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A New Look at Material Breach in the Law of Contracts

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Every year beginning law students embark on a tour of the basic principles of contract law. The journey may be hurried through a single semester or extended across the entire first year, but inevitably the course encounters the topic of material breach. Inquiring minds want to know the difference between a material breach and any other breach of contract.

The instructor has a ready answer: any breach entitles the victim to a remedy, usually damages. But a *material* breach has additional consequences. It constitutes the nonoccurrence of a constructive condition of exchange, which gives the victim the power to treat the breach as total. The exercise of that power brings the contract to an end, discharges all executory duties of both parties and gives the victim a right to damages in lieu of the future performance of the other.[1] Using the

[1] *See* E. FARNSWORTH, CONTRACTS § 8.15, at 606-08 (1982).

terminology of the Uniform Commercial Code, the victim is entitled to "cancel" the contract.[2]

Some students are not satisfied. They understand that they have been given an explanation of the consequences of a material breach, but not of its substance. They insist on knowing what makes a breach material or not.

The instructor, beginning to feel uncomfortable, responds that "[t]here is no simple test to ascertain whether a breach is material."[3] It depends on "whether on the whole it is fairer"[4] to permit the victim to cancel than not to permit cancellation. "It is always a question of fact, a matter of degree, a question that must be determined relative to all the other complex factors that exist in every instance. The variation in these factors is such that generalization is difficult and the use of cases as precedents is dangerous."[5]

The students persist: surely the law can do better than that. Even if no mathematically precise test for materiality exists, there must be a standard, an approach of some kind that governs so important a question.

The instructor is relieved to direct them to the *First* and *Second Restatements of Contracts*,[6] in which careful attention is devoted to the meaning of materiality. The *Restatements* set out a number of "circumstances" to be considered to determine whether a breach is material. Some students may accept this approach to materiality, especially when assured that scores of courts have dutifully noted or quoted the *Restatement* factors and applied them to resolve disputes. Others are more skeptical; to them the relevant *Restatement* provisions seem enigmatic at best.

Then the students become lawyers and encounter the material-breach case law in practice. Any confidence they may have had that those cases reflect a basic coherence and rationality is likely to be shaken. They soon discover that many courts that purport to follow the *Restatements* actually ignore them when the time comes to decide the materiality question.[7] Others seem to pick and choose among the stated

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[2] U.C.C. § 2-106(4) (1987).

[3] J. CALAMARI & J. PERILLO, CONTRACTS § 11-22, at 459 (3d ed. 1987).

[4] S. WILLISTON, 6 A TREATISE ON THE LAW OF CONTRACTS § 841, at 159 (3d ed. 1962).

[5] A. CORBIN, 3A CORBIN ON CONTRACTS § 704, at 318 (1960).

[6] *See* RESTATEMENT OF CONTRACTS § 275 (1932) [hereafter FIRST RESTATEMENT]; RESTATEMENT (SECOND) OF CONTRACTS § 241 (1979) [hereafter SECOND RESTATEMENT].

[7] *See infra* note 52 and accompanying text.

factors without justifying their choices.[8] Still others do not even attempt to apply the "circumstances" of the *Restatements*, but follow tests under which materiality is simply "a question to be decided on 'the inherent justice of the matter'."[9]

A close look at the relevant *Restatement* provisions makes it difficult to blame the courts for falling into confusion or completely bypassing them. The provisions resemble a list of ingredients rather than a recipe;[10] no real guidance is provided on the order or proportions in which to combine the provisions. Indeed, a careful analysis suggests that some of the *Restatement* factors are substantively irrelevant or misleading as elements of the materiality analysis.[11] In a cynical moment, the lawyer — whether practitioner, jurist, or academic — may wonder whether a paraphrase of Professor Gilmore's quip about the inclusion of section 90 in the *First Restatement* might also apply to the materiality factors in the *Restatements*: An attentive study leads to the despairing conclusion that no one has any idea what the damn things mean.[12]

This Article proposes a new perspective on material breach. It argues that materiality is best understood in terms of the specific purpose of the cancellation remedy that material breach entails. That remedy is designed to secure and enhance the likelihood that *future* duties will be properly performed. It does so by enabling the victim of a breach to acquire elsewhere the performance (or its economic equivalent) of the future duties that were to have been rendered by the other party. A breach should be considered material only when, given the particular facts of the case at hand, the victim needs that ability. Although this perspective does not eliminate doubt or uncertainty, it has the advantage of a simple and internally coherent theory. It remains for the courts to exercise judgment, but by using the approach proposed by this Article the courts are aided by a clear view of the questions they must answer.

This Article begins by examining the traditional material breach doctrine including the important relationship of material breach to constructive conditions of exchange and the conventional understanding of materiality as set out in the *Restatements* and applied by the courts.

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[8] *See infra* note 53 and accompanying text.

[9] Lundberg v. Church Farm, Inc., 502 N.E.2d 806, 814 (Ill. App. 1986) (quoting Leazzo v. Dunham, 95 Ill. App. 3d 847, 850 (1981)).

[10] The comparison is suggested by Matasar, *Rediscovering "One Constitutional Case": Procedural Rules and the Rejection of the* Gibbs *Test for Supplemental Jurisdiction*, 71 CALIF. L. REV. 1399, 1402-03 (1983).

[11] *See infra* part I.B.1.

[12] G. GILMORE, THE DEATH OF CONTRACT 64-65 (1974).

Part II proposes a remedial approach to material breach. It argues that materiality should turn on whether cancellation — the remedy that accompanies a finding of material breach — is necessary to protect the victim's expectation interest. For purposes of the analysis, the expectation interest is divided into two components: (1) the interest in present performance; and (2) the interest in future performance. The cancellation remedy protects only the latter, so the materiality inquiry must focus on that interest. Part II also discusses the proper way to minimize the costs of cancellation for the party in breach. Part III applies the proposed materiality standard in some common factual settings.

I. THE CONVENTIONAL UNDERSTANDING OF MATERIAL BREACH

The idea of material breach is connected with an important and well known concept in contract law — constructive conditions of exchange. Constructive conditions provide a basis for the victim of a breach to withhold its own, remaining performance and to be discharged of all further obligations under the contract. Applying constructive conditions to all breaches often would entail unnecessarily harsh consequences for the party in breach. The purpose of the material breach doctrine is to mitigate that harshness. The doctrine holds, therefore, that a discharge is not available in response to any breach, but only to a material one.

As qualified by the material breach doctrine, constructive conditions of exchange explain the consequences of materiality, but they do not define it. Although the meaning of materiality is the subject of frequent controversy in litigation, its meaning is confused under existing law.

A. Material Breach and Constructive Conditions of Exchange

Any breach of contract by nonperformance gives rise to a cause of action for damages. A damages award is intended to compensate for the injury that the missing or imperfect performance causes. Damages are subject to long-established limitations on recovery such as those based on the foreseeability of the injury caused by the breach[13] and the cer-

[13] *See* Hadley v. Baxendale, 9 Ex. 341, 156 Eng. Rep. 145 (1854) (damages for breach of contract limited to loss reasonably within contemplation of parties at time they made contract as probable result of breach); Spang Indus., Inc., Fort Pitt Bridge Div. v. Aetna Casualty & Sur. Co., 512 F.2d 365, 368 (2d Cir. 1975) ("notice of the facts which would give rise to special damages in case of breach [must] be given at or before the time the contract was made"); Shinrone, Inc. v. Tasco, Inc., 283 N.W.2d 280, 285-86 (Iowa 1979) (allowing recovery for lost profits foreseen by defaulting party at time the parties entered the contract); *see also* SECOND RESTATEMENT, *supra* note 6, § 351, at 135 ("damages are not recoverable for loss that the party in breach did not

tainty with which the extent of the injury can be determined.[14] The damages remedy, however, often is insufficient to protect the victim's interests. The party in breach may be insolvent or likely to disappear before a judgment is collected. The victim's dissatisfaction with damages will be particularly strong if the breach occurs before the victim has performed under the contract. If the only permissible response to the breach were to perform and seek damages for breach, the victim would be required to expend resources for the benefit of the party in breach, who might not later make good the injury caused. Moreover, if the breach occurred before the party committing it had finished performing, the victim might fear that future breaches also would occur if the contract continued in effect.

The position of the victim of the breach in these circumstances is greatly enhanced if the victim is entitled to withhold its own remaining performance and bring the contract to an end. The victim's resources committed to, but not yet expended on, performance then can be used to repair the defective performance and to acquire a substitute for the remaining performance of the party in breach. Constructive conditions of exchange provide the conceptual basis for permitting the victim of a breach to take this course of action. The performance of one party is treated as a condition of the other's duty to perform. The commission of a breach by one side thus prevents the duty of the other from coming due. The constructive condition doctrine permits the victim not only to withhold performance, but to cancel the contract.[15] As indicated by the

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have reason to foresee as a probable result of the breach when the contract was made."); A. CORBIN, 5 CORBIN ON CONTRACTS § 1007, at 70 (1964); E. FARNSWORTH, *supra* note 1, § 12.14, at 873.

[14] An early case explaining this limitation is Griffin v. Colver, 16 N.Y. 489, 491 (1858) ("damages to be recovered for a breach of contract must be shown with certainty;" speculative profits are not recoverable). Since *Griffin*, the certainty requirement has relaxed. *See* Peter Kiewit Sons' Co. v. Summit Constr. Co., 422 F.2d 242, 261 (8th Cir. 1969) (injured party need show damages with "only reasonable certainty, not absolute certainty" and doubts are resolved against the party in breach); King v. King, 507 A.2d 1057, 1060 (Me. 1986) (damages need not be proven with mathematical certainty, but must be supported by evidence of value lost). *See generally* SECOND RESTATEMENT, *supra* note 6, § 352 ("[d]amages are not recoverable for loss beyond amount that evidence permits to be established with reasonable certainty"); A. CORBIN, *supra* note 13, § 1020, at 124 (basis for reasonable estimate of value of harm suffered is required for recovery of damages); E. FARNSWORTH, *supra* note 1, § 12.15, at 881.

[15] The victim is not required to invoke those remedies, of course. One who does so is said to treat a material breach as "total." One who does not is said to treat it as "partial" or immaterial. A. CORBIN, 4 CORBIN ON CONTRACTS, § 946, at 809-13 (1951); E. FARNSWORTH, *supra* note 1, § 8.15, at 606-08; S. Williston, 11 A TREATISE ON THE LAW OF CONTRACTS § 1292, at 8-11 (3d ed. 1962); *see* Sitlington v. Fulton, 281

word "constructive," the parties need not expressly or implicitly agree that one's performance is a condition of the other's duty. The condition relationship is judicially supplied as a matter of public policy.[16]

The facts of *Kingston v. Preston*,[17] the case widely viewed as the effective origin of the constructive conditions of exchange doctrine, illustrates the power of this concept in protecting the victim of a breach. A silk mercer's apprentice agreed to purchase his master's business, including stock in trade, on credit. Payment was to be made in monthly installments. The buyer promised to provide "good and sufficient security"[18] for the purchase price before the seller conveyed the property. When the seller refused to convey, the buyer sued for damages. The seller's defense was that the buyer had failed to provide the promised security. The buyer argued that the seller was free to raise that claim in a separate action for damages, but that it did not excuse the seller's failure to convey the business as promised.

The buyer was correct, of course, that the seller might have brought a separate action seeking damages for breach.[19] But that remedy would have fallen far short of protecting the seller's position under the contract. It probably was precisely because the seller doubted the likelihood of collecting damages in the event of default in payment of the purchase price that the buyer's promise to provide security had been included in the agreement in the first place. The only safe way to protect the seller's interest was to permit him to withhold his own performance if the security were not forthcoming. It was exactly that remedy that was made available by the "dependency" or constructive-condition relationship declared by Lord Mansfield.

Constructive conditions provide powerful protection for the victim of a breach. They may operate harshly, however, on the other party. In some circumstances that harshness obviously is disproportionate to the

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F.2d 552, 555 (10th Cir. 1960).

[16] Corbin championed the use of "construction," which refers only to a judicially assigned legal meaning. He contrasted construction with "interpretation," which is the meaning derived from the parties' agreement. *See* A. CORBIN, *supra* note 5, § 354, at 236. He was influential in the development of the notion of constructive conditions in contracts. *See* Corbin, *Conditions in the Law of Contracts*, 28 YALE L.J. 739 (1919). This general approach to the use of "construction" was followed in Professor Patterson's influential article. *See* Patterson, *Constructive Conditions in Contracts*, 42 COLUM. L. REV. 903 (1942).

[17] Lofft 194, 98 Eng. Rep. 606 (N.D. 1773). The case also is reported in the argument of counsel in Jones v. Berkeley, 2 Dougl. 684, 689, 99 Eng. Rep. 434, 437 (K.B. 1781).

[18] *Jones*, 2 Dougl. at 689-90, 99 Eng. Rep. at 437.

[19] Such an action today probably would take the form of a counterclaim.

good accomplished. If, for example, perfect performance by a builder is a constructive condition of the other party's duty to pay the contract price, then the slightest imperfection in performance will relieve the owner of that duty,[20] even if money damages would fully compensate for the breach and the builder is certain to honor a judgment for such damages. It is precisely to mitigate such harshness that the material breach doctrine has evolved. Thus, while any unjustified failure to perform is a breach of contract, only a *material* failure will constitute the nonoccurrence of a constructive condition of exchange.[21] The doctrine often is stated in the affirmative: a party who "substantially performs" is entitled to the other party's return performance, even though a breach may have been committed for which damages must be paid.[22]

The burden of the material breach doctrine, then, is to qualify — to regulate the potential power of — the doctrine of constructive conditions of exchange.[23] The standards governing material breach should be

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[20] The need to mitigate the harshness of making contractual promises dependent was recognized by Lord Mansfield himself in Boone v. Eyre, 1 H. Bl. 273, note, 126 Eng. Rep. 160(a) (K.B. 1777), four years after *Kingston* was decided. *See infra* text accompanying note 69.

[21] *See* E. FARNSWORTH, *supra* note 1, § 8.12, at 590-91; A. CORBIN, *supra* note 5, § 946, at 811.

[22] *See* E. FARNSWORTH, *supra* note 1, § 8.12, at 590-91, § 8.15, at 606-611; A. CORBIN, *supra* note 5, § 700, at 308-311.

[23] As powerful a tool as constructive conditions are, they suffer from at least one important conceptual weakness. It is axiomatic that "one party's duty to perform cannot be conditional or dependent on the other party's rendering a performance that is to come at a later time." E. FARNSWORTH, *supra* note 1, § 8.9, at 581-82. A limited exception may exist in the sense that a delay by one party until the time for the other's performance, even though the former should have performed first, may permit the duty of the former to be constructively conditioned on the performance of the latter. *Id.* § 8.11, at 587; SECOND RESTATEMENT, *supra* note 6, § 234 comment d. The delay, of course, must not itself amount to a material breach that itself is treated as total.

The order of performance rule makes constructive conditions theoretically inapplicable to cases in which, at the time a breach occurs, the victim already has performed fully. Thus, if an owner pays for construction work in advance, the owner's duty to pay cannot be a constructive condition of the builder's performance. Similarly, a lender's duty to advance a loan cannot be conditioned upon the debtor's timely repayment.

The order of performance in these cases has important implications for the material breach doctrine. Because material breach is a refinement of the concept of constructive conditions, if a constructive condition cannot exist, then strictly speaking a material breach cannot occur. To the extent that the cancellation remedy is the province of the constructive condition concept, that remedy would be unavailable to the owner, who would not be entitled to fire the builder for even the most serious breach of contract. Nor would it be available to the lender who (if the agreement lacked an acceleration clause) would be unable to declare the entire outstanding amount of the loan due and

capable of screening out those breaches of contract for which cancellation is the appropriate remedy from those in which it is not.

B. The Meaning of Materiality

The material breach doctrine is primarily an element of the common law.[24] Judicial opinions therefore are the most authoritative source for discovering the conventional meaning of materiality. The *First* and *Second Restatements* have produced the most widely acknowledged standard of materiality, however, and have been followed by many courts.

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payable immediately, even in response to a complete repudiation by the debtor. The need of the owner or the lender to bring the contract to an end, however, would be no less than if that party had duties yet to perform.

Section 316 of the *First Restatement* and § 243(3) of the *Second Restatement* acknowledge that one in the position of the lender is not permitted to cancel. The comments in both documents, however, reflect discomfort with the possible injustice of the result. *See* FIRST RESTATEMENT, *supra* note 6, § 316 comment a; SECOND RESTATEMENT, *supra* note 6, § 243 comments c, d. The comments in the *Second Restatement* go so far as to suggest that the black-letter rule might be ignored to avoid "manifest injustice." *Id.* § 243 comment d.

The owner's problem with the errant builder might be covered by § 243(4) of the *Second Restatement*, which creates a rule for "residual" cases not covered by the constructive condition concept. *See id.* § 243 comment e. The illustrations given in connection with this section make clear that the drafters were concerned about precisely the situation in which the victim of a breach already had performed fully. *Id.* § 243 comment e, illustrations 6, 7.

Section 243(4) proposes that, when "it is just in the circumstances," damages for total breach — the damages that accompany the cancellation remedy and entail a discharge of all duties under the contract (except those that are severable or made independent by agreement, see *id.* § 236, comment b) — be made available in "any case other than those stated in the preceding subsections." Those subsections are tied by both the text and the official commentary to the constructive condition and material breach concepts. *See id.* § 243(1) and comment a.

These illustrations reveal an important weakness in the constructive condition concept as the medium for the cancellation remedy. That concept fails to make the remedy available in an important class of cases in which it clearly may be needed. No doctrinal device is perfect, of course, but the need to resort directly to notions of justice to avoid the clear implications of an established doctrine at least suggests the need for a close look at whether the conventional understanding of the doctrine is equal to the tasks required of it.

[24] The notion of materiality is, however, incorporated into statutory contract law in important ways. For example, U.C.C. § 2-612 requires that a breach "substantially impair the value" of an installment or the entire contract before rejection is permitted under an installment contract for the sale of goods. This provision is discussed *infra* note 205.

An inquiry into what makes a breach material appropriately begins with them.

1. Material Breach in the *Restatements*

The *First Restatement* was heavily influenced by the work of its reporter, Professor Williston. That influence is manifested clearly in the material breach provisions.[25] Williston framed the materiality issue in terms of this question: "whether on the whole it is fairer to allow the plaintiff [party in breach[26]] to recover [on the contract], requiring the defendant [victim] to bring a cross action or counterclaim for such breach of contract as the plaintiff may have committed, or whether it is fairer to deny the plaintiff a right of recovery on account of his breach, even at the expense of compelling him to forfeit any compensation for such part performance as he has rendered."[27] Williston thus saw comparative fairness as the guiding principle. He went on to discuss a number of factors that seemed relevant to fairness, such as the extent one party had performed prior to committing the breach, the benefit which the victim derived from that part performance, whether the breach consisted of tardiness as opposed to defective performance, and the seriousness of the injury to the victim.[28]

Given Williston's approach to the material breach issue, it is not surprising that the *First Restatement* dealt with the matter with a list of factors to be taken into account in the analysis. Sections 275 and 276 identify a number of "circumstances" as relevant to the question whether a breach of contract is material.[29] Sections 241 and 242 of the

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[25] *Compare* FIRST RESTATEMENT, *supra* note 6, § 275 comment a *with* 6 S. WILLISTON, *supra* note 4, § 841, at 1610.

[26] The quoted statement is given in the context of a discussion of the "substantial performance" doctrine. The one committing the breach is identified as the plaintiff because, as is typically the case when substantial performance is in issue, that party seeks to recover the unpaid portion of the contract price, while the victim is the defendant resisting that payment.

[27] S. WILLISTON, *supra* note 4, § 841, at 1610.

[28] *Id.* §§ 841-868, at 1610-65.

[29] FIRST RESTATEMENT, *supra* note 6, §§ 275, 276 provide:

> § 275. Rules for Determining Materiality of a Failure to Perform.
>
> In determining the materiality of a failure fully to perform a promise the following circumstances are influential:
>
> (a) The extent to which the injured party will obtain the substantial benefit which he could have reasonably anticipated;
>
> (b) The extent to which the injured party may be adequately compensated in damages for lack of complete performance;
>
> (c) The extent to which the party failing to perform has already partly performed or made preparations for performance;

Second Restatement continue to reflect the influence of Williston's thinking on the subject of material breach. The basic list-of-factors approach to materiality is the same, although some of the circumstances specified as relevant have been changed significantly.

Despite their distinguished pedigree, the *Restatement* factors fall seriously short of providing a workable definition of materiality. Their most obvious failing is the absence of any guidance on their relative priorities or on how to combine them. The *Restatements* fail to identify an underlying, unifying principle more specific than "fairness" or "justice" — which, of course, is where Professor Williston began. Fairness

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(d) The greater or lesser hardship on the party failing to perform in terminating the contract;
(e) The willful, negligent or innocent behavior of the party failing to perform;
(f) The greater or less uncertainty that the party failing to perform will perform the remainder of the contract.

§ 276. Rules for Determining Materiality of Delay in Performance.

In determining the materiality of delay in performance, the following rules are applicable:

(a) Unless the nature of a contract is such as to make performance on the exact day agreed upon of vital importance, or the contract in terms provides that it shall be so, failure by a promisor to perform his promise on the day stated in the promise does not discharge the duty of the other party.
(b) In mercantile contracts performance at the time agreed upon is important, and if the delay of one party is considerable having reference to the nature of the transaction and the seriousness of the consequences, and is not justified by the conduct of the other party, the duty of the latter is discharged.
(c) If delay of one party in rendering a promised performance occurs before any part of his promise has been rendered, less delay discharges the duty of the other party than where there has been part performance of that promise.
(d) In contracts for the sale or purchase of land delay of one party must be greater in order to discharge the duty of the other party than in mercantile contracts.
(e) In a suit for specific performance of a contract for the sale or purchase of land, considerable delay in tendering performance does not preclude enforcement of the contract where the delay can be compensated for by interest on the purchase money or otherwise, unless
  (i) the contract expressly states that performance at or within a given time is essential, or
  (ii) the nature of the contract, in view of the accompanying circumstances, is such that enforcement will work injustice.

and justice are not empty concepts, but unaided by a more specific theory of materiality they cannot provide anything close to the sense of certainty or predictability that is important to both the formation of agreements and the resolution of contract disputes.

When the *Restatement* factors are considered individually, their contribution to a workable materiality standard is marginal at best. This Article is not the place for a thorough critique of the relevant *Restatement* provisions, but a brief look at sections 241 and 242 of the *Second Restatement* reveals why they have not produced a practicable approach to materiality.[30] Section 241 reads as follows:

> In determining whether a failure to render or to offer performance is material, the following circumstances are significant:
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> (a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
> (b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
> (c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
> (d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurance;
> (e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

Courts have cited widely subsection (a)[31] and its close counterpart in

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[30] Sections 241 and 242 are not framed in terms of breach of contract, but rather of failure to perform. The latter phrase encompasses the notion of breach, but extends as well to failures to perform that are justified by such doctrines as impracticability or frustration of purpose. *See* SECOND RESTATEMENT, *supra* note 6, §§ 237, 267. The same applies to FIRST RESTATEMENT, *supra* note 6, §§ 275, 276; *see also id.* § 274 and accompanying comments on subsection (2). This Article's discussion of the relevant *Restatement* provisions is limited to their application to cases in which the failure to perform is a breach of contract.

[31] *E.g.*, Dr. Franklin Perkins School v. Freeman, 741 F.2d 1503, 1518 (7th Cir. 1984) (citing SECOND RESTATEMENT, *supra* note 6, § 241(a)); Greyhound Lines, Inc. v. Bender, 595 F. Supp. 1209, 1224 (D.D.C. 1984) (same); Oak Ridge Constr. Co. v. Tolley, 504 A.2d 1343, 1348 (Pa. Super. 1985) (same); *In re* Bisio, 33 Or. App. 325, 331, 576 P.2d 801, 804 (1978) (citing FIRST RESTATEMENT, *supra* note 6, § 275(a)); Schlein v. Gross, 186 Pa. Super 618, 625, 142 A.2d 329, 333 (1958) (same); Jennings v. League of Civic Org., 180 Pa. Super. 398, 403, 119 A.2d 608, 611 (1956) (same); Advance Components, Inc. v. Goodstein, 608 S.W.2d 737, 739-40 (Tex. Civ. App. 1980) (same); *see also* Ferrell v. Secretary of Defense, 662 F.2d 1179, 1181-82 (5th Cir. 1981) (citing both FIRST RESTATEMENT, *supra* note 6, § 275(a) and SECOND RESTATEMENT, *supra* note 6, § 241(a)); Circle Sec. Agency, Inc. v. Ross, 107 Ill. App. 3d 195, 202, 437 N.E.2d 667, 672 (1982) (same).

the *First Restatement.*[32] Subsection (a) recognizes the victim's claim to the protection of the expectation interest. Referrence to the extent to which the victim is deprived of the expected benefit invites inquiry into the breach's seriousness. The issue, of course, is how seriousness is to be measured. An intuitive response to the problem is to compare the magnitude of the loss caused by the breach to the contract price. Comment b to section 241, while claiming that the comparison may be relevant, correctly warns against making much of it. It notes that the magnitude of the loss in cases in which material breach traditionally has been found varies from the trivial to the severe, according to the factual setting involved. No other method of approaching or conceptualizing the notion of seriousness is proposed, suggesting that subsection (a) has no substantive content of its own, but rather depends for its efficacy on the other factors.

Subsection (b) appears to come to the aid of subsection (a) by making "the extent to which the [victim] can be adequately compensated" for the deprivation of benefit a factor in the materiality analysis. The *First Restatement*'s counterpart, section 275(b), is similar.[33] In a general sense, of course, lack of compensation for a loss caused by a breach is connected with the problem of seriousness: the less adequate the compensation, the more severe the net effect of the breach. The compensation factor must mean more than this, however. Observing that inadequate compensation deprives the victim of the benefit of the bargain does not provide an answer to the question of how serious the deprivation must be to support a finding of materiality. The official explanations of the compensation factor have not shown that it can contribute significantly to the materiality analysis. On the contrary, the explanations suggest that, at best, it is largely irrelevant to the mainstream of cases in which material breach is in issue.

Under the *First Restatement* a breach tends to be material if the victim ordinarily would be entitled to compensation in the form of specific relief, but under the circumstances that remedy is impossible.[34] It

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[32] FIRST RESTATEMENT, *supra* note 6, § 275(a).

[33] *See supra* note 29.

[34] The best clue about the meaning of § 275(b) in the *First Restatement* is its accompanying illustration 3, which deals with a contract for the sale of land. Before the property is transferred, the seller removes something of value from the property that was to be included in the deal. According to the illustration, if the thing removed was "a small building of ordinary construction," the breach is not material because "[t]his breach of duty can be adequately compensated by damages." By contrast, if some large, ornamental trees were cut down, the buyer "could not [be] adequately compensated in damages and [the breach] would be material." FIRST RESTATEMENT, *supra* note 6, § 275(b), at 402.

may be entirely appropriate to cancel a contract in such a case. Unfortunately, that observation is of little use in the vast majority of contract disputes about material breach, which do not raise that particular issue. The *First Restatement* has nothing better to offer. The compensation factor as presented fails to carry its own weight as an integral part of the materiality analysis.

The *Second Restatement* suggests a very different rationale for the compensation factor, illuminated by only a short, explanatory comment.[35] The comment's thrust is that compensation may be inadequate if the victim is unable to satisfy the certainty requirement for recovery of damages.[36] Thus, if the full extent of the victim's actual loss cannot be proven with sufficient certainty to justify monetary damages, cancellation should be available as a substitute.[37]

At least two questions about this justification for the compensation factor immediately come to mind. First, the certainty requirement presumably is justified in its own right as a limitation on damages for breach of contract. If so, it is not clear why cancellation should be available in place of compensatory damages when the requirement is not satisfied. If the certainty requirement is indefensible or in need of reform it should be abandoned or modified rather than circumvented by the material breach doctrine.

The second problem with the certainty-based justification for the compensation factor parallels the objection to the *First Restatement*'s rationale. Even if that justification is valid, it applies to only a small fraction of the cases in which materiality is in issue. The *Second Restatement* fails to explain why inadequate compensation due to uncertainty of loss should be of general concern to the problem of identifying a material breach.[38]

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[35] SECOND RESTATEMENT, *supra* note 6, § 241 comment c.

[36] *See supra* note 14 and accompanying text.

[37] The point is made most clearly if the victim is assumed to be the defendant who is sued by the party in breach seeking to recover the unpaid contract price on a substantial performance theory. *See* E. FARNSWORTH, *supra* note 1, § 8.12, at 592-93. The argument is that if the victim's counterclaim for compensatory damages is infected with uncertainty, the court can protect the victim by discharging the obligation to pay the remainder of the contract price.

[38] A third reading of the compensation factor is possible, although it is not advanced in either *Restatement*. Perhaps a breach by nonperformance should be considered material if the victim is unlikely to be compensated adequately because the party in breach is "judgment proof." There may be merit in the notion that the victim should have the extra security of withholding its own performance if a judgment requiring the party in breach to pay damages is unlikely to be satisfied. But targeting the compensation factor

Subsection (c) shifts the focus from the victim of the breach to the party committing it. It recognizes that even one who breaches a contract has a claim to the law's protection, particularly when a reliance interest is at stake. The factor suggests that the greater the forfeiture that cancellation causes the party in breach, the less the likelihood that the breach is material.[39] Contract law has a fundamental concern with the effect of its remedies on the party in breach.[40] That concern is properly raised in connection with the materiality analysis. For reasons explained elsewhere in the Article, however, the costs of cancellation to the party in breach should not act as a direct counterweight to the factors that do legitimately bear on a finding of materiality.[41] The forfeiture factor relates to an important idea in the theory of material breach, but the *Restatement* does not position the idea correctly within the materiality analysis.

Subsection (d) and its accompanying comment[42] suggest that cure and assurances of future performance by the party in breach cut against a finding of materiality. As discussed below, that conclusion is correct.[43] The relevance of cure to materiality becomes apparent, however, only against the backdrop of a defensible theory underlying material breach. Unfortunately, section 241 as a whole presents no such theory.[44]

Under subsection (e), the final factor listed in section 241, a breach is more likely to be material if the behavior of the party in breach comports with "the standards of good faith and fair dealing," and vice versa. The inclusion of good faith was part of a deliberate strategy to

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on the specific problem of the insolvent defendant does not justify it as a main component of the general materiality analysis.

[39] The *First Restatement*'s counterparts are § 275(c)-(d). *See supra* note 29.

[40] *See infra* part II.A.

[41] *See infra* part II.E.

[42] SECOND RESTATEMENT, *supra* note 6, § 241 comment e.

[43] *See infra* part III.A.1.b.

[44] SECOND RESTATEMENT, *supra* note 6, § 241(d) has no close parallel in the *First Restatement*. Rather, it appears to have been a replacement for FIRST RESTATEMENT, *supra* note 6, § 275(f). *See supra* note 29, a provision of considerable interest for the analysis presented in this Article. Section 275(f) finds importance in "[t]he greater or less uncertainty that the party failing to perform will perform the remainder of the contract." The close connection between this provision and the thesis of this Article as developed in part II is obvious. Unfortunately, § 275(f) never became an important part of material-breach analysis. Had it done so, it might have gone far toward steering the law of material breach in a more profitable direction. The courts have routinely quoted it as part of § 275, and occasionally an opinion appears to have applied it to good effect. *See* Goff v. Graham, 306 N.E.2d 758, 765 (Ind. App. 1974). Its substance largely has been ignored in favor of the other provisions of the *First Restatement*.

eliminate references in the *First Restatement*[45] to the willfulness of the breach.[46] As discussed below,[47] the state of mind of the party in breach can be relevant to materiality. However, the reference to good faith in section 241 does not significantly advance the materiality analysis because no general consensus exists about the meaning of that term[48] and because of the lack of a general theory of materiality within which good faith can operate.

Section 242 of the *Second Restatement*[49] deals specifically with the problem of delay, raising two general issues. The first is the relevance of delay to the materiality of a breach. The second issue is cure, in particular the length of time the victim must wait before cancelling the contract.[50] The materiality issue is the most important for present purposes. Section 242's approach is to incorporate by reference all of the factors listed in section 241. It thus correctly recognizes that there is no reason not to consider the materiality of a breach by delay under the

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[45] *See, e.g.*, FIRST RESTATEMENT, *supra* note 6, § 275(e).

[46] *See infra* note 159.

[47] *See infra* part III.A.1.a.

[48] That lack of consensus exists despite, or perhaps because of, a growing body of scholarship on the subject of good faith. *See* Andersen, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299, 300 (1988).

[49] SECOND RESTATEMENT, *supra* note 6, § 242 states:

> In determining the time after which a party's uncured material failure to render or to offer performance discharges the other party's remaining duties to render performance under the rules stated in §§ 237 and 238, the following circumstances are significant:
>
> (a) those stated in § 241;
>
> (b) the extent to which it reasonably appears to the injured party that delay may prevent or hinder him in making reasonable substitute arrangements;
>
> (c) the extent to which the agreement provides for performance without delay, but a material failure to perform or to offer to perform on a stated day does not of itself discharge the other party's remaining duties unless the circumstances, including the language of the agreement, indicate that performance or an offer to perform by that day is important.

[50] It is not immediately apparent from the text of § 242 that cure is central to the provision. But the importance of cure is emphasized in comment a to that section. It also was emphasized by the Reporter in his remarks to the American Law Institute. American Law Institute, 50th Annual Meeting Proceeding — 1973, 221-23 (1974). The *Second Restatement*'s treatment of both the materiality and the cure facets of delay has been criticized for failing to deal with these two problems separately. Lawrence, *Cure After Breach of Contract Under the Restatement (Second) of Contracts: An Analytical Comparison with the Uniform Commercial Code*, 70 MINN. L. REV. 713, 735-51 (1986).

same analysis that applies to other breaches of contract. Section 241, however, does not create an adequate framework for that analysis.[51]

2. Judicial Application of the Material Breach Doctrine

Not surprisingly, the courts have struggled when attempting to use the *Restatements* to decide whether a breach of contract is material. The absence of a unifying theory or concept of materiality usually derails the analysis before the destination is reached. Some courts part company with the *Restatements* soon after the journey begins. They cite or quote the relevant sections of one or both *Restatements*, but ignore them in the actual analysis of materiality, either applying some other test or failing to articulate a standard at all.[52] Other courts appear

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[51] The *First Restatement*'s provision on delay, § 276, is devoted largely to a description of the effects of delay in two particular kinds of contracts: those for the sale of goods and those for the sale of land. It stresses the greater importance of timely performance in most mercantile contracts, as compared with those for the sale of real estate. *Compare* FIRST RESTATEMENT, *supra* note 6, § 276(b) *with id.* § 276(d)-(e). It also alludes to the relevance of forfeiture by the party in breach, see *id.* § 276(c), a topic discussed later in this Article. *See infra* part II.E.

Although the points made in § 276 about the importance of delay in mercantile versus land contracts may be roughly accurate, they either have little to do with the materiality issue or are remarkably vague and fail to suggest either a theoretical or a practical basis for approaching materiality. As discussed *infra* note 205, cancellation following an imperfect tender of goods (which includes a tender that is imperfect by its tardiness, Marlowe v. Argentine Naval Commission, 808 F.2d 120, 124 [2 U.C.C. Rep. Serv. 2d 1226, 1231] (1986); June G. Ashton Interiors v. Stark Carpet Corp., 142 Ill. App. 3d 100, 106, 491 N.E.2d 120, 124, [2 U.C.C. Rep. Serv. 2d 74, 80] (1986)) does not depend on the materiality of the breach. Thus, the observation that untimely tender is likely to lead to discharge in contracts for the sale of goods, see FIRST RESTATEMENT, *supra* note 6, § 276(b), does not teach much about the nature of materiality. On the other hand, saying that in land sale transactions a delay "must be greater in order to discharge the duty of the other party than in mercantile contracts," *id.* § 276(d), fails to provide any basis for relating the extent of delay or the harm it causes to a finding of materiality.

[52] In Greyhound Lines, Inc. v. Bender, 595 F. Supp. 1209 (D.D.C. 1984), for example, the property owner and a contractor each claimed that the other had materially breached an agreement for a major construction project. The court quoted *Second Restatement* § 241, at 237, in full as a materiality standard. *Id.* at 1224. Thereafter, in its rather extensive discussion of the materiality issue, the court never again refers to § 241. The court also quoted three additional materiality factors from an excerpt from J. CALAMARI & J. PERILLO, *supra* note 3, which are similar to parts of *First Restatement* § 275. It then added: "A breach which actually prevents further performance of the contract or provides a valid defense for a party's failure to continue performance would be considered material." The latter statement is not attributed to another authority. The court apparently did not consider whether these standards from various

to organize their materiality analysis around one or more of the *Restatement* factors, but fail to apply them in a meaningful way.[53] Still others make a serious attempt to apply one of the *Restatements*, perhaps reaching a correct result, but losing sight of the forest of materiality for the trees of the individual factors.[54]

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sources could be made to operate harmoniously together. *Greyhound*, 595 F. Supp. at 1226-30; *see also* Ferrell v. Secretary of Defense, 662 F.2d 1179, 1181-82 (5th Cir. 1981) (citing *First Restatement* § 275, at 402-03, and *Second Restatement* § 241, at 237, but defining materiality in terms of "whether the injured party has received substantially what he bargained for in spite of the breach."); Circle Sec. Agency, Inc. v. Ross, 107 Ill. App. 3d 195, 202, 437 N.E.2d 667, 672 (1982) (citing *First Restatement* § 275, at 402-03, and *Second Restatement* § 241, at 237, but making no reference to them in analysis); Cowman v. Allen Monuments, Inc., 500 S.W.2d 223, 225 (Tex. Civ. App. 1973) (quoting *First Restatement* § 275, at 402-03, in full, but ignoring it in analysis).

[53] An example is Baith v. Knapp-Stiles, Inc. 2 Mich. App. 305, 139 N.W.2d 781 (1966), in which the court held that a subcontractor's failure to apply progress payments to its payroll obligations as agreed was a material breach. The court quoted *First Restatement* § 275 in its entirety, then applied it with a series of one-sentence conclusions corresponding to each of the subsections of § 275. Several of those conclusions mask complex issues that the court completely ignored or overlooked. For example, the court concluded: that the general contractor "obtains no substantial benefit [from the subcontractor's part performance] until the work has been completed"; that "[t]he only adequate compensation for [the general contractor] is completion of the work"; and that "[t]he behavior of [the subcontractor] was wilful." *Id.* at 310, 139 N.W.2d at 784. As a factual matter, it is difficult to see why the subcontractor's apparently proper part performance of the work was of no substantial benefit to the general contractor. There is no explanation of why money damages could not compensate for the subcontractor's breach. The complexity and confusion inherent in the willfulness issue is discussed *infra* part III.A.1.a.; *see also* Hunt v. Salon De Coiffures, 3 Ohio Misc. 2d 5, 444 N.E.2d 488, 491-92 (Akron, Ohio Mun. Ct. 1982) (cursory references to *Second Restatement* §§ 241(a), (c), the former being applied to the wrong party) (dictum or alternative holding).

[54] In Oak Ridge Construction Co. v. Tolley, 504 A.2d 1343 (Pa. Super. 1985), a property owner and a contractor constructing a new residence disputed the latter's charges for the drilling of a water well on the property. The court, first concluded that the owner had not anticipatorily breached by withholding payment of the disputed charges, then turned to the question whether the contractor materially breached by walking off the job in response to that withholding. The court quoted *Second Restatement* § 241 in full and discussed each of its subparts. (Apparently the court misunderstood § 241(b); the court seems to conclude that the availability of adequate compensation for the victim *supports* a finding of materiality. *Id.* at 1348.) The conclusion that the breach was material is obviously correct. One should not have to comb through the *Restatement* factors, however, to conclude that a builder who unjustifiably refuses to continue work when major parts of the construction remain to be done has committed a material breach. The court's discussion of the *Second Restatement* adds no clarity to its analysis.

There are, of course, cases in which most or all of the *Restatement* factors, when carefully applied, point clearly to one result in what appears to be a close case.[55] It cannot be said, however, that the *Restatements* have provided a workable approach to material breach. The lack of an underlying theory of materiality is fatal to attempts to organize and manage the analysis when the various *Restatement* factors point in inconsistent directions or have no apparent application at all.

Some courts take a different tack. They displace or ignore the *Restatement* factors, relying instead upon statements such as that "[materiality] is to be decided on 'general principles based upon the inherent justice of the matter,' "[56] or that a material breach "goes to the root of the bargain of the parties and defeats [their] object . . . in making the agreement."[57] Other courts rely upon convoluted tests for materiality taken from legal encyclopedias.[58] Still other courts characterize materiality as a question of fact.[59] Courts taking that route perhaps overlook the necessity of an instruction to a jury charged with finding that fact.

An "essence of the contract" approach to materiality, of course, is even less useful than Professor Williston's resort to fairness as the guiding principle. The "essence" approach acknowledges, at least implicitly, that materiality as conventionally understood is inexorably obscure and can be applied only through a gut-level judgment about how a particular case should be decided. Professor Corbin insisted that material breach should be approached only in this way.[60] Thus, for Corbin, whether a breach is material "is a question of degree; and it must be answered by weighing the consequences in the light of the actual custom of men in the performance of contracts similar to the one that is

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[55] *See, e.g.*, Formigli Corp. v. Fox, 348 F. Supp. 629, 645-46 (E.D. Pa. 1972) (subcontractor that failed to complete or imperfectly completed a number of relatively minor tasks had substantially performed).

[56] Hanson v. Duffy, 106 Ill. App. 3d 727, 732, 435 N.E.2d 1373, 1378 (1982) (quoting Leazzo v. Dunham, 95 Ill. App. 3d 847, 850, 420 N.E.2d 851, 854 (1981)).

[57] Silliman Co. v. S. Ippolito & Sons, Inc., 467 A.2d 1248, 1251 (Conn. App. 1983).

[58] *See* Standard Millwork & Supply Co. v. Mississippi Steel & Iron Co., 38 So. 2d 448, 450 (Miss. 1949).

[59] *See* Jim Arnott, Inc. v. L & E, Inc., 539 P.2d 1333, 1336 (Colo. Ct. App. 1975).

[60] A. CORBIN, *supra* note 5, § 704, at 318-20. Professor Corbin inveighed against attempts to generalize or conceptualize about material breach:

> It is not necessary to go astray into a feckless logomachy. Without knowing how to define a "fact," or a "rule of law," it is possible to work out a practical system of justice by which men can live, keeping our stumbling feet in the ploughed fields and not blinding our eyes by metaphysical clouds.

Id. at 319-20.

involved in the specific case."[61]

The raw honesty of that perspective on material breach — the admission that attempts to generalize have failed — has a certain appeal. What it cannot do, of course, is provide practical guidance. Perhaps a Professor Corbin or a common-law judge of long tenure has sufficient experience to intuit the essence of materiality without the aid of theory, but the persons who most need to know what a material breach is — those who must decide or advise on a course of action when a commercial transaction goes awry — do not. It is they who must judge whether cancelling a contract is justified as a response to a breach, or whether the cancellation will bring down liability on their own heads. To so important a question the law owes a better answer than the incoherence of the *Restatement* factors, the vagueness of an "essence of the contract" test, or the intuitive, rough justice Professor Corbin would administer. No materiality standard can eliminate all doubt or uncertainty, but the development of a simple, coherent approach to the subject would be an important step forward.

II. A Remedial Approach to Material Breach

Material breach is best understood on the basis of the cancellation remedy it invokes.[62] Remedies for breach of contract are subject to, or at least influenced by, a number of important policies. A primary policy is to protect the victim's expectation interest without imposing unnecessary costs on the party in breach. A useful approach to material breach emerges when the cancellation remedy is examined in light of that policy.

For present purposes, the contractual expectation interest may be understood as consisting of two distinct components. This Article refers to them as the *interest in present performance* and the *interest in future performance*. The purpose and effect of the cancellation remedy is to protect the interest in future performance, not the interest in present performance. In keeping with remedial policy, the cancellation remedy should be made available — that is, a breach is material — only when that remedy would protect the victim's interest in future performance without imposing unnecessary costs on the other side.

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[61] A. Corbin, *supra* note 15, § 946, at 809.

[62] I am indebted to my colleague, Steven J. Burton, for stimulating my thinking about the important connection between materiality and the policies underlying contract remedies.

A. Material Breach and Remedial Policy

Characterizing a breach of contract as material is equivalent to saying that the cancellation remedy, in addition to compensatory damages, should be made available to the victim of the breach. That remedy includes the power to withhold one's own performance for the period (if any) during which cure is permitted, and thereafter to bring the contract to an end, discharging the remaining duties of both parties. Thus, if a builder pours a defective foundation for a new house, and the breach is considered material, the owner has not only a cause of action for the damages to remedy the defective work, but also the power to fire the builder and a right to damages in lieu of the future work the builder will not be permitted to perform. When the owner takes advantage of that power and seeks those additional damages, the material breach has been treated as total.

Materiality is most usefully approached by focusing not on the specifics of the breach, but on the appropriateness of making the cancellation remedy available to the victim under the circumstances of the particular case. That appropriateness is based on the fundamental remedial policy that seeks to accommodate two competing goals: (1) the victim's expectation interest — the benefit of the bargain — should be protected, (2) but without imposing on the party in breach costs unnecessary to doing so.[63]

That policy is not the only one bearing on contract remedies, of course. But it plays a distinct and crucial role in contract enforcement. In contrast to the rules on foreseeability[64] and certainty,[65] which establish boundaries on the nature and extent of the legally cognizable expectation interest, the policy of avoiding needless costs governs the means by and extent to which that interest will be protected. That policy, therefore, is pivotal to understanding the meaning of materiality because the effect of characterizing a breach as material is precisely to make available to the victim certain important means for protecting the expectation interest.

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[63] *See* Andersen, *supra* note 48, at 306-12. On the question why the expectation interest should be protected — which is not the subject of this Article — *see* E. FARNSWORTH, *supra* note 1, § 12.1, at 811-15.

[64] *See supra* note 13 and accompanying text.

[65] *See supra* note 14 and accompanying text. Another important remedial policy is that compensation for breach generally will be substitutional in nature, although under limited circumstances, specific relief may be available. *See generally* D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 12.2, at 795-97 (1973); E. FARNSWORTH, *supra* note 1, § 12.4, at 818-23; SECOND RESTATEMENT, *supra* note 6, § 359(1).

The qualification of the constructive-condition concept with the doctrine of material breach can be accounted for by the policy of avoiding needless costs, as illustrated by the facts in *Kingston v. Preston*[66] and *Boone v. Eyre*.[67] In *Kingston*, the buyer of a business on credit failed to keep a promise to give security to the seller by the time the property was to be transferred. The seller's expectation interest was effectively protected by making the buyer's giving of security a condition of the seller's duty to convey. Permitting the seller to withhold his performance may have imposed a serious burden on the buyer, but that remedy was necessary to protect the security that the seller had bargained to receive.[68]

In *Boone* the seller of a West Indies plantation lacked title to slaves that were to have been included in the sale. The buyer invoked *Kingston*'s rule, claiming that the seller's failure to perform constituted the nonoccurrence of a condition of the buyer's duty to pay. Lord Mansfield, who four years earlier had decided *Kingston*, concluded that permitting the buyer to withhold his performance because of the seller's failure to tender clear title to all of the slaves was not necessary to protect the buyer. Lord Mansfield stressed that "where a breach may be paid for in damages, there the [buyer] has a remedy on his covenant, and shall not plead it as a condition precedent."[69] Although making perfect performance by the seller a constructive condition of the buyer's duty to pay would have protected the buyer's expectation interest, it would have done so at an unnecessarily high cost to the seller.

These cases illustrate that the constructive condition concept, as qualified by the material breach doctrine, can be justified by its tendency to promote the remedial policy of protecting the victim's expectation interest while avoiding needless costs for the party in breach. The expectation interest is protected by empowering the victim to cancel if the other party breaches. The costs of cancellation to the party in breach are contained by limiting the power to cases in which the breach warrants cancellation. The best approach to the meaning of materiality, therefore, is to inquire whether the cancellation remedy is necessary to protect the relevant interest of the victim of the breach. Unfortunately, the law does not generally view the problem from that perspective. This Article argues that it should.

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[66] 2 Dougl. 689, 99 Eng. Rep. 437 (K.B. 1773).

[67] 1 H. Bl. 273, note, 126 Eng. Rep. 160(a) (K.B. 1777).

[68] *See supra* text accompanying notes 17, 18.

[69] 1 H. Bl. 273, note, 126 Eng. Rep. 160(a) (K.B. 1777).

B. The Interests Impaired When a Contract is Breached

The most obvious interest of a party to a contract is in receiving the promised performance when due from the other party. When that interest is impaired because performance is wrongfully delayed, withheld, or imperfectly rendered, the victim is injured in the sense that what was received (if anything) is less valuable than what was promised. For example, when a landowner contracts to have a commercial building constructed, direct financial interests are impaired if the building is completed late or imperfectly. The owner may lose rent from tenants, be liable to tenants for delays, or be required to spend money repairing defects.[70] The interest in receiving proper performance when due is the interest in present performance. This interest comes into existence at the time performance is due. It is impaired by nonfeasance or malfeasance of the performance promised by the other side.

Impairments of the interest in present performance routinely are remedied through compensatory damages. The victim of the breach is entitled to a judgment sufficient to pay for the loss of value that breach causes. To be sure, difficult issues can and do arise in connection with determining the amount of money required to compensate for a failure to perform properly,[71] or with the decision to award specific relief rather than damages.[72] Nevertheless, an award of damages to compensate for missing or imperfect performance is a standard and well-understood part of the remedial landscape.

The interest in present performance is not a party's only interest,

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[70] Similarly, if the owner wrongfully fails to pay for work properly done by a builder, the latter is injured by the lack of funds. Obligations or needs of the builder that would be satisfied with the funds, such as paying workers' wages or purchasing materials, cannot be satisfied; at the very least, interest that could be earned on the money, if invested, is lost.

[71] One of the best known is the problem whether to base damages on the cost of repairs or completion as opposed to the diminution in value to the victim as a result of the breach when the former significantly exceeds the latter. This issue is reflected in such venerable cases as Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921), Groves v. John Wunder Co., 205 Minn. 163, 286 N.W. 235 (1939), and Peeveyhouse v. Garland Coal Co. 382 P.2d 109 (Okla.), *cert. denied*, 375 U.S. 906 (1963). In each case, the issue is not whether to award damages sufficient to put the victim of the breach in the same position as if the contract had been performed, but how to measure or define that position.

[72] The question whether to grant specific relief may be challenging in particular factual settings. *Compare* McCallister v. Patton, 214 Ark. 293, 215 S.W.2d 701 (1948) *with* Heidner v. Hewitt Chevrolet Co., 166 Kan. 11, 199 P.2d 481 (1948). Both cases deal with whether specific performance should be available to enforce a contract for the sale of an automobile during a time when such goods were unusually scarce.

however. A breach may impair another distinct and important interest. The moment a contract is formed each party acquires an interest in the likelihood that the contract will be performed in the future as agreed. The most important element of that interest is the probability that the other party will perform as and when agreed.[73] To the extent that probability of performance exists, a sense of security about the future arises upon which plans may be based and commitments made. That security is one of the primary benefits to individuals participating in contractual relationships.

As John Rawls put it, one person must have confidence in the word of another "to set up and to stabilize small-scale schemes of cooperation, or a particular pattern of transactions."[74] These schemes or transactions do not come into existence or are unstable unless each person has confidence that the other will perform. That confidence arises by "putting oneself under an obligation to carry through later. Only in this way can the scheme be made secure so that both can gain from the benefits of their cooperation. The practice of promising exists for precisely this purpose."[75]

Charles Fried, in keeping with his view that the moral obligation created by a promise is the basis of contract, describes the confidence that another will perform a promise as "my conviction that you will do what is right."[76] That "trust becomes a powerful tool for our working our mutual wills in the world. So remarkable a tool is trust that in the end we pursue it for its own sake; we prefer doing things cooperatively when we might have relied on fear or interest or worked alone."[77]

The importance of the interest in the likelihood of future performance is recognized in section 2-609 of the Uniform Commercial Code, which provides an innovative remedy — the right to demand assurances[78] — when that interest is impaired, although not to a degree sufficient to warrant cancellation. The official comment to that section states:

> [A] continuing sense of reliance and security that the promised performance will be forthcoming when due[] is an important feature of the bargain. If either the willingness or the ability of a party to perform declines

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[73] This assumes an executory, bilateral contract, of course. If the contract is or becomes unilateral, then only one party has an interest in the future performance of the other.

[74] J. RAWLS, A THEORY OF JUSTICE 346 (1971).

[75] *Id.* at 347.

[76] C. FRIED, CONTRACT AS PROMISE 8 (1981).

[77] *Id.*

[78] U.C.C. § 2-609 (1978).

> between the time of contracting and the time for performance, the other party is threatened with the loss of a substantial part of what he has bargained for.[79]

The likelihood of future performance usually is demonstrably important to the individual entering a particular agreement. The owner who contracts for the construction of a building needs the confidence that the building will be built by the time agreed. On the basis of that confidence, the owner is willing to make commitments to the building's future tenants that it would be unwilling to make without that confidence.

A party's interest in the likelihood of future performance is not limited to the probability that the other side will perform properly and on time. A party may have an important interest in the opportunity to perform its own future duties. A construction company under contract to erect a building, for example, may act in important ways, such as marshalling its resources in a particular manner, because of its confidence that it will be participating in the project in the future. Moreover, public awareness that the company will engage in that performance may enhance the company's reputation and prospects for other employment.

A party's interest in a sense of confidence or security about the future performance of a contract is the interest in future performance. It comes into being when the contract is formed and exists until the time for performance arrives.[80] Although its value could be quantified in

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[79] *Id.* comment 1. The comment goes on to describe particular circumstances in which the interest in future performance is of considerable importance in contracts for the sale of goods:

> A seller needs protection not merely against having to deliver on credit to a shaky buyer, but also against having to procure and manufacture the goods, perhaps turning down other customers. Once he has been given reason to believe that the buyer's performance has become uncertain, it is an undue hardship to force him to continue his own performance. Similarly, a buyer who believes that the seller's deliveries have become uncertain cannot safely wait for the due date of performance when he has been buying to assure himself of materials for his current manufacturing or to replenish his stock of merchandise.

Id. Section 2-609 was the model for § 251 of the *Second Restatement*, which proposes a right to demand assurances as a general principle not limited by the scope of U.C.C. Article 2. Section 251 relies explicitly § 2-609 comment 1 as its justification. SECOND RESTATEMENT, *supra* note 6, § 251 comment 1.

[80] When performance comes due, the interest in future performance disappears and is replaced with the interest in present performance. For example, when the building is due to be completed and the tenants are ready to move in, the owner's need no longer is for the confidence to plan and make commitments for the future; it is to have the

many cases, it is sufficient for present purposes to establish its existence as an important benefit of the bargain under a contract. For reasons to be discussed,[81] it is not necessary to determine its precise economic value.

Understanding the nature of the interest in future performance is aided by emphasizing what it is not. It is not simply the economic benefit that future performance will bring, discounted to present value. It may encompass but goes well beyond the value of preparations to perform or receive performance that might or might not be cognizable under the rules governing compensatory damages.[82] It is not the idiosyncratic sense of comfort that a particular person might enjoy on account of an agreement, the impairment of which might cause that individual some degree of emotional distress.[83] On the contrary, the interest in future performance is based on the objective theory of contract.[84] It is the value of the confidence and security that a reasonable person in the position of the relevant party would enjoy at the time the contract was made if it were assumed that the other side would be ready, willing, and able to perform at the appointed time.[85]

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building available and properly constructed.

[81] *See infra* text accompanying notes 122-123.

[82] Such losses might be excluded from recovery in damages under the rules relating to certainty and foreseeability. *See supra* notes 13-14 and accompanying text.

[83] Indeed, contract remedies traditionally have not been applied to protect the idiosyncratic sense of security that a particular person claims to have lost when a contract is breached. *See, e.g.*, Valentine v. General Am. Credit, Inc., 420 Mich. 256, 362 N.W.2d 628 (1984). *See generally* E. FARNSWORTH, *supra* note 1, § 12.17, at 894-95.

[84] The objective theory is typically applied to the parties' manifestations of assent to a contract. Thus, those manifestations are taken to mean what a reasonable person would understand by them, even if the party making them subjectively intended a different meaning. *See infra* note 104. The objective theory can apply equally well to define the interest in future performance that the law will protect.

[85] Thus, the interest in future performance would not be diminished or fail to come into existence merely because, at the time of contract formation, one party entertained doubts that the other would be willing or able to perform at the appointed time. The frame of reference of the interest in future performance is the relationship created by the contract; one who enters an enforceable agreement, thus committing whatever consideration is given in exchange for the promise of the other, is entitled not only to the proper performance of the other at the agreed time, but to a reasonable degree of confidence in advance of that time that it will be forthcoming. If the doubts that a party may have harbored are confirmed by the circumstances of a breach, as discussed below in this part and in part III, then the impairment of the interest in future performance may entitle the victim to a remedy. One need not be surprised by a breach for it to be material.

A quite different question is raised if, subsequent to the formation of the contract, circumstances arise that would cause a reasonable person *not* to value the probability of

Specific examples help give life to the idea of the interest in future performance and its relation to the interest in present performance.

Example 1: A *and* B *make an agreement under which* A *is to accompany* B *and act as* B*'s courier on a forthcoming trip to the European Continent. After the contract is formed, but well in advance of the trip,* B *informs* A *that* B *does not intend to take* A *on the trip or to pay the agreed price.*[86]

A has suffered no impairment of the interest in present performance because that interest has not yet come into existence. But the interest in future performance has been seriously undermined. Prior to *B*'s repudiation, *A* could prepare to perform, forgo opportunities for other employment or commitments, or make other plans on the assumption that the trip would take place. After the repudiation, *A* obviously no longer enjoys that confidence. *B*'s statement has injured *A* in a demonstrable way.

Example 2: A *contracts to build a house for* B. *The contract price, to be paid in a series of progressive payments, includes the drilling of a water well on* B*'s property to a depth of 150 feet. The contract states that* B *will pay an agreed price per foot if a greater depth is required to achieve an adequate flow of water. While the house is under construction,* A *drills to a depth of 250 feet before an adequate flow is achieved and includes the per-foot charge for the extra 100 feet in the next bill to* B. *Before the payment is due,* B *writes to* A *that the charge for the extra well depth is "in dispute" and will not be paid, but that the remainder of the bill, as well as future progress payments, will be timely paid.*[87]

When *B*'s letter is received, *A* has suffered no impairment of the interest in present performance, because the progress payment in question is not yet due. *A*'s interest in future performance has been im-

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proper performance in the future. For example, if a reasonable person in the position of the owner of the office building would be delighted with a delay in completion because of difficulties in attracting tenants, then the prospect of a delay might not impair the interest in future performance at all. The owner's attempt to cancel on the ground of material breach in that circumstance should fail for the reasons discussed *infra* part III.A.3.

[86] The facts are based on Hochster v. De la Tour, 2 H. Bl. at 689-90, 118 Eng. Rep. at 922 (Q.B. 1853).

[87] The facts are adapted from Oak Ridge Construction Co. v. Tolley, 504 A.2d 1343 (Pa. Super. 1985). In *Tolley* the well was drilled to 800 feet.

paired. In contrast to Example 1, however, that impairment extends only to *A*'s confidence about receiving the payment for the extra drilling. *A*'s confidence that *B* will make the rest of the progress payment, as well as those that are to follow, is undisturbed. The harm caused *A* by the impairment of the interest in future performance is relatively insignificant.

Example 3: A *and* B *enter a contract under which* B *is to do earthmoving and grading work on a building site at which* A *is the general contractor. While driving a bulldozer close to a building under construction by* A, B*'s employee seriously damages the building in breach of a term of the agreement requiring* B *to perform in a "workmanlike manner." The cost of repairing the damage is more than twice the amount of the next progress payment.*[88]

A has suffered an injury to the interest in present performance. Proper performance by *B* would have left the building unharmed. From the facts given, it cannot be ascertained whether *A*'s interest in future performance has been impaired. If, for example, *B* promptly replaced the errant employee with someone of known skill and judgment, or if the remainder of the work to be done under the contract involved no work close to any other structure and *B*'s work had been entirely satisfactory in every other respect, then *A* might have no grounds for lack of confidence that future performance would be rendered properly and timely. In that case, *A*'s interest in future performance might remain unimpaired.

By contrast, if the work remaining to be done required using earthmoving equipment in close proximity to twenty other buildings under construction, and if it were clear that the same employee would be using the same bulldozer to do that work, *A* might be unable to assume with any confidence that the remainder of the job would be carried out without further mishap. The interest in future performance would be seriously impaired.

Example 4: B *is under contract to construct a house for* A. *When* B *states that the work has been completed and requests final payment,* A *discovers that* B *has used a different kind of sewer pipe than called for in the contract. The pipe used is*

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[88] The facts are based on K & G Construction Co. v. Harris, 223 Md. 305, 164 A.2d 451 (1960).

> *grossly inferior to that specified and can be expected to corrode and leak within a few years.*[89]

The impairment of *A*'s interest in present performance is obvious. The house as delivered is significantly less valuable than that promised. *A* has suffered no impairment of the interest in future performance, however, because that interest has ceased to exist. When *A* acted on the breach, *B* had completed the job, although with major imperfections. At that point in time, *A* had no need for confidence in the likelihood of proper performance by *B* in the future because *B* had nothing left to do. Although the harm to *A* is serious, it is restricted entirely to the interest in present performance.

The preceding examples underscore the conceptual separateness of the interest in present performance and the interest in future performance. They also illustrate that the impairment of the latter is not simply a function of the magnitude of a breach, whether measured by the cost of repairs or the harm or inconvenience imposed upon the victim. As shown by Examples 2, 3, and 4, a breach may injure the victim demonstrably, yet harm the interest in future performance only slightly or not at all. The proper inquiry is a specific one. It must focus on that period of time between promising and performing during which one is entitled to assume that, as far as the contract is concerned, the future is organized securely. A breach of contract may or may not seriously disrupt that assumption. If it does, however, an injury has been caused that warrants a particular remedy.

C. The Burden of the Material Breach Doctrine: Protecting the Interest in Future Performance

The preceding discussion shows that the expectation interest consists of two distinct components: the interest in present performance and the interest in future performance. Although the goal of contract enforcement is to protect the expectation interest,[90] the remedies for breach

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[89] The facts are adapted from Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921). The difference is that in *Jacob & Youngs* the pipes used were of a quality equal to those required by the contract.

[90] There are exceptions to the principle that the expectation interest of the victim of a breach should be protected by the damages remedy. For example, if a seller of goods breaches a contract by refusing to deliver, and the market price of the goods has declined to a level below the contract price, the "injured" buyer will be better off than if the contract had been performed. The law of contract does not require the buyer to have the "benefit" of its bargain in such a case. *See* Vernon, *Expectancy Damages for Breach of Contract: A Primer and Critique*, 1976 WASH. U.L.Q. 179. There may be other circumstances in which the traditional measure of damages for certain breaches of

protect each component of that interest in a distinct way. Example 3 above illustrates the point. When the subcontractor negligently injured the building in breach of a contract term requiring performance in a workmanlike manner, the general contractor suffered an impairment of the interest in present performance and therefore became entitled to damages sufficient to repair the harm done to the building. In this Article, that remedy is referred to as *compensatory damages*. Although it often is used in a somewhat broader sense, the term here means the damages to which the victim of a breach is entitled to compensate for a defective or missing performance.

As noted, the general contractor's interest in future performance also was impaired if the circumstances indicated that the subcontractor was likely to commit other breaches of contract in the future.[91] The payment of compensatory damages does nothing to remedy the general contractor's loss of confidence in the subcontractor's ability or commitment to perform its executory duties properly. The remedy for that loss is cancellation,[92] which is made available by a finding of material breach.

Cancellation actually consists of two separate but complementary remedies. The first is the discharge of all remaining executory duties of both parties.[93] The second is an entitlement to damages in lieu of the

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contract should be discarded in favor of a more generous recovery. An example might be the owner who, after paying for a new house, discovers that the builder has used cheaper materials than those called for in the contract, and under existing case law a court would award only the diminution in value of the property rather than the cost of redoing the work. *See* Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1382-93 (1985) (advocating the disgorgement of gains from a breach involving "abuse of contract, the rendering of a defective performance that leaves the injured party with no opportunity to use that party's own return performance to obtain a reasonable substitute.").

[91] *See supra* text accompanying note 88.

[92] "Cancellation" is the term employed by article 2 of the Uniform Commercial Code to describe the bringing of a contract to an end in response to a breach. U.C.C. § 2-106(4) (1987). It will be used in that way in this Article. Cancellation is distinguished from "termination," which is bringing the contract to an end not in response to a breach, but "pursuant to a power created by agreement or law." *Id.* § 2-106(3).

[93] Prominent authority suggests that the victim of a material breach is required to wait a reasonable time between the commission of the breach and cancellation in order to give the other party an opportunity to cure. Professor Farnsworth defends this view, E. FARNSWORTH, *supra* note 1, § 8.17, at 613-15, and it has been incorporated into the *Second Restatement*. *See* SECOND RESTATEMENT, *supra* note 6, § 237, at 215 ("*uncured* material failure" to perform constitutes nonoccurrence of constructive condition of exchange) (emphasis added); *id.* § 242 and accompanying comment a. The cure concept has been taken up in a limited form by § 2-508 of the Uniform Commercial Code. The extent to which it will become an accepted part of the common law remains

discharged, executory duties of the party in breach. Thus, if the cancellation remedy is properly invoked, the general contractor is entitled both to fire the subcontractor and to be awarded damages sufficient to hire another person to finish the work.[94] This Article refers to the damages arising in connection with cancellation as *cancellation damages.*

Depending upon the factual context, cancellation damages may be measured in a variety of ways. For example, if the victim was to receive goods or services, cancellation damages may be the amount required to permit the victim to purchase substitute goods elsewhere or to hire someone else to complete the job, subtracting the amount not paid to the party in breach.[95] If the victim was to supply goods or services, then cancellation damages are the amount that should have been paid, less amounts saved by not having to perform and any value received by otherwise using the resources that would have been committed to the

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unclear. *See* Lawrence, *supra* note 50, at 714-18, 738-39. Under the *Second Restatement*, cure may have an important bearing on both compensatory damages and materiality: the party in breach has the opportunity to reduce the damages owed on account of the breach and to repair the injury done in such a way or to such an extent that the breach ceases to be material. *See id.* at 728-30.

To the extent cure simply delays the point in time at which cancellation may occur, it does not significantly affect the description of the cancellation remedies discussed in this part of the text. The very existence of a power of cure for the party in breach may affect the analysis of when a breach is or is not material, however. This issue is taken up *infra* part III.A.1.b.

[94] Under familiar rules, the amount due the victim is reduced by any costs avoided or gains realized by the victim on account of the discharge of the contract. *See* E. FARNSWORTH, *supra* note 1, § 8.15, at 608. Thus, the amount due the general contractor would be reduced by, for example, the amount of the contract price not yet paid the party in breach.

[95] *See* Austin v. Parker, 672 F.2d 508, 522 (5th Cir. 1982) (awarding contractor damages equal to extra costs incurred in hiring replacement subcontractor after first subcontractor breached); Bell v. McCann, 535 P.2d 233, 235 (Colo. Ct. App. 1975) (damages for contractor's failure to complete house equal to difference between contract cost and fair market cost for completion); Yonan v. Oak Park Fed. Sav. & Loan Ass'n, 27 Ill. App. 3d 967, 976, 326 N.E.2d 773, 780-81 (1975) (measure of damages when builder fails to commence construction is fair market cost of construction less contract price); Palmer v. Howse, 133 Ga. App. 619, 619 212 S.E.2d 2, 3 (1974) ("[W]here a building contract is breached or abandoned . . . measure of damages is ordinarily the reasonable cost of completion); *see also* E. FARNSWORTH, *supra* note 1, § 12.11, at 856-57. In such cases, damages also might be based on the profits that would have been made if performance had been rendered as agreed. *See* For Children, Inc. v. Graphics Int'l, Inc., 352 F. Supp. 1280, 1284 (S.D.N.Y. 1972) (awarding lost profits to distributor when printer failed to manufacture books correctly); *see also* E. FARNSWORTH, *supra* note 1, § 12.11, at 856-57.

breached contract.[96] However they are measured, cancellation damages are intended to put the victim in the same economic position as if the parties' executory duties under the contract were performed.[97]

Cancellation (including both discharge and cancellation damages) and compensatory damages perform distinct functions. The latter do nothing more than make up for the loss in value to the victim of a breach caused by the missing or imperfect performance of duties that already have come due. By contrast, the cancellation remedy does not address the interest in present performance at all. Rather, it focuses on the performance which is to come. The remedy responds to the impairment, caused by a breach, of the victim's confidence that the remaining duties under the contract will be properly performed. Bringing the contract to an end and awarding damages equal to the value of the other party's executory duties remedies the injury by enabling the victim to regain that confidence elsewhere.[98]

The distinct purposes and effects of compensatory damages and cancellation can be seen clearly by comparing an anticipatory repudiation with breach by nonperformance, either of which may be material. As illustrated by Example 3 above, a breach by nonperformance always injures the interest in present performance. It may or may not impair the interest in future performance, but it will be a material breach only

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[96] *See* Vitex Mfg. v. Caribtex Co., 377 F.2d 795, 799 (3d Cir. 1967) (awarding wool processor gross profits less costs when buyer breached); Holiday Mfg. v. B.A.S.F. systems, Inc., 380 F. Supp. 1096, 1105 (D. Neb. 1974) (awarding seller of cassette tapes difference between contract price and resale price on tapes produced; awarding lost profits on tapes not manufactured before breach); F. Poss Farms, Inc. v. Miller, 35 Colo. App. 152, 154, 529 P.2d 1343, 1344 (1974) (vendor of land entitled to contract price less market value of land at breach and payment received); *see also* E. FARNSWORTH, *supra* note 1, § 12.9, at 848-49.

[97] The description of damages measurements in the text is greatly simplified, of course. Difficult questions dealing with mitigation and other important issues may greatly complicate the determination of cancellation damages in many cases. For present purposes it is sufficient to stress the general purpose of the damages awarded in lieu of the discharged duties of the party in breach.

[98] Cancellation tends to protect a party's interest in future performance even when that remedy is not invoked. In many cases, cancellation will be more costly to the party in breach than simply paying compensatory damages for nonfeasance or malfeasance. The opportunity to render future performance, and presumably to earn a profit or to gain some other advantage in doing so, is lost when a contract is discharged. The availability of the cancellation remedy thus may provide an incentive against the commission of a material breach, and in that way may protect the other party's interest in future performance, in circumstances in which the availability of compensatory damages alone would not. That incentive can exist without the possibility of an award of punitive damages.

if it does so. By contrast, an anticipatory repudiation always impairs *only* the interest in future performance and not the interest in present performance.[99] By definition, the person committing an anticipatory breach has not failed to perform a duty when due, but has manifested either an unwillingness or an inability to perform future duties.

Breach by anticipatory repudiation is thus a "pure" example of material breach. Because only the interest in future performance is affected, the repudiation is either material, justifying cancellation, or no breach at all. Compensatory damages, as the term is used here, never are appropriate.

When a breach by nonperformance harms both the interest in present performance and the interest in future performance, compensatory damages and cancellation are concurrently available. In theory, at least, the combination of the two remedies fully protects the victim's expectation interest.[100] It is crucial to recognize, however, that the victim's interest in future performance is protected by discharge and cancellation damages. Compensatory damages cannot do so.

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[99] This assumes, of course, that the repudiation is not accompanied by unexcused nonperformance. It is common for a repudiation of future duties to occur simultaneously with a breach by nonperformance.

[100] The distinction between damages intended to compensate for imperfect or missing performance and those granted in lieu of the discharged future performance of the party in breach is sharp in theory, and in a given case of cancellation for material breach the total damages award should be capable of being allocated into these two components. In general, however, there is no practical reason to make that allocation. Once it is decided that a contract has been breached, the parties are interested in the amount of the total damages award, not the relative magnitude of the interests to which it is attributable. Moreover, court opinions dealing with damages generally will not have occasion to compare the damages that would be payable if the breach were partial with those that would be required if it were total. This is because an incorrect judgment by the victim of a breach that the breach was material, and thus that the contract may be cancelled, means that the victim becomes the party committing the first material breach and thus is the one responsible for damages in lieu of future performance. This point was made clearly in Walker & Co. v. Harrison, 347 Mich. 630, 635, 81 N.W.2d 352, 355 (1957): The decision to cancel a contract "is fraught with peril, for should such determination, as viewed by a later court in the calm of its contemplation, be unwarranted, the repudiator himself will have been guilty of material breach and himself have become the aggressor, not an innocent victim." *Id.* For these reasons, the formulas for computing damages in various kinds of cases do not typically reflect the distinction between the portion of the recovery attributable to compensatory damages and that constituting cancellation damages. *See, e.g.*, E. FARNSWORTH, *supra* note 1, §§ 12.9-.11.

D. A Proposed Standard for Material Breach

The essential conclusions of Part II are: (1) that a finding of material breach can be understood as a decision that cancellation should be made available to the victim of a breach of contract in addition to compensatory damages; and (2) that the effect of cancellation is to protect the victim's interest in future performance. Those conclusions, when considered in light of the basic principle of contract remedies that the expectation interest of the victim should be protected at the least cost to the breaching party, produce a workable standard for material breach. A breach is material only if the cancellation remedy is necessary to protect the victim's interest in future performance.

Undoubtedly, making the cancellation remedy available to the victim always will protect the interest in future performance, when it exists. Assuming that the victim acts in its own best interest, that remedy will be invoked only when discharge and damages in lieu of future performance will leave that party at least as well off as if the other party had fully performed. The question, however, is not whether cancellation will in fact protect the interest in future performance, but whether it is *necessary* to do so. The need for cancellation turns on two key issues: whether the degree of impairment of that interest warrants the invocation of the remedy, and if so, whether the victim of the breach could take reasonable steps to eliminate or reduce that impairment.

1. Finding the Materiality Threshold

By its very nature, the magnitude of the interest in future performance is difficult, perhaps impossible, to quantify.[101] The degree of the impairment of that interest which a breach of contract causes probably would be even more difficult to measure in any given case. The inability to quantify the interest is scarcely a fatal impediment to its use in the materiality doctrine, however. Indeed, rarely if ever do fundamental legal interests or concepts lend themselves to such treatment. Rather, one consistently is required to deal with these interests on the basis of inherently vague verbal standards.[102]

In the realm of private law, exemplified by the law of torts and contract, the standard of the "average reasonable person" is routinely

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[101] *See supra* text accompanying notes 73-85.

[102] For example, the standards of proof that lay juries routinely are expected to apply — preponderance of the evidence, clear and convincing evidence, proof beyond a reasonable doubt —illustrate that this is done in matters of even the gravest importance.

used.[103] That approach serves well enough here.[104] Thus, the materiality threshold is crossed when the impairment of the interest in future performance is serious enough that a reasonable person would believe that cancellation was justified.[105]

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[103] The reasonableness standard is a central feature of compensatory damages doctrines. For example, U.C.C. § 2-704(2) (1987) permits the seller of goods whose buyer wrongfully repudiates to finish its manufacture "in the exercise of reasonable commercial judgment for the purpose of avoiding loss and of effective realization." *Id.* The official comment adds that reasonable judgment is based on "the facts as they appear at the time [the seller] learns of the breach." *Id.* Similarly, U.C.C. § 2-712 (1987) permits the buyer of goods to "cover" by purchasing substitute goods when the seller fails to make a conforming tender. The official comment notes that "[t]he test of proper cover is whether at the time and place the buyer acted in good faith and in a reasonable manner, and it is immaterial that hindsight may later prove that the method of cover used was not the cheapest or most effective." The same principle applies in connection with the mitigation rule in general contract law. *See* SECOND RESTATEMENT, *supra* note 6, § 350 comment h.

[104] Adopting the perspective of a reasonable person is required by the "objective theory of contract." *See* E. FARNSWORTH, *supra* note 1, § 3.6, at 113-16, § 7.9, at 485. *See, e.g.*, Eustis Mining Co. v. Beer, Sondheimer & Co., Inc., 239 F. 976, 984-85 (S.D.N.Y. 1917) ("It makes not the least difference whether a promisor actually intends that meaning which the law will impose upon his words."); Slice v. Carozza Properties, Inc., 215 Md. 357, 368, 137 A.2d 687, 693 (1958) ("the theory of 'objective law' of contracts has been almost universally adopted . . . "); Cohn v. Fisher, 118 N.J. Super. 286, 291, 287 A.2d 222, 225 (1972); Lucy v. Zehmer, 196 Va. 493, 503, 84 S.E.2d 516, 522 (1954). *See generally* Kabil Dev. Corp. v. Mignot, 279 Or. 151, 566 P.2d 505 (1977) (objective theory of contract does not preclude admission of party's testimony that he believed an oral contract had been made). That perspective is the proper one because discovering a party's subjective reaction to a breach, which might range from idiosyncratic fearfulness to extraordinary optimism about its implications for the future performance of the contract, would be difficult. Neither a person who commits (or contemplates committing) a breach nor a court asked to resolve a dispute can be expected to gauge the legal significance of the breach on the basis of an essentially unknowable fact. For the materiality standard to be workable, it must rest on the perception we share (or at least believe we share) in how an average, reasonable person would respond to a given state of affairs.

[105] As noted *supra* text accompanying notes 99-100, a breach by anticipatory repudiation falls squarely within the general materiality analysis proposed in this Article. Accordingly, the approach to determining the threshold level of impairment of the interest in future performance discussed in the text applies fully to anticipatory repudiation. Thus, even though any repudiation of a future duty will impair the interest in future performance, that impairment must rise to the necessary degree of seriousness before a material breach (meaning, in this context, any breach at all, *see supra* note 99 and accompanying text) occurs and cancellation is in order. That degree might not exist for a number of reasons, such as that only one particular duty out of a larger set of contractual obligations has been repudiated. *See* Examples 2 and 4 *supra* notes 87, 89.

The *Second Restatement* recognizes that not just any unwillingness to perform a

The effectiveness of a "reasonable person" standard depends on the context in which it is used. In the absence of a coherent conceptual framework it is vacuous to say that a breach is material if a reasonable person in the position of the victim would cancel the agreement. The standard becomes meaningful when applied in the setting suggested by this Article: basic contract policy requires the tailoring of remedies to protect the expectation interest; a distinct and essential component of the expectation interest is the interest in future performance; and that interest is protected in a unique and effective way by the cancellation remedy. When these important features are charted, the "average reasonable person" can hope to find the boundaries of material breach.

An observation by John Rawls helps bring the materiality threshold into focus. He noted that "[t]he role of promises is analogous to that which Hobbes attributed to the sovereign. Just as the sovereign maintains and stabilizes the system of social cooperation by publicly maintaining an effective schedule of penalties, so men in the absence of coercive arrangements establish and stabilize their private ventures by giving one another their word."[106] An extension of Rawls' analogy of contract to politics assists in gaining a sense for the level of harm to the interest in future performance that makes a breach material.

In countries such as the United Kingdom that have parliamentary systems of government, the current administration (or "government") remains in office until the next election or until it falls under a vote of no-confidence. Contract formation may be likened to the installation of a new government. One who enters a contract presumably has sufficient confidence in its future performance to make the promises or to give the other consideration required to bind the contracting partner to the deal, just as a majority in parliament has sufficient confidence in party leaders to entrust it with political power. This is not to say that the person has full or even great confidence about the outcome, but only sufficient confidence to enter a relationship in which new legal

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future duty will constitute an anticipatory repudiation. But the attempt to describe the required level of seriousness is not successful. According to § 250, a breach by anticipatory repudiation occurs if the failure to perform the repudiated duty when due would be a material breach. The most obvious shortcoming of this definition is that it simply incorporates the approach to materiality of § 241, which is criticized elsewhere in this Article. *See supra* part I.B.1. Moreover, it fails to recognize that the repudiation of a future duty might be a material breach, while a breach of that same duty by simple nonperformance might not be. As discussed *infra* part III.B., the failure to perform a duty as and when agreed may occur when the interest in future performance has disappeared and the notion of materiality therefore has lost relevance.

[106] J. RAWLS, *supra* note 74, at 346.

obligations are created. With the creation of those obligations arises the interest in future performance. As previously discussed,[107] that interest exists in the frame of reference created by the contract. Thus, even one who lacks great confidence that the agreement will be properly performed is legally entitled to look to the other party for full, proper performance, just as the members of parliament are entitled to hold the government accountable to provide effective leadership even if its ability to govern well is in doubt.

A change of government under a regularly scheduled election may be compared to the full performance of a contract. A majority may be content to have the government retain power, despite flaws in its performance. Similarly, although one party may breach a contract, the other party, as a reasonable person, may be willing to seek only compensatory damages rather than end the contract.

A change of government under a vote of no-confidence is comparable to cancellation following a material breach. Just as a majority in parliament may develop sufficient doubts about the government's ability to govern that they are prepared to undergo the uncertainties, confusion, and inefficiencies that accompany an unplanned election, a party to a contract may reasonably conclude that a breach has so impaired the interest in future performance that terminating the contract relationship is prudent, despite the disruptions and difficulties it may entail. When that point is reached, the materiality threshold has been crossed.[108]

2. The Victim's Responsibility to Protect the Interest in Future Performance

Materiality requires more than a showing that the impairment of the victim's interest in future performance is sufficiently serious. The requirement that cancellation be a *necessary* remedy places some responsibility for the protection of the interest in future performance on the victim.

The clearest example of this principle is the "mitigation" rule, under which damages are determined as if the victim had taken reasonable steps to reduce the losses that a breach causes.[109] The same principle

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[107] *See supra* notes 80-85 and accompanying text.

[108] The analogy based on the operation of a parliamentary system was the helpful suggestion of my colleague Richard A. Matasar.

[109] *E.g.*, Hollwedel v. Duffy-Mott Co., 263 N.Y. 95, 101, 188 N.E. 266, 268 (1933); *see also* University of Alaska v. Chauvin, 521 P.2d 1234, 1240 (Alaska 1974) (wrongfully terminated professor must accept suitable alternative employment, if available, in

should apply to the discharge element of cancellation. Even though a breach may have so harmed the interest in future performance that discharge otherwise would be warranted, the breach is not material if the victim has available a reasonable course of action to eliminate the harm or reduce it below the threshold.

McCloskey v. Minweld Steel Co.[110] illustrates this rule. A subcontractor promised to supply structural steel for the construction of a new hospital. The subcontractor became unable to acquire the material needed to perform the contract because of governmental restrictions on the availability of steel following the outbreak of the Korean War. The subcontractor appealed to the general contractor for assistance, believing that intervention by the latter, or by the state for which the hospital was to be built, might succeed in making supplies available. Although, as the court later assumed, such intervention would have been successful, the general contractor refused to assist. Instead, the general contractor cancelled the contract, claiming that the obvious inability of the subcontractor to perform constituted a breach by anticipatory repudiation.

The court rejected the claim that the subcontractor had committed an anticipatory breach, stressing that party's obvious willingness and desire to perform. The court's holding is correct, but not simply because the subcontractor was willing to proceed. Willingness alone is insufficient to prevent a breach by anticipatory repudiation if the party concerned is ***unable*** to perform and is not otherwise excused.[111] The best ground for the court's decision is that the general contractor should have assisted the subcontractor "by urging its plea for the hospital construction materials to the State Authority."[112] Instead, the general contractor "took the position that the subcontractor had repudiated its agreement and then moved quickly to have the work completed. Shortly thereafter, and without the slightest trouble as far as appears, [the general contractor] procured the steel from Bethlehem [Steel Company]

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mitigation of damages); McClelland v. Climax Hosiery Mills, 252 N.Y. 347, 359, 169 N.E. 605, 609 (1930) (Cardozo, C.J., concurring) (a wrongfully discharged employee who unreasonably rejects other employment may not recover for lost wages), ***modified***, 253 N.Y. 533, 171 N.E. 770 (1930); RESTATEMENT (SECOND) OF CONTRACTS § 350 (1979) (damages are not recoverable for loss that the injured party could have avoided without undue burden); *id.* comment c, illustration 8 (fired employee's damages are reduced by amount he could have earned at an available and equally good job).

[110] 220 F.2d 101 (3rd Cir. 1955).

[111] *See* RESTATEMENT (SECOND) OF CONTRACTS § 250 (1974); *id.* comment b.

[112] 220 F.2d at 104.

and brought in new subcontractors."[113]

The subcontractor's inability to perform obviously jeopardized the general contractor's interest in future performance. Had the latter been powerless to make the supplies available, then the former's willingness to proceed should not have prevented the conclusion that a breach by anticipatory repudiation had occurred.[114] But the court concluded that the general contractor, without serious inconvenience to itself, could have eliminated the risk to its interest in future performance simply by asking government officials to make steel available to the subcontractor. Under those circumstances, the court rightly concluded that cancellation was not appropriately invoked by the general contractor. The victim of a breach often will be unable to eliminate or significantly reduce a serious impairment of the interest in future performance. But when the victim is able to do so, the breach is not material.

E. Taking Account of the Costs of Cancellation to the Party in Breach

An important question is whether the materiality standard can rest solely on the extent of the impairment of the victim's interest in future performance. The key remedial policy, after all, permits the invocation of a remedy when necessary to protect the expectation interest *without unnecessary costs to the breaching party.*[115] The materiality analysis requires consideration of the significance of the effects of cancellation on the party against whom the remedy is applied.

The conventional wisdom is that the costs of cancellation to the breaching party must be balanced against the harm the breach caused the victim. Despite the distinguished pedigree and intuitive appeal of the balancing approach, it is not an appropriate element of the materiality standard. Rather, a finding of materiality should turn solely on the effect of the breach on the victim's interest in future performance. Minimizing the costs of cancellation for the breaching party can be accomplished in ways other than permitting those costs to offset the significance of the victim's injury.

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[113] *Id.*

[114] This assumes, of course, that the subcontractor's failure to perform was not excused under the doctrine of impracticability.

[115] *See supra* part II.A.

1. The Balancing Approach

A routine element of conventional material breach analysis balances the harm that the breach caused the victim against the forfeiture that cancellation would impose on the other party.[116] The notion of balancing the hardships of the parties was intrinsic to Williston's fairness test of materiality.[117] Subsections (c) and (d) of section 275 of the *First Restatement* and the accompanying commentary reflect that understanding.[118] The balancing approach was carried forward explicitly in the *Second Restatement*, in which "the extent to which the party failing to perform or to offer to perform will suffer forfeiture" is one factor to be weighed in the materiality inquiry.[119] The commentary to section 241 adds: "a failure is less likely to be regarded as material if it occurs late, after substantial preparation or performance, and more likely to be regarded as material if it occurs early, before such reliance."[120]

The balancing approach is intuitively appealing. It may seem a matter of common sense and basic fairness to demand a rough parity between the harm to the victim that triggers the cancellation remedy and the hardship to the other side that cancellation will entail. A closer look at the issue, however, suggests at least two reasons why balancing is inappropriate.

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[116] *E.g.*, Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 244, 129 N.E. 889, 891 (1921) ("We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, *the cruelty of enforced adherence.*") (emphasis added).

[117] *See supra* notes 25-28 and accompanying text. Thus, Williston argued that if the partial and imperfect performance of the party in breach were of no benefit to the victim, the breach ordinarily should be judged material. Yet, "cases may arise where a detriment incurred by the plaintiff [in breach] in [the forfeiture of] part performance of his contract [which would result from cancellation] will influence the conclusion of the court, although there has been no corresponding benefit received by the defendant [victim]." S. WILLISTON, *supra* note 4, § 843, at 1616.

[118] Subsections (c) and (d) read as follows:

> (c) The extent to which the party failing to perform has already partly performed or made preparations for performance.
>
> (d) The greater or lesser hardship on the party failing to perform in terminating the contract.

Comment a states:

> Where the failure [i.e. the breach] is at the outset, a very slight failure is often sufficient to discharge the injured party. But even in that case, and more obviously if the failure of a promisor occurs after part performance by him, the question becomes one of degree. Both the amount that he has done and the benefit that the injured party has received are considered.

[119] SECOND RESTATEMENT, *supra* note 6, § 241(c).

[120] *Id.* comment d; *see also* E. FARNSWORTH, *supra* note 1, § 8.12, at 593.

a. Priority for the Interests of the Victim

First, the remedial principle that accommodates the interests of the parties gives priority to the victim's interests. This is most clearly seen in mitigation-of-damages rule. If reasonable steps are open to the victim to reduce the extent of the losses suffered because of a breach, damages are calculated as if those steps had been taken. Significantly, however, the mitigation rule is sensitive to the needs of the victim. For example, if the steps necessary to lessen the injury would "involve undue burden, risk or humiliation,"[121] then the victim is not accountable for not having taken them. While the interests of the party in breach clearly matter, it is plain that victim's interests come first.

The mitigation rule as applied to compensatory damages illustrates that a balancing approach of sorts is not precluded by giving priority to the victim's interests. Incremental reductions in harm to the victim can be translated into reduced costs for the breaching party. The same is not true of cancellation. Unlike compensatory damages, discharge either occurs or it does not. A discharge protects the victim, not by compensating for the degree of loss suffered, but by enabling the victim to replace the entire future relationship with the breaching party with its economic equivalent elsewhere.[122] The discharge element of cancellation makes it an all-or-nothing remedy. There is no need to quantify the impairment of the interest in future performance because the remedy for that impairment cannot be "fine-tuned," as often can be done when the only issue is the extent of monetary reparation to be made.[123]

A simple balancing of the costs to the breaching party against the harm to the victim's interest in future performance fails to give the correct priority to the needs of the victim. Suppose, for example, that an owner of two plots of land engages two separate contractors to erect buildings on each plot. In each case, the builder commits serious breaches by failing to follow contract specifications when the project is approximately half completed. Assume that each of those breaches gives the owner cause for grave concern about the quality of work that can be expected in the future. The only difference is that the first builder

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[121] E. FARNSWORTH, *supra* note 1, § 12.12, at 859; *accord* SECOND RESTATEMENT, *supra* note 6, § 350(1).

[122] *See supra* text accompanying notes 94-98.

[123] The mitigation rule can apply, of course, to the damages component of the cancellation remedy. For example, a wrongfully discharged employee will be entitled to damages in lieu of salary that would have been paid. But the award will be calculated on the assumption that other, reasonably available employment had been taken. *See supra* note 109.

has been paid for all of the work done to date and has made no significant investment in preparations to perform that have not been incorporated into the work. By contrast, the second builder has been paid none of the contract price at the time the breach occurs and, even if entitled to restitution,[124] will not be compensated for a large portion of the materials and labor purchased for, but not yet used, on the job if the owner cancels. Under the balancing approach, the owner might be permitted to cancel in the first instance, but not in the second. Yet, by hypothesis an equally serious impairment of the owner's interest in future performance occurred in each case.

The risk of forfeiture to the builder in the second case clearly is a matter of concern to the law. Yet, the balancing approach to material breach is not the appropriate expression of that concern because it is inconsistent with the priority that ought to be given the victim's interests. As noted below,[125] the costs of cancellation to the party in breach can be taken into account in other ways.

b. The Self-help Nature of the Cancellation Remedy

In addition to the demands of the remedial principle, an important practical argument against the balancing approach also must be considered. By its nature, cancellation is a self-help remedy. The victim need not seek prior judicial approval of the decision to bring the contract to an end, but typically commits to that course of action prior to litigation. Indeed, litigation undoubtedly never occurs in the vast majority of contract cancellations. When the matter does come before a court, it is to sort out the precise amount of damages owed and, more importantly, to decide whether the decision to cancel was correctly made. If it was not correct, that is, either no breach or no material breach occurred, then the victim wrongfully repudiated the contract and has committed the first material breach.[126] The decision to cancel thus is a hazardous one.[127]

While the party cancelling a contract should be held to account if cancellation was not justified, the risks of the decision should not be made greater by holding the victim responsible for information that becomes known with certainty or clarity only with the benefit of hindsight. Knowledge about the costs that cancellation imposes on the breaching party often are in that category. If the victim paid for little

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[124] *See infra* text accompanying notes 135-137.

[125] *See infra* part II.E.2.

[126] *See* E. FARNSWORTH, *supra* note 1, § 8.15, at 609-11.

[127] *See supra* note 100.

or none of the performance rendered prior to the breach, of course, it may be possible to surmise that the other party stands to lose a great deal if the contract is cancelled. But the extent of that loss will depend on a number of factors, none of which may be within the victim's knowledge. For example, to determine the costs of cancellation, an owner injured by a contractor's breach would have to know, among other things, the extent of the builder's investment in preparations for performance that had not yet been incorporated into the job.[128] One asks too much if the victim of a breach is held responsible for knowing the risk of forfeiture to the other side and, though self-interested, must balance harm to self against harm to another. Yet, the balancing approach requires nothing less.

The balancing approach to material breach will not always lead to incorrect results. In fact, it may be roughly accurate to say that the further performance has progressed, the less likely a breach will be material. That may be true because the magnitude of the interest in future performance, and thus the victim's vulnerability to injury by its impairment, necessarily diminishes as the contract ceases to be executory.[129]

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[128] Many states permit restitution in favor of one committing a material breach. *See infra* note 135. A restitutionary recovery may significantly reduce the costs of cancellation. But the law governing restitution for parties in breach of contract is unclear. *See generally* Kovacic, *A Proposal to Simplify Quantum Meruit Litigation*, 35 AM. U.L. REV. 517, 604-12 (1986); G. PALMER, 1 THE LAW OF RESTITUTION § 5.1, at 568-74 (1978). In contrast to the Uniform Commercial Code, which allows restitution to a defaulting purchaser, see U.C.C. § 2-718(2) (1987), not all jurisdictions even permit such recoveries. *See, e.g.*, Maxton Builders, Inc. v. Lo Galbo, 68 N.Y.2d 373, 381-82, 502 N.E.2d 184, 187-89, 509 N.Y.S.2d 507, 511-12 (1986) (rejecting rule permitting party in default to seek restitution for part performance). Presumably, this rule would apply in other contexts. *See* Pruett v. La Salceda, Inc., 45 Ill. App. 3d 243, 247-48, 359 N.E.2d 776, 779-80 (1977) (denying restitution to defaulting buyer of land); Quillen v. Kelley, 216 Md. 396, 401-02, 140 A.2d 517, 520 (1958) (applying rule denying restitution of down payments to buyer of real estate in breach); Evergreen Amusement Co. v. Milstead, 206 Md. 610, 621-22, 112 A.2d 901, 906 (1955) (stating "general rule" that plaintiff in default cannot recover, but finding substantial performance to allow recovery for construction performed); *see also* G. PALMER, *supra*, § 5.13, at 654 nn.47-48 (suggesting that New York, Maryland, and Illinois generally deny restitution). When restitution for a defaulting plaintiff is allowed, the measure of the recovery may be uncertain. *See* E. FARNSWORTH, § 8.14, at 604-05. The injured party must have at least a rudimentary knowledge of the law of restitution in the governing jurisdiction to determine the extent of the loss that cancellation would impose.

[129] For example, when a new building is 90 to 95% completed, the owner's interest in future performance has become relatively small because little work remains to be done. As the magnitude of that interest diminishes, the potential risk of harm from future malfeasance decreases. A breach that might warrant cancellation at the beginning of the job might not do so as completion nears. When the work is fully completed,

Moreover, a breaching party with a substantial investment at risk is more likely to protect the investment against forfeiture by taking, for example, prompt action to cure a breach.[130] But the costs of cancellation to the breaching party must remain an indirect influence on materiality. Those costs do not provide a pro rata deduction or offset against the impairment of the victim's interest in future performance, as the traditional balancing approach would suggest.

2. Protecting the Interests of the Party in Breach

If the costs of cancellation to the breaching party are not to be balanced directly against the injury to the victim, how are they to be taken into account? There are two ways it may be done. The first turns on the extent to which the breaching party is permitted to claim the benefit of its bargain following cancellation. Although many jurisdictions grant restitution for a defaulting plaintiff, that measure of recovery may be unnecessarily miserly. The second relates to how much of its own performance the victim of the breach is entitled to withhold. One may be tempted to infer from the notion of discharge that the victim necessarily is entitled to retain its entire executory performance at least pending a settlement or a judicial award in favor of the other party. That conclusion is incorrect.

a. Beyond Restitution for the Party in Breach

The requirement that a significant impairment of the interest in future performance must exist before the materiality threshold is crossed[131] provides a measure of protection to one who breaches a contract. Although the threshold is not sensitive to the magnitude of the costs of cancellation to the one in breach, it serves as a barrier to those costs in all cases in which the harm to the victim's interest in future performance falls short of the requisite degree of seriousness.

A more important source of protection is the doctrine of restitution for a defaulting party, which is at least indirectly sensitive to the costs of cancellation.[132] By this means many jurisdictions take significant steps to lessen those costs to one against whom the cancellation remedy

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cancellation becomes irrelevant. *See infra* part III.B.

[130] *See infra* part III.A.1.b.

[131] *See supra* part II.D.

[132] To the extent the breaching party's costs of performance incurred prior to cancellation are reflected in the benefit that performance confers on the victim, a restitutionary remedy will take account of those costs.

is invoked. Although a full examination of the issue is beyond the scope of this Article, at least in some cases, restitution for a breaching party may be less generous than it need be.

A simple hypothetical illustrates the problem.[133] Assume that *B* agrees to do remodel *O*'s house for $100,000. *B* commences and partially completes the job, and in keeping with the agreed schedule of payments, *A* pays $20,000 against the contract price. After *B* has expended $45,000 in labor and materials on the project, *O* discovers that *B* has breached by using poor workmanship. *O* cancels the contract and pays another person $15,000 to repair the defects in the work and $50,000 to complete the job according to contract specifications. The value of the house then is increased by $90,000.

The conventional understanding is that, absent a right to recover in restitution, *B* would receive nothing beyond the $20,000 already paid because the discharge eliminates any further claim against *O*. At the time of cancellation, *O* still had $80,000 of the funds originally intended for the project. Of that amount, $15,000 was spent on repairs and another $50,000 on completing the project. *O* then had the completed work bargained for, plus $15,000 that would have been spent on the project had the breach not occurred. *B* has failed to recover even the amount invested in the project, not to mention any profit that would have been earned had the breach not occurred. *O*'s windfall above the expectation interest is at *B*'s expense.[134]

In response to that possibility, many jurisdictions would make restitution available to *B*.[135] *B* then would be entitled to recover the net benefit conferred upon *O*.[136] Calculating that benefit solely by reference

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[133] The facts are based on *Second Restatement* § 374 illustrations 4 and 5. They have been changed to show response to the breach in the middle of the project rather than after its imperfect completion.

[134] The court permitted this result in S. Onorato Corp. v. Levin, 348 Mass. 740, 205 N.E.2d 722 (1965).

[135] The seminal case is Britton v. Turner 6 N.H. 481 (1834); *see also* Peters v. Halligan, 182 Neb. 51, 58-60, 152 N.W.2d 103, 109 (1967) (allowing breaching contractor to recover in quantum meruit); Lancellotti v. Thomas, 341 Pa. Super. 1, 5-10, 491 A.2d 117, 119-22 (1985) (discussing need to avoid forfeiture in allowing breaching party restitution of down payments for business); Kreyer v. Driscoll, 39 Wis. 2d 540, 547, 159 N.W.2d 680, 683 (1968) (awarding restitution to contractor in breach because homeowner "should not receive a windfall" from contractor's breach); A. CORBIN, *supra* note 13, § 1125, at 18-20 (discussing restitution for defaulting building contractors); Corbin, *The Right of a Defaulting Vendee to the Restitution of Installments Paid*, 40 YALE L.J. 1013 (1931).

[136] *See generally* A. CORBIN, *supra* note 13, §§ 1122-1135, at 1-90; E. FARNSWORTH, *supra* note 1, § 8.12, at 593; G. PALMER, *supra* note 128, §§ 5.1-.15, at 567-

to the work performed may be difficult because there is probably not a market for defective, partially completed work. The benefit can be determined, however, by taking into account the benefit conferred by the properly completed job and subtracting the costs of repairs and completion.[137] Thus, in the example at hand, the benefit conferred by *B* would be $90,000 (the value of the properly completed performance), less $65,000 (the cost of completion and repairs after cancellation), or $25,000. *O* thus would required to pay *B* an additional $5000. Assuming that sum were paid at the time of cancellation, *O* retained $75,000 of the funds originally intended for the project. Of that amount, $65,000 was spent on repairs and completion. Thus, *O* has the work bargained for, plus $10,000 that would have been spent on the project if the breach had not occurred. *B* still has failed to recover its investment, and *O* still enjoys a windfall at *B*'s expense.

Suppose now that *B*'s recovery is not premised on the theory of restitution at all, but that the remedial policy of protecting *O*'s expectation interest at the least cost to *B* is taken as the governing principle. *O* would be entitled to retain from the $100,000 originally intended for the project, $15,000 for repairs and $50,000 to complete the building.[138] *B* would be entitled to the remaining $35,000. *O*'s expectation interest would be protected, and although *B* would remain worse off than if the contract had been performed — indeed, even *B*'s investment would not be fully recouped — the costs to *B* of cancellation would be less than if *B*'s interest were based on the net benefit conferred on *O*.[139]

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685. That benefit arguably may be measured either by the increase in the market value of *O*'s property or by the amount *O* would have had to spend to have another builder perform the same work at the market price for such services. *Cf.* SECOND RESTATEMENT, *supra* note 6, § 371. When restitution is granted to a defaulting party, the former measure is preferred as the presumably less generous. SECOND RESTATEMENT, *supra* note 6, § 374 comment b; E. FARNSWORTH, *supra* note 1, § 8.14, at 604-05. ***But see*** Kovacic, *supra* note 128, at 604-12. The law of restitution for a defaulting plaintiff is complex and inconsistent. *See* G. PALMER, *supra* note 128, § 5.1, at 568-69, § 5.15, at 684-85. Beyond the general observations made here and in the text, this Article does not attempt to take account of those difficulties.

[137] *See* SECOND RESTATEMENT, *supra* note 6, § 374 illustration 2.

[138] The former amount would be compensatory damages, the latter cancellation damages.

[139] This approach to recovery for one committing a material breach is advocated in D. DOBBS, *supra* note 65, § 12.24, at 922-24. Professor Dobbs characterizes the recovery as a restitutionary one, but argues that attempting to calculate the recovery of the party in breach by the value of the part performance is not "functional," *id.* at 922, apparently because basing recovery on the contract price is much simpler. In many cases a contract-based recovery undoubtedly is easier to determine. The more important issue, however, is whether this approach can be theoretically justified. As the example

In fact, courts sometimes reach the result described in the preceding paragraph. They do so by the simple means of assuming that the value of the work performed is equal to the contract price or a ratable portion of that price.[140] In the example just given, the assumption would be that *B*'s performance had increased the value of *O*'s house by $35,000 (taking into account the $15,000 required for repairs). "The result is as generous as if recovery were allowed on the contract . . . ."[141] Indeed, the contract price (rather than the economic benefit to *O*) *is* the starting point for the calculation of *B*'s recovery under this approach.

The question is why restitution must form the basis of the defaulting party's recovery. The answer is to be found in our understanding of the consequences of a discharge. When the victim of a material breach cancels and both parties' duties are discharged, then by definition all executory duties disappear. The breaching party has no claim against the victim "on the contract." In terms of our hypothetical case, *O*'s contractual obligation to pay the remainder of the contract price ceases to exist. Thus, using the contract price as the basis for *B*'s recovery may appear to be inconsistent with the implications of discharge.

A discharge does bring the contract to an end. *O* no longer is bound by express contractual provisions relating, for example, to the time and place of payment, or by such implied terms as that *O* must not unjustifiably interfere with the performance of *B*'s work. But a discharge is not a rescission, requiring that the parties' exchange be "undone," nor does it require that the original terms of the exchange be ignored. It is simply a remedy designed to protect a particular component of the expectation interest — the interest in future performance. It calls for an immediate settling of accounts rather than permitting performance to continue. As long as the victim's expectation is given first priority, the expectation interest of the breaching party need not be ignored in that settlement. Making the contract price the basis of the recovery of the breaching party does not require the victim to perform the contract. It

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in the text shows, it is not justified if the governing principle is the restitution by the victim of net benefits received. It is justified if the governing principle is the elimination of costs to the party in breach that are unnecessary to protect the victim's expectation interest.

[140] *See* R.J. Berke & Co. v. J.P. Griffin, Inc., 116 N.H. 760, 766, 367 A.2d 583, 587 (1976) (subcontractor who failed to substantially perform allowed restitution equal to contract price less cost of completing and repairing subcontractor's performance); Kreyer v. Driscoll, 39 Wis. 2d 540, 546-47, 159 N.W.2d 680, 683 (1968) (awarding restitution of contract price less cost of completion and other harm when contractor failed to complete construction of house).

[141] E. FARNSWORTH, *supra* note 1, § 8.14, at 605.

does no more than implement that policy that the victim's expectation interest is to be protected at least cost to the breaching party.[142]

b. Limiting the Victim's Right to Withhold Performance

The costs of cancellation to the breaching party sometimes could be reduced in another way. Even if the defaulting party is entitled to restitution, the victim typically withholds its entire remaining performance when a contract is cancelled. Absent a settlement agreement, the breaching party must await a court judgment awarding restitution before receiving any payment from the victim.[143] Thus, in the example just discussed, once *B* is fired, *O* probably would make no payment to *B* until ordered to do so. If *B*'s recovery were based on the contract price, as proposed above, instead of on the value of the benefit conferred net of damages, the victim could be expected to act no differently.

O's right to withhold the entire unpaid contract price pending judgment may seem to follow from the discharge of *O*'s contractual obligations. As noted, however, a discharge does not mean that, in the attempt to eliminate unnecessary costs of cancellation, the contract terms no longer may be considered. That *B* cannot enforce the contract should not necessarily entitle *O* to retain the entire unpaid contract price until *B*'s rights are determined in litigation. Instead, *O* should be permitted to retain only a good faith estimate of the amount to which *O* ultimately will be entitled as a result of the breach.[144] Thus, in a jurisdiction granting the traditional restitutionary remedy in *B*'s favor, *O*

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[142] Depriving the party in breach of any element of its expectation interest that would exceed its restitution interest often is taken as axiomatic. For example, Professor Palmer appears to suggest that basing the recovery of one committing a material breach on restitution is justified *because* it tends to deprive that party of any profit on the transaction. G. PALMER, *supra* note 128, § 5.14(e), at 680-81. The same point is made in Nordstrom & Woodland, *Recovery by Building Contractor in Default*, 20 OHIO ST. L.J. 193, 219 (1959) ("In no event should the defaulting contractor's expected profits be protected."). The assumption is made uncritically, however. These authors do not say why depriving the party in breach of all profit should be a goal routinely pursued. There may be circumstances in which that result is appropriate, such as when the party in breach would recover *more* than its expectation interest. *See* Farnsworth, *supra* note 90, at 1382-93. In most cases of material breach, however, there is no reason not to allow the defaulting party a recovery based on the contract price, subject to the full protection of the victim's expectation interest.

[143] This appears to have happened in the cases cited *supra* note 135.

[144] The victim's action is analogous to the right of a bank to deduct from its defaulting debtor's checking account an amount up to the balance due on the loan. *See* Skilton, *The Secured Party's Rights in a Debtor's Bank Account Under Article 9 of the Uniform Commercial Code*, 1977 S. ILL. L.J. 120, 186-206.

would be required to pay *B* $5,000 within a reasonable time following cancellation.[145] If *B*'s recovery were based on the expectation interest as proposed in this Article, *O* would be obliged to pay $15,000.

Sometimes, of course, the victim's damages may exceed the unpaid contract price. In that case, the entire amount properly could be withheld. But if, as in the hypothetical case, the unpaid contract price clearly exceeds the amount to which *O* is entitled, the governing remedial principle requires that the excess be paid over to *B* within a reasonable time, rather than after the many months or years that may be required to bring the matter to judgment. Deprivation of those funds during that period may cost *B* more than lost interest. Prompt payment of the money might provide *B* with working capital necessary to keep its business afloat or otherwise prevent consequential losses.[146] *O*, on the other hand, is fully protected, as long as reasonable doubts about the amount to be withheld are resolved in *O*'s favor. If *B*'s entitlement is based on the contract price, the amount withheld equals the total of compensatory and cancellation damages, thus providing the essential security that always has justified the concept of constructive conditions of exchange.[147]

Two important observations must be made about the proposed limit on the victim's right to withhold performance. First, that limit will be practicable only when the victim's performance consists of the payment

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[145] The victim should be granted sufficient time to make the required estimate. This might involve such steps as inviting bids on the remainder of the project, and so forth.

[146] Whether prejudgment interest would be payable on *B*'s contract-based recovery appears to depend, under traditional principles, largely on the extent to which the amount of the recovery is "liquidated" or known with certainty. *See* D. DOBBS, *supra* note 65, § 3.5, at 165-74. Today, statutes often govern the availability of prejudgment interest. *See* CAL. CIV. CODE § 3287(b) (Deering 1984); N.Y. Civ. Prac. Law § 5001(b) (Consol. 1978). A more interesting question is whether *O* would be liable for *B*'s consequential losses if the required payment were not made seasonably, an issue beyond the scope of this Article. No basis for precluding such liability is obvious, however, as long as doubts about the amount and timing of the payments were resolved in favor of *O* as the victim of the breach. The courts' power to structure the cancellation remedy consistent with remedial principles should permit linking the exercise of the cancellation power to a duty in the victim to pay over amounts estimated to be due the party in breach within a reasonable time following cancellation. The enforcement of that duty could include liability for consequential losses on the same basis as such losses are recoverable for breach of contract.

[147] Either party, of course, would be entitled to additional amounts later found to be owing as a result of litigation. The amount of withholding might be affected by whether compensatory damages were measured by the cost of repairs as opposed to the diminution in value resulting from the breach. *See supra* note 71. A good faith judgment by the victim as to the appropriate measure of damages should be respected.

of money or perhaps the transfer of some other divisible, fungible units of goods or services. It is simple for the injured owner to withhold a portion of the payment for work performed; it is not practicable for the injured builder to withhold a portion of the work while continuing to perform the remainder of the job.

Second, the interest of the breaching party will be subject to the good faith of the victim in determining a reasonable estimate of compensatory and cancellation damages. That is no reason to reject the idea. The law routinely empowers one party to a dispute to exercise honest, reasonable judgment in matters adversely affecting the interests of the other.[148] Permitting — and requiring — the exercise of such judgment in this context is consistent with that practice as well as with the important remedial principle of eliminating unnecessary, and sometimes serious, costs to the breaching party.[149]

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[148] *See, e.g.*, U.C.C. § 2-712 (1978) (injured buyer who has not taken possession of goods may "cover" by purchasing substitute goods "in good faith and without unreasonable delay," the seller being responsible for the difference between the cover price and the contract price).

The willingness of the law to grant the kind of discretionary, self-help remedies reflected in § 2-712 and other remedies would seem to answer Professor Corbin's concern that a disputed, unliquidated claim, such as damages for breach, should not be permitted to offset a liquidated payment obligation under an existing contract. *See* A. CORBIN, *supra* note 5, § 710, at 340-41.

[149] The text discusses a withholding by the victim of a breach of its own performance in connection with the invocation of the cancellation remedy. It also would be possible, of course, to permit such withholding when cancellation did not occur, either because the breach was not material or because the victim elected not to treat it as total. If that were done, the victim would be permitted to withhold payment equal to an honest estimate of compensatory (not cancellation) damages owed, while still requiring the party in breach to continue performance. In that setting, withholding by the victim could have very different implications than when the contract has come to an end. Especially if the party in breach has substantial duties remaining to be performed, its ability to perform those duties may be seriously impaired by such a withholding. For example, the contractor who is denied all or a substantial part of a progress payment may be forced to abandon the project for lack of funds. Given its potentially serious impact on the ability of the party in breach to continue performance, it is an important and difficult question whether such withholding should be permitted.

It appears to have been allowed in K & G Constr. Co. v. Harris, 223 Md. 305, 164 A.2d 451 (1960). A subcontractor required to perform grading services at a construction site breached the duty to perform in a workmanlike manner by damaging a partially completed wall with a bulldozer. The court, which considered the breach to be material, said that the general contractor was justified in both requiring the subcontractor to continue performance and in withholding the next two progress payments, which amounted to something less than the cost of repairing the damage. The subcontractor thus was held to have committed a second (material) breach by refusing to continue the

III. Applying the Proposed Materiality Standard

A number of common factual settings show how the proposed materiality standard is to be applied. Some of those settings were illustrated by the hypothetical cases described in Part II.B.2. This Part looks more closely at circumstances in which an impairment of the interest in future performance may, or may not, arise from a breach of contract.

A. Cases in Which a Breach is Likely To Be Material

The cases in which a breach is likely to be material may be divided into two groups: (1) those in which there is doubt about the *willingness* of the party in breach to perform properly in the future, and (2) those in which that party's *ability* to perform is in question. This part discusses these categories, then comments on the significance of motives or the state of mind of the victim of the breach in relation to both categories.

1. Unwillingness to Perform

The willingness of the breaching party to perform executory duties obviously is important to the victim's interest in future performance, and thus to the materiality of a breach. "Willingness," of course, is an elastic word that can encompass a variety of states of mind. A clear

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work. It is unclear to what extent *K & G* is sound authority for the victim's right to withhold in the absence of cancellation, however. The court justified the withholding with a dubious reading of a passage from Corbin, which refers to temporary withholding of performance by the victim of a material breach during a period in which cure by the other is possible. *See id.* at 315, 164 A.2d at 456.

Another example of such withholding by the victim is Howard S. Lease Constr. Co. & Assoc. v. Holly, 725 P.2d 712 (Alaska 1986), in which the court found that a subcontractor breached by failing to perform "finegrading" in connection with the construction of a high school. The general contractor had withheld from the progress payment the costs of doing that work itself. Based upon the same misreading of Corbin as occurred in *K & G*, the court held that the general contractor was justified in doing so. It reasoned that the subcontractor's failure to render substantial performance "justified [the general contractor] in refusing to make [an entire] progress payment," and that it therefore "follows that the general contractor is entitled to withhold from a progress payment a valid backcharge for work within the scope of the subcontract which the general contractor has had to perform itself." *Id.* at 715-16. Significantly, the court considered and rejected the subcontractor's claim that withholding the progress payment was improper because it prevented the subcontractor from performing other duties under the agreement. *Id.* at 716 (only amounts withheld in excess of the general contractor's damages should be considered in connection with the subcontractor's claim of prevention). Further consideration of this issue is beyond the scope of this Article.

example is a "pure" anticipatory repudiation, in which a party simply renounces any intention to perform future duties.[150] As noted above,[151] such conduct falls squarely within the meaning of materiality.

Less extreme unwillingness may be manifested in a number of ways. One of the more important is by the commission of a "willful" breach. Another is the failure to reassure the victim of a breach by nonperformance that future duties will be properly performed.

a. Willful Breach

The willfulness of a breach long has been considered relevant to determining its materiality. The *First Restatement* includes willfulness among the circumstances to be taken into account,[152] and numerous courts, particularly in older cases, have referred to willfulness or bad faith in their various tests for materiality.[153]

A principal difficulty with this factor has been the absence of an agreed definition. To some, willfulness has meant simply an intentional deviation from the requirements of a contract, as opposed to one committed by inadvertence. This seems to have been what Cardozo had in mind when he suggested in dictum that an intentional breach would lead to a finding of materiality because "[t]he willful transgressor must accept the penalty of his transgression."[154] The difficulty with this approach to willfulness, of course, is that deliberateness alone does not inflict harm cognizable by contract remedies. Compensatory damages for an intentional breach usually come out the same as for a negligent one. Moreover, it is widely accepted that an intentional breach is not necessarily to be discouraged.[155]

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[150] If a repudiation is accompanied by a breach by nonperformance, the impairment of the victim's interest in future performance may be increased. The nonperformance always impairs the interest in present performance, of course, but it also may underscore the breaching party's intention not to perform properly in the future.

[151] *See supra* text accompanying note 99.

[152] FIRST RESTATEMENT, *supra* note 6, § 275(e)("[t]he willful, negligent or innocent behavior of the party failing to perform").

[153] *E.g.*, Atkinson v. Webster City, 177 Iowa 659, 680, 158 N.W. 473, 480-81 (1916); Groves v. John Wunder Co., 205 Minn. 163, 165, 286 N.W. 235, 236 (1939); Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 244, 129 N.E. 889, 891 (1921); *Cf.* S. WILLISTON, *supra* note 4, § 842, at 1614-15.

[154] Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 244, 129 N.E. 889, 891 (1921).

[155] *See* Nicholson v. United Pac. Ins. Co., 710 P.2d 1342, 1348 (1985) (noting that contract law encourages intentional breaches which promote efficient economy); *see also* E. FARNSWORTH, *supra* note 1, § 12.3, at 816-17. *See generally* R. POSNER, ECONOMIC ANALYSIS OF LAW 88-93 (2d ed. 1977); Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 284 (1970);

But if willfulness must mean something more or something else than a deliberate breach, no one knows exactly what it is. Its meaning can run from modest corner-cutting[156] to deliberately using materials significantly inferior to those required by the contract,[157] to something as unattractive as a malicious intent to do injury.[158] Accordingly, there has been considerable dissatisfaction with its use. References to willfulness were carefully omitted from the materiality section (and elsewhere) in the *Second Restatement*.[159]

Many of the difficulties that plague the concept of willfulness in the materiality analysis fall away when the interest in future performance is made the key element of that analysis. It is not necessary to settle upon any particular definition of "willfulness" or other term as a prescribed element in a formula for materiality. What is important are the implications of attitude of the breaching party for the interest in future performance. To the extent the breach is motivated or accompanied by a state of mind suggesting that future breaches are likely, the interest in future performance is impaired. By contrast, a state of mind indicating that future nonperformance is unlikely cuts against materiality. The

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Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980); Goetz & Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558 (1977).

[156] *E.g.*, Lautenbach v. Meredith, 240 Iowa 166, 172, 35 N.W.2d 870, 874 (1949) (builder's failure to complete a few "comparatively unimportant" items of work acknowledged to be intentional, but nevertheless held not to constitute a material breach).

[157] *E.g.*, Ylijarvi v. Brockphaler, 213 Minn. 385, 387, 7 N.W.2d 314, 319 (1942) (contractor under contract to drill well substituted 2-½" casing for the 4" casing required by the agreement, despite protests by the owner).

[158] *See* White v. Benkowski, 37 Wis. 2d 285, 288, 155 N.W. 2d 74, 75-76 (1967) (jury found that supplier of water interrupted water flow for the purpose of harassing recipient).

[159] Professor Farnsworth, as Reporter of the relevant part of the *Second Restatement*, informed the American Law Institute that the drafters were pleased to report having "succeeded in driving out of the Restatement the term 'willful'[, which was] among other things . . . a consideration in [§ 275, the principal material breach provision of the *First Restatement*]." American Law Institute, 50th Annual Meeting — Proceedings 1973 at 221 (1974). Eliminating the reference to willfulness did not solve the problem, for it was replaced with another term: "good faith and fair dealing." *See, e.g.*, RESTATEMENT SECOND *supra* note 6, § 205 and accompanying comments; *supra* notes 45-48 and accompanying text.

If the drafters thought that "good faith" would be less troublesome a phrase than willfulness, they doubtless have been disappointed. Despite a great deal of recent interest in contractual good faith in both the case law and scholarly literature, *see* Andersen, *supra* note 48, at ____. No general consensus has been reached about the meaning of this important term.

facts of two decided cases illustrate.

In *Ylijarvi v. Brockphaler*,[160] a land owner and a contractor agreed that the latter would drill a water well using four inch casing. After the drilling had progressed to a depth of 204 feet, the contractor began to use two and one-half inch casing instead and persisted in doing so despite the owner's protests. The state of mind reflected by the contractor's conduct quite clearly impaired the owner's interest in future performance. That impairment existed, however, not simply because the breach was deliberate, but because it evinced an intent to breach the contract in the future.

In another water-well case, *Oak Ridge Construction Co. v. Tolley*,[161] the owner disputed the contractor's charges for drilling the well. In *Tolley*, the drilling was part of a larger contract for the construction of a residence. While refusing to pay the disputed well-charge, the owner indicated that performance by both sides on all other aspects of the contract should continue.[162] The owner's refusal to pay was every bit as "willful" as was the breach of the contractor in *Ylijarvi*. But, unless the owner's refusal to pay the relevant part of one progress payment made it financially impractical for the contractor to proceed,[163] that refusal did not impair the interest in future performance. The contractor had no reason to believe that the owner would not perform in relation to the major, undisputed portion of the work. Accordingly, the court correctly held that the contractor materially breached by stopping all further work on the job. As these cases illustrate, the relevance of willfulness is not what it demonstrates about why a particular breach was committed, but what it implies about the willingness of the party committing it to perform in the future.

Evidence that the breaching party does not intend to perform in the future may be particularly strong when the breach prevents or seriously hinders the victim's future performance. It usually will be clear that the breaching party does not intend to perform if the victim's own performance is not forthcoming.

In *Zancanaro v. Cross*,[164] for example, a developer contracted with a plumbing company for the installation of plumbing and fixtures in fifty new houses to be built by the developer. After twenty-five houses had

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[160] 213 Minn. 385, 7 N.W.2d 314 (1942).

[161] 504 A.2d 1343 (Pa. Super. 1985).

[162] This appears to be the court's interpretation of the owner's letter to the contractor; it is clearly the correct one. 504 A.2d at 1345-47.

[163] *See infra* notes 166-67 and accompanying text.

[164] 85 Ariz. 394, 339 P.2d 746 (1959).

been built, the developer breached the contract by refusing to construct the remainder. Since the plumbing company could not work on structures not in existence, it was prevented from performing. It would be possible, of course, for the developer in such circumstances to continue performing by paying the profits that would have been earned on the remaining homes. In the absence of some evidence of that intent, however, the plumbing company was justified in assuming that the developer was unwilling to perform in the future, and correctly concluded that the breach was material.[165]

A typical fact pattern illustrating a breach that prevents the victim from performing involves the wrongful withholding by an owner of a progress payment due a contractor. The effect of the withholding often will be to prevent further performance by the contractor who is not able to finance the project in the absence of periodic payments against the contract price.[166] Even if only a single progress payment were in dispute, the breach would be material if the contractor were compelled to stop work, because it would be safe to assume that the owner would not make future payments once progress on the building ceased. The case for materiality would be even more clear if the owner manifested an intent to withhold future payments even if work continued.[167]

Knowing how the state of mind of the breaching party bears on ma-

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[165] In *Zancanaro* the plumbing company treated the material breach as total by ceasing work and suing for the profits it would have earned on the houses not built. The court agreed that the developer's breach was material and that the cancellation remedy was appropriate. 85 Ariz. at 399-400, 339 P.2d at 749-50; *see also* Guerini Stone Co. v. Carlin Construction Co., 248 U.S. 334, 339, 341 (1919) (general contractor's lengthy and indefinite delay in making work site available to subcontractor was a material breach entitling the latter to cancel); Watson Constr. Co. v. Reppel Steel & Supply Co., 123 Ariz. 138, 143, 598 P.2d 116, 121 (1979) (general contractor materially breached by ceasing construction, thus preventing subcontractor from performing).

[166] *E.g.*, Zulla Steel, Inc. v. A & M Gregos, Inc., 174 N.J. Super. 124, 131, 415 A.2d 1183, 1186-87 (1980) ("defendant's failure to pay plaintiff meant that plaintiff could not pay its subcontractor and thus could not complete its contract with defendant"); Aiello Constr. v. Nationwide Tractor Trailer Training & Placement Corp., 121 R.I. 861, 865, 413 A.2d 85, 87 (1980) (owner's failure to make progress payment under construction contract justified cancellation); Wagstaff v. Remco, Inc., 540 P.2d 931, 933 (Utah 1975) (unjustified failure to make progress payment is material breach where "it materially impairs the contractor's ability to perform.").

[167] The discussion in the text assumes that the contractor's interest in future performance does not include an interest in rendering its own performance, in addition to receiving payment from the owner. *See supra* text preceding note 80. If such an interest existed, then prevention by the owner by, for example, a wrongful lock-out from the work site might be a material breach even in the unlikely event that the owner was willing to pay the contractor's profits on the remainder of the job.

teriality does not eliminate all difficulties, of course. It always is challenging to find the most elusive of all facts, the thoughts of a person at a time in the past. Yet the law is accustomed to dealing with the problem. Various sources of evidence of state of mind are available, ranging from the utterances of the person in question[168] to inferences drawn from conduct.[169]

The proposed approach to the state of mind of the breaching party does not require or imply a moral judgment. For purposes of material breach, ill-will is significant not because it is morally reprehensible (however true that may be), but because it reveals an increased probability that the victim cannot expect proper performance in the future. By the same token, one who fails to perform purely for economic reasons may signal the same risk to future performance as accompanies a malicious breach. The interest in future performance is the key to materiality. The willfulness of the party committing a breach is relevant so far, and only so far, as it bears on that interest.

b. Cure and the Giving of Assurances

The state of mind of the defaulting party does not cease to be relevant with the commission of a breach. After the breach occurs, the one committing it may take action or otherwise manifest intentions that bear on the interest in future performance. In particular, that party may cure, or attempt to cure, the breach or give assurances about proper performance in the future.

Cure is closely linked to the interest in present performance. When applicable, it empowers the breaching party to take action to repair the injury caused, thus reducing or eliminating the liability for compensatory damages.[170] When such action is taken, the victim receives, in effect, compensation in kind for the harm to the interest in present performance.[171]

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[168] *Cf.* United States Fidelity & Guar. Co. v. Millonas, 206 Ala. 147, 153, 89 So. 732, 737 (1921) (employer's declarations admissible to show reasons for firing employee).

[169] In Golwitzer v. Hummel, 201 Iowa 751, 756, 206 N.W. 254, 256 (1925), the court inferred from the nature and large number of breaches committed by a builder "a willful purpose to make as cheap a job as possible out of this."

[170] *See generally* E. FARNSWORTH, *supra* note 1, § 8.17, at 613-15; Lawrence, *supra* note 50.

[171] One might argue that cure may apply directly and exclusively to the interest in future performance in the context of a breach by anticipatory repudiation. When the repudiator retracts a repudiation, it might be said that breach has been cured. *See* U.C.C. § 2-611 (1987); *Second Restatement*, *supra* note 6, § 256. The point is correct,

Cure also may be protective of the interest in future performance.[172] In some cases, the repairs or corrective action taken may eliminate or reduce barriers to future performance. More importantly, cure, or attempts to cure, may demonstrate a careful or responsible attitude toward performance suggesting that future breaches are unlikely to occur or will be quickly corrected if they do. Cure thus not only mitigates compensatory damages, but may save a breach from being material.[173] On the other hand, one's failure to cure, given the opportunity to do so, may invite precisely the opposite inference. It is the implied assurance, or lack of assurance, about future performance that makes cure or its absence relevant to materiality.[174]

Assurances about future performance, of course, may be explicit instead of implicit, and they may be given independent of cure. Whether or not a breach is curable, if the party committing it gives explicit and adequate assurances about future performance, the victim's legitimate concerns about that performance may be quieted. On the other hand, those concerns may be aggravated if such assurances are not forthcoming, particularly in response to a request by the victim.[175]

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although the common usage of "cure" generally seems limited to the repair of injury caused by a breach by nonperformance.

[172] Cure was not mentioned in the *First Restatement*. In the *Second Restatement*, it appeared as a replacement for *First Restatement* § 275(f), discussed *supra* note 44. Section 241(d) of the *Second Restatement* provides that the following is significant in deciding whether a failure to perform is material: "the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances." This is a helpful statement if the focus is properly directed to the interest in future performance, as suggested above. It is not enough that cure simply take place, however; as discussed in the text, the implications of cure for that interest must be examined.

[173] *See* Lawrence, *supra* note 50, at 729-30.

[174] *See, e.g.*, Wright v. Vickaryous, 611 P.2d 20, 22 (Alaska 1980) (cattle seller's failure to cure "substantial shadow" on title by informing buyer that third parties' security interests had been discharged permitted buyer to cancel); Graulich Caterer Inc. v. Hans Holterbosch, Inc., 101 N.J. Super. 61, 76-77, 243 A.2d 253, 262 (1968) (applying U.C.C. § 2-612; food supplier's failure to cure deliveries justified cancellation of installment contract).

[175] A need for assurances about future performance may exist even in the absence of a breach by nonperformance or facts rising to the level of a breach by anticipatory repudiation. SECOND RESTATEMENT, *supra* note 6, § 251 and U.C.C. § 2-609 (1987) provide that one who reasonably feels insecure that the other party will perform in the future may demand assurances about that performance. The failure to give the requested assurances then becomes a breach by anticipatory repudiation. As observed *supra* text accompanying notes 78-79, the importance of the interest in future performance and the willingness of the law to protect it with the cancellation remedy is clearly reflected in these rules.

2. Inability to Perform

The willingness of a breaching party to perform a contract will not secure the other's interest in future performance if the breaching party is unable to do what was promised. Inability to perform may make a breach material for two reasons: (1) as a consequence of the breach the party committing it is prevented from performing; or (2) the breach demonstrates that party's lack of skill or resources necessary to accomplish what was promised.

If a breach of contract prevents the future performance of the party committing it, the impairment of the victim's interest in future performance is clear.[176] For example, suppose a restaurant owner breaches a contract to offer discount meals over a one-year period by closing the restaurant after six months. The breach makes future performance by the owner impossible, and thus is material.[177] Other cases are not difficult to imagine,[178] although materiality will not frequently be disputed because the materiality of the breach is obvious.

A more common and more difficult dispute arises when the circumstances of the breach do not preclude future performance, but reveal that, even given the opportunity, the breaching party lacks the ability to fullfil its remaining executory duties. The victim thus may infer from a present breach that significant breaches of contract are likely to be committed in the future.

The point is illustrated by the facts, though not the court's opinion, in the well-known case of *K&G Construction Co. v. Harris*.[179] A general contractor made an agreement with a subcontractor to do excavat-

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[176] Such cases are to be distinguished from those in which the breach prevents the *victim* from performing in the future. *See supra* text accompanying notes 164-67. They also are distinct from cases in which a mistake of fact or an intervening event excuses performance under the doctrines of mistake, impracticability or frustration of purpose.

[177] *Cf.* Perlman v. Westin Hotel Co., 154 Ill. App. 3d 346, 506 N.E.2d 1318 (1987) (hotel closed one of two restaurants at which discount meals had been promised).

[178] Consider, for example, a contract in which one party agrees to maintain in good operating order the other's equipment, but in the course of performance irreparably damages it. *Cf.* Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co., 69 Cal. 2d 33, 69 Cal. Rptr. 561, 442 P.2d 641 (1968).

[179] 223 Md. 305, 164 A.2d 451 (Ct. App. 1960). The facts of other cases suggest that a party's lack of skill or ability to perform future obligations justifies cancellation. *See, e.g.*, B & B Equipment Co., Inc. v. Bowen, 581 S.W.2d 80, 84-85 (Ct. App. Mo. 1979) (partnership agreement properly cancelled in response to partner's continuing failure to perform required services adequately); McIntyre v. Fort Vancouver Plywood Co., Inc., 24 Wash. App. 120, 129-30, 600 P.2d 619, 624 (1979) (employee properly discharged prior to termination of employment contract for failing to perform adequately, even though employee claimed to be working to best of ability).

ing and earth-moving work at a construction site. The agreement required the subcontractor to perform in a "workmanlike manner, and in accordance with the best practices."[180] In breach of that obligation, the subcontractor drove a bulldozer too close to one of the general contractor's buildings, causing the collapse of a wall and other damage to the structure.[181]

An important issue in the case was whether the subcontractor's breach was material.[182] The court decided that issue solely by reference

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[180] *See* 223 Md. at 308, 164 A.2d at 452.

[181] *See id.* at 309, 164 A.2d at 453.

[182] The court's analysis in *K & G* is unnecessarily complicated and somewhat misguided. Assuming the breach was material, as the court found it to be, 223 Md. at 314-15, 164 A.2d at 456, it would seem that the general contractor should have been put to a choice: either treat the breach as total and cancel the contract, or treat it as partial and continue making progress payments while seeking compensatory damages for the breach. Instead the general contractor sought the best of both worlds: withholding progress payments while requiring the subcontractor to continue performance.

The court held that the general contractor had acted correctly and had treated the material breach as partial. The first material breach treated as total therefore came when the subcontractor walked off the job in response to the general contractor's refusal to make progress payments.

The difficult problem in the case is to explain why the general contractor was entitled both to withhold its own performance and to insist on further performance by the other. The court's answer is unconvincing. It is based entirely on the following statement from Corbin's treatise: "If the refusal to pay an instalment is justified on the owner's part, the contractor is not justified in abandoning the work by reason of that refusal. His abandonment of the work will itself be a wrongful repudiation that goes to the essence, even if the defects in performance did not." A. CORBIN, *supra* note 5, § 708, at 333. That statement, however, is made on the assumption that "the time for curing defects [has not] expired," *id.* § 708, at 332, and that the owner is withholding progress payments only temporarily to see whether cure by the contractor will occur. The court never discusses the possibility of cure, and in the circumstances of the case cure was unlikely: the subcontractor and its insurer disclaimed liability for the damage caused by the bulldozer. 223 Md. at 309, 164 A.2d at 453. Unlike a simple failure to complete work on time or to the required specifications, the breach in this case was not the kind of problem that was capable of correction by an agreed deadline for the completion of performance. Thus, the time for cure, assuming one existed at all, must have passed as soon as it was clear that the subcontractor would take no action to correct the problem. At that point, Professor Corbin's statement ceased to be applicable.

One therefore might conclude that the decision is simply wrong, that the general contractor could not have it both ways, and, if it chose to treat the subcontractor's breach as partial, itself committed a breach — perhaps material — by withholding progress payments. A possible justification for the decision exists, however. It is that the general contractor was justified in invoking a set-off remedy by withholding progress payments until an amount necessary to compensate for the bulldozer damage was held as security. This important idea, which is mentioned *supra* note 149, was not discussed by the court. Corbin was skeptical about it. *See* A. CORBIN, *supra* note 5, § 709, at

to the amount of damages required to repair the injury in relation to the amount of the monthly progress payments the general contractor was paying the subcontractor.[183] The court should have focused more directly on other questions focusing concerning the general contractor's interest in future performance. In particular, it is important to know what the bulldozer incident implied about the likelihood of future breaches. Would the subcontractor's work require driving a bulldozer close to other structures? If so, would the same operator be doing the job? If those questions were answered in the affirmative, the general contractor might have genuine cause for alarm. On the other hand, if there were no more buildings around which earth-moving was to be done, or if the unskilled operator were dismissed or reassigned and replaced with someone known to have superior skills, then concern about the subcontractor's future performance might be minimal.

The inquiry must be directed toward the impairment of the interest in future performance when a breach by nonperformance that suggests a lack of skill or resources on the part of the party in breach. Close and difficult judgments about materiality will be necessary in some cases, but the result is more likely to be correct when the proper questions are asked.

3. The Victim's State of Mind

The most important connection between materiality and the victim's state of mind, or at least the victim's point of view, already has been noted. The self-help nature of the cancellation remedy requires that the impairment of the interest in future performance be assessed from the perspective of a reasonable person in the victim's position, not that of a court having the benefit of hindsight and carefully presented evidence.[184]

The need to base the analysis on the perspective of a hypothetical victim suggests an important way in which the victim's state of mind may be relevant to materiality. If the victim seizes upon a breach to cancel an unfavorable contract, an argument can be made that the breach was not material. *Continental Grain Co. v. Simpson Feed Co.*[185] illustrates. A company contracted to buy five railroad car loads of soybeans. It delayed forty-eight hours before giving the seller shipping instructions regarding the second car load. The seller had loaded the

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339-40. It deserves careful consideration but is beyond the scope of this Article.

[183] *See* 223 Md. at 315, 164 A.2d at 456.

[184] *See supra* part II.E.1.b.

[185] 102 F. Supp. 354 (E.D. Ark. 1951).

goods and was being pressed by the railroad either to move the car or unload it. When the instructions eventually were given, the seller told the buyer that the contract had been cancelled because of the delay. Between the date of the contract and the time of cancellation, the market price for soybeans had been rising steadily. The buyer covered at a price higher than that agreed under the contract and sought damages.

The court held that even if the buyer's delay was a breach, it was not a material one. The definition of materiality quoted by the court was whether "the default is so substantial and important as in truth and in fairness to defeat the essential purpose of the parties."[186] In fact, the court approached materiality in terms suggestive of the interest in future performance.[187] Of crucial importance to the court's decision was the rising market:

> We are of the opinion that the evidence in the instant case permits only one inference to be drawn with respect to the plaintiff's assumed breach of contract, and that is that it was trivial and insubstantial and did not justify the defendant in refusing, either in whole or in part, to perform the contract further. In truth the defendant entered into a contract with the plaintiff which became disadvantageous when the soybean market rose, and from all of the facts and circumstances in the case we can not escape the conclusion that the defendant simply seized upon what was at most an inconsequential breach on the part of the plaintiff as an excuse for release from that contract.[188]

The court's conclusion that the seller's motive for cancelling was the desire to take advantage of the rising market should not, by itself, have defeated a claim of materiality. It did, however, permit an inference that the seller was not concerned about the interest in future performance, but about another interest — increasing profits — not appropriately protected by cancellation.

Such an inference was drawn in *Bart Arconti & Sons, Inc. v. Ames-*

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[186] *Id.* at 358 (quoting Helgar Corp. v. Warner's Features, Inc., 222 N.Y. 449, 454, 119 N.E. 113, 114 (1918).

[187] The court quoted the following language from *Helgar Corp.*, 222 N.Y. at 454, 119 N.E. at 114, which to some extent emphasizes the effect of the delay on the future performance of the contract:

> If the default is the result of accident or misfortune, if there is a reasonable assurance that it will be promptly repaired, and if immediate payment is not necessary to enable the vendor to proceed with performance, there may be one conclusion. If the breach is willful, if there is no just ground to look for prompt reparation, if the delay has been substantial, or if the needs of the vendor are urgent so that timely performance is imperiled, . . . there may be another conclusion.

102 F. Supp. at 358.

[188] 102 F. Supp. at 361.

Ennis, Inc.,[189] in which a masonry subcontractor entered three agreements for work on different projects. After a dispute with the general contractor, the subcontractor walked off two of the jobs, alleging that the other side had materially breached. In ruling for the general contractor, the court relied in part on the fact that the subcontractor had ended only two of the three agreements. The appellate court said that the trial court

> was free to infer from the evidence in this case . . . that . . . unlike the other two projects, the work at the [site controlled by the agreement not terminated] would likely have been profitable whereas that would not have been true at the other locations.[190] Thus, the subcontractor's allegations on which the claim of material breach rested were "merely a pretext for abandoning the job."[191]

It is essential that the argument not be misunderstood. The victim's motivation does not itself bear a causal relationship to the interest in future performance. All plausible explanations for the victim's conduct must be considered.[192] But evidence that the motivation for cancelling a contract was to escape a losing contract or to take advantage of more favorable terms elsewhere may provide circumstantial evidence of lack of materiality. The cancellation remedy is not necessary to protect the interest in future performance if convincing evidence is presented that cancellation was motivated by another purpose.[193]

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[189] 275 Md. 295, 340 A.2d 225 (1975).

[190] *Id.* at 308, 340 A.2d at 233.

[191] *Id.*; *see also* Circle Sec. Agency, Inc. v. Ross, 107 Ill. App. 3d. 195, 204, 437 N.E.2d 667, 674 (1982) (employer's claim that employee's insubordination was material breach of employment contract was undermined by the employer's "alleged motivation to modify or end [the] contract.").

[192] Harness Tracks Sec. Inc. v. Bay State Raceway, Inc., 374 Mass. 362, 373 N.E.2d 353 (1978), illustrates that a claim of material breach is not necessarily defeated merely because the victim harbors a motive for cancellation other than the protection of the interest in future performance. In that case, a corporation engaged in pari mutuel harness racing had cancelled its contract with a private detective agency on the ground that the agency had materially breached by failing to be properly licensed in Massachusetts. The court agreed that cancellation was warranted, since the agency's failure to become licensed might have subjected the corporation to liability in tort to third persons. Apparently responding to the agency's argument that the prospect of tort liability had not in fact motivated the cancellation, the court said: "If it is a fact that the defendant cancelled the contract for some other reason, that fact does not impair the justification." *Id.* at 357. That conclusion is correct. As long as the corporation could demonstrate a legitimate impairment of the interest in future performance, cancellation was in order, even if other interests, irrelevant to that remedy, also were advanced.

[193] *See* Andersen, *supra* note 48, at ____, for a similar argument in connection with attempts to invoke an agreed enforcement term in order to secure an interest other than

B. Cases in Which an Interest in Future Performance is Lacking

Part III.A. discussed cases in which the problem is recognizing and evaluating the extent to which a breach impairs the interest in future performance. The materiality inquiry in such cases may be difficult, but the approach suggested in this Article facilitates the analysis by providing a coherent conceptual framework.

The materiality analysis often is applied unnecessarily to another category of cases — those in which the victim has no interest in future performance at all. Perhaps the most typical and important example of such cases is the construction contract in which the builder completes performance, but does so imperfectly. The analysis that follows is set in the context of that factual setting, although the principles involved apply more broadly. The builder will seek to recover the contract price, less damages for any breach, under a claim of "substantial performance," which means simply the absence of material breach.[194] The owner may resist the claim that anything further is owed under the contract on the basis that substantial performance was not rendered — meaning that the builder's breach was material — and that the owner's duty to make further payments under the contract therefore is discharged. In such cases, the application of the material breach doctrine is pointless.

Analysis of the category of cases described — indeed the very existence of the category — depends upon the distinction between incomplete and imperfect performance. The difference may seem elusive. Suppose that a contractor breaches a contract to install a new roof by using tiles of uneven color, so that when all the tiles are in place, the roof has a patched and streaked appearance instead of a uniform color.[195] It may not be immediately apparent why it matters whether one considers the work to be incorrectly performed as opposed to unfinished. When material breach is concerned, however, it matters very much whether the job is considered to be only imperfect or also incomplete.

In approaching this distinction, it helps to bear in mind the reason for making it in the first place. The purpose of the cancellation remedy is to protect the owner's interest in future performance. Arming the owner with the potential power to discharge the builder — to deprive

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the one the term was intended to protect.

[194] E. FARNSWORTH, *supra* note 1, § 8.16, at 612.

[195] *See* O.W. Grun Roofing & Construction Co. v. Cope, 529 S.W.2d 258 (Tex. Ct. App. 1975).

the builder of the right to perform, and be paid for, future duties under the contract — is the best way of protecting the owner's interest in the likelihood that those duties will be performed without serious shortcomings — if not by the builder, then by someone else.

The time may come under the contract when, notwithstanding any flaws in the builder's past performance, the builder will have no further executory duties. At that point, therefore, the owner no longer has an interest in future performance.[196] Discharging the builder becomes meaningless because the builder has no executory duties to discharge. Moreover, the compensation owed the victim cannot include an element of cancellation damages, because those damages consist of the value to the victim of the discharged, executory duties of the breaching party.[197]

To those not schooled in such concepts as executed and executory duties, the distinction can be made by asking the practical question whether the breaching party has any further opportunity to commit a breach of contract in the future. The facts of two decided cases illustrate. In *Merrill Iron & Steel, Inc. v. Minn-Dak Seeds, Ltd.*,[198] a general contractor agreed to construct a plant for the processing and cleaning of mustard seeds. When the owner put the plant into service, water penetrated the storage bins, making the seeds unusable, and cleaned and uncleaned seeds from adjacent bins became mixed, requiring a repetition of the cleaning process. While the breach was serious, and replacement or repairs by the builder or some other party would have been of value to the owner, the builder had no further executory duties. For purposes of the materiality analysis, therefore, the builder's work was complete because the builder had no opportunity to commit further breaches of contract.

A contrasting case is *Golwitzer v. Hummel*,[199] in which the builder of a new residence committed numerous breaches of contract in the course of construction, resulting in such problems as improper drainage of the basement floor, a leaking and sagging roof, a misplaced furnace, and an undersized chimney.[200] The owners complained about these deficiencies during the course of work, and finally discharged the builder when a major part of the construction remained to be done. Unlike the situa-

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[196] The hypothetical case assumes that the owner's interest in future performance does not include an interest in rendering its own performance, which in this case is simply the payment of money.

[197] *See supra* notes 93-98 and accompanying text.

[198] 334 N.W.2d 652 (N.D. 1983).

[199] 201 Iowa 751, 206 N.W. 254 (1925).

[200] *Id.* at 754-56, 206 N.W. at 255-56.

tion in *Minn-Dak Seeds*, at the time the owner acted on the breach, the builder had many remaining opportunities to commit serious breaches of contract.[201]

In cases such as *Minn-Dak Seeds*, the material breach doctrine has no proper application. The owner was not at risk of future malfeasance, although compensatory damages were required to repair the faulty work already done. By contrast, in *Golwitzer*, the owner needed to be rid of the slothful builder, and required both compensatory damages to repair the faulty work performed and the cancellation remedy to see the job properly finished. The single, critical factual difference between the two cases is that in one the performance of the party in breach was not only imperfect, but also incomplete; in the other, it was merely imperfect.

Going through the motions of the materiality analysis would be a harmless waste of time in such cases were it not for the common belief that a necessary consequence of a discharge upon cancellation is that the breaching party can recover only on a restitutionary theory. As discussed,[202] that is not a necessary consequence of discharge, and it can lead to a windfall for the victim when the unpaid contract price exceeds the damages owed on account of the breach.[203] That result could be avoided if it were accepted that the recovery of the party who had performed completely but imperfectly should be based on the contract price. The party in breach would be entitled to the payment of the

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[201] There will, of course, be cases that fall close to the line, those in which the party in breach *almost* has completed performance. An example is Plante v. Jacobs, 10 Wis.2d 567, 103 N.W.2d 296 (1960), in which the owners of a new house to be constructed by a builder unsuccessfully claimed material breach (the absence of substantial performance), and therefore discharge of their executory payment obligations under the contract, on the basis of a number of shortcomings in the builder's work. The breaches on which the owners relied included both flaws in past performance, particularly the misplacement by over one foot of an internal wall, and the failure to complete a number of items called for in the agreement, such as the installation of kitchen cabinets, gutters and downspouts, a sidewalk, etc. In contrast to the situation in *Minn-Dak Seeds*, the builder *did* have the opportunity to commit breaches in the future in the performance of the items remaining to be done. Yet, unlike the facts in *Golwitzer*, the remaining performance was minor in comparison to the entire project. If the remaining performance is not trivial, and if the risk of non-performance is sufficiently serious, the owner does have a legitimate need to cancel in order to have the work properly completed.

[202] *See supra* part II.E.2.a.

[203] That may have been precisely what occurred in *Minn-Dak Seeds*. The court, upon concluding that substantial performance had not been rendered, ruled that the general contractor properly had been denied a credit in the amount of the unpaid contract price to offset the damages owed the builder. 334 N.W.2d at 657-58.

contract price less damages, which in the nature of the case would be compensatory damages only.

The better way to avoid the problem is to recognize the irrelevance of the material-breach doctrine in this setting. When the interest in future performance disappears, the need for the cancellation remedy as a means of protecting that interest disappears with it. Pending judgment or settlement, the victim does need the right to retain from the unpaid contract price an amount not exceeding an honest and reasonable estimate of damages as security for their payment.[204] But the notion of materiality has no place in the analysis.

Despite the irrelevance of the cancellation remedy when the breaching party has completed performance,[205] the material-breach doctrine routinely is applied in such cases.[206] Some courts, no doubt sensing the

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[204] *See supra* part II.E.2.b.

[205] The Uniform Commercial Code appears to make cancellation available when the interest in future performance does not exist (or, if it exists, is not impaired). Under the "perfect tender rule" incorporated into U.C.C. § 2-601 (1987), a buyer of goods under a contract not permitting or requiring delivery in installments is entitled to reject the goods if the tender fails in any respect to conform to the requirements of the contract. Under U.C.C. § 2-711(1) (1987), the buyer also may cancel the contract. The buyer has no interest in future performance upon the breach of a non-installment contract because the seller has no future duties to perform. (Even if there is an interest in the future performance of a seller's warranty in such cases, an imperfect tender may not put that interest at risk, as when the breach consists of tardiness or a delivery of less than the required number of units).

The reference to cancellation in U.C.C. § 2-711 is not inconsistent with the thesis of this article. A buyer faced with an imperfect tender may choose to accept or reject the goods. *See* U.C.C. § 2-601 (1987). If the former choice is made, the buyer is awarded damages necessary to make good the loss caused by defects in the goods. *See* U.C.C. § 2-714 (1987). If the latter course is taken, the buyer's remedy (assuming specific performance is not available) is damages equal to the difference between the market (or cover) price and the contract price. *See* U.C.C. §§ 2-711, 2-712, 2-713 (1987). In either case, the damages are compensatory only; they do no more than make good the injury caused by the seller's imperfect performance. "Cancellation," in the sense the word is used in this article, does not occur, because there is no discharge of unperformed future duties, accompanied by an award of damages in lieu of those duties. It therefore is irrelevant to say, as does § 2-711, that the buyer may cancel the agreement. By contrast, cancellation is a genuine option when an installment contract has been breached. The Code properly imposes a materiality requirement in such cases. *See* U.C.C. § 2-612 (nonconformity must "substantially impair" the value of an installment or of the whole contract).

[206] *E.g.*, Dr. Franklin Perkins School v. Freeman, 741 F.2d 1503, 1518 (7th Cir. 1984) (no material breach); Jim Arnott, Inc. v. L & E, Inc., 539 P.2d 1333, 1336 (Colo. App. 1975) (finding substantial performance); Independent School Dist. No. 35 v. A. Hedenberg & Co., 214 Minn. 82, 84, 92, 7 N.W.2d 511, 514, 518 (1943) (finding absence of substantial performance); Standard Millwork & Supply Co. v.

inconsistency between the material breach (or, as it is referred to in this context, the substantial performance) doctrine and the expectancy principle in such cases, solve the problem by granting restitution to the party in breach on the uncritical assumption that the value of the work performed is equal to the contract price less compensatory damages.[207] In the absence of a good reason to apply the materiality analysis, the proper approach is simply to disregard the material breach doctrine and consider recovery to be "on the contract."

CONCLUSION

The idea of constructive conditions of exchange is among the most important in all of contract law, for it establishes a conceptual mechanism for the exercise of the power of cancellation. The material-breach doctrine qualifies constructive conditions. Its function is to control that power, to mitigate the harshness that would follow if it routinely were put into the hands of one injured by any breach, however slight. Effective control requires a coherent and intelligible theory of material breach. Unfortunately, such a theory has eluded the law of contract. The *Restatements* have not offered a satisfactory approach to materiality and the courts have found nothing to supplement or replace them other than the vacuous "essence of the contract" notion.

Material breach can be brought into sharp focus by viewing it from the perspective of the cancellation remedy. Basic remedial principles already are in place that make materiality comprehensible. The most important is that a remedy for breach should protect the victim's expectation interest at the least cost to the breaching party. To apply that

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Mississippi Steel & Iron Co., 205 Miss. 96, 110-12, 38 So.2d 448, 449-51 (1949) (finding substantial performance); Jacob & Youngs, Inc. v. Kent, 230 N.Y. 239, 240, 244-45, 129 N.E. 889, 890, 891-92 (1921) (finding substantial performance); Merrill Iron & Steel, Inc. v. Minn-Dak Seeds, Ltd., 334 N.W.2d 652, 655, 658 (N.D. 1983) (finding absence of substantial performance).

[207] *See* Pinches v. Swedish Evangelical Lutheran Church, 55 Conn. 183, 187-88, 10 A. 264, 265-66 (1887) (awarding restitution of contract price less diminution in value for building defects to contractor in breach); Nelson v. Hazel, 91 Idaho 850, 852, 433 P.2d 120, 122 (1967) (awarding restitution of contract price less set-off for cost of repair to contractor in default). The approach to restitution used by these courts parallels that advocated earlier in this article for cases in which the victim cancels prior to completion by the party in breach. *See supra* text accompanying notes 140-41. The critical difference between the two situations is that in the cases discussed previously, cancellation is necessary, and the question is how to minimize the costs of that remedy to the party in breach by means of a restitutionary or other recovery. By contrast, in the cases under discussion here, cancellation itself is unnecessary, so there is no need for a resort to restitution at all.

principle to material breach, one must recognize that the expectation interest consists of two components: the interest in present performance and the interest in future performance. The cancellation remedy protects only the latter, which is one party's contractually-based sense of security that the other will perform its executory duties as and when agreed. Cancellation should be invoked only when a breach so impairs the interest in future performance that the victim has reasonable cause to bring the contract to an end, so that the bargained-for security, or its economic equivalent, may be acquired elsewhere.

When cancellation is appropriately invoked, its costs for the party in breach must not be unnecessarily high. The costs of cancellation, however, even if substantial, must not deprive the victim of access to the cancellation remedy when the interest in future performance is genuinely threatened. Rather, needless costs should be avoided by awarding the breaching party a post-cancellation settlement of accounts that is as generous as possible, consistent with giving first priority to the victim's expectation interest. Specifically, the recovery of the defaulting party need not be restricted to the value of the benefit conferred on the victim, and during the time between cancellation and resolution of the dispute the victim should be entitled to retain from the unpaid contract price no more than an honest estimate of the damages owed on account of the breach.

When material breach is so understood and administered, the cancellation power is effectively harnessed. It may be exercised only when the interest it protects is seriously at risk. Even then, it preserves for the one in breach what remains of the benefit of that party's bargain.