party's incentive to delay.

Finally, a game theory analysis shows that, under the rule proposed by the minority, the breaching party has no incentive to disclose their intention to breach in the future, even though it is socially desirable for them to do so. In contrast, under the rule proposed by the majority, the breaching party will not benefit from concealing their intention to breach, so they will have a relatively stronger incentive to inform the other party as early as possible of their intention to breach, and the outcome will be more efficient.