Contractual Rights and Third Parties: a Unified Perspective of the Law of Property and the Law of Delict

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1 Introduction

1.1 A Conflict

In this article I will discuss a conflict between two persons who – at first – had nothing to do with each other. Let us call them Promisee and Transferee. Their conflict arose because they were interested in the same piece of property and consequently they had dealings with the same third person, the owner of the said piece of property.

Promisee was there first. Promisee had entered into a contract with the above mentioned third person – Promisor. The contract concerned an object that Promisor owned. According to the contract, Promisee had a right in that property. His contractual right might be, e.g., a right of use or a right of pre-emption.

After entering into the contract with Promisee, the Promisor sold the piece of property to Transferee, who – at the time of the sale – knew of Promisor's duties arising from the contract with Promisee. After the sale, Promisee wanted to exercise his contractual right – e.g., to use the object or to buy it according to the terms of his right of pre-emption – while Transferee, as owner of the object, was not willing to let him do it.

Is Promisee entitled to exercise his contractual right in the property despite the subsequent sale to Transferee? If not, is Promisee entitled to a monetary compensation from Transferee for the right which he has lost due to the sale?[1]

1.2 The Traditional View

A traditional answer to a conflict of rights concerning the same piece of property is to classify rights as property rights on the one hand and personal rights on the other. According to the traditional theory, property rights are binding on third parties, while mere personal rights are not. If the Promisor's right is a property right, it is enforceable against Transferee. If it is not, it will not affect Transferee, even if he knew of it at the time of the transfer.[2]

Giving priority to Transferee might be rational, if he did not know of Promisee's prior right at the time of the transfer. However, if Transferee knew of Promisee's right, this traditional rule

[1] The issue is discussed in detail in Hoffrén (2008).

[2] See, e.g., Terré & Simler (2002), 52–54 and Fikentscher (1985), 42–46.

leads to outcomes that are neither efficient nor fair. Why should we give priority to the transferee, while the promisee was there first and the transferee was the one who would have been able to prevent the conflict of rights?

1.3 A Fair and Efficient Solution

Given the lack of efficiency and fairness of the traditional rule, it is not a surprise that this rule is not strictly followed in Finland or in other European jurisdictions. Roughly, the alternatives to this traditional rule can be divided in three. First, the traditional rule can be kept as a main rule and then exceptions to it can be made. Second, the core of the traditional rule can be kept, but its details altered. Third, the traditional rule can be rejected.

German law is a model example of the first alternative. Property rights (dingliche Rechte) are good against all, while mere personal rights (Forderungen) do not have effect on third parties. There are two kinds of exceptions to this rule: First, some obligatory rights are, according to specific legislation, protected against third parties. For instance, a tenant of a rented apartment is protected against a transferee (BGB § 566), and certain personal rights can be registered in order to achieve protection against third parties (BGB § 883).

Second, under some circumstances, third parties have been held liable for damages if they interfere with a contract between a promisee and a promisor. According to BGB § 826, a person who, in a manner contrary to public policy, intentionally inflicts damage on another person is liable to the other person to make compensation for the damage.[3] However, as a rule, third parties are not required to take other people's contracts into account.[4] Liability in damages is an exception restricted to cases where, taking into account all circumstances, the conduct of the interfering party is considered as immoral. For example, an agreement to indemnify the promisor for liability that she might incur in breaking her earlier contract is an element that could be indicative of immoral conduct.[5]

In France, the traditional rule has been altered. Art 1165 Code civil provides that contracts have effect only between parties to them and that they impose no burdens on third parties.[6] In 1800's, courts did not find interference with contract culpable.[7] This stand started to change

[3] "Wer in einer gegen die guten Sitten verstoßenden Weise einem anderen vorsätzlich Schaden zufügt, ist dem anderen zum Ersatz des Schadens verpflichtet."

[4] See, e.g., Larentz & Canaris (1994), 405 and Palandt (2006), 1280.

[5] BGH NJW 1981, 2184.

[6] "Les conventions n'ont d'effet qu'entre les parties contractantes; elles ne nuisent point au tiers, et elles ne lui profitent que dans le cas prévu par l'article 1121."

[7] See, e.g., Palmer (1992), 304–305.

when an employer was held liable in damages for hiring away another's employee.[8] After that, similar decisions were given also in disputes concerning other types of contract.[9] Nowadays, it is commonly accepted that third parties can not ignore legal consequences of contracts. Knowingly interfering with an existing contract is actionable.[10]

In Finland, a sharp division between property rights and personal rights has been rejected. Rights can be binding on some third parties and not binding on others.[11] According to legislation, registrable rights to real property bind subsequent buyers of the property, even if they are not registered, if the buyer knew or should have known of them at the time of the purchase.[12] Even rights that are not registrable will bind a purchaser who knew of them at the time of the transfer.[13] Rules for movable property are not so clear, since they are not laid down in legislation. On the one hand, the Supreme Court has given some decisions in which contractual rights are not considered binding on subsequent purchasers with knowledge of them.[14] On the other hand, a rule, according to which a contractual right should bind a transferee who knows of it at the time of the transfer, has gained support in legal literature.[15]

All the above-mentioned alternatives have something in common. There exists a number of rights – call them property rights or not – which are effectively protected against subsequent transferees. Other rights enjoy a more limited protection. In this article, this starting point is taken as given and not called into question. Furthermore, rules of defining which types of rights are property rights and which are not, vary from one jurisdiction to another and are not considered in this article. Here, it is assumed that a number of contractual rights which are not prima facie binding on subsequent transferees exist and that Promisor's right belongs to that group.

This article concerns the protection of rights which are not prima facie binding on transferees, specifically their protection against transferees who have knowledge of them. Consequently, protection of contractual rights against transferees who do not know of them at the time of the transfer falls outside the scope of the article. As seen above, the conditions and the scope of protection differ in different European countries. Conditions differ in that sometimes mere knowledge of a

[8] Cour de cassation, chambre civile, 27 mai 1908.

[9] See, e.g., Palmer (1992), 303.

[10] See, e.g., Terré & Simler (2002), 55, Terré, Simler & Lequette (2002), 484–485 and Wiederkehr (2004), 1008.

[11] See, e.g., Zitting (1951), 83 and Tuomisto (1993), 45–47.

[12] Maakaari (Code of Real Estate) 3:7.1 and 13:3 §§.

[13] Maakaari (Code of Real Estate) 3:8 §.

[14] Most recent cases are KKO 1999:111 and KKO 2002:58.

[15] See, e.g. Tuomisto (1993), 127–136, Tammi-Salminen (2001), 180–182 and Niemi (2002), 6–7. It has been suggested that protection should be denied only from rights that are considered undesirable from a social and economic perspective.

previous contractual right is deemed sufficient for protecting it, and sometimes more is required. The scope of protection differs in that the prior right can be binding on the transferee or the transferee may only be liable to pay damages if he interferes with the prior right.

In this article, I will discuss the appropriate conditions and scope of the protection independently from specific statutory rules of any jurisdiction. I will suggest a resolution of the conflict described above, which is both efficient and fair. First, in section 2, I will introduce the theoretical framework used. In section 3, I will argue that there are no grounds for denying Promisee protection, if Transferee knew of Promisee's contractual right at the time of the transfer. Therefore, contractual rights should be protected against transferees with actual knowledge of them. In section 4, I will point out some problems that enforcing a contractual right against a transferee who is not a party to the contract could present. Due to these problems, the best way to protect Promisee's contractual right in most cases is to hold Transferee liable in damages for interfering with the contract. The results are summarized in section 5.

2 The Law of Property and the Law of Delict from a Unified Perspective

2.1 Different Fields of Law Consider Different Questions

As a rule, the law of property and law of delict are conceptually separate. Those interested in the law of property and those interested in the law of delict may sometimes search answers to same conflicts – but find different answers, because the answers to be found on a given issue in these different areas of law are different. In order to find the best answers, these two subject areas have to be unified.

I have described a conflict between a contract promisor and a transferee. Facing this conflict, a scholar interested in the law of property – at least a Finnish one – asks: Is Promisee's right binding on Transferee? One interested in the law of delict might ask if Transferee is liable to damages for interfering with the contract. The problem with asking these questions separately is that the answers to these questions should be interdependent. It is easy to see that if the right is binding on Transferee, there is usually no need for liability for interference, because Promisee suffers no harm due to the transfer. A less obvious observation is that the interdependency works also the other way around: if there is liability in damages, it is not so crucial for Promisee that his right is binding on Transferee.

Therefore, the two questions raised by this conflict should be discussed from a unified perspective. We should not ask separately, if the right is binding on the transferee and if the transferee is liable in damages. If we do, we find separate answers which may be incompatible. To find an answer to the problem instead of answers to two separate questions, we need better questions. To find better questions, I will utilize a framework created by *Calabresi* and *Melamed*.

2.2 Property Rules and Liability Rules

Calabresi and Melamed have pointed out that in any given dispute between two people with conflicting interests it has to be decided (1) which party is to be favored and (2) what kind of protection is to be granted to the favored party's entitlement. An entitlement can be protected by a property rule, a liability rule or an inalienability rule. Since the inalienability rule[16] is not relevant here, only the property rule and the liability rule will be elaborated below.

If an entitlement is protected by a property rule, its holder can lose it only through a voluntary transaction. If it is protected by a liability rule, it can be taken away against holder's consent if an objectively determined value is paid to the holder.[17]

In our setting, the first question ("which party to favor") means asking if Promisee has any remedy against Transferee. Answered in the affirmative, the second question ("what kind of protection") means asking if Transferee must permit Promisee to exercise his right according to the contract despite the transfer (property rule) or if Promisee is denied the exercise of his right, but entitled to a payment of damages by Transferee (liability rule).

This situation can be illustrated with an example. Promisee and Promisor have agreed that Promisee has a right to use the object for a fixed period of time. Promisor sells the object to Transferee. If we decide to favor Transferee, Transferee can prevent Promisor from using the object and Promisee can do nothing about it. If we decide to favor Promisee, we still need to decide how to protect his entitlement. If we choose a property rule, Promisee can use the object despite the fact that it has been sold to Ttransferee. If we choose a liability rule, Transferee can prevent Promisee from using the object, but Transferee will be liable for damages.

Answering two questions gives us a solution to the conflict in question: (1) Is Promisee protected against Transferee who has knowledge of his contractual right and, answered in the affirmative, (2) should Promisee be protected by a property rule or a liability rule. Below, in sections 3 and 4, the questions are answered.

3 Why Protect Promisee's Right?

3.1 Why Not?

As noted above, favouring Transferee who knows of Promisor's pre-existing right at the time of the purchase seems to be neither fair nor efficient. However, there are arguments in favour of

[16] The inalienability rule means that the sale of the entitlement in question is not allowed (Calabresi–Melamed 85 Harv. L. Rev. 1089 (1972), 1111–1115).

[17] Calabresi–Melamed 85 Harv. L. Rev. 1089 (1972), 1092.

not protecting all contractual rights in property against subsequent transferees. In short, it has been argued that (1) Promisee does not need protection against Transferee; (2) Promisee does not deserve protection against Transferee; (3) protecting Promisee would have undesirable effects; and (4) protecting Promisee would create undesirable incentives. Below, I will discuss these arguments and demonstrate why they are not sufficient grounds for denying the promisee protection against a transferee with actual knowledge of his right.

3.2 Promisee Needs Protection

Promisee's need for protection against Transferee has been called into question. First, it has been argued that Promisor is responsible for complying with the terms of the contract between him and Promisee, and that *Promisor's liability* provides for sufficient protection for Promisee.[18] Second, those rights which fall outside the category of property rights are considered to be of little importance.[19] Third, it has been suggested that it is not worthwhile protecting a right against one person if the right is not protected against all.[20]

These arguments are not convincing. It is true that Promisor is liable for breach of contract, if Promisee can not exercise his contractual right due to the sale of the object to Transferee. However, Promisor's liability is inadequate. It is highly probable that, despite Promisor's liability, Promisee will not receive any compensation from him. Promisor might be insolvent or at least reluctant to pay. Given the circumstances – Promisor has entered into inconsistent contracts – Promisor does not seem to be a very reliable debtor.

Even if Promisee was to receive compensation from Promisor, the compensation might not cover all his losses. Due to the transfer of the object, the promisor is incapable of specific performance and Promisee is merely able to sue him for damages. True, the aim of contract damages for breach is to put the promisee in the position in which he would have been had the promisor fulfilled his contractual obligations. Due to both legal and practical reasons, the compensation is likely to fail to achieve that aim. First, all disadvantages for Promisee are not considered as compensable damage. Second, Promisee might not be able to prove the damage in court.[21]

[18] See, e.g., Hemmo (1998), 107, Perlman 49 U. Chi. L. Rev. 61 (1982), 92–93 and Cane (1996), 124–125.

[19] See, e.g., Hessler (1973), 82.

[20] See, e.g., Lohi (2003), 201 and Håstad (2000), 441.

[21] See, e.g., Calabresi–Melamed 85 Harv. L. Rev. 1089 (1972), 1108, Schwartz 89 Yale L. J. 271 (1979), 275–276, Epstein 16 J. Legal Stud. 1 (1987), 37–38 and Craswell 61 S. Cal. L. Rev. 629 (1988), 637.

Of course, if Transferee was – according to a liability rule – merely liable for damages, the liability of Transferee would not solve the problem of damages being inadequate. Still, protection against Transferee could provide for compensation if Promisor was insolvent.

There is a fundamental weakness in the argument which suggests that all rights of importance are already protected as property rights and rights falling outside that category do not need protection. That argument is based on a static view of exchange and contracts. It seems to assume that all relevant contractual rights have been taken into consideration when legislation has been given and rights have been classified as property rights or other rights. Such a view fails to acknowledge that new types of contractual rights can and do arise, and it is very difficult to take these rights into account in advance, before conflicts have already arisen. Even after it has been noted, that a specific right has become both significant and widely used, legislator might not act immediately – or at all.[22]

Furthermore, a suggestion that contractual rights should be protected either merely against the promisor or against the world can be supported by claiming that if a promisee would be protected against the promisor and transferees with knowledge, the protection would be so weak and uncertain that it is not at all worthwhile.[23] True, Promisee would still risk losing his contractual right due to Promisor's insolvency or a transfer to a bona fide transferee. However, this does not mean that Promisee does not need protection against transferees with actual knowledge. *If* conflict between Promisee and Transferee has arisen, it is important for Promisee to be protected in that particular relation. If Promisee loses the conflict, he will find no comfort in the fact that he could have lost his right also in Promisor's insolvency.[24]

3.3 Promisee Deserves Protection

Despite Promisee's need for protection, it has been claimed that he does not deserve protection because he has knowingly and perhaps negligently taken a risk of losing his right. His dealings are risky since

[22] A good example is a leasing contract. Leasing contracts have become widely used, are often long-term and involve considerable economic interests. Still, the legislator has not granted protection against third parties to the rights arising from a leasing contract. This problem has been noted both in Finland and in Sweden. See, e.g., Tepora (1999), 287–291, Hessler (1973), 300–303 and Håstad (2000), 434–438.

[23] See, e.g., Lohi (2003), 201 and Håstad (2000), 441.

[24] See, e.g., Forssell (1976), 113.

(1) he has chosen to enter into a contract, even if he knows (or should know) that his contractual right is not binding on third parties and can thus be lost due to a subsequent transfer[25];
(2) he has failed to protect his contractual right in an appropriate way[26]; or
(3) he has chosen an unreliable contracting party[27].

The first argument can be dismissed as circular reasoning: Promisee has entered a contract despite the fact that his contractual right will not be protected against third parties. If we decide for a rule according to which contractual rights *are* in fact protected against third parties, this statement becomes false. When Promisee's right is protected, the same circular reasoning could be applied to Transferee: Transferee has purchased the object despite the fact that Promisee's right will be binding on him.

The claim that Promisee has failed to protect his right requires some elaboration. In some cases, rights are binding on subsequent transferees only if they are registered or some other measures have been taken to make them public. E.g. in Finland, an agreement of a real estate lien is binding between the parties, but the lien will become complete and protected against all other people only after certain legal formalities have been met.[28] It has been discussed if an agreement of a lien should be protected against transferees with knowledge even if the lien is not yet complete. The answer according to the legislation is negative: If a creditor is so careless that he lends money before the formalities are fulfilled, he is not protected against third parties.[29]

There is some sense in not protecting someone who has acted carelessly. It is a part of the basic structure of private law that those who have acted negligently should suffer the consequences of their own negligence. Negligence of an injured party is often a sufficient reason for eliminating or at least limiting the liability of a tort-feasor.[30] However, to estimate the consequences of Promisee's assumed negligence we will have to look into the actions of Transferee.

Transferee knew of Promisee's right at the time of his dealing with Promisor. He knowingly and willingly entered into a sales contract which was to give rise to a conflict. It is often suggested in legal literature that the negligence of an injured party should lack significance, if the wrong-doer

[25] See, e.g., Kartio XXX Oikeustiede–Jurisprudentia 152 (1997), 159–163.

[26] See, e.g., Kaisto (1997), 19, Jokela, Kartio & Ojanen (2004), 482 and Tammi-Salminen (2001), 172.

[27] See, e.g., Hemmo (1998), 108 and Howarth M. L. Rev. 68 (2005) 195, 206.

[28] A real estate lien is raised by creating a mortgage over the real estate and handing the mortgage instrument over to the creditor as security for a debt (maakaari (Code of Real Estate) 15:2.1).

[29] This argument, brought up in the preparatory works for legislation (HE 120/1994, 111), has been vigorously criticized by Erkki Havansi, according to whom bad faith should not be favoured (see, Havansi (1996), 93–97).

[30] According to vahingonkorvauslaki (Tort Liability Act) 6:1, "if there has been a contribution to the injury or damage from the side of the person sustaining it – – the damages may be adjusted as is reasonable". (Translation at http://www.finlex.fi/fi/laki/kaannokset/)

has caused damage willfully.[31] This is reasonable, since the negligence of the injured party only gives the wrong-doer an opportunity to cause damage, and he is free to decide if he causes damage or not. The same is not true if the wrong-doer is only negligent: then the negligence of both parties increases the probability of damage, and it can not be said that only one of them caused it. Thus, in a conflict between Promisee who has acted carelessly and a Transferee who has acted willfully, it is fair to protect the one who has been "only" careless. Despite the carelessness of Promisee, Transferee could have chosen not to enter into an incompatible sales contract. Had he not known of the pre-existing right, the situation would have been different: then he would not have *chosen* to cause a conflict of rights but it would have arisen accidentally.

Moreover, since Transferee knew of the pre-existing right, it becomes irrelevant, that the right was not appropriately made public. The purpose of registration of rights is to make them visible to affected third parties and to prevent unpleasant surprises that could arise if secret rights were binding on subsequent purchasers and other third parties. In this case, the pre-existing right *was* visible to Transferee and the conflict of rights *was not* a surprise to him. The purpose of registration is in fact met in our setting, so the defect in formalities should not have relevance.

The argument based on choosing an unreliable contract party can be criticized on the same grounds as the argument based on failing to fulfill formalities. Even if Promisee has chosen an unreliable contracting party, Transferee's intentional interference is more blameworthy. Furthermore, Promisor's breach of contract would not have beem so detrimental to Promisee had the Transferee not interfered. Without the transfer, Promisee would have been able to claim specific performance from Promisor. Only after the transfer did it become impossible.

In sum, even negligent Promisee deserves protection against Transferee who knowingly interferes with his contract with Promisor.

3.4 Protection Does Not Necessarily Have Undesirable Effects

Protection against Transferee could have harmful effects since contractual terms which have been negotiated between Promisee and Promisor would not be appropriate between Promisee and Transferee. The harm for Transferee for being bound by Promisee's right could exceed the harm that Promisee would suffer if he was to lose his right. In such cases, enforcement of Promisee's contractual right against Transferee would lead to an inefficient outcome.

One conceivable solution to this problem is a contract between Promisee and Transferee. If Promisee's right would be so harmful to Transferee and not so important to Promisee,

[31] See, e.g., Saxén (1975), 126, Hemmo (2005), 208 and Epstein 16 J. Leg. Stud. 1 (1987), 28–29.

Transferee could buy out the Promisee.[32] However, achieving an agreement could be difficult in such a conflict since Transferee would try to negotiate as low a price as possible. Negotiations are made more difficult by the fact that there is a bilateral monopoly: neither Promisee nor Transferee needs to be afraid for competition, if they do not reach an agreement. Both parties have thus incentives to use resources to reach as good a deal as possible.[33]

The problem with avoiding the above-mentioned problems by denying the promisee protection is that *we can not know in advance*, how important a certain right is to Promisee and how harmful to Transferee. Thus, if we decide not to protect any other rights than rights in rem, we end up denying protection also from rights which benefit Promisee more than they harm Transferee. Then, Transferee and Promisee would again have to reach an agreement in order to achieve an efficient outcome. This shows us that an efficient outcome can not be reached simply by denying protection from all rights which fall outside the category of rights in rem.

Luckily, the problem can be avoided by choosing a suitable way to protect Promisee. If Transferee is not bound by Promisee's right but is only liable in damages, the problem described above does not emerge. If Transferee has to compensate Promisee for his losses, he will accept Promisee's right as binding on him if he would have to pay more compensation than what it is worth to him not to be bound by it. Respectively, Transferee would prevent Promisee from exercising his right, if and only if, losses caused to Promisee and compensable by Transferee would be inferior to Transferee's gain. I will return to this possibility below in section 4.

3.5 Protecting Promisee Creates Good Incentives

Last, I will consider incentives that protecting Promisee would create. It is commonly held that protection of pre-existing rights against transferees can make exchange more difficult and increase transaction costs. If transferees were bound by pre-existing contractual rights, they would need to use time and other resources to find out about other people's rights before they could enter into sales contracts. Besides generating these costs, protecting contractual rights against third parties would prevent so-called efficient breaches, i.e. breaching a contract when Promisor would gain from the breach more than Promisee would lose.[34]

The argument on transaction costs is not plausible when we discuss rules in conflicts where Transferee knew of the prior contract at the time of the purchase. Undoubtedly, even then it

[32] This solution goes back to Coase who has emphasized the possibility to modify legal rights by market transactions (3 J. Law & Econ. 1 (1980)).

[33] See, e.g., Epstein 106 Yale L. J. 2091 (1997), 2094 and Krier & Schwab 70 N.Y.U.L. Rev. 440 (1995), 460–462

[34] See, e.g., Posner (1998), 145–146 and Perlman 49 U. Chi. L. Rev. 61 (1982), 82–83.

could prove costly to find out the precise terms of the contract between Promisor and Promisee. However, this is not a sufficient ground for denying Promisee protection, since these costs are ultimately borne by Promisor and thus internalized.

This needs elaboration. On economic terms, transaction costs caused to third parties due to a contract between two people are a problem since they are external costs and the contracting parties do not have incentives to avoid them. Merril and Smith have illustrated this with an example of "Monday watches". Monday watch is a watch which its owner is allowed to use on every day of the week but Monday. On Mondays, right of use belongs to an other right-holder. If people dealing with watches know that there are Monday watches on the market, they would have to find out about owner's exact right every time they purchase a watch. This extra transaction cost would affect the price of all watches and thus everyone who is trying to sell a watch – not only those, who actually sell Monday watches. This is a sound reason for not protecting third party rights against bona fide purchasers.[35]

The same does not apply, if the right-holders' right is only binding on those transferees who know that they are buying a Monday watch. That rule would not generate external costs because people who are not (or do not know that they are) dealing with Monday watches would not have to be afraid of secret third-party rights and use resources to make sure that such rights do not exist. Only those who knowingly buy Monday watches would incur transaction costs for investigating the details of third-party rights. These transaction costs would affect the price of Monday watches and thus be borne by those who own Monday watches, i.e. people who have given away "Monday rights" to their watches.[36] Were these people rational, these internalized costs would affect their decision to sell Monday rights and thus affect also the price of Monday rights. If transaction costs would be too high, Monday rights would not exist. Since the transaction costs are internalized, they do not cause a problem of two people being able to burden others by their contract.

Efficient breach is a controversal issue. Some scholars argue that legal rules should encourage efficient breaches i.e. breaching a contract when Promisor's gains from breach outweight losses Promisee incurs. For example, a certain object which A owns is worth 90 € to A and 110 € to B. A and B have entered into a sales contract for a price of 100 €, but the object has not been delivered to B. After that, C is willing to buy the object from A and pay 150 €. Proponents of efficient breach theory suggest that A should be allowed to breach the contract with B, sell to C and compensate for B's losses since this would lead to an efficient allocation of resources: All parties involved would be at least as well off as they would have been had the contract not been breached. A and C would be better off because A got more money and C got the object he

[35] Merrill & Smith 110 Yale L. J. 1 (2000), 27–34.

[36] Merrill & Smith 110 Yale L. J. 1 (2000), 30.

wanted. B would be in the same position as if he had gotten the object according to the contract if he receives full compensation for his losses.[37]

There is an evident shortcoming in the theory. Why should A and C have all the gains from the breach? Should not C go to the first buyer, B, and buy the object from him? A contract between B and C is a more efficient and more fair solution than a breach of contract between A and B and a new contract between B and C. It is more efficient because it does not generate transaction costs which would follow from dispute over A's breach of contract.[38] It is more fair because it gives gains from the latter transaction to B. After all, when contracting of the sale and sales price with A, B has assumed the risk of changes in prices. If the price of the object had sunk, B would still have paid the contract price to A. If the price had risen – as it in this case did – B should have the gain.

However, the theory of efficient breach is somewhat more plausible if B and C are not interested in the exactly same right. For example, A owns an object, B has a right to use it and C is willing to buy it and use it himself. In such a setting, C would not be able to contract with B since B does not own the object. If B's use right would be binding on transferee, C would have to reach an agreement with both A and B in order to become owner and be allowed to use the object. If B's right was not binding on a transferee, the transaction would be easier: C would have to negotiate only with A. As noted above, in a bilateral monopoly like this between new owner C and right-holder B, it could prove difficult to reach an agreement even though it would be beneficial to both parties. Luckily, this too is a problem which can be solved by choosing an appropriate remedy. I will return to this issue in section 4.

Favouring efficient breaches by not protecting Promisee against Transferee would create problems since under some circumstances also "inefficient breaches" would be encouraged. Parties are encouraged to efficient breaches if and only if Promisee is to receice full compensation for his losses. If Promisor and Transferee were to gain 100 € and Promisee lose 50 €, it would be advantageous for Promisor to breach and pay compensation. If Promisee was to lose 150 € and be fully compensated, the breach would not be efficient and rational Promisor would not breach. Such a mechanism does not work if – for some reason, e.g. Promisor's insolvency – Promisee is not going to be compensated by Promisor. In such cases the liability of Transferee would guarantee that inefficient breaches would not occur: if Promisee could not receive compensation from Promisor, he could receive it from Transferee, and thus Promisor and Transferee would have a stronger incentive to take into account the losses caused to Promisee.

[37] See, e.g., Posner (1998),145–146 and Perlman 49 U. Chi. L. Rev. 61 (1982), 82–83.

[38] See, e.g., Bevier 76 Va. L. Rev. 877 (1990), 921–922 and McChesney 28 J. Legal. Stud. 131 (1999), 148–151.

3.6 Summary

In this section we have seen that Promisee should be protected against Transferee who has actual knowledge of his right. However, we have noted a problem with this solution. If Promisee's right is binding on Transferee, it is possible that Promisee maintains his right even when his gains from maintaining his right are less than the disadvantage caused to Transferee by being bound by Promisee's right. This should be taken into account when discussing the appropriate remedy.

4 Why a Liability Rule?

4.1 Differences Between Property Rules and Liability Rules

As mentioned before, the topic of this article is often discussed solely in the context of the law of property or the law of delict. At least in Finland, this restricts possible outcomes. From the point of view of the law of property, the outcome can be either that Transferee is bound by Promisee's right or that he is not. From the point of view of the law of delict, Transferee can be liable in damages or not. Isolated discussion does not permit comparison between possible remedies: which one is better? In the following, the choice is made on the basis of fairness and efficiency, not on the formal ground of deciding first the field of law and after that the remedy typical to that field.

To make a choice between property rules and liability rules, we have to consider their differences, especially the different consequences that these rules have. If a property rule is used, Promisee maintains his right concerning the property in question. If a liability rule is used, a sum of money is taken away from Transferee and given to Promisee. Consequently, a property rule means an "all-or-nothing" resolution, while applying a liability rule involves deciding the amount of damages to be paid.

A property rule is more advantageous for Promisee. He is allowed to maintain his right, or if he is willing to part with it, he can negotiate for a suitable price. Respectively, a liability rule is more advantageous for Transferee. He can have the property in its entirety for himself by paying a certain amount of money. If he does not want to pay, but is willing to tolerate Promisee's right, he is free to accept the right as binding on him. In short, a property rule gives the right to decide, and consequently, more bargaining power to Promisee, while a liability rule favours Transferee. After we have decided to protect Promisee, we are facing the question of *how strong* a protection we want to grant him.

Another issue to be observed are the problems characteristic of each rule. A property rule might lead to a long-term relationship between Promisee and Transferee. Exact terms of that relationship would have to be decided, and it would have to be ensured that both parties comply with these terms. When applying a liability rule, the correct amount of damages to be paid would have to be decided.

4.2 Preventing Unfair Advantage

As noted in section 3, it is possible that Promisee's right is inefficient so that its value to Promisee is less than disadvantages it causes to Transferee. This problem would not appear, if Promisee was protected by a liability rule. Even if Promisee was protected by a property rule, Promisee and Transferee may reach an agreement according to which Promisee's right will be terminated. In such case, Promisee is in a better position than if his right was protected merely by a liability rule. According to a liability rule, he would receive compensation equal to his losses for losing the right. In voluntary negotiations, he could receive more. Is this fair or not?

Let us return to Monday watches to illustrate the setting. Promisor owns a valuable watch that he does not need on Mondays. Promisor enters into a contract with Promisee. According to the contract, Promisee is allowed to use the watch every Monday. After entering into the contract, Promisor faces financial difficulties and needs to sell the watch. There is a potential buyer, but he is not interested in a watch that someone else is entitled to use on Mondays. He needs a watch every day and, in addition, lives so far away from Promisee that it would be very difficult to deliver the watch to him for use every Monday. Besides him, there is no one interested in buying the watch.

If Promisee was protected by a property rule, he could negotiate quite a high price from Promisor or Transferee for giving up his Monday right in the watch. The price could be much more than what the Monday right is actually worth for Promisee. This does not seem fair, since the purpose of the contract between Promisor and Promisee has probably been to give Promisee a right to use the watch while Promisor does not need it, not to give him opportunity to take advantage of Promisor's financial difficulties. From this point of view, liability in damages seems to be a more appropriate remedy.

The same applies also when a pre-existing right becomes an obstacle for using the object in a new, more profitable way. It is often fair to give profits gained from a more profitable use to someone who invented that the property can be used in that way – not to someone, who happens to be able to prevent it unless he is bought out.[39]

Here, we can distinguish between two types of conflicts. One is a conflict where Promisee has a use right or another limited right in the object and Transferee wants to buy the object to use it in its entirety. Another possible setting is that Promisee has a *right to become the owner* of the thing – e.g. he has a right of pre-emption or a right to buy the object according to a pre-contract of sale. When Promisee has only a limited right, the above-said applies: most probably the purpose of the contract between Promisor and Promisee *has not* been to give Promisee part of the profits that can be obtained by using the property in its entirety in a more efficient way. It is

[39] See, e.g., Yorio 82 Colum. L. Rev. 1365 (1982) 1401–1402.

different when the right of Promisee is a right to become owner. One essential feature of ownership is the right to profit from increases in the value of the property. If Promisee is entitled to become owner, he should be the one who gains from the new opportunities which make the object more valuable.

4.3 Preventing Practical Problems

Finally, we have to consider practical problems typical of both remedies. One characteristic problem in applying a liability rule is that it is not easy to decide a proper amount of compensation to be paid. It is often claimed that the parties themselves know best how valuable a certain right is to them, and they should have to part with it solely through voluntary exchange.[40] True, as described in subsection 3.1, there is always the risk of not compensating Promisee's losses in full.

However, a property rule is not so simple either. To decide the dispute between Promisee and Transferee, we would have to find out what the exact content of the contract between Promisor and Promisee is. After that, we would have to decide if all the terms of the contract can be applied in the relationship between Promisee and Transferee. Can Transferee be obligated to active behaviour or is the burden on him only negative so that he must not prevent Promisee from exercising his right?

Even though the terms of the relationship between Promisee and Transferee could be set in a satisfactory manner, it would have to be ensured that both parties comply with these terms. In a long-term relationship this could prove difficult – at least more difficult than simply transferring a certain amount of money from Transferee to Promisee. Moreover, contractual terms which have been negotiated between Promisee and the Promisor might not be appropriate between Promisee and Transferee. They could, for instance, be influenced by Promisor's personal capabilities and needs. In subsections 3.3 and 3.4, it has been noted that problems of enforcing rights which are less important to Promisee than harmful to Transferee can be solved by choosing a liability rule.

A liability rule seems to have more advantages than a property rule. There is one exception. Problems of long-term relationship between Promisee and Transferee do not occur if Promisee has a right of pre-emption or some other right which entitles him, and not Transferee, to *become owner* of the property. If Promisee becomes owner, Transferee is left with no right in the property, and there is no long-term relationship between Promisee and Transferee.

[40] See, e.g., Epstein 106 Yale L. J. 2091 (1997), 2093–2096

5 Summary and conclusions

We have seen above that both fairness and efficiency seem to suggest a similar solution to a conflict between Promisee and Transferee. There are no grounds for denying Promisee protection if Transferee knew of Promisee's contractual right at the time of the transfer. Therefore, contractual rights should be protected against transferees with actual knowledge of them. Since enforcing a contractual right against a transferee who is not a party to the contract can present a variety of problems, it is, as a rule, better to employ a liability rule than a property rule. A property rule is more suitable if Promisee's right is a right to become owner.

It is certain that there are contractual rights which, for instance on social grounds, should be protected by a property rule. The rule proposed here leaves this choice to the legislator. For example in Finland, a tenancy agreement is binding on a buyer of an apartment if the tenant has the apartment in his possession before the sale. The rule stated in this article is a default rule, a rule to be applied to those rights the protection of which has not been considered by the legislator.

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