

## Article

# Duress As Rent-Seeking\*

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### INTRODUCTION

Under the contract law doctrine of duress, courts require, among other things, that the party seeking to assert this defense establish that the other party induced the contract by a wrongful threat.<sup>1</sup> Courts have allowed parties to assert the defense even absent a threat of tortious or criminal conduct.<sup>2</sup> A wrongful economic threat is sufficient.<sup>3</sup> Unfortunately, the cas-

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1. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 175(1) (1981) (“If a party’s manifestation of assent is induced by an improper threat by the other party that leaves the victim no reasonable alternative, the contract is voidable by the victim.”); 7 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 28.6 (rev. ed. 2002) (“[A] modification coerced by a wrongful threat to breach under circumstances in which the coerced party has no reasonable alternative should prima facie be voidable . . . .”); see also Steven Shavell, *Contractual Holdup and Legal Intervention*, 36 J. LEGAL STUD. 325, 334–41 (2007), and the references cited therein.

2. Shavell, *supra* note 1, at 335 (“Improper threats include threats of crimes and torts and threats to act in lawful ways that, however, would violate the general contractual duty of good faith and fair dealing.” (citing U.C.C. § 1-203 (2004); RESTATEMENT (SECOND) OF CONTRACTS §§ 176, 205 (1981); JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS 457–61 (4th ed. 1998); E. ALLAN FARNSWORTH, CONTRACTS 504–09 (3d ed. 1999); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 57–60 (5th ed. 2000))).

3. See *Bank of Am., N.A. v. 108 N. State Retail LLC*, 928 N.E.2d 42, 57 (Ill. App. Ct. 2010); see also JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 9-2, 337 (3d ed. 1987) (“Today the general rule is that any wrongful act or threat which overcomes the free will of a party constitutes

es do not develop a coherent concept of what constitutes a wrongful economic threat.<sup>4</sup>

Other scholars have attempted to provide such a coherent concept.<sup>5</sup> Omri Ben-Shahar and Oren Bar-Gill rely on the notion of “credible” threat, meaning that the threat-maker has an interest in carrying out the threat whenever the threatened party refuses his demands. They observe that prohibiting a person from making a credible threat will result in the person carrying the threat out, to the detriment of the target.<sup>6</sup> Thus, they propose that a credible threat should not be deemed wrongful.<sup>7</sup> Steve Shavell focuses on the fact that extortionate threats generally arise in a situation where the threat-maker has a monopoly.<sup>8</sup> The target of the threat has no reasonable alternative but to succumb to the threat. Although such a monopolist may actually create social value by agreeing not to carry out the threat, the price the victim must pay to obtain this agreement provides a rent<sup>9</sup> to the threat-maker. Shavell argues that such abuse of monopoly power should be constrained much the way states have traditionally limited natural monopoly<sup>10</sup>

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duress.”).

4. See Oren Bar-Gill & Omri Ben-Shahar, *The Law of Duress and the Economics of Credible Threats*, 33 J. LEGAL STUD. 391, 392 (2004) (“For centuries, contract law has been searching for a unifying principle that will determine when such threats should be considered ‘improper,’ rendering the resulting agreement unenforceable on the grounds of duress. Thus far, such a general criterion has failed to emerge.”).

5. See PÉTER CSERNE, *DURESS IN CONTRACTS: AN ECONOMIC ANALYSIS* (2009), available at <http://ssrn.com/abstract=1498236> (reviewing economic theories of duress).

6. Bar-Gill & Ben-Shahar, *supra* note 4.

7. *Id.* at 391 (“This paper argues that enforcement of an agreement, reached under a threat to refrain from dealing, should be conditioned solely on the threat’s credibility.”).

8. Shavell, *supra* note 1, at 330 (“At most, one contractor will be available to furnish aid to a victim—bilateral monopoly is assumed . . . .”); *id.* at 342 (“In the circumstances of *Magnolia Petroleum* and *Post v. Jones*, the vessels in distress did not have the ability to obtain bids for rescue and faced large expected losses, so were in classic bilateral monopoly situations.”).

9. In economics, “rent” is “a return in excess of the resource owner’s opportunity cost.” Robert D. Tollison, *Rent Seeking: A Survey*, 35 KYKLOS 575, 575 (1982).

10. The technical definition of natural monopoly is: “An industry in which multifirm production is more costly than production by a monopoly . . . .” William J. Baumol, *On the Proper Cost Tests for Natural Monopoly in a Multi-product Industry*, 67 AM. ECON. REV. 809, 810 (1977). This occurs for utilities because the average “unit” cost for production of the good decreases over the entire range of demand for the good. In such a situation, the cheapest way to produce the good is for a single producer to do so. See 2 ALFRED E. KAHN, *THE*

utility companies from obtaining monopoly rents—by explicitly limiting the amount that the threat-maker can charge for agreeing to cooperate with the victim.<sup>11</sup> Provided that the threat-maker did not create the victim’s vulnerable position,<sup>12</sup> Shavell would limit recovery to a percentage of the value created by such cooperation.<sup>13</sup> Contracts arising due to vulnerabilities created by the threat-maker’s conduct, however, ought to be voided.<sup>14</sup> Accordingly, Shavell “distinguishes between contracts that should not be made at any price and contracts that should be made but only at moderate prices.”<sup>15</sup>

Although we have concerns with court mandated price caps,<sup>16</sup> the main focus of this Article is not identifying remedies

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ECONOMICS OF REGULATION: PRINCIPLES AND INSTITUTIONS, 119–22 (1971). But, price regulation is then necessary to ensure that the producer does not abuse its resulting monopoly power. See MARK SEIDENFELD, MICROECONOMIC PREDICATES TO LAW AND ECONOMICS 62 (1996).

11. Shavell, *supra* note 1, at 325 (“Price-conditioned voiding prevents the imposition of holdup prices but still allows contracts (to tow ships in distress) to be made.”).

12. *Id.* (“One type of legal intervention is flat voiding of contracts. Such intervention tends to be advantageous when holdup situations are engineered.”).

13. *Id.* at 332 (“[A]s a general matter there will be an optimal price, impounding some of the contractual surplus, that will best resolve the problems of holdup on one hand and the potential contractor incentive benefit of a high price on the other. The magnitude of the optimal price will depend on the context.”).

14. See *supra* note 12.

15. Shavell, *supra* note 1, at 327.

16. In particular, if the court’s (or regulator’s) judgment regarding the optimal price for a contract is subject to error, then price-caps are likely to inefficiently distort incentives for people to put themselves in a position to “help out” entities in distress, especially when they are risk-averse. Shavell himself notes this point:

The information of the state will, of course, be imperfect, which means that practically optimal legal intervention will have to reflect the social cost of mistake. A major cost of mistake in setting prices is chilling desirable new contracts. If the price ceiling turns out to be less than the cost of furnishing aid, then a contract will not be made, even though the resulting harm to the victim could greatly exceed the cost of aid. For example, if the price allowed for rescuing a ship were less than the actual cost to the salvor (suppose there was a risk to the salvor, owing to high seas), the salvor would not perform the rescue and the ship might be lost . . . . To guard against such costly mistakes resulting in failure to make desirable contracts or in undesirable breach of existing contracts, optimal policy should feature generosity in price setting and limits on whether there will be legal intervention.

*Id.* at 333–34.

Intuitively, because the primary benefit of price caps is to limit precautionary activity by potential victims, these types of inefficiencies become more

applicable for contracts “that should be made,”<sup>17</sup> but identifying a comprehensive test to determine which contracts should be voided completely. Consistent with this objective, this Article develops an alternative basis for a coherent approach to determining which economic threats should be considered wrongful within the doctrine of duress. In line with Shavell’s understanding that duress often involves monopoly power, it suggests that the key to understanding wrongful economic threats is the concept of rent-seeking described by several scholars of law and economics.<sup>18</sup> But, the Article distinguishes between

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likely as the ability of the potential victim to reduce its vulnerability decreases. In fact, in the limiting case where victims cannot reduce their vulnerability at all (or, equivalently, when they can take precautions but doing so is not an economically viable option) it is easy to demonstrate that the optimal price is always above the monopoly price. To see this, let  $e$  denote the contractor’s effort, and  $p(e)$  the probability that the contractor will find a victim in need of help, and  $\pi_m$  the monopoly price that the contractor will be able to charge. Absent price caps, the contractor’s private objective is to maximize his expected benefit expressed by  $p(e)\pi_m - e$ . The social objective, on the other hand, is to maximize total wealth, which is expressed by  $p(e)h - e$ , where  $h$  is the harm to the victim absent help from the contractor. It follows under reasonable assumptions (i.e., concavity of  $p$ ) that the contractor will choose effort  $e^l < e^*$ , where  $e^*$  is the effort level that maximizes social welfare, because  $h > \pi_m$  as long as the victim has some bargaining power. This implies that even absent price control, the effort exerted by the contractor is sub-optimal, and thus that price control will make the problem even more severe. Therefore, the question becomes an empirical one: are the aggregate costs associated with court mistakes greater than the marginal gain from reduced self-help investments due to the availability of price-caps? The most we can do is to speculate about the proper answer to this important question, which is a task that we decline to undertake. Rather, as stated, our main focus is not the remedy that should be available when the contract is one that ought to be made, but on the test that ought to be used for determining which contracts ought to be made in the first place.

17. *Id.* at 327.

18. Gordon Tullock was the first to conceive of rent-seeking as an economic problem of interest in 1967, but the term was coined by Anne Krueger in 1974. See CHARLES K. ROWLEY & FRIEDRICH SCHNEIDER, READINGS IN PUBLIC CHOICE AND CONSTITUTIONAL POLITICAL ECONOMY 16 (2008). A series of articles by Gordon Tullock, as well as Anne Krueger’s 1974 article, have systematically studied the problem of rent-seeking. See Gordon Tullock, *Efficient Rent Seeking*, in TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 97–112 (James M. Buchanan, Robert D. Tollison & Gordon Tullock eds., 1980); Gordon Tullock, *Rents and Rent-Seeking*, in THE POLITICAL ECONOMY OF RENT-SEEKING 51 (Charles K. Rowley, Robert D. Tollison & Gordon Tullock eds., 1988); Gordon Tullock, *Rent Seeking as a Negative-Sum Game*, in TOWARD A THEORY OF THE RENT-SEEKING SOCIETY, *supra*, at 16–36; Anne O. Krueger, *The Political Economy of the Rent-Seeking Society*, 64 AM. ECON. REV. 291 (1974); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967). We use “rent-seeking” generally to include action that is not in the self-interest of the actor except as a means of securing a transfer

rent-seeking that involves wasteful investment of resources and rent-seeking that paradoxically reduces investment of resources by reducing costs of negotiation—respectfully wrongful versus valuable rent-seeking. The proposed criteria<sup>19</sup> for determining when a threat is wrongful that result from this Article’s focus on rent-seeking, in fact, turn out to be similar to Ben-Shahar and Bar-Gill’s credible threat criterion, when ex-ante investments are impossible. This Article, however, clarifies how to evaluate whether a threat is wrongful when it has been made credible by the threat-maker’s investment.<sup>20</sup> In these circumstances, the question is not whether the threat is credible ex-post, but whether the cost of investment<sup>21</sup> exceeds the ex-post benefit to the threatener from carrying out his threat. Furthermore, this Article identifies the need for an exception to the rent-seeking criterion to allow for normal contract negotiation.<sup>22</sup>

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of wealth. See DAVID D. FRIEDMAN, LAW’S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 32 (2000) (using the term in this general sense).

Other scholars have related the doctrine of duress to rent-seeking. See, e.g., ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 219, 270–71 (4th ed. 2004) (distinguishing between voluntary contracts that create wealth versus involuntary contracts that redistribute wealth); Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, in 1 HANDBOOK OF LAW AND ECONOMICS 54 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (asserting that a “justification of the doctrine is found in the phenomenon of rent seeking”). This Article goes beyond the prior scholarship by explaining how and why duress should be defined in terms of rent-seeking.

19. In developing its criteria for determining when threats are wrongful, this Article takes wealth maximization as its measure of social value, and ignores wealth distributive implications of the conclusion.

20. Oren Bar-Gill and Omri Ben-Shahar acknowledge that allowing the duress defense based on a simple credibility inquiry may not generate the efficient result if ex-ante investments are possible. *Credible Coercion*, 83 TEX. L. REV. 717, 733 (2005) (“When the threatening party can take initial actions and investments that are intended to enhance the credibility of his subsequent threats—such that would enable him to effectively extract a coerced act or promise—the law may be able to deter such actions by nullifying the coerced act or promise.”). Although they do not explicitly focus on determining which threats ought to be deemed wrongful when ex-ante investment is possible, to the extent that they suggest that all such investments warrant undoing the contract because of duress, we disagree. See *infra* Part II.

21. By “cost of investment,” we mean the cost of making the threat possible plus the cost of carrying out the threat. In other words, our definition of investment includes all costs necessary to carry out the threat.

22. Other scholars have made the observation that threats made as part of negotiations ought not to constitute economic duress. See, e.g., COOTER & ULEN, *supra* note 18, at 269 (“It is easy to see why the law permits people to make demands when bargaining . . . . In so far as the law forbids private bargains, a third party must decide who should cooperate with whom. Third par-

Finally, we argue that, contrary to Shavell's assertion,<sup>23</sup> not all contracts where one party (the threat-maker) has engineered dire needs of the other party (the victim) ought to be voided. If a threat-maker invests in enabling conduct that would generate value to him but harms another party and later enters a contract with that party induced by threatening to engage in that conduct, the availability of a defense of duress ought to hinge on a comparison between the generated value to the threat-maker and the cost of his investment—not on the harm to the other party. Accordingly, our rent-seeking based test diverges from both the Bar-Gill and Ben-Shahar credibility test, and Shavell's engineering-focused test.

More specifically, this article argues that efficiency is enhanced, in theory, by reading "wrongful economic threats" to mean threats induced by plaintiffs' rent-seeking, used in its broad sense to mean investment in transferring wealth from the target of the threat to the threat-maker.<sup>24</sup> But this Article also contends that an exception should be made for rent-seeking that takes the form of a person declining to enter a contract that would benefit her, even if she knows that such a declination will put the defendant in a dire situation.<sup>25</sup> The Article then applies our concept of duress to the specific contexts where duress is frequently raised as a defense—settlement of contract disputes and modifications of contracts.

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ties typically lack the information and motivation to make such decisions."); F. H. Buckley, *Three Theories of Substantive Fairness*, 19 HOFSTRA L. REV. 33, 38 (1990) ("[A] seller's assertion of a right to withdraw from negotiations is a threat of non-contracting. Were it to constitute economic duress, property owners would be required to sell their goods to anyone who offered a derisory price for them. Since this would dissolve property rights, a distinction must be made between permissible threats and economic duress."). But, these scholars do not appear to acknowledge that, because a person making a threat in the process of bargaining is refusing an offer that is beneficial to him only for purposes of transferring wealth from the other party to himself, refusal is rent-seeking. *See supra* note 18 and accompanying text (defining rent-seeking).

23. *See supra* note 12 and accompanying text.

24. *See infra* Part II, defining rent-seeking with more precision.

25. Throughout this Article, unless otherwise made apparent, for convenience we assign plaintiff the role of the party asserting that the contract is valid, and the defendant the role of seeking to be relieved of its obligation because it entered the contract under duress. In fact, the roles of the parties sometimes can be reversed, such as when the plaintiff sues for breach of contract, and the defendant asserts that the plaintiff has forfeited the right to sue by entering a settlement agreement. In such a case, the plaintiff in the original action asserts the defense of duress to get out of the settlement agreement. Nonetheless, the convention of the roles we assign lends clarity to this Article without any loss of generality of the arguments.

## I. THE DOCTRINE OF DURESS

Courts have created the defense of duress to a breach of contract action.<sup>26</sup> A defendant that successfully asserts this defense is relieved of its contractual obligations.<sup>27</sup> For the defendant to be successful, courts require the defendant to prove that the plaintiff made a wrongful threat,<sup>28</sup> the threat left the defendant with no reasonable alternative but to enter the contract,<sup>29</sup> and the threat actually induced the defendant to enter the contract.<sup>30</sup>

In this Article, we focus on the first prong of this test: that the plaintiff made a wrongful threat. Threats to engage in conduct that is criminal or tortious clearly are, and should be, deemed wrongful. By deeming an act criminal or tortious, society has determined that it considers the act harmful and seeks to discourage it. Generally, criminal penalties and tort compensation rules will deter such conduct.<sup>31</sup> But, the opportunity to bargain for a large payment in return for a promise not to engage in the harmful and non-wealth generating conduct may entice a person to invest in making the threat of such tortious and criminal conduct credible. This investment at best is wasteful, as it does not lead to wealth creation, and at worst is destructive, as the threat-maker may end up engaging in the harmful conduct if the victim of the threat calls his bluff. Hence, wealth is enhanced by refusing to enforce agreements extracting such payments, thereby eliminating the incentive from a payment by the victim to make or carry out the threat.<sup>32</sup>

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26. *United States v. Chi Tong Kuok*, 671 F.3d 931, 947 (9th Cir. 2012) (“Duress is not a statutory defense, but a common-law defense that allows a jury to find that the defendant’s conduct is excused . . .”).

27. *Bank of Am., N.A. v. 108 N. State Retail LLC*, 928 N.E.2d 42, 57 (Ill. App. Ct. 2010).

28. *Id.*

29. *Totem Marine Tug & Barge, Inc. v. Alyeska Pipeline Serv. Co.*, 584 P.2d 15, 22 (Alaska 1978) (“[I]n order to avoid a contract, a party must also show that he had no reasonable alternative to agreeing to the other party’s terms, or, as it is often stated, that he had no adequate remedy if the threat were to be carried out.”).

30. *See id.*

31. See John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—and What Can Be Done About It*, 101 *YALE L.J.* 1875, 1882 (1992); see also Kenneth Mann, *Punitive Civil Sanctions: The Middleground Between Criminal and Civil Law*, 101 *YALE L.J.* 1795, 1830 (1992).

32. It may be that even without the prospect of a payment from the victim, in the absence of state efforts to discourage the conduct, the perpetrator would derive a net benefit from the conduct. This can lead to a decrease in

Courts have also allowed defendants to assert the defense of duress even when the conduct threatened is neither criminal nor tortious—in cases of “economic duress.”<sup>33</sup> In these cases, courts have recognized the defense when plaintiffs have threatened to take action that leaves the defendant in dire economic straits.<sup>34</sup> But they have not held all such threats to be wrongful.<sup>35</sup> Unfortunately, courts have not explained what distinguishes those threats that are wrongful from those that are not.<sup>36</sup>

To understand the arguments we make about what economic threats should be considered wrongful, it is useful first to digress to discuss a proposition suggested by Judge Posner in his opinion in *Selmer Co. v. Blakeslee-Midwest Co.*,<sup>37</sup> and sub-

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wealth, but because there is no agreement, it falls outside the realm of contract law. The hope is that the criminal and tort law can deter such wealth-destroying conduct.

33. *Totem*, 584 P.2d at 22 (stating that the conduct threatened need not be criminal or tortious, but merely “wrongful in the moral sense.”); Ian J. Silverbrand, *Workplace Romance and the Economic Duress of Love Contract Policies*, 54 VILL. L. REV. 155, 171 (2009) (“The doctrine of economic duress is fundamental in contract law. Where a party to a contract manifested assent as a result of an improper economic threat, the contract may be voidable by the victimized party.”). See Judge Richard Posner’s description of economic duress as a “situation in which one person obtains a temporary monopoly that it tries to use to obtain a benefit to which it is not entitled.” Douglas G. Baird, *The Young Astronomers*, 74 U. CHI. L. REV. 1641, 1645 (2007). See Debora L. Threedy, *Labor Disputes in Contract Law: The Past and Present of Alaska Packers’ Ass’n v. Domenico*, 10 TEX. WESLEYAN L. REV. 65, 72 (2003) (“It was not until the 1940s that courts generally started to recognize the defense of economic duress.”).

34. See Alan M. Christenfeld, *Forbearance Agreements in Funded Credit Arrangements*, 42 UCC L.J. 385, 406 (2010) (“Three elements are necessary to establish economic duress: (1) that one side involuntarily accepted the terms of another; (2) that circumstances permitted no other alternative; and (3) that the other party’s coercive acts caused the circumstances.” (emphasis added)). See also James A. Harley, *Economic Duress and Unconscionability: How Fair Must the Government Be?*, 18 PUB. CONT. L.J. 76, 164 (1988) for a reference to “dire financial circumstances” in the context of economic duress.

35. The threat must be more than wrongful or unlawful, it must be “one which deprives the victim of his unfettered will.” *Totem*, 584 P.2d at 21; see also Meredith R. Miller, *Revisiting Austin v. Loral: A Study in Economic Duress, Contract Modification and Framing*, 2 HASTINGS BUS. L.J. 357, 399 (2006) (stating that the threat is wrongful if “it crossed the line from a legal application of economic pressure to an illegal one”).

36. *Totem*, 584 P.2d at 22 (“Courts have not attempted to define exactly what constitutes a wrongful or coercive act, as wrongfulness depends on the particular facts in each case . . . . In many cases, a threat to breach a contract or to withhold payment of an admitted debt has constituted a wrongful act.”).

37. 704 F.2d 924 (1983); see also Brian Bix, *Epstein, Craswell, Economics, Unconscionability, and Morality*, 19 QUINNIPIAC L. REV. 715, 718 n.19 (2000)

sequently followed by several other courts, that the traditional test for duress is incomplete. These courts effectively impose a fourth prong to the defense of duress, which requires that the plaintiff have created the dire situation that leaves the defendant without a reasonable choice to reject the contract terms offered by the plaintiff.<sup>38</sup>

A hypothetical helps illustrate the efficiency rationale for this fourth prong. Consider Pete, a homeowner in South Florida who stockpiles 100 gallons of potable water in case a hurricane contaminates the public water supply. Pete stockpiles the water thinking that in the event of a hurricane he can price the water well above the \$2 per gallon cost he pays. Moreover, he has room in his back closet for the water, so it is really only a small inconvenience for him to stockpile it. As Pete envisioned, a short time later a hurricane hits the area and does contaminate the water supply. Shortly after the hurricane abates, Pete's neighbor Dave indicates to Pete that he is in dire need of potable water. Pete tells Dave that he has plenty of water but that it will cost Dave \$200 per gallon. Dave complains that the price is way too high, but he can find no other source of potable water. Predictions are that there will not be drinking water made available for at least two days, and the temperature is hot. Dave fears dehydration and possibly death. His only alternative to buying water from Pete is to drink the contaminated water, which will almost certainly make him sick and also could lead to his death. Having no alternative, Dave agrees to

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(citing *Blakeslee-Midwest* as “rejecting the argument that financial distress [due to a threat] alone is sufficient to rescind a contract for duress”); Hila Keren, *Consenting Under Stress*, 64 HASTINGS L.J. 679, 686 (2013) (characterizing *Blakeslee-Midwest* as “[a] leading case for the proposition that the duress defense necessitates fault”).

38. In *Blakeslee-Midwest*, Posner explains: “The mere stress of business conditions will not constitute duress where the defendant was not responsible for the conditions.” *Blakeslee-Midwest*, 704 F.2d at 928. He then states: “Matters stand differently when the complaining party’s financial distress is due to the other party’s conduct.” *Id.*; see also, e.g., *Rochester Ford Sales, Inc. v. Ford Motor Co.*, 287 F.3d 32, 43 (1st Cir. 2002) (holding that the defense of duress faltered “on a core point: the causation requirement, i.e., proving that the constraints on its options result from the defendant’s conduct”); *Amoco Oil Co. v. Gomez*, 125 F. Supp. 2d 492, 503 (S.D. Fla. 2000) (holding that to show economic duress a party must prove that “financial distress [was] caused by the wrongful acts or threats” of the other party); *San Diego Hospice v. Cnty. of San Diego*, 37 Cal. Rptr. 2d 501, 507 (Cal. Dist. Ct. App. 1995) (noting that one criterion for duress due to refusal to pay debt is that the debtor has “created the economic duress” of the creditor).

buy five gallons of water from Pete for \$1000, which he will give to Pete once he regains access to his bank account.

Pete delivers the water, and eventually life returns to normal. But Dave refuses to pay Pete the \$1000. When Pete sues Dave for breach, Dave asserts that he entered the contract for the water due to duress and therefore should be excused from having to pay the price. He is willing to pay Pete \$2 and change for each gallon for the amount his purchase of the water unjustly enriched him. The alleged wrongful threat by Pete was the threat not to contract with Dave unless Dave paid \$200 per gallon.

According to courts that require a fourth prong, this should not make out a case of duress. Advocates of the added “creation of risk” prong of duress would note that Pete did not do anything that destroyed existing wealth. The hurricane put Dave in his precarious position, and Pete actually provided him with an alternative better than if Pete did not have water to spare. If we allow Dave to avoid the contract, we remove any incentive for Pete to stockpile water.<sup>39</sup> If Pete did not stockpile water, Dave would have been worse off because he would have no alternative but to risk either dehydration or serious illness. Hence, allowing Pete to sell the water for \$200 a gallon actually provided a benefit to Dave.<sup>40</sup> As we will make clear in Part II of this Article, our approach to determining which economic threats are lawful will reach the same conclusion.

In comparison, consider the classic duress case of *Austin Instrument, Inc. v. Loral Corp.*<sup>41</sup> Essentially, this case involved the enforceability of a contract modification and a second contract entered in the shadow of a threatened breach of the first contract.<sup>42</sup> Loral received a \$6 million contract to provide radar

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39. An alternative to fully voiding the contract would be a price cap, as advocated by Shavell. See Shavell, *supra* note 1; see also *supra* notes 8–16 and accompanying text. We are not making claims about the types of remedies, if any, that should be available when the existence of the conduct induced by the contract is desirable.

40. For those who find an outcome that threatens Dave’s life if he cannot afford Pete’s monopoly price too unjust to swallow, the government could promise to pay Pete the difference if Dave and Pete can show that Dave really could not pay and faced a real risk of death. That essentially redistributes wealth to Dave to allow him to compensate Pete for his risks and therefore does not distort incentives, except to the extent that the tax system that raises money for such payments distorts economic activity.

41. 272 N.E.2d 533 (N.Y. 1971).

42. See *id.* at 534 (“The defendant, Loral Corporation, seeks to recover payment for goods delivered under a contract which it had with the plaintiff

sets to the United States Navy.<sup>43</sup> Loral subcontracted for the supply of forty precision parts needed for the radar sets and awarded Austin the subcontract for twenty-three of those parts.<sup>44</sup> About ten months after being awarded the first contract, Loral was granted a second contract for more radar sets and again sought subcontractors to supply the forty precision parts.<sup>45</sup> When Loral put out bids for the parts, Austin informed it that unless Loral gave the bid for all forty parts to Austin—at a higher price than the prior contract—and retroactively agreed to a price increase on the first contract, Austin would not deliver the parts on the first contract.<sup>46</sup> At the time Austin so informed Loral, there was not enough time for Loral to find another supplier for the first contract.<sup>47</sup> Faced with the threat from Austin, Loral agreed to the second contract.<sup>48</sup> After receiving the parts from Austin, Loral sued seeking a refund of the excess price it paid for the parts, claiming that the second contract was void due to duress.<sup>49</sup>

The New York Court of Appeals reversed the trial court's ruling in favor of Austin.<sup>50</sup> The trial court had held that a threat to breach the initial contract could not constitute duress because the threatened party could avail itself of the remedies for breach of contract.<sup>51</sup> Essentially, the trial court reasoned that a party to a contract is not entitled to more than its remedies for breach. The court of appeals disagreed.<sup>52</sup> It viewed the

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Austin Instrument, Inc., on the ground that the evidence establishes, as a matter of law, that it was forced to agree to an increase in price on the items in question under circumstances amounting to economic duress.”).

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

47. *See id.* at 534–35.

48. *Id.* at 535.

49. *Id.*

50. *Id.* at 537.

51. *See Austin Instrument, Inc. v. Loral Corp.*, 316 N.Y.S.2d 528, 528 (App. Div. 1970) (“The Supreme Court, Trial Term, New York County, Thomas A. Aurelio, Special Referee . . . dismissed contractor’s complaint, and contractor appealed. . . . [S]ubcontractor’s threat to break first subcontract by work stoppage did not constitute basis for recovery by contractor on theory of economic duress after contractor entered new contract with subcontractor and agreed to price increases and contractor’s acting deliberately and voluntarily precluded recovery.”).

52. *Austin*, 272 N.E.2d at 537 (“It is hardly necessary to add that Loral’s normal legal remedy of accepting Austin’s breach of the contract and then suing for damages would have been inadequate under the circumstances, as Lo-

issue as whether the breach would leave Loral in such a dire position that it had no choice but to accept the terms offered by Austin.<sup>53</sup> The court of appeals noted that an action for contract damages would not have sufficed to make Loral whole because damages would not compensate for harm to reputation from the breach, which would have essentially precluded Austin from obtaining future military contracts.<sup>54</sup>

Those who advocate for limiting duress to situations in which the party asserting the defense was put in a dire situation by the other party have no quarrel with this outcome. Austin certainly caused Loral to be in the vulnerable position that induced it to acquiesce to Austin's demands. Austin had entered the first contract with Loral and had waited until it was too late for Loral to find a substitute supplier before indicating that it would breach the first contract if Loral did not agree to its demands. From an economic perspective, we want to discourage parties like Austin from putting individuals in such a vulnerable position in order subsequently to exploit the vulnerability. Hence, we certainly do not want to allow them to keep the benefits of the bargain obtained by this tactic. But, as we will show in Part II, this does not mean that duress should be available anytime the threat-maker creates the vulnerability of the target of the threat. According to our test based on rent-seeking, the creation of the vulnerability is not a sufficient condition, even when the creation of vulnerability is intentional (as advocated by Shavell).<sup>55</sup>

## II. RENT-SEEKING AS THE FOUNDATION OF DURESS

We contend that if economic efficiency is the goal of the contract law of duress, then rent-seeking should be the foundation of that law. Rent-seeking initially described interest group efforts to convince legislatures or regulatory agencies to provide benefits for the interest group at the expense of other groups or the general public.<sup>56</sup> Essentially, rent-seeking was behavior

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ral would still have had to obtain the gears elsewhere with all the concomitant consequences mentioned above.”).

53. *Id.* (“In other words, Loral actually had no choice, when the prices were raised by Austin, except to take the gears at the ‘coerced’ prices and then sue to get the excess back.”).

54. *Id.* at 536 (“Loral was anxious to perform well in the Government’s eyes . . .”).

55. Shavell, *supra* note 1, at 331–32.

56. Although Gordon Tullock described what is now known as rent-seeking, the term was coined several years later by Anne Kreuger. *See supra*

that involved making investments in having the legislature or regulator transfer wealth from others in society to the rent-seeker. Some law and economics scholars have generalized the concept from its roots in the political process, defining rent-seeking as any investment of resources for the purpose of transferring rather than creating wealth.<sup>57</sup> Essentially, conduct is rent-seeking if it doesn't generate wealth exceeding the cost of the conduct itself, and is therefore motivated by the potential for a wealth transfer.<sup>58</sup> It is important to note here that conduct which might appear aimed at transferring wealth often will involve ex-ante investments, and these investments have to be included in evaluating the cost of the conduct.

Some illustrations of rent-seeking may be helpful here. Suppose a mugger who otherwise does not know us comes up to us on the street, pulls out a gun, and demands: "Your money or your life." Being people who enjoy our lives more than our money, we fork over the \$100 in our wallets.<sup>59</sup> Assuming the mugger does not get apprehended, this is an example of successful rent-seeking. From the perspective of wealth maximization, interestingly, the fact that the mugger gets our money does not lead to a normatively inferior outcome. From that perspective, \$100 changes hands from us to the mugger, with no attendant gain

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note 18 and the references cited therein.

57. See *supra* note 18 and the references cited therein.

58. The word "rent" was introduced in economics by David Ricardo, where he used the term to mean "the payment to a factor of production in excess of what is required to keep that factor in its present use." See David R. Henderson, *Rent Seeking*, in THE CONCISE ENCYCLOPEDIA OF ECONOMICS (David R. Henderson ed., 2d ed. 2007), available at <http://www.econlib.org/library/Enc/RentSeeking.html>. The term "rent-seeking," used in this broad sense, is not necessarily detrimental. But, economists generally "use the term to describe people's lobbying of government to give them special privileges." *Id.* Our definition of rent-seeking is similar to the latter, narrower definition of rent-seeking. Also, note that rent-seeking is not defined in terms of whether the ultimate transaction sought by the seeker decreases social wealth. For example, when the mugger offers his victim, "your money or your life," the ultimate transaction—the transfer of money—neither increases nor decreases social wealth. Rather, rent-seeking is defined in terms of whether an offeror's investment in being able to carry out a threat is in the offeror's interest when the offeree does not accept the offer.

59. The way we have worded this example is meant to emphasize that this transaction is voluntary in the sense that once the mugger indicates he is going to kill us, we willingly trade our \$100 for our lives. While the choice of giving up the money is one that almost everyone would make, the classic Jack Benny routine makes it clear that there is a choice. In that routine, after delaying his reaction to the mugger's repeated request, Benny responds: "I'm thinking it over!" *The Jack Benny Program: Jack Is Robbed of Ronald Colman's Oscar* (NBC radio broadcast Mar. 24, 1948).

or loss of wealth by society as a whole.<sup>60</sup> The problem from the efficiency perspective is that the mugger invests in transferring the money to himself and we invest in trying to keep hold of our money. Because the transaction does not directly change social wealth, those investments are social losses. If the mugger has invested \$60 in purchasing a gun, planning the mugging, and taking the time to execute it, then that is \$60 that is spent without any concomitant increase in social wealth. If we invested \$20 in trying to fend off muggers, that is another \$20 that is wasted on preventing wealth transfers rather than on creating value for society.<sup>61</sup> It is the wasted investments inherent in rent-seeking that wealth maximization despises.

One might argue that this is a contrived example because it directly involves a transfer of dollars, while most examples of wealth transfers involve goods and services, not cold cash. For example, suppose that the mugger eyes a piece of jewelry he sees on a woman who regularly walks by him. The mugger will invest up to his valuation of the jewelry to enable him to threaten to kill the owner unless she transfers the jewelry to him. The owner will invest up to the value of the jewelry to her to keep the mugger from getting it. In this case, the transfer of the jewelry from the owner to the mugger may cause a net change of wealth. In most cases, the fact that the owner paid the price for the jewelry in the first place, and the mugger did not, suggests that the value to the owner, in terms of ability and willingness to pay,<sup>62</sup> exceeds that of the mugger. But even

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60. This follows from the “popular” definition of efficiency, which “refer[s] to the relationship between the aggregate benefits of a situation and the aggregate costs of the situation.” See A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 (4th ed. 2011). Since benefits are measured in dollars, a monetary transfer from one party to another does not increase or decrease social welfare. See *id.* at 8 (“[A]ll benefits and costs can be measured in terms of a common denominator—dollars. This assumption is made for expositional simplicity. It is not essential to economic analysis and it does not exclude considerations that might be thought of as noneconomic—such as the protection of life and limb.”).

61. This example illustrates two types of socially wasteful investment. In this Article, we are focusing on investment by the potential threatener, and we have not explicitly considered the investment of potential victims in avoiding susceptibility to threats in our analysis of duress. We suspect, however, that including such investment would strengthen the arguments for our rule because such investments increase the social loss that results from rent-seeking.

62. See generally Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980) and Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103 (1979) for examples of wealth being defined in this manner. See Anthony T. Kronman, *Wealth Maximization As a Normative Principle*, 9 J.

if the mugger happens to value the jewelry more than the owner, his investment in being able to threaten to kill the owner is rent-seeking that is problematic. For example, assume that the owner values the jewelry at \$700, and the mugger at \$1000. If the mugger is successful in getting the owner to give up the jewelry, then social wealth increases by \$300. But, as explained below, rent-seeking can still cause a decrease in social wealth.

First, note that if the transaction were voluntary then the parties would not invest more than the surplus in making the transaction occur. In economic terms, if transaction costs are greater than \$300, then there is no price that the mugger would be willing to pay for the jewelry that the owner will accept. If the owner's transaction costs are \$200, then the price will have to be at least \$900—\$200 dollars to cover those costs and \$700 to compensate the owner for giving up the jewelry. But then, if the mugger's transaction costs are more than \$100, he will not be willing to give the owner \$900 for the jewelry because that would result in his spending more than \$1000 for a jewelry that he valued at that amount. If the transaction is coerced, however, in the sense that the mugger gets the jewelry by threatening the owner's life, then, although the mugger would still be willing to devote up to \$1000 in resources to that endeavor, if he invests more than \$300, total social wealth will decrease. If one further recognizes that the owner would be willing to spend up to \$700 to prevent the mugger from being able to kill her, then the probability of wasteful investment above the wealth increase that results from the transfer increases. Hence, even transactions that would represent an increase in wealth absent transaction costs can be plagued by rent-seeking problems.

Our proposition regarding duress is that a wrongful economic threat is one that is motivated by rent-seeking—investment in conduct by the threat-maker that would not be in the self-interest of that person except as a means of securing a transfer of wealth. These are precisely the kinds of threats that involve investments in actions that are at best deadweight losses to society and at worst trigger wealth decreases both by inducing defensive measures by the targets of these threats and, if targets call the threat-makers' bluffs, occasionally leading to conduct that directly decreases the wealth of both the threat-maker and the target. For that reason, the law should

discourage such threats, which the doctrine of duress accomplishes by denying the wealth transfer at which the threats are aimed.

If the conduct threatened, however, happens to be in the interest of the threat-maker independent of whether the threat is capable of inducing a transfer of wealth, the law should not discourage the threat. In that situation, discouraging the threat leaves the threatening party with an incentive to carry out the threatened action without giving the adversely affected party the opportunity to prevent it.<sup>63</sup> In contrast, encouraging the threat induces negotiation that can inform the parties whether the threatened conduct is wealth maximizing and allows the parties to agree to prevent the conduct if it would reduce their combined wealth. In fact, it is a misnomer to label such threatened conduct as threats at all. Rather, they are opportunities. The threat-maker essentially is informing the target of how he intends to act, and providing the target an opportunity to pay not to have him act as threatened. The fact that the target does pay the price indicates that it prefers doing so to having the threat-maker engage in the conduct—that is, the cost of the conduct to the target is greater than the cost of paying to prevent it. Thus, if the threat-maker is going to engage in the threatened conduct for reasons other than extorting wealth from the target, then the target will prefer receiving an offer to pay to stop the conduct. In short, by encouraging these threats, we increase social wealth by allowing the person who is adversely affected to pay to avoid the conduct.

This perspective on duress provides a new lens with which to view the cases we described above. In *Austin v. Loral*, the question is whether Austin would be better off by not delivering the parts to Loral if it did not have the opportunity to threaten Loral.<sup>64</sup> If the answer is yes, the threat was not rent-seeking, and Loral should be able to avail itself of the defense of duress. On the facts as reported by the court, the outcome of the case seems correct. Austin did not notify Loral of its intent not to perform the first contract until Loral put out bids on the second one. And, Austin never explained its interest in withholding performance on the first contract.<sup>65</sup>

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63. This is why Bar-Gill and Ben-Shahar contend that credible threats should never be wrongful under the doctrine of duress. Bar-Gill & Ben-Shahar, *supra* note 4, at 424.

64. *Austin Instrument Inc. v. Loral Corp.*, 272 N.E.2d 533 (N.Y. 1971).

65. Bar-Gill & Ben-Shahar, *supra* note 4, at 424–25.

We can, however, envision a very similar situation in which our perspective on duress would lead to a different outcome. Suppose that the navy had just put out the second contract for bid. Hearing of this, Austin informs Loral that it is having difficulty with the first contract. It did not predict accurately the cost of meeting the contract given its existing equipment and indicates that it intends to repudiate the contract. But, Austin also informs Loral that if it got a second contract then it would perform because, given the second contract, it can achieve economies of scale. Austin can then make money by obtaining expensive but more sophisticated equipment that would allow it to produce each part more quickly and cheaply. Austin explains that even then it would need an increase in price to justify purchase of the equipment. If it got the bid for all forty parts and the price was high enough, then the average price of the parts supplied under both contracts would make it less costly for Austin to perform than to pay damages on the first contract. Notice that from Loral's perspective the reason why Austin intends to breach if it does not get a more lucrative second contract does not change the dire circumstances in which Loral is left. In either case, if it does not agree to the new deal, it will probably be shut out from future military contracts. Also, Posner's fourth prong of duress would not change the outcome in this hypothetical from that in the actual case.<sup>66</sup> In both, the plaintiff caused the defendant's vulnerability by entering into the first contract.

The difference between this hypothetical and the actual case is that under this scenario it is in Austin's interest to breach unless it gets the second contract. In the actual case, the facts suggest that if Austin could not hold Loral up for more money, its best interests would be served by performing the first contract.<sup>67</sup> Hence, in our hypothetical, unlike the actual case, the threat is actually an opportunity for Loral to avoid a more devastating consequence that will occur if Austin's incentive to give Loral this opportunity is deprived by denying it the benefit of the second bargain. Moreover, without opportunity to threaten, Austin may have no way of signaling to Loral that performing the contract may be wealth decreasing and that it

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66. See *Selmer Co. v. Blakeslee-Midwest Co.*, 704 F.2d 924 (1983) (requiring the plaintiff to have created the dire situation that leaves the defendant without a reasonable choice to reject the contract terms offered by the plaintiff).

67. See *Miller*, *supra* note 35.

pays for the parties to negotiate to modify the contract. One important conclusion that follows from our evaluation of this *Austin v. Loral* hypothetical is that allowing a defense of duress might not be warranted even if the threat-maker is responsible for the vulnerability of the target to the threat.

Although our argument seems similar to that Bar-Gill and Ben-Shahar use to argue that duress should not enable a party to avoid a contract entered in response to a credible threat,<sup>68</sup> there is an important but subtle distinction between the two tests. This is best demonstrated by a simple hypothetical example, where the two tests generate opposite results. For example, suppose we invest \$50 to find private embarrassing information about some celebrity. We know that a tabloid will pay us \$25 for the information. We also suspect that the celebrity would pay much more than \$50 for us not to make the information public. According to Bar-Gill and Ben-Shahar's simple model, at the time this threat is made (i.e. ex-post investment), it is credible because we stand to receive \$25 for making the information public if they do not pay us off. But, the investment is rent-seeking because the payment by the tabloid cannot justify our investment in getting the information. The only reason we would invest the \$50 would be because of the prospect of extracting wealth from the celebrity. Although this hypothetical is a bit contrived, it clarifies the distinction between Bar-Gill and Ben-Shahar's criteria for duress and ours.<sup>69</sup>

A variant on the same hypothetical again reinforces our conclusion that intentionally putting the victim in a vulnerable position is not sufficient for allowing the defense of duress. Suppose that again we invest \$50 in obtaining embarrassing information about a celebrity, and again we think that the celebrity will pay handsomely for us to keep the information private. But, this time suppose we knew before the investment that a tabloid would pay us \$75 for the information. If a contract with the celebrity to keep the information private would be unenforceable due to duress, we would still invest in the information, but this time make it public. The result would be to

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68. See Bar-Gill & Ben-Shahar, *supra* note 4, at 424.

69. Bar-Gill and Ben-Shahar have discussed investments and the ex-post feature of credible threats, but they do not come up with a test identifying the conditions under which duress should be applicable when ex-ante investment is possible, and they do not specifically link it to rent-seeking. See Bar-Gill & Ben-Shahar, *supra* note 20, at 747–48.

decrease wealth by the difference between the value to the tabloid of giving it the information and the harm to the celebrity from making it public.<sup>70</sup>

We turn now to a brief discussion of a conjecture that one might think warrants an exception to our criterion but which we ultimately reject. If the purpose of our definition of wrongful conduct is to encourage negotiation to determine whether threatened conduct is wealth increasing, one might conjecture that threat-makers should not be allowed to profit when they know or should know that their conduct will provide less benefit to them than the harm it will cause the victim. No information is gained in this situation, and we want to discourage the threat-maker from investing in the ability to make the threat, as well as following through on it. The problem is that merely denying the threat-maker an opportunity to transfer wealth from the victim will not discourage the conduct in this situation because the conduct benefits the threat-maker. To deter such conduct requires a rule that would impose damages on the threat-maker equal to the harm that his conduct imposes on the victim.

When the threat is to breach a contract, in theory contract law already imposes such damages—expectation damages generally being the amount of money that make the victim indifferent between performance and breach.<sup>71</sup> Of course, this remedy is not perfect; the victim bears the costs and hassles of litigation, and litigation costs aside, there are limitations that

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70. Technically, this threat would constitute blackmail, and hence would be wrongful *per se*. Consequently, every court would allow the celebrity to avoid enforcement of the contract by invoking duress. Our analysis shows, however, that such a refusal can result in a loss of social wealth. Economically, one might still be able to justify applying the law of blackmail to this hypothetical if one takes into account the uncertainty that a court will correctly determine whether investment in being able to make a threat was rent-seeking. If courts incorrectly conclude that such threats are justified by potential wealth creation even in a small percentage of cases, the potentially huge wealth transfer to the investor might prompt frequent rent-seeking investment in the information. Criminal liability might be needed to counterbalance the behavioral influences of the likely small potential costs to the investor compared to the potentially huge windfall that the investor will reap on occasions where the court erroneously finds that no rent-seeking occurred. We discuss the potential impact of uncertainty of judicial determinations in Part VI. For economic analyses of blackmail, see Steven Shavell, *An Economic Analysis of Threats and Their Illegality: Blackmail, Extortion, and Robbery*, 141 U. PA. L. REV. 1877 (1993) and Oleg Yerokhin, *The Social Cost of Blackmail*, 7 REV. L. ECON. 337 (2011).

71. Bar-Gill & Ben-Shahar, *supra* note 4, at 395.

sometimes prevent expectation damages from being fully compensatory.<sup>72</sup> More generally, because duress also requires that the threat put the victim in such dire straits that a court will infer that it had no choice, it follows that the victim is facing a harm for which it cannot be fully compensated by damages for breach. Moreover, for threats other than breach of a prior contract, the problem falls in the realm of tort, not contract law. It would be nice for our arguments if tort law actually imposed liability whenever the threat-maker knew or should have known that his conduct decreased social wealth. Although this criterion for negligence is advocated by law and economics scholars,<sup>73</sup> and perhaps applied in some cases by courts,<sup>74</sup> generally tort

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72. See, e.g., *Austin Instrument, Inc. v. Loral Corp.*, 272 N.E.2d 533, 536–37 (N.Y. 1971) (noting that harm to reputation would not be compensable by contract damages); *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109 (Okla. 1962) (holding that measure of contract damages is the effect on market value, and, hence, ignores excess of subjective value over market value of property); *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145, 9 Ex. 341 (holding that expectations damages for breach of contract are limited to those reasonably foreseeable at the time the contract is entered); see also Shawn J. Bayern & Melvin A. Eisenberg, *The Expectation Measure and Its Discontents*, 2013 MICH. ST. L. REV. 1, 10–11 (noting that “litigation risks and litigation costs” reduce the expected value of contract damages below the fully compensatory level); Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 CALIF. L. REV. 975, 989–97 (2005) (giving various reasons why expectation damages are not fully compensatory).

73. See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* (1970) (the liability rule under tort law should be that which minimizes the net costs of accidents); Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 33 (1972) (“If . . . the benefits in accident avoidance exceed the costs of prevention, society is better off if those costs are incurred and the accident averted, and so in this case the [injurer] is made liable, in the expectation that self-interest will lead it to adopt the precautions in order to avoid a greater cost in tort judgments.”).

74. *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (Judge Learned Hand announced the infamous formula for finding the efficient level of care for negligence: “[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P . . . .”); see also *Davis v. Consol. Rail Corp.*, 788 F.2d 1260, 1263–64 (7th Cir. 1986) (“[A] defendant is negligent only if  $B < PL$ , meaning, only if the burden of precautions is less than the magnitude of the loss if an accident that the precautions would have prevented occurs discounted (multiplied) by the probability of the accident.”); *Am. Hosp. Supply Corp. v. Hosp. Prods. Ltd.*, 780 F.2d 589, 593 (7th Cir. 1986) (This formula, a procedural counterpart to Judge Learned Hand’s famous negligence formula . . . .); *U.S. Fid. & Guar. Co. v. Jadranska Slobodna Plovidba*, 683 F.2d 1022, 1025–26 (7th Cir. 1982) (“[T]he negligence formula . . . requires ‘balancing the usefulness to the ship of the dangerous condition and the burden involved in curing it against the probability and severity of the harm it poses.’ This formula echoes that of Judge

law implements such a standard only in the general sense that if an actor knows or should know that the *type of conduct* in which it engages is more harmful than good for society, it will be liable for the harm. Rarely do courts instruct juries to find a defendant liable in tort if the jury determines on the facts of the situation that the defendant should have known that it would cause more harm to the particular plaintiff than benefit to itself.<sup>75</sup> Nonetheless, it might seem that courts can at least discourage threats of conduct that the threat-maker *knows* would provide less benefit to him than the harm it imposes on the target.

But we reject advocating such an exception to our rent-seeking criterion. Given imperfections in contract and tort damage awards as they exist, were a court to refuse to enforce the resulting agreement in which the threat-maker promises not to act, that would merely result in the action occurring. That is good for neither wealth maximization nor the victim. Thus, while it might strike some as unjust, given wealth maximization as our goal, it would be counterproductive to include within wrongful conduct action that is not otherwise tortious but which the threat-maker knows or should know will impose greater harm on the victim than benefit to itself.

### III. WEALTH ENHANCING RENT-SEEKING AS AN EXCEPTION TO WRONGFUL THREATS

Having disposed of this potential exception to our principle of wrongful conduct, we want to address a different problem that we believe does require an exception to our rent-seeking criteria for duress. To illustrate the problem, reconsider the hypothetical involving Pete and Dave, which may appear simpler than *Austin v. Loral* but actually is a bit trickier. Once the hurricane occurs, it seems that Pete acts in a manner that

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Learned Hand in *United States v. Carroll Towing Co.* . . . ."); *Burgess v. M/V Tamano*, 564 F.2d 964, 981 (1st Cir. 1977) (citing Learned Hand's formula for negligence); *Andros Shipping Co. v. Pan. Canal Co.*, 298 F.2d 720, 725–26 (5th Cir. 1962) (also citing Learned Hand's formula for negligence from *Carroll Towing*); *Rosenquist v. Isthmian S.S. Co.*, 205 F.2d 486, 489 (2d Cir. 1953) ("Negligence may be measured as a product of the gravity of the injury, if it occurs, multiplied by the factor of its probability." (also citing *Carroll Towing*)).

75. The information costs of the actor determining the harm its action imposes on a particular potential victim suggests that such a tort rule would not be workable. See Shawn J. Bayern, *The Limits of Formal Economics in Tort Law*, 75 BROOK. L. REV. 707 (2010). Hence, tort is only roughly efficient.

serves his self-interest, and hence is not rent-seeking. He offers Dave water for \$200 a gallon. Dave needs the water, so he agrees. He is in dire straits but that is due to the hurricane, and Pete's offer of the water to Dave seems to be wealth increasing because, when Pete offers it, it is worth more to Dave than the \$200 per gallon that he pays. But again, a slight change in the fact pattern can change the analysis. Suppose that Dave hears that Pete has water and offers Pete \$5 a gallon for it. Suppose that Pete realizes that Dave is in dire straits, and believes that he can get \$200 per gallon from Dave, and they enter into the agreement at that price.<sup>76</sup> But for the opportunity to extract more money from Dave, Pete should have accepted Dave's \$5 per gallon offer. So viewed, Pete has engaged in rent-seeking and, were we to apply our criteria, should be denied the benefit of his ultimate \$200 per gallon bargain with Dave. Unfortunately for our theory, we have already explained why allowing Dave to assert the defense of duress is not likely to maximize wealth. If our approach is to lead to wealth maximization, we need to tweak it to change the outcome in this hypothetical.

Although at first blush it seems implausible, some rent-seeking can enhance social wealth. The reason is that rent-seeking is often the best means by which people reveal information about how they value goods. To illustrate this, consider an example of a book we own and value at \$4, which our colleague Rob Atkinson, who knows we own it, values at \$10. Suppose that there is no one else who knows about our owning the book who values it more highly than either the two of us or Atkinson, and that it would cost more than \$6 for anyone who does not know we own the book to find that out. Thus, the universe of those who will seek to own the book is just Atkinson and us.

Atkinson, always looking for a good deal, offers us \$3 for the book. Because we value it at \$4, we decline the offer. No problems so far. It is not in our interest to sell the book for \$3. But Atkinson is nothing if not persistent. He subsequently offers us \$5 for the book. Now we think, this is the kind of book he would really like. He probably values it at more than \$5. So we again decline the offer. At this point, we have engaged in

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76. To simplify the problem, assume that there is no one else around to whom Pete can sell the water. Were this not the case, Pete could legitimately refuse to sell water to Dave without engaging in rent-seeking so long as he believes that someone else would pay a higher price for the water.

rent-seeking. We have declined an offer that would have made us better off only because we hope to transfer wealth from Atkinson to us. But this is precisely how contracts are negotiated. Every time parties haggle about price, they are seeking first to determine whether there is surplus to be gotten by contracting, which is a potentially wealth producing endeavor, and second to determine how that surplus will be divided between them, which is purely a wealth transferring endeavor.<sup>77</sup>

This hypothetical illustrates that rent-seeking in formation of contracts provides valuable information.<sup>78</sup> Due to difficulties with third parties like the government determining how individuals value various goods and services<sup>79</sup>—and still other difficulties motivating individuals to explore potential wealth increasing transactions if they are later subject to forfeiture of the benefit of their bargains—allowing individuals to engage in rent-seeking in the formation of contracts seems to be the most efficient way to encourage the creation of wealth-enhancing deals. There is a good chance that a third party assigned the task of deciding whether a transaction will be wealth creating, and ordering the parties to engage in it if it is, will make mistakes. Recall that no matter whether parties seek to maximize their individual gain via wealth creation or wealth transfer, if they both voluntarily enter into a transaction, we know that the transaction is wealth increasing.<sup>80</sup> Allowing a party to a contract to assert a defense of duress if she believes that the other party initially rejected an offer above her subjective value seems to us a recipe for costly uncertainty as well as a jobs program for contract litigators.

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77. See COOTER & ULEN, *supra* note 18, at 80 (“We have explained that the process of bargaining can be divided into three steps: establishing the threat values [i.e., *go-it-alone* values], determining the cooperative surplus, and agreeing on terms for distributing the surplus from cooperation.”).

78. See *id.* at 269–70 (discussing the value of bargaining and “why the law permits people to make demands when bargaining”).

79. *Id.*

80. See Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237, 242 (1988) (“Probably the most common formulation of the Coase Theorem asserts that, absent transaction costs, interacting parties will reach an efficient outcome even if the law awards initial legal entitlements to less valued uses.”); see also COOTER & ULEN, *supra* note 18, at 80 (“In any voluntary agreement, each player must receive at least the threat [or *go-it-alone*] value or there is no advantage to cooperating.”); R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960) (noting that if “market transactions are costless . . . rearrangement of rights will always take place if it would lead to an increase in the value of production”).

To illustrate our intuitions, note that every contract involves negotiations about price, and essentially a rule that would prohibit rent-seeking in contract negotiation would obligate an offeree to accept the first price above the offeree's subjective value or not to contract with the offeror.<sup>81</sup> For simplicity, think of the offeree as the seller (S) and the offeror as the buyer (B). If S believed that he could get a higher price from B, he would have to try to create a record to support his assertion that his subjective value was higher than the offer price. So he might claim that his real motive was to find another potential buyer who might pay him more. Then his rejection of B's offer is not rent-seeking. But his need to create a record might induce him to go through the charade of trying to find another buyer. That would seem to increase transaction costs. In addition, knowing that S could not simply reject his offer if it is above S's subjective value, B will try to guess that value and to offer a price just above it. Similarly, S will have an incentive to counter with an offer just below B's value. The ultimate effect of the duress rule would be to discourage the parties from offering prices close to those that they have reason to believe split surplus more equally. This guessing game is likely to prolong the time it takes for parties to finally find a price that is in the interests of both parties, if in fact they are able to do so. Finally, given the difficulty of proving subjective value, S might be tempted simply to lie about whether B's offer is above S's value, and the parties would negotiate as they do now. But, S will always have to fear that B might try to get out of the contract by claiming duress. Hence, a rule that rent-seeking by trying to negotiate a more favorable price constitutes a wrongful act that can support a defense of duress would increase uncertainty about contract performance.

In sum, rent-seeking in the context of negotiating contracts provides value to society by channeling individual incentives to gain wealth toward transactions that actually increase social wealth, without a barrage of wasteful offers and counter-offers and with minimal uncertainty about a contract's validity.<sup>82</sup>

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81. Similar observations were made by other scholars in the past. *See supra* note 22. Of course, if the offeree thought he could get more than the current price for the good or service from someone other than the offeror, that alternative price would serve as a floor for the subjective value to the offeree. In other words, we are using the economic definition of opportunity cost as part of the subjective value to the offeree.

82. In many economic models a particular bargaining solution is assumed and the bargaining process is not explicitly modeled whenever the negotiating

Given the valuable role of such free negotiations, the law should encourage them once a person has determined that without a contract he will engage in conduct that may impose harm on another person. That will allow the parties to determine whether the harm to the victim is greater than the benefit to the threat-maker, and if so, to strike a deal that keeps the threat-maker from acting.<sup>83</sup> Refusing to enforce the resulting deal by recognizing a defense of duress merely because a party threatened to walk away from the negotiation would seriously impair the process by which the parties obtain information about the relative costs and benefits of the threatened conduct. Hence, we need to amend our rule about what constitutes wrongful threats to exclude rent-seeking by threatening to walk away from contract negotiations, leaving the status quo ante.

So amended, the rule works in both the *Austin v. Loral* context and the hypothetical involving Pete and Dave. On the facts of *Austin v. Loral*, Austin was not simply threatening to end contract negotiations.<sup>84</sup> Rather, it threatened to breach the prior contract,<sup>85</sup> changing the status quo from what it was prior to the contract negotiations. On the alternative facts that we presented, Austin already had reason to breach, and hence

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parties have to split a cooperative surplus. See, e.g., Lucian Arye Bebchuk, *A New Theory Concerning the Credibility and Success of Threats To Sue*, 25 J. LEGAL STUD. 1, 6 (1996) (applying the “backward induction” approach); Murat C. Mungan, *Reverse Payments, Perverse Incentives*, 27 HARV. J.L. & TECH. 1, 5–6 (2013) (discussing reverse payment settlements). One of the most commonly used bargaining solutions, for instance, is the Nash bargaining solution, see NOLAN MCCARTY & ADAM MEIROWITZ, *POLITICAL GAME THEORY: AN INTRODUCTION* 275–80 (2007) (explaining bargaining theory and discussing the Nash bargaining solution), although there exist methods to explicitly analyze bargaining as a process where parties make alternating offers, see Ariel Rubinstein, *Perfect Equilibrium in a Bargaining Model*, 50 ECONOMETRICA 97 (1982). In models assuming the Nash bargaining solution it is hard to recognize that the bargaining process itself actually involves rent-seeking, because the parties’ actions—which, as discussed, are motivated by the prospect of wealth transfers—are not explicitly analyzed. In reality, however, bargaining takes the form of alternating offers, threats, and bluffs—which, when observed, can be interpreted as rent-seeking. It is therefore important to note the negotiation exception to rent-seeking that we have discussed in this Part, which very often goes unnoticed in formal models where some cooperative surplus is being shared.

83. See *supra* notes 77–80 and accompanying text on the value of voluntary transactions and negotiation in generating wealth for both parties.

84. *Austin Instrument, Inc. v. Loral Corp.*, 272 N.E.2d 533, 534 (N.Y. 1971).

85. *Id.*

breach was the status quo ante. Austin merely indicated that if Loral would agree to its contract demands, it was willing to promise not to breach the first contract. In the hypothetical involving Pete and Dave, it does not matter whether we characterize Pete's offer as wealth increasing or as rent-seeking. If it is rent-seeking, it is done as part of contract negotiation where the only threat was not to enter into the contract. Hence, neither characterization supports a defense of duress.

#### IV. A SPECIAL CASE: DURESS AND SETTLEMENT AGREEMENTS FOR CONTRACT DISPUTES

The theory of duress as rent-seeking other than as part of contract negotiation provides a focus for fact-finders trying to determine whether, in a given instance, a defendant should be able to avail itself of that defense. Nonetheless, this theory leaves some issues still to be resolved. Perhaps the most important, because it so often leads to claims of duress,<sup>86</sup> is how to treat settlement of contract disputes. The frequency with which duress cases are based on settlements reflects that parties enter contracts to be able to rely on the performance of promises by other parties. Hence, entering a contract often makes one vulnerable to total breach by the other party—breach that effectively terminates the contract. When total breach occurs, this vulnerability may help induce the non-breaching party to settle on terms that seem to impose on it more than its “fair share” of the costs of contractual breakdown. At the same time, because of the nature of settlement agreements, the breaching party's threat of refusal to enter into a reasonable settlement

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86. For a demonstration of how duress may be implicated in the context of divorce settlements, see, e.g., Penelope Eileen Bryan, *The Coercion of Women in Divorce Settlement Negotiations*, 74 DENV. U. L. REV. 931, 931 (1997) (“Some wives seek relief from these unfair divorce settlements and move to have them vacated on grounds of coercion, duress, misrepresentation, and unconscionability. These contract doctrines, and the particular spin that family law places on them, generally fail to comprehend or to take seriously the disadvantages confronting many women in settlement negotiations. Rather, as written and as applied, these doctrines frequently confirm, rather than correct, unfair results.”). See also *Berardi v. Meadowbrook Mall Co.*, 572 S.E.2d 900, 901 (W. Va. 2002) (“[A]llegations of economic duress by sophisticated tenants, who were represented by attorneys in settlement negotiations, were insufficient to warrant setting aside settlement agreement.”); *Centric Corp. v. Morrison-Knudsen Co.*, 731 P.2d 411, 411 (Okla. 1986) (“[E]conomic duress was [a] possible basis for avoiding mutual release and settlement of claims, based on specific facts of each case . . .”).

essentially can be the means of springing the trap set by a prior rent-seeking breach.

To clarify this discussion, let us assume that one party to a contract would stand to lose greatly from total breach, even in light of the ultimate damages it might be able to collect. (Call this the vulnerable party.) The second party to the contract stands to lose only a little from breach. (Call this the non-vulnerable party.) If the non-vulnerable party breaches the contract, it has engaged in rent-seeking behavior because breach is in its interest only as means to secure wealth from the vulnerable party. Moreover, if the parties engage in settlement negotiations, the non-vulnerable party is likely to reject any settlement that does not more than compensate it for the costs of its breach. Hence, it will effectuate its rent-seeking behavior by holding out for a very advantageous settlement. One might surmise that such a refusal to contract on anything other than extremely generous terms should be the basis for a defense of duress—an exception to our exception if you will. Careful analysis of the settlement context, however, requires a distinction between refusal to negotiate a settlement and refusal to pay an acknowledged debt, which can be considered separate from the settlement process. This obviates any need for an exception to the exception.

The problem of duress in the context of a settlement is well illustrated by another classic case, *Totem Marine v. Alyeska Pipeline*.<sup>87</sup> Alyeska contracted with Totem to carry materials that Alyeska needed to ship from the Houston area to Alaska, where Alyeska planned to use them to construct an oil pipeline.<sup>88</sup> Due to circumstances that, at least in part, may have been the fault of Alyeska, the delivery of the material was significantly delayed, and Totem experienced greater costs than it anticipated.<sup>89</sup> Totem claimed that as the problems with carrying the materials arose, Alyeska agreed to cover the extra costs.<sup>90</sup> Nonetheless, by the time the ship reached the Los Angeles area, Alyeska decided to terminate the contract.<sup>91</sup> It offload-

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87. *Totem Marine Tug & Barge, Inc. v. Alyeska Pipeline Serv. Co.*, 584 P.2d 15 (Alaska 1978).

88. *Id.* at 17.

89. *Id.* at 18.

90. *Id.*

91. *Id.*

ed the material in Long Beach, California and secured a different carrier to transport the material to Alaska.<sup>92</sup>

After the contract was terminated, Totem submitted invoices for somewhere between \$260,000 and \$300,000 to Alyeska, which indicated that it would have to look over the invoices before paying them.<sup>93</sup> Alyeska indicated that it could take up to eight months for it to determine the validity of the invoices and to pay those it determined were legitimate.<sup>94</sup> Totem needed the cash as the invoices represented charges for debts it had agreed to pay within ten to thirty days.<sup>95</sup> Facing demands from its creditors, Totem claimed that it would go bankrupt without payment by Alyeska.<sup>96</sup> Totem informed Alyeska of its financial difficulties, and after negotiation, Totem accepted \$97,500 from Alyeska in return for agreeing to release Alyeska from any claims arising from the terminated contract.<sup>97</sup>

Subsequently, Totem brought suit against Alyeska seeking to rescind the settlement on grounds of duress and recover the unpaid balance of the invoices allegedly due under the original contract.<sup>98</sup> According to Totem, Alyeska wrongfully terminated the contract and subsequently withheld funds knowing the devastating impact this would have on Totem's financial situation.<sup>99</sup> Totem claimed that it had no choice but to accept the \$97,500 settlement in order to remain in business.<sup>100</sup> The trial judge granted Alyeska's motion for summary judgment,<sup>101</sup> but the Supreme Court of Alaska reversed and remanded, stating that if, among other things, "Alyeska deliberately withheld payment of an acknowledged debt, knowing that Totem had no choice but to accept an inadequate sum," then Totem would have made out its defense of duress.<sup>102</sup> The court noted that Totem need not prove that Alyeska's termination of the contract

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92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*

97. *Id.* at 18–19.

98. *Id.* at 19.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* at 23–24.

was wrongful, although if it did, that would have a bearing on Totem's duress defense.<sup>103</sup>

According to the rent-seeking theory of duress, the Alaska Supreme Court got the law correct in all respects, although it takes some analysis to see why and to illuminate precisely what it means for Alyeska to have withheld payment of an "acknowledged debt."<sup>104</sup> In this case, as in many settlement cases, breach plus refusal to settle can stand in for threat of breach as a means of extracting rent from the other party. In *Alyeska*, Totem had performed much of the contract and been paid for none of its work. Thus, rather than threaten breach, Alyeska could transfer wealth from Totem simply by breaching and then threatening not to pay what it owed until ordered to do so by a court. This wealth transfer would be implemented by a settlement agreement, which, by demanding Totem to give up its contract claim, would essentially modify the original contract in favor of Alyeska. Thus, proof that the total breach was not in the self-interest of Alyeska but for this opportunity to transfer wealth would be dispositive evidence that the breach was part of a rent-seeking plan.

But Alyeska might have engaged in rent-seeking even if its termination of the contract was not part of a wealth-transfer scheme. Assume that by terminating the contract Alyeska reduced its total cost of getting the material to Alaska, taking into account whatever damages it might have to pay if the termination is deemed breach of contract. That is, assume that the termination of the contract was not motivated by a potential wealth transfer. Once the contract is terminated, Alyeska still has the opportunity to take advantage of Totem's precarious financial position by refusing to pay what it recognizes it owes to Totem—or, as the court termed it, its "acknowledged debt."<sup>105</sup> But for Totem's precarious position, refusal to pay such a debt would only add to Alyeska's costs because it would have to respond to requests for payment and ultimately defend against a law suit, both of which can be expensive propositions. On the flip side, there appears to be no legitimate (i.e., non-wealth-transfer-motivated) reason not to pay such a debt. Hence, the threat not to pay the debt for eight months would seem to support a conclusion that Alyeska is rent-seeking.

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103. *Id.* at 24.

104. *Id.*

105. *Id.*

This all assumes that at the time Alyeska refused to pay the invoice, there was some debt it acknowledged it owed to Totem. The rent-seeking theory of duress clarifies that the term acknowledged debt means the sum that Alyeska could not avoid paying except by taking advantage of Totem's precarious position. For example, had Alyeska determined, taking into account the possibility that it could prove breach of the contract by Totem and damages it incurred, that the best it could do if the case was litigated was to have to pay Totem a sum of money, then the acknowledged debt would be that sum. Under the rent-seeking doctrine of duress, Alyeska cannot choose to refuse to pay this sum and then enter into an enforceable settlement for a lesser amount. Assuming that Alyeska is an economically rational actor, because failure to pay the acknowledged debt eliminates the possibility of avoiding litigation and thereby ensures that Alyeska will incur litigation costs, Alyeska will be induced to pay the acknowledged debt.

The key to understanding contested settlements is the court's recognition that the decision not to pay an acknowledged debt can be separated from the decision whether to enter into a settlement.<sup>106</sup> Had Alyeska paid the acknowledged debt, it would be free to negotiate a settlement with Totem on any terms it could then get Totem to accept. Thus, cases alleging that settlement agreements were entered under duress depend on whether the conduct prior to negotiation of the settlement was rent-seeking; it should not depend on the threat of a party to decline to enter a settlement.

#### V. ANOTHER SPECIAL CASE: THE RELATED DOCTRINE OF CONTRACT MODIFICATION

As hinted in our prior discussion of *Austin v. Loral*, our definition of wrongful conduct for duress also has significance for cases of contract modification. At common law, courts rely on the "legal duty rule" to decline to enforce contract modifications that change contract obligations of only one party.<sup>107</sup> Es-

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106. *Riehm v. State Farm Mut. Auto. Ins. Co.*, 07-651, p. 5 (La. App. 5 Cir. 1/22/08); 977 So. 2d 1045, 1048 ("The court noted a settlement rather than acknowledgment of the debt occurred . . .").

107. Kevin E. Davis, *The Demand for Immutable Contracts: Another Look at the Law and Economics of Contract Modifications*, 81 N.Y.U. L. REV. 487, 508 (2006) ("For instance, enforcement of contract modifications has often been denied . . . on the theory that a promise to render performance that a person has a preexisting legal duty to render cannot provide the consideration required to support a promise to modify a contract."); see, e.g., *Romero v.*

entially, this rule deems such modifications invalid for lack of consideration because one party merely promises what it is already contractually obligated to do.<sup>108</sup> The rule is both perverse from a wealth maximization perspective and largely ineffectual—essentially a trap for the unwary—no matter what one’s normative view of contract law.

The rule is perverse because all agree that there are some situations in which modifying a contractual obligation is in the interests of both parties to the agreement.<sup>109</sup> For example, suppose Builder (B) agrees to build a house for Owner (O) for \$200,000 in accordance with building plans agreed to by the parties. As B starts preparing the foundation, it determines that it will cost \$50,000 more than both parties expected to place the house as specified in the plans. B informs O of this and that B will lose so much on the contract that it would be better off breaching and paying damages. O, who values the house as planned more highly than the market value of the house if built, fearing that she will not be able to obtain fully compensatory damages, agrees to increase the price she will pay for the house by the \$50,000. In this situation, the contract is wealth maximizing because O prefers the house be built for at least as much as \$250,000 and allowing modification avoids

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Buhimschi, 396 F. App’x 224, 233 (6th Cir. 2010) (“The preexisting duty rule states that a contract fails for lack of consideration where the party promises something that he is already legally bound to do.”); *see also* Robert A. Hillman, *Contract Modification Under the Restatement (Second) of Contracts*, 67 CORNELL L. REV. 680, 686 (1982) (explaining that the Restatement (Second) of Contracts’ approach to the enforcement of contract modifications “retains the preexisting-duty rule in section 73 on the theory that modifications without additional consideration by the promisee are likely to be the product of ‘an express or implied threat to withhold performance of a legal duty’”).

108. *Romero*, 396 F. App’x at 233.

109. Hillman, *supra* note 107, at 687–88 (“[T]he presumption of coercion in modified contracts lacking additional consideration is suspect in view of the realities of the modern business world in which parties frequently engage in unilateral modification of agreements. Thus, erecting barriers to the enforceability of modifications based on the technical requirement of additional consideration is ill-advised.”); *see also* Antony W. Dnes, *The Law and Economics of Contract Modifications: The Case of Williams v. Roffey*, 15 INT’L REV. L. & ECON. 225, 237 (1995) (“The very fact that so much is left implicit in long-term contracts . . . tells us that, generally, modifications should be enforceable. The nature of the long-term contract is one where it would be too costly to assign all risks at the outset. The parties have no option but to deal with events as they unfold. Therefore, one of [Aivazian, Trebilcock, and Penny’s] exceptions to the desirability of the pre-existing-duty rule applies. . . . The welfare analysis of contract modification . . . shows that modifications in long-term contracts sustain efficient contracting. The buyer always has the option of not agreeing to a change and obtaining expectation damages for breach.”).

transaction costs of having the parties agree to terminate the agreement and enter a new one.

The rule is largely ineffectual for those who know about it because, as noted above, the parties can accomplish the same outcome by terminating the initial agreement and entering a new one, and courts do not usually look behind termination of agreements to see whether they are shams.<sup>110</sup> Moreover, even if a party is hesitant to free the other party from the initial agreement for fear she will bolt without signing the new one, the parties can change the agreement slightly so that both parties have obligations in addition to those found in the initial agreement. Because courts will not look behind the adequacy of consideration, as long as the additional obligations provide benefit to the other party, the modification will be held to have been supported by consideration.<sup>111</sup> For example, in our house building hypothetical, B might agree to use a higher quality of roof shingles, which will cost it an extra \$1000, in return for the \$50,000 price increase. Unless a party had independent evidence that the additional obligation was not bargained for, a court would find such modification enforceable.<sup>112</sup> Finally, there are many exceptions to the rule, including contracts for sales of goods, modifications that are fair in light of circumstances not

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110. Hillman, *supra* note 107, at 685 (“The ‘mutual rescission’ theory, perhaps the most frequently invoked exception to the preexisting-duty rule, avoids the rule by suggesting that parties are free to rescind their earlier agreement, and thus eliminate the preexisting duty to perform. The new promise is then supported by the other party’s promise, even though the latter is exactly the same as in the original ‘rescinded’ contract.”); *see also* Michael A. Dorelli & Phillip T. Scaletta, *Recent Developments in Indiana Business and Contract Law*, 43 IND. L. REV. 603, 637 (2010) (“Generally, when a contract is terminated, neither party has any further duties or obligations under the contract. On the other hand, when a party breaches a contract, that party may be required to compensate the other party for damages resulting from the breach.” (quoting *Winterton, LLC v. Winterton Investors, LLC*, 900 N.E.2d 754, 762–63 (Ind. Ct. App. 2009))).

111. This tendency appears to have very old roots. *See, e.g.*, Pinnel’s Case, (1602) 77 Eng. Rep. 237 (Ct. Com. Pl.) 237; 5 Co. Rep. 117 a, 117 a (“Payment of a lesser sum on the day in satisfaction of a greater, cannot be any satisfaction for the whole, because it appears to the Judges that by no possibility, a lesser sum can be a satisfaction to the plaintiff for a greater sum: but the gift of a horse, hawk, or robe, &c. in satisfaction is good. For it shall be intended that a horse, hawk, or robe, &c. might be more beneficial to the plaintiff than the money . . .”).

112. *See, e.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 73 (1981) (“Performance of a legal duty owed to a promisor which is neither doubtful nor the subject of honest dispute is not consideration . . .”).

anticipated by the parties, and parties seeking to enforce a modification on which they have relied.<sup>113</sup>

For the reasons just outlined, courts need another basis for determining whether allowing a particular modification will maximize wealth. When the modification is entered in response to a threat of breach, which describes the vast majority of modification cases, we contend that the courts should enforce the modification when the threat is not rent-seeking. The reasons are precisely the same as the reasons for enforcing agreements that result from other threats that are not rent-seeking. Essentially, if it is known that the courts will not enforce the modification, the threat-maker will simply breach the contract, leaving the victim worse off than if it had negotiated a modification.

Modification, however, is a special case because the parties have already negotiated a prior agreement and in that context may have provided for the contingency that prompts the threat to breach. For example, in our hypothetical, O might specify that she values the house so greatly that even if B's costs turn out to be greater than anticipated, B agrees not to breach the contract. Presumably O will have to pay extra for that provision. In such a situation, one might contend that the courts should not allow the threat-maker to profit from threatening the very conduct that the parties envisioned and precluded by agreement. That would allow the party to avoid risks that it specifically agreed to bear.<sup>114</sup> Thus, they would advocate that the court not enforce a modification.

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113. The Uniform Commercial Code (U.C.C.) does not require consideration for the modification to be valid. *See* U.C.C. § 2-209(1) (2014). Modifications satisfying the good faith requirement outlined by the U.C.C. are enforceable. Similarly, under the Restatement (Second) of Contracts modifications are enforceable if they are “fair and equitable in view of circumstances not anticipated by the parties when the contract was made” even if there is no consideration for the modification, RESTATEMENT (SECOND) OF CONTRACTS § 89(a) (1981), and “to the extent that justice requires enforcement in view of material change of position in reliance on the promise,” *id.* § 89(c).

114. *See* JOHN C. COATES IV, ALLOCATING RISK THROUGH CONTRACT: EVIDENCE FROM M&A AND POLICY IMPLICATIONS (2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2133343](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2133343) (discussing “[r]isk allocation provisions,” which “consist of terms that alter property rights depending on the realization of one or more uncertain facts related to the value of the target”); Edwin W. Patterson, *The Apportionment of Business Risks Through Legal Devices*, 24 COLUM. L. REV. 335, 347–59 (1924) (discussing legal devices used in the apportionment of risk); A. Mitchell Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427, 427 (1983) (studying how breach remedies can be used to allocate risks “due to changed circumstances” between the contracting parties).

A better rule, however, would be for courts to enforce explicit contractual allocation of risk with specific performance and allow for modification of contract against this background remedy. To see why, we return to the inability of courts to prevent breach even from agreements in which the very nature of the breach was envisioned and provided for by the parties. Despite the provisions of the initial contract, B will breach unless the costs it will bear due to breach exceed the costs of performance. Under specific performance, if litigation costs are not zero, the cost of breach will necessarily exceed the cost of performance. Hence, B will not breach unless O agrees to allow B to do so. But, both parties would wish to modify the contract if the costs to B from performance exceeded the value to O. Thus, rather than disallow such a modification, the court should enforce the parties' initial agreement by ordering specific performance and allow them to contract around this order if they so agree.<sup>115</sup> In short, what encourages threats of inefficient breach in such cases is not enforcement of resulting modifications, but courts' reluctance to enforce contractually specified damages.

Essentially, modification of a contract can be viewed as creation of a new contract under threat of breach of the original one. Such a threat may or may not be rent-seeking, and the modification should be voided or not accordingly. Even when the parties have anticipated the very nature of the threatened breach and have prohibited modification as part of the bargain, modification might still reflect a credible threat of breach and hence should not be barred *per se*. If the courts are worried that enforcing a modified contract in the face of such a provision might deprive a party of risk avoidance for which it bargained, the court can discourage such deprivation by enforcing the contract via specific performance.

### CONCLUSION

This Article has demonstrated that wealth maximization would be well served by defining the wrongful threat component of the doctrine of economic duress to mean threat of rent-seeking conduct other than the threat simply to withdraw from contract negotiations. The exception for threats to withdraw from contract negotiations recognizes that, although parties

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115. Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 284-91 (1979) (arguing that the costs of post-breach negotiations against the background of a specific performance remedy are no greater than the costs against an expectation damages remedy).

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technically may engage in rent-seeking as part of such negotiations, the negotiations are too valuable as means for the parties to determine whether there is surplus to be gained from contracting. This proposed definition will discourage investment in pure wealth transfers, while providing a mechanism for a person harmed by a potentially productive (i.e. wealth increasing) endeavor to “buy out” the pursuer of such an endeavor when that harm exceeds the benefit that flows from the endeavor.