Contracting for the Case of Breach:  
Second-Order Duties and Extracompensatory Remedies  

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Gregory Klass* 
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In 1984, the city of Richmond contracted with McDevitt Street Bovis for the construction of a new baseball stadium. The stadium was built, but a decade later the city discovered significant deterioration in the concrete tubes supporting the cantilevered roof. McDevitt, it turned out, had failed to fill the tubes with grout, as the contract required. The city sued, claiming both breach of contract and fraud, the latter based on false certificates of completion and other documents McDevitt had submitted. In Richmond Metropolitan Authority v. McDevitt Street Bovis, the Virginia Supreme Court held that because the contract required McDevitt to provide the certificates and other documents, misrepresentations in them might be a breach, but could not give rise to fraud liability.¹

McDevitt is a good example of how courts police the border between contract and tort, building a fence that, among other things, protects mandatory contract rules against punitive damages and other extracompensatory remedies. But look at the holding’s effect on a Virginia contractor’s decision whether to submit a false certificate of completion. A false certificate breaches the contract. But damages for that breach will be limited to compensation for harms caused. The harm of a false certificate of completion is that the promisee doesn’t find out about noncompliant work. To prove that harm, the promisee must first show that the work did not comply. But if the promisee can prove noncompliant work, she can recover on that basis, and the false certificate has caused her no actual loss. Compensatory contract damages for the false reports make no practical difference. Punitive damages in fraud might deter contractors from filing false certificates. But McDevitt excludes fraud liability from the contracting context.

This strange situation is not limited to certificates of completion in the building industry. The above argument, or one like it, applies to almost

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¹ 507 S.E. 2d 344, 347 (Va. 1998). In addition to the false certificates of compliance, Richmond claimed constructive fraud based on McDevitt’s decision to seal the ends of the tubes with grout, giving the false impression that they had been filed. The Virginia Supreme Court held that these allegations were “nothing more than allegations of negligent performance of contractual duties,” and therefore nonactionable as constructive fraud. 507 S.E.2d at 347.
any contract term whose purpose is to make it easier for the promisee to discover and prove breach of the contract. As long as contract remedies are limited to compensatory measures, such terms will not make a practical difference. This Article argues that this is unfortunate. The law should enable parties to adopt meaningful contractual duties to cooperate in recovery. To do so, it must permit parties to back those duties up with extracompensatory remedies.

I will use “obstruction of recovery” as a technical term to refer both to promisor actions designed to avoid legal liability and to his failure to act in ways that would assist in the recovery of damages due, where he has a duty to do so. Examples of obstructive acts designed to avoid legal liability include hiding breach, transferring assets to be judgment proof, or using delaying tactics in litigation. Examples of obstructive failures to act include not keeping contractually required records, breach of a contractual duty to report nonperformance, or refusal to permit required audits. I will say that a contract term imposes a “second-order” duty if it imposes a duty not to obstruct. That is, a second-order duty either prohibits bad acts that tend to prevent recovery for first-order breach, or requires good acts that increase the likelihood of such recovery.

The idea of second-order contractual duties recalls an interpretive dispute about Holmes’s famous dictum that “the duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,– and nothing else.” The “Holmesian heresy” is sometimes read to mean that, as far as the law is concerned, the promisor does not have a duty to perform, but only to perform or pay damages. But that

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3 See, e.g., Brian Bix, Contract Law Theory, Chapter One 18 (SSRN draft, April 2006) (“As Oliver Wendell Holmes, Jr., famously pointed out, one’s (legal) obligation under a valid contract (under American law) is not to perform, but either to perform or pay damages.”); Matthew S. Levine, Punishment and Willingness to Pay, 40 Gonz. L. Rev. 329, 361 (2004-2005) (“Contracts, at least since Holmes, are conceived of economically; one's rights are to a quantum of value, not a specific thing. Thus, paying damages rather than performing is not really a coercion of rights at all.” (footnote omitted)); Avery Wiener Katz, The Option Element in Contracting, 90 Va. L. Rev. 2187, 2201 (2004) (“In option terminology, we can restate Holmes's point by saying that the promisor holds a call option to buy her way out of the contract by paying a strike price equal to the value of court-awarded damages.”); Robert E. Scott & George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law, 104 Colum. L. Rev. 1428 (2004) (“It is well known that contract damages effectively give the promisor an option between performing the promise or breaching and paying damages. The classic statement is by Justice Holmes”).
formulation is difficult to square with the fact that the law does not impose a duty to pay damages voluntarily, and the promisor has every right to defend himself from even a meritorious breach of contract suit. From the perspective of Holmes’s “bad man,” liability in contract creates a duty to perform else risk possible liability. And in fact, Holmes rejected the alternative-promise reading, explaining that “the statement that the effect of a contract is the assumption of the risk of a future event does not mean that there is a second subsidiary promise to assume that risk, but that the assumption follows as a consequence directly enforced by the law, without the promisor’s co-operation.”

This accurately describes the law’s treatment of simple contractual promises. But what about where the parties include in the contract a “second subsidiary promise”? Contracts with second-order terms appear to have the form of a promise to perform or pay damages – or at least of a promise to perform or cooperate in the recovery of damages. This Article’s surprising result is that Holmes was right even about these contracts. So long as remedies are limited to compensatory measures, legal liability for the breach of second-order terms doesn’t make a practical difference. The law will not impose duties to cooperate in recovery, even where the parties want them.

This result runs contrary to the received wisdom that expectation damages are an efficient generic remedy for breach. Such compensatory measures provide little or no added incentive when it comes to contractual duties to cooperate in recovery for breach, much less an efficient incentive. If such second-order contractual obligations are to make a practical difference, they must be backed by punitive damages, penalties or other sanctions that are not conditioned on or limited to compensation for proximate harm. This conclusion provides further support for a thesis I have developed in other contexts: that the extracompensatory remedies available in tort can have “well defined function[s] within the apparatus of the law of contract.”

Robert Scott and George Triantis have recently observed that, to date, “contracts scholars [have focused] principally on the substantive terms and not on the ability of the parties to regulate the procedural course

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of their future enforcement.” Second-order duties are one way parties might attempt to regulate the enforcement of their contract. This Article therefore begins to correct for the scholarly neglect Scott and Triantis diagnose.

The importance of second-order duties has not been lost on courts and legislatures. Thus musicians have successfully lobbied for enforceable requirements that recording labels account for and permit audits of the sales data to check royalty payments. Federal statute requires that major defense procurement contracts give the agency head and Comptroller General the right to examine related records, a provision whose purpose is, *inter alia*, to discover impermissible charges on cost-plus contracts. On the judicial side, California briefly experimented in the mid-80s with permitting the recovery of punitive tort damages where “a contracting party seek[s] to avoid all liability on a meritorious contract claim by adopting a ‘stonewall’ position (‘see you in court’) without probable cause and with no belief in the existence of a defense.” And just two years ago, the California Supreme Court affirmed a punitive damages award against the supplier of helicopter parts for fraudulently shipping components with false certificates of compliance. These sporadic efforts, however, have all fallen short of the mark. This Article explains why and describes what these lawmakers should be doing instead.

The discussion is structured as follows. Part I briefly describes why parties, including a promisor who knows she could breach, might want to contract for legally enforceable duties not to obstruct recovery. Part II explains why currently available contract remedies – which are limited to compensation for actual losses – are insufficient to enforce such second-order duties. When it comes to contractual duties not to obstruct, only extracompensatory remedies will do. Part III then discusses design issues – the different ways extracompensatory remedies can be structured

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6 Robert E. Scott & George G. Triantis, Anticipating Litigation in Contract Design, 115 Yale L.J. 814, 857 (2006). For an example of the neglect in a fairly famous source, see Fuller & Perdue, The Reliance Interest in Contract Damages (Pts I), 46 Yale L.J. 52, 58 (1937) (“If a contract represents a kind of private law, it is a law which usually says nothing at all about what shall be done when it is violated. A contract is in this respect like an imperfect statute which provides no penalties, and which leaves it to the courts to find a way to effectuate its purpose.”).


to provide for a meaningful duty not obstruct. I conclude that courts should relax the rules against party-stipulated penalties and punitive damages when they are applied to breach of second-order terms. Alternatively or in addition, courts might adopt a more permissive attitude toward recovery in fraud for misrepresentations about performance. Finally, Part IV applies these results to show that familiar economic arguments against extracompensatory remedies fail when it comes to contractual duties not to obstruct recovery. Where the parties write second-order duties into their contract, everyone gains by permitting them to back them up with penalties, punitive damages or other extracompensatory remedies.

Before jumping into the analysis, a few words about method. My argument employs a broadly instrumentalist perspective on the law of contracts, in that it assumes that among contract law’s primary aims is facilitating transactions that would otherwise be prevented by lack of trust. In order to capture practical reasoning in the absence of trust, I employ nontechnical economic analysis of the self-interested calculations of individuals entering into and performing legally binding agreements. I assume that each party both undertakes such cost-benefit analysis to decide whether to enter into and how to perform under the contract, and that each tries to anticipate and influence the cost-benefit analysis of his or her counterpart. In undertaking this analysis, I assume that the only curbs on self-interest are legal ones – that is, the prospect of legal liability for bad acts. This is of course a theoretical fiction: extra-legal norms, sanctions and other consequences also enter into the mix. Nor is every decision in a contractual relationship based on such heartless cost-benefit analysis. But if contract law has a function in structuring the ongoing relationship between the parties, it is to substitute where non-legal mechanisms for coordination, cooperation or collaboration do not suffice. Ignoring extra-legal norms, incentives and reasons is an analytic device for exploring how legal mechanisms might substitute for them.

I. Second-order contractual duties not to obstruct recovery

I begin with a more exact description of the category of contract terms I will be discussing, as well as and the relation of those duties to

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other sorts of legal duties, both contractual and noncontractual. In order to
get at this, I want to begin by asking why the parties to a contract might
want to include duties designed to promote recovery for first-order breach – in my parlance, duties not to obstruct, or second-order duties. I will
describe the utility of second-order duties from two angles: efficiency, or
the role second-order duties can play in securing optimal remedies for
breach, and the transactional perspective of the parties, which is to say, the
role of second-order duties in securing a mutually acceptable agreement.

Both stories begin with the problems caused by underenforcement – the possibility that the promisee won’t win a meritorious breach of contract suit because of lack of evidence, limited litigation resources, court
error or other practical hurdles. The effects in terms of efficiency are
straightforward. For any given contract, the optimal remedy for breach is
the remedy that creates the most efficient incentives across the whole of
the contract’s life. That is, the optimal remedy gives rationally self-
interested parties reasons to create the most value possible in their
transaction. At the time of formation, the parties want the optimal remedy,
for it promises to maximize the joint gains of trade they have to divide
among themselves. Underenforcement erodes otherwise optimal damage
measures, because in reckoning with the possibility of recovering or
having to pay damages, the parties will discount the amount due by the
possibility that the remedy won’t be imposed, thereby diluting their
incentive effects.

Underenforcement can also be a problem from the narrower
transactional perspective of parties attempting to negotiate mutually
acceptable terms. We make promises to convince others of our future
actions. More specifically, very often the point of a contractual promise is
to convince the promisee to incur costs in reliance on performance. The
promisor wants to convince the promisee that the transaction’s benefits to
her outweigh her reliance costs. If the promise is legally enforceable, the

\[\text{12}\] There are reasons to doubt whether any single breach-of-contract remedy can induce all
sides to behave efficiently across the entirety of the contractual transaction. See generally
Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach,
61 S. Cal. L. Rev. 630 (1988); Richard Craswell, In That Case, What Is the Question? Economics
is the best of all possible remedies, and should not be confused with a perfectly efficient remedy.

\[\text{13}\] For a classic application of this reasoning, see Alan Schwartz, The Myth that
Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage

\[\text{14}\] Contractual promises are also used to shift risk between the parties, a function that is
parasitic on reliance-inducement and won’t be a major focus of this Article.
transaction’s potential benefits include any damages the promisee will receive in the case of breach, discounted by the likelihood of receiving them. This last factor – the likelihood of receiving damages – depends on the probability of enforcement, or the chance that the promisee will win a meritorious breach of contract suit.

Faced with a promisee who doubts that the transaction is in her interest, the promisor can sweeten the pot in a variety of ways. He will choose to offer the modification that provides the greatest additional benefit to the promisee at the least cost to himself. Where the transaction is a simple sale of goods, this might be a change in the price or quantity term, additional assurances of that conforming goods will be delivered or promised payments made, or a higher damage measure. Alternatively, where the promisee is particularly worried about underenforcement, the promisor may find that the cheapest option is a contract term that will increase the probability of enforcement.

Now an alternative solution to the underenforcement problem, from both the efficiency and the transactional perspectives, is a damage multiplier – to set damages at the plaintiff’s actual loss multiplied by the reciprocal of the probability of performance, or liquidated damages to approximate that amount. If the parties are risk neutral, damage multipliers perfectly correct for underenforcement’s erosion of otherwise efficient incentives. From the transactional perspective, the promisor who expects to perform but has difficulty communicating that fact to the promisee may find a multiplier the cheapest additional benefit he can offer to make the deal happen.

But first-order multipliers are in most cases unavailable, and for other reasons are unlikely to be the parties’ first choice. They are unavailable because of the rules against punitive damages and penalties: “Punitive damages are not recoverable for a breach of contract,” and “[a] term fixing unreasonably large liquidated damages is unenforceable on

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grounds of public policy as a penalty.” These rules prohibit any damage award that cannot be described as compensating the promisee’s actual loss, and therefore rule out damage multipliers or other extracompensatory measures designed to correct for a low probability of enforcement. In addition to these doctrinal restrictions, there are practical reasons why the parties might not want extracompensatory damages for first-order breach. A properly functioning damage multiplier presumes good information about the probability of enforcement, which may be very difficult to measure, whether by the parties at the time of formation, or by the factfinder after breach. Extracompensatory damage measures can also cause the promisee to prefer breach to performance, a moral hazard that can lead to promisee non-cooperation, an unwillingness to renegotiate in the face of unforeseen circumstances, and even frivolous lawsuits. These and other factors (which I discuss in greater detail in Part IV) suggest that, on the whole, first-order damage multipliers will result in lower gains of trade, reducing the size of the pie the parties will share. Where multipliers are unavailable or unattractive, the promisor can offer instead terms to increase the probability of enforcement. There are several categories of contract provisions that fit this description. One group puts the payment of damages out of the control of the breaching promisor and into the hands of the disappointed promisee or a third party. Examples include security deposits, installment payments, funds held in escrow and performance bonds. Alternatively, the parties can contract into alternative adjudicative procedures they believe will increase the likelihood of recovery. Choice of forum and choice of law clauses can be used to opt-into more plaintiff-friendly or less costly legal regime. Similarly, mediation and arbitration provisions can increase the probability of enforcement through specialization (the use of expert adjudicators) and cost savings (lower litigation costs). Or the tinkering

18 See infra at _____.
19 See infra at _____.

might be more targeted, such as stipulating to specialized discovery procedures or non-standard burdens of proof. The subject of this Article is a third family: contractual duties not to hinder, or to assist in, the promisee’s recovery of damages due her – second-order duties not to obstruct recovery.

A breaching promisor can obstruct recovery in any number of ways. Most obvious is outright dissimulation. Promisors attempt to hide breaches from the promisee; once the breach is discovered, they prevent or delay a lawsuit with false assurances that a cure or damages payment is forthcoming; and once the matter goes to court, they lie about the nature of the agreement or their performance under it. But not all obstruction involves outright lies. A promisor might, for example, destroy records or other evidence of his nonperformance; he might transfer or manipulate assets to make himself judgment-proof; or he might raise frivolous defenses and employ other delaying tactics in the course of litigation.

Finally, my broad definition of “obstruct” is meant to capture sins of omission as well: a promisor’s failure inform the promisee of his breach, to keep records that would show nonperformance, to voluntarily pay damages obviously due, to cooperate in judicial proceedings. Each of these tactics decreases the likelihood that a meritorious breach-of-contract suit will succeed – both directly, by affecting legal processes, and indirectly, by increasing the costs of litigation.

Among the obstructive behaviors listed above, several are subject to mandatory legal penalties. If a defendant gives false testimony about the existence of a contract, its content, or his performance, he commits perjury and risks criminal or civil sanctions. A promisor who, after nonperformance but before a lawsuit, lies about his intent to cure the breach might be held liable for fraud. Litigation tactics that fall short of misrepresentation can violate provisions like Rule 11, which permits a court to sanction pleadings that are “presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.” Finally, discovery rules, which are again backed by

20 For the ability to modify discovery procedures, see FRCP 29. For the possible use of alternative burdens of proof, see Robert E. Scott & George G. Triantis, Anticipating Litigation in Contract Design, 115 Yale L.J. 814, 856-78 (2006). Perhaps the most common means of altering the burden of proof is with a liquidated damages clause, which relieves the plaintiff of her usual burden of proving damages.

21 Ayres & Klass, Insincere Promises at 165-68. This statement must be qualified by the already noted reluctance of some courts to permit actions for fraud in the contractual setting. See infra ____.

22 FRCP 11(b)(1). See also, e.g., Cal.C.C.P. § 128.7; Ill. S.Ct. R. 137; N.J. R. Ct. 1:4-8; Tex. R. Civ. Proc. 13. But see Chris Sanchirico, Detection Avoidance, 10/05 draft at 50-
punitive sanctions, address post-complaint attempts to hide evidence of nonperformance or other wrongful behavior under a contract.

The point of each of these mechanisms is to prevent the defendant from obstructing plaintiff’s recovery of damages due. None, however, is specific to the contracts setting. Nor are most contractual in a more technical sense of the term: They are not duties that the parties have contracted to undertake, or could contract out of. Rather, they are mandatory or quasi-mandatory rules that apply in a contract case no matter what the contract says. The question of this Article is what the parties need to contract for more. In circumstances where these mandatory and quasi-mandatory anti-obstruction rules provide insufficient protection, what does it take for the parties to supplement them with contractual duties to cooperate in recovery?

II. The ineffectiveness of compensatory damages for second-order breach

The answer is that they need remedies for second-order breach that go beyond those usually available in contract. While contract theorists have written volumes on how legal liability can provide the right incentives to perform, little or nothing has been said about how legal liability – and in particular contractual liability – should be structured to address obstruction of recovery. This Part explains why the presently available compensatory damage measures for breach of contract cannot do the job. Part III will then examine the relative merits of other measures.

To compare the efficacy of different measures, it will help to have a general model of the promisor’s decision to obstruct. Recall that in my artificial use of the term, obstruction includes both affirmative acts – such as misrepresentations about performance, destroying evidence, or hiding 52 (observing the limited scope of criminal and procedural sanctions for detection avoidance).

23 A rule can be said to be “quasi-mandatory” when the parties have a limited ability to modify it, though not to contract out of it entirely. Thus Rule 29 of the Federal Rules of Civil Procedure and many state analogs allow the parties to stipulate to discovery procedures in a contract, though such stipulations are subject to court review to ensure no undue frustration of the administration of justice. See, e.g., Garden State Plaza Corp. v. S. S. Kresge Co., 189 A.2d 448 (N.Y. App. Div. 1963); Franklin v. White, 493 N.E.2d 161 (Ind. 1986). There is another sense in which all of these rules are mere defaults: The parties always have the option of using an alternative dispute resolution clause to opt-out of the court system, at least as the primary adjudicator of their case, or might use a TINALEA clause (“This is not a legally enforceable agreement.”) to opt-out of legal liability altogether.
assets—and failures to act—not informing the promisee that a breach has occurred, or refusing in the face of clear breach to pay liquidated damages. Assuming that, except for the threat of legal liability, obstruction costs the promisor little or nothing, the promisor will choose to obstruct recovery only where her gain from possibly avoiding breach-of-contract sanctions is greater than the cost of legal liability for the obstructive tactics, where that cost is discounted by chances it will be imposed. That is, a legal mechanism will deter obstruction only when:

\[
\text{damages for obstruction, discounted by the chance that they will be imposed} > \text{expected value of reduction in probability of a damage award}
\]

This can be expressed formally as follows. Assume that the promisor has breached or expects to do so. Let \( p \) represent the probability of enforcement without obstruction and \( \lambda \) the difference between the probability of enforcement absent a given obstructive tactic and the probability of enforcement with it, so the probability of enforcement with obstruction is \( p - \lambda \). For example, if hiding a breach decreases the probability of enforcement from eighty-percent to thirty-percent, \( p = .8 \) and \( \lambda = .5 \). Let \( s \) stand for the measure of damages due for the first-order breach. From the promisor’s post-breach perspective, then, the benefit of obstruction is \( (\lambda)(s) \), that is, the percentage-point reduction in the probability of enforcement multiplied by the cost of first-order damages.

Now let \( s_o \) represent the cost of the remedy for the breach of a contractual duty not to engage in the obstruction at issue. That is, \( s_o \) represents the costs of the second-order remedy over and above any payments for breach of the underlying duty. Let \( p_o \) represent the probability that \( s_o \) will be imposed. The anticipated cost of obstruction, then, is \( (p_o)(s_o) \) – the damage amount discounted by the probability of enforcement. The threat of contract sanctions should prevent a rationally self-interested promisor who has or expects to breach from engaging in prohibited obstruction if and only if:

\[
(1) \quad (p_o)(s_o) > (\lambda)(s).
\]

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24 I consider the potential costs to the promisor of obstructive behavior infra at 45-45.
25 Adding promisor uncertainty as to whether or not she will perform complicates the calculations, but does not change the basic result.
When all that is at stake is money damages for first- and second-order breaches, every cost to the promisor equals the benefit to the promisee, and vice versa. Consequently, the threat of legal liability will insure the promisee against the costs of an obstructive breach if and only if:

\[(2) \quad (p_o)(s_o) \geq (\lambda)(s).\]

The question, then, is this: What must \(s_o\) be to assure the promisee, at the time of formation, that in the event of nonperformance (2) will be true – that the promisor will not obstruct recovery, or if he does, that the promisee will be insured against it?

The remainder of this Part applies this model to show that so long as \(s_o\) is limited to the promisee’s actual losses, legal liability for second-order breach will not make a significant difference in the promisor’s obstruction decision. The discussion is structured according to the different harms obstructive breach can cause. The most obvious harm – built into my definition of the term – is the disappointed promisee’s inability to recover for a first-order breach. The first two sections of this Part demonstrate that, as a result of the unusual proof-structure of compensatory damages for inability to recover, those remedies cannot satisfy the condition described in (2). This is true whether the amount of the loss is determined at trial or stipulated in a liquidated damages clause. The third section examines compensation for secondary harms of obstructive breach, which include preventing the promisee from mitigating damages, delayed recovery, and increased cost to recover. Compensation for these obstructive harms can provide a measure of deterrence against second-order breach – a result that casts new light on familiar mechanisms like the mitigation rule, prejudgment interest and fee-shifting clauses. In most instances, however, that recovery will not provide effective protection against obstructive breach.

A. Unliquidated damages for obstruction of first-order recovery

I begin with the default remedy for breach of contract: a monetary award in the amount that the court or jury deems necessary to compensate the promisee for her loss – that is, unliquidated compensatory damages. Obstructive behavior harms the promisee first and foremost by reducing the chances she will recover for any first-order breach. The claim of this section is that unliquidated compensatory damages for that harm can neither deter nor insure against obstructive breach.
Just why this is so depends on the type of obstruction at issue. I will call obstruction “independent” if it can be proven in court without first proving that there was a first-order breach. Other obstruction is “dependent”, which is to say capable of proof only by first showing breach of the underlying duty.

An example will illustrate the distinction and be useful in the analysis that follows. Suppose Builder is deciding whether to hire Contractor to install high-speed network wiring in a home she is constructing. Because damages may be difficult to prove, the contract includes a $10,000 liquidated damages clause, which represents the anticipated cost of replacing substandard work. Suppose also that Builder is concerned about underenforcement. In particular, she is worried that nonconforming work may be both unobservable – because Builder doesn’t have the necessary expertise – and unverifiable – because the wiring will be built into the walls and it won’t be worth it to tear apart the building to prove breach. Contractor, aware of Builder’s concerns, suggests adding a Recordkeeping Clause, which will require Contractor to keep detailed records of materials and work performed.

There are two ways Contractor might breach the Recordkeeping Clause. First, he could fail to keep any of the required records. That breach would, in my terminology, be a form of independent obstruction, for Builder can show that Contractor didn’t keep the records even if she cannot show faulty installation. Alternatively, Contractor might breach the Recordkeeping Clause by falsifying the required records to cover up the faulty installation. In order to demonstrate that obstructive breach, Builder would have to show that the records were false, which is to say that the installation was in fact noncompliant. Falsifying records is generally a form of dependent obstruction, for its proof depends on a showing of first-order breach. Other examples of independent obstruction include: refusal to allow audits, non-provision of required certificates of compliance, and destruction of evidence. Among the other varieties of dependent obstruction: not reporting a first-order breach, hiding nonperformance, and, where breach is beyond doubt, obstructive or delaying litigation tactics.

The distinction between independent and dependent obstruction marks a difference between types of obstructive behavior, not between second-order duties. Thus breach of the Recordkeeping Clause is either independent or dependent, depending on the manner of noncompliance.

26 I follow here the convention of using “observability” to refer to the parties’ ability to detect some fact, and “verifiability” to refer to the ease with which that fact can be proven in court.
Some second-order duties, however, are such that their breach is necessarily dependent. Suppose Contractor agrees instead to a Reporting Clause, which requires that he immediately disclose any nonconforming work. That second-order duty has as its condition precedent noncompliant installation. To prove a second-order breach – failure to report – Builder must first prove satisfaction of its condition precedent, which is a first-order breach. The breach of a second-order duty that is conditioned on first-order breach is necessarily dependent.

With these distinctions in hand, we can turn to the functioning of unliquidated compensatory damages for second-order breach, beginning with dependent obstructive breach. Consider the situation where Contractor has falsified the documents required by the Recordkeeping Clause. There are two possible cases: where Builder has separate, sufficient evidence of the first-order breach (noncompliant installation), and where she does not. If Builder has such evidence, she can prove that Contractor breached his duty to install the wiring. She can therefore recover for the first-order breach, and the falsified records have caused her no actual loss. If Builder cannot prove the first-order breach, then (assuming Contractor breached the duty to install) Builder has been harmed by Contractor’s failure to keep accurate records. Such records would have demonstrated the noncompliant installation and permitted recovery for the first-order breach. But without proof of noncompliant installation, Builder cannot prove that the records were false – that is, she cannot prove second-order breach. Either way, the second-order breach costs Contractor nothing.

The Recordkeeping Clause requires Contractor to take affirmative steps that will assist Builder in recovering for any first-order breach. But the result is the same for second-order duties that prohibit bad behavior. Thus suppose the parties adopt instead a No-Conceal Clause, requiring that Contractor not take extra steps to hide any noncompliant installation. The duty not to conceal applies only if Contractor is in first-order breach, so breach of the No-Conceal Clause is necessarily dependent. If Contractor is deciding whether or not to cover up his faulty work, the threat of compensatory second-order damages won’t affect his decision. Should his attempt to hide the first-order breach succeed, he will not be held liable for the second-order breach; should it fail, Builder then has independent proof of the noncompliant installation, and Contractor’s second-order breach caused her no harm.

We can now state the generic inherent limitation of compensatory damages for dependent breach. To prove dependent breach, the promisee must prove breach of the first-order duty. So if the promisee cannot
demonstrate first-order breach, she cannot recover for the second-order breach, or in terms of the above variables, \( p_o = 0 \). If the promisee can demonstrate first-order breach, she can recover for that breach on those grounds, and the second-order breach has caused her no harm. Because there is no loss to compensate, \( s_o = 0 \). So long as the second-order remedy is limited to compensatory damages, it makes no practical difference.

The same holds true for independent obstruction, though here the problem is not proof of the second-order breach, but of proximate harm. Suppose Contractor breaches the Recordkeeping Clause not by falsifying the records, but by failing to keep them at all. In that case, it may be easy for Builder to prove second-order breach – in part because proof of no records does not depend on a showing of noncompliant installation. But to recover compensatory damages, Builder must also be able to show that the second-order breach caused her some loss – that Contractor’s failure to keep records prevented Builder’s first-order recovery. Again there are two cases to consider. If, despite Contractors failure to keep records, Builder can discover and prove nonconforming installation, Builder can recover for the first-order breach. In that case, Builder has suffered no harm as a result of the second-order breach and, so long as damages are limited to compensatory measures, there is no recovery. If Builder cannot prove nonconforming installation, then she cannot prove that but for the failure to keep records, she would have recovered for a first-order breach. Again there is no recovery for the second-order breach, now because she cannot show that the obstruction caused her any actual loss.

Again we can generalize the result. To show that the defendant’s second-order breach (be it dependent or independent) harmed the promisee, the promisee must show that, but for the obstruction, she would have recovered for the first-order breach. That is, she must prove that she has a meritorious claim of breach of the underlying duty. But this is precisely what she cannot do if the obstructive breach was successful. The result is a win-win situation for the promisor. If his obstructive breach succeeds, the promisee cannot prove proximate harm and so recovers nothing \( (p_o = 0) \). If the obstructive breach is unsuccessful, the promisee can prove first-order breach and so suffers no compensable loss \( (s_o = 0) \). Once again, there is no possible state of the world in which (2) satisfied.

### B. Liquidated damages for obstruction of first-order recovery

If one problem with compensatory damages is proof of actual loss, perhaps liquidated damages are part of the solution, for liquidated damages relieve the plaintiff of her burden of proving harm. In fact,
liquidating damages for inability to recover represent some progress against certain forms of obstructive breach. But so long as liquidated damages are limited by the compensation principle – that is, so long as courts refuse to award liquidated damages they regard as penalties – such measures will be of limited effectiveness in enforcing second-order duties.\textsuperscript{27}

Suppose Builder and Contractor, recognizing the proof problems described above, decide to stipulate to liquidated damages for breach of the Recordkeeping Clause. The rule against penalties states that damages may be liquidated “only at an amount that is reasonable in the light of the anticipated or actual loss” and a “term fixing unreasonably large liquidated damages is unenforceable . . . as a penalty.”\textsuperscript{28} In seeking out an enforceable liquidated damage amount, the parties must therefore predict what breach of the Recordkeeping Clause is likely to cost Builder.

Because the provision’s purpose is \textit{ex hypothesi} to enable Builder to recover for any first-order breach, the second-order breach will harm Builder, only if two conditions are satisfied: Contractor has breached the agreement to install, and the missing or false records prevent Builder from proving first-order breach. If these two conditions are met, Contractor’s second-order breach costs Builder $10,000 – the amount she would have recovered in liquidated damages had she been able to show noncompliant installation. If either condition is not satisfied – if Contractor has performed the installation correctly, or if Builder can prove noncompliant installation despite the missing or falsified records – then the second-order breach costs Builder nothing.

So, what should the parties set as the liquidated damages amount? If a second-order breach causes Builder a loss, it can only be in the amount of $10,000 – the first-order liquidated damages figure. But it is highly unlikely that a court would ever award that amount in liquidated damages. If Builder can show improper installation despite the second-order breach, she will recover $10,000 for the first-order breach, and the second-order award would mean double recovery. If Builder cannot show improper installation, the court will probably balk at a $10,000 award for so minor an infraction as faulty recordkeeping.

\textsuperscript{27} Specific performance is another compensatory remedy that obviates the need for proof of actual damages. Timing issues, however, prevent specific performance from being an effective remedy for most second-order duties. The damage of destroying records, hiding or not reporting first-order nonperformance, using delaying tactics and most other forms of obstruction cannot be undone by an injunction ordering subsequent performance of the duty.

\textsuperscript{28} Rest. 2d Contr. § 356(1).
Builder and Contractor will therefore choose some lower amount—say $1,000, which they will stipulate as representing the decreased chance of proving first-order breach. In some cases, this may be an adequate remedy. I have argued that a second-order remedy works if and only if:

\[ (p_o)(s_o) \geq (\lambda)(s). \]

Solving for a second-order damage amount, we arrive at:

\[ s_o \geq \frac{(\lambda)(s)}{p_o}. \]

In some situations, $1,000 in second-order liquidated damages might satisfy (3). Suppose, for instance, Contractor fails to keep the required records. Such a breach is easily observed and verified, so let \( p_o = 1 \). If the absence of records decreases the probability of enforcement by ten-percentage-points or less (\( \lambda \leq .1 \)), then the $1,000 second-order liquidated damages amount is enough. But if the obstructive tactic at issue is more effective, liquidated damages will have to be increased. And of course the greater the liquidated damage amount, the less likely the court is to enforce it where the promisee cannot show actual loss. Thus if no records will result in, say, a fifty-percentage-point decrease in the likelihood of enforcement, liquidated damages will have to be at least $5,000—an amount that begins to look like a penalty for what, as far as the court knows, may be no more than a bookkeeping error.

The underlying problem is that courts find it difficult to assess the reasonableness of damages where the existence of a loss depends on nonverifiable facts—in this case, whether or not there was a first-order breach. As a result, liquidated damages must be reduced to take account of the possibility, in the court’s mind, of first-order performance. But the promisor who is deciding whether to obstruct recovery likely knows whether he has or will breach his first-order duties. If so, the reduced liquidated damage amount will not be enough to dissuade him from obstructive breach. This is not to say that liquidated damages are not an improvement. Where unliquidated compensatory damages result in no recovery, liquidated damages can impose some cost on and provide some insurance against second-order breach. Nonetheless, the penalty rule will tend to push enforceable damage amounts below what is needed to fully deter or insure against many second-order breaches.

\[ 29 \$1,000 \geq (.1)(\$10,000)/1. \]
\[ 30 \$5,000 \geq (.5)(\$10,000)/1. \]
So far, I have considered only an example of independent obstructive breach. A more intractable difficulty appears in the case of dependent obstruction.

Recall the No-Conceal Clause, which prohibited Contractor from attempting to hide noncompliant installation. Because the duty not to conceal is conditioned on first-order breach, any breach of the No-Conceal Clause is necessarily dependent: to show that Contractor attempted to hide nonconforming installation, Builder must first show that the installation did not conform. Now suppose that the parties stipulate that breach of the No-Conceal Clause will entitle Builder to $1,000, and that this amount is meant to capture the increased likelihood that a first-order breach won’t be discovered. Many courts follow the Second Restatement rule that “[i]f . . . it is clear that no loss at all has occurred, a provision fixing a substantial sum as damages is unenforceable.” The argument for the rule is this: if it is certain that the promisee has suffered no loss, liquidated damages lose their purpose, for the amount of actual loss is not difficult to prove. But if Builder can show breach of the No-Conceal Clause, then it is only because he can also prove improper installation, and can therefore already recover the $10,000 first-order liquidated damage amount. That is, whenever Builder can show second-order breach, Contractor can show no actual loss. In jurisdictions that follow the Restatement rule, liquidated damages for dependent obstructive breach should never be enforceable, for the defendant can always show no actual loss. Any second-order liquidated damage award – be it $1,000, $100 or $10 – is a pure penalty.

This may even be the case in jurisdictions that do not follow the Restatement approach, though the lack of clear rules and decisions make it difficult to say for certain. Williston suggests that whether or not a court will award liquidated damages where there is proof of no loss might depend on the extent to which the jurisdiction considers actual damages in evaluating the reasonableness of the liquidated damages amount. In the case of dependent obstructive breach, however, we get the same result whether reasonableness is evaluated ex ante or ex post. Unlike other sorts of breach, we can say in advance that if a plaintiff can prove dependent second-order breach, the defendant will be able to show no actual loss. Consequently, even from the ex ante perspective second-order liquidated

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31 Rest. 2d Contr. § 356 cmt. b.
32 Rest. 2d Contr. § 356 ill. 4. See also Rest. 2d Contr. § 356(1) (“Damages for breach by either party may be liquidated in the agreement but only at an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss.”) (emphasis added)).
damages will be available only where the amount of loss is certain – namely, where it is demonstrably zero. Liquidated damages for dependent obstructive breach violate both the rule that damages may only be liquidated when actual loss is difficult to prove and the rule against penalties.

C. Other losses: avoidable harms, delayed recovery and litigation costs

So far I have considered compensation for only the most obvious harm of obstructive breach: the promisee’s inability to recover for first-order nonperformance. But obstructive behavior not only decreases the likelihood of recovery. It also increases the costs of winning a suit for first-order breach. The promisee will have to spend more to discover and prove the first-order breach, and may have to wait longer for the award she is due. In addition, if the obstruction keeps the promisee in the dark about nonperformance, it can harm her by preventing her from taking actions to limit her losses. If compensation for inability to recover makes little or no practical difference, perhaps compensation for these secondary harms of obstructive breach will. Increased litigation costs, delayed recovery and the inability to mitigate do not redound to the benefit of the promisor. Forcing the promisor to internalize those secondary costs of his obstructive breach may outweigh the benefit he expects to receive from avoiding recovery.

Parties need not add second-order terms to their contract to secure recovery for these secondary harms. Fee-shifting and pre-judgment interest clauses also require the promisor to pay for any increase in litigation costs or delay in recovery her obstruction causes. And the mitigation rule forces the promisor to internalize the costs of not informing the promisee of breach: the longer the promisee remains in the dark, the longer she will be unable to take “reasonable efforts” to mitigate her losses, and the greater the promisor’s liability.34

The analysis of contractual anti-obstruction clauses casts new light on these familiar mechanisms. Proponents of fee-shifting, for instance, commonly emphasize its role in achieving full compensation, reasoning that a successful plaintiff who still has to pay her attorney fees has not yet been made whole. Less commonly noticed is that fee shifting has a deterrent effect on obstructive behavior: the more the defendant obstructs recovery, the greater the plaintiff’s litigation costs, which the defendant pays for if he loses. Similar arguments apply to prejudgment interest and

34 See Rest. 2d Contr. § 350 cmt. b (“[A] party cannot recover damages for loss that he could have avoided by reasonable efforts.”).
the mitigation rule. Aside from any other advantages they may have, such provisions work to deter obstruction of recovery.

In fact, these rules have an important advantage over terms that prohibit specific categories of obstructive behavior. Contractually specified second-order duties function only when the parties can identify, at the time of formation, behavior that is likely to affect the probability of recovery — to create a contractual obligation, one has to describe what is required of the obligor. Fee-shifting, prejudgment interest and the mitigation rule, on the other hand, capture any post-breath obstructive behavior, whether anticipated or not in the contract.

This observation suggests two separate questions: First, can compensatory damages for second-order breach add anything to these existing mechanisms? Second, when might compensation for litigation costs, delayed recovery and inability to mitigate — whether in an award for second-order breach or pursuant to more familiar rules or terms — provide the promisee sufficient protection against obstructive behavior?

Let’s begin with the first question. The one place where specific second-order duties provide a possible advantage is in the recovery of litigation expenses caused by an independent obstructive breach. A typical fee-shifting clause provides for the recovery of attorneys fees and other costs only if the promisee win her first-order breach of contract suit. If second-order breach can serve as a separate and sufficient basis for litigation-cost recovery, the second-order duty can provide greater protection against obstructive behavior. Thus suppose Contractor has failed to keep any of the records required by the Recordkeeping Clause. Because proof no records is independent of and more likely than proof of the underlying breach, litigation-cost recovery for the second-order breach might well provide greater assurances than a simple fee-shifting provision.

35 The plausibility of recovery of attorney fees for obstructive breach can be seen in some contemporary reactions to California’s experiment with punitive damages for obstruction of recovery in Seaman’s Direct Buying Serv., Inc. v. Standard Oil Co., 686 P.2d 1158 (Cal. 1984). See Dana R. Landsdorf, Note, California’s Detortification of Contract Law: Is the Seaman’s Tort Dead?, 26 Loy. L.A.L. Rev. 213, 238 (1992) (“Contracting parties who deny — in bad faith — the existence of a contract should be liable for all damages proximately caused and resulting from such conduct. For example, the breaching party should not only be liable for compensatory damages but also for the injured party’s attorney’s fees because the non-breaching party does not expect to incur attorney’s fees from the transaction.”); C. Delos Putz, Jr. & Nona Klippen, Commercial Bad Faith: Attorney Fees — Not Tort Liability — Is the Remedy for “Stonewalling”, 21 U.S.F. L. Rev. 419, 499 (1987).

36 It might be objected that no court would award litigation costs without proof of first-order breach, the idea being that such easy recovery of litigation costs would give
This result holds true, however, only for independent obstructive breaches, where it is possible for the promisee to demonstrate second-order breach even though she cannot show first-order breach. A dependent second-order breach results in recovery only upon proof of the first order breach, and even then second-order recovery is not automatic: the disappointed promisee must also prove breach of the second-order duty. For example, to show breach of the No-Conceal Clause, Builder must prove both that Contractor breached his duty to install, and that he attempted to hide that breach. Builder’s chance of recovering second-order damages, therefore, may be less than her chance of recovery for the first-order breach. In the case of dependent obstruction, litigation-cost recovery provides less protection than a generic fee-shifting clause that automatically awards litigation costs upon proof of first-order breach.

Compensatory second-order damages for delayed recovery – the next category of secondary harm – provide no advantage over a prejudgment interest clause, whether the second-order breach is dependent or independent. There can be no award for extra time spent waiting for a damage award without a showing that that award was warranted – without a showing of first-order breach. Consequently, second-order compensatory damages provide no greater protection than a simple prejudgment interest clause, which automatically compensates upon proof of first-order breach.

The same result applies to losses resulting from the promisee’s inability to mitigate damages. Like compensation for delayed recovery, recovery for first-order losses the promisee might have avoided presupposes proof of first-order breach. This is so whether the obstruction in question is dependent or independent. But if the promisee can show first-order breach, she can already recover for her first-order losses that might have been avoided. Now that recovery might not cover every harm the promisee might have avoided. First-order recovery won’t include, for instance, emotional damages or speculative harms the promisee might have avoided had she learned of the breach earlier. But if these are unrecoverable pursuant to the first-order award, they are also promises a perverse incentive to sue. This objection, however, ignores the fact that litigation-cost damages for breach of an anti-obstruction clause are limited to costs attributable to the defendant’s obstructive behavior. Thus litigation-cost recovery for breach of the Recordkeeping Clause would not give Builder a free suit on the first-order breach. It would, however, support her expenditure of extra resources to determine whether there was a first-order breach – expenses that would be unnecessary but for Contractor’s failure to keep the required records. Builder should be permitted to sue for these costs whether or not she sues for the underlying breach, and if she does sue on the underlying breach, whether or not she prevails in that suit.
unrecoverable as compensation for the second-order breach. Second-order compensatory damages add nothing.

On the whole, then, compensatory damages for the secondary harms of obstructive breach provide no more protection against obstruction than more familiar and broadly effective mechanisms like fee-shifting, prejudgment interest and the mitigation rule. But the question remains: Can liability for these secondary harms, be it based on specific second-order terms or these more generally applicable mechanisms, protect the promisee against obstruction?

Common sense suggests the answer is No. Forcing the promisor to internalize the costs to the promisee of delayed recovery, more complex litigation, and the inability to mitigate will not, in most cases, outweighed obstruction’s potential payoff: avoiding liability for first-order breach. There are at least three reasons why this is so. First, because the promisor generally pays for the secondary harms of obstruction only if he loses in court, he discounts that cost by the possibility that the promisee won’t be able to prove breach, an eventuality obstruction makes all the more likely. As a result, the promisor internalizes a diminished portion of secondary costs of his obstructive tactics. Second, should the promisor be held liable, the added cost of her obstructive behavior will not be all of the promisee’s secondary costs, but only those caused by the obstruction. For instance, second-order litigation-cost recovery does not include all the promisee’s attorneys’ fees, but only the cost of the extra work attributable to the defendant’s obstructive behavior. As an empirical matter, these costs are likely to be orders of magnitude less than damages for the underlying breach. Finally, the potential upside of obstruction – the increased chance that the plaintiff will lose her meritorious lawsuit and the defendant won’t have to pay anything – can be very large. This is so where the parties expect high damages for the underlying breach or there is a high probability that the obstruction will succeed. The latter case is particularly relevant, since effective obstruction both lowers the likelihood that the promisor will have to pay for these secondary harms (the first point above) and means a big gain in terms of avoiding first-order liability. Compensatory damages for the secondary harms of obstructive breach are unlikely to protect the promisee against obstruction’s primary harm, preventing recovery for first-order breach of obstructive breach.

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37 As noted above, this statement does not apply to litigation-cost recovery for an independent second-order breach. It does apply to compensation for any other secondary harm of an obstructive breach, and of course applies if recovery is by way of a fee-shifting or prejudgment interest clause, or damages subject to the mitigation rule.
To summarize the results of this Part: Compensatory damages for breach of second-order duties provide only minimal assurance to a promisee worried about whether she will be able to recover for first-order breach. Obstruction harms the promisee first and foremost by decreasing the probability of first-order recovery. When damages are unliquidated, the plaintiff cannot prove second-order loss (and sometimes not even second-order breach), and so compensatory measures result in no recovery. While liquidated damages can provide some measure of protection against independent obstruction, the rule against penalty clauses significantly diminishes their utility. Finally, recovery for the secondary harms of obstructive breach – additional litigation costs, delayed recovery and losses that could have been avoided – will rarely be enough to dissuade the promisor from obstructing.

III. Effective remedies for second-order breach

Having concluded that compensatory remedies for second-order breaches make little or no practical difference, I now turn to the details of how the parties might structure effective second-order remedies, the relative merits of different approaches, and existing legal obstacles and loopholes.

Where the parties are in a long-term relationship or an industry where reputational sanctions have bite, extra-legal penalties may be enough to deter obstructive breach. In the case of relational contracts, it may be enough if second-order breach gives the promisee a right to rescind. If the promisor values the relationship enough, a credible threat to exercise a termination right can be enough dissuade him from any breach. Alternatively, in industries that are highly organized or composed of repeat players, reputational or other extra-legal sanctions may be enough to deter obstructive breach.

This Part asks what tools the law can provide parties when such extra-legal mechanisms are unavailable. I discuss two broad categories of legal liability the parties might use: liability for breach-of contract and fraud liability.

A. Extracompensatory contract damages

Within the category of contract liability, I will consider three separate approaches to crafting effective second-order remedies: dynamic
first-order damage multipliers, adverse inferences, and second-order penalty or punitive-damage clauses. Which remedy is practicable or preferable depends both on general considerations of institutional competence and on the type of obstruction the second-order duty is meant to prevent. Of the three, the only remedy presently available is a contractually specified adverse inference, and even here the law is not entirely clear. At present, courts will enforce neither a dynamic multiplier clause nor a penalty or punitive damages clause. This Article recommends changing the latter rule.

1. **Dynamic multipliers**

   I’ve already mentioned the idea of using damage multipliers to correct for first-order underenforcement: Multiplying actual damages by the reciprocal of the probability of enforcement ratchets awards up to where the risk-neutral or risk-prefering promisee is fully insured against breach, and the promisor has the right incentives to perform. But ideally functioning multipliers have another, widely overlooked benefit: If correctly structured and implemented, a damage multiplier renders post-breach obstructive tactics valueless and fully insures the risk-neutral promisee against them.\(^\text{38}\)

   I will use the term “dynamic multipliers” to refer to damage multipliers that are sensitive to the particular facts of the case under consideration. A dynamic multiplier corrects not for the average probability of enforcement, but for the probability of enforcement *in this case*, taking into account the identity of the parties, their unique history, the circumstances of the transaction, and so forth.\(^\text{39}\) A perfectly dynamic multiplier renders obstruction otiose. The more the promisor acts to obstruct recovery, the lower the probability of enforcement; the lower the probability of enforcement, the greater the multiplier; the greater the multiplier, the greater the potential damage award. Whether the breaching promisor helps or hinders recovery, the anticipated, risk-adjusted damage amount remains the same.\(^\text{40}\) A perfectly dynamic multiplier, therefore,

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\(^{38}\) Richard Craswell notes a parallel benefit of case-by-case multipliers: they properly incentivize harm-avoidance measures that tend to reduce the likelihood of enforcement. 97 Mich. L. Rev. at 2194-98. Craswell does not consider their effect on obstruction of recovery.

\(^{39}\) In practice, most multipliers are not simply dynamic or static, but somewhere in between, depending on how fine grained or fact-dependent they are. The idea of a “perfectly” dynamic multiplier is a theoretical fiction, useful in my analysis, but not to be mistaken as a description of how any multiplier actually works.

\(^{40}\) This can be stated formally as follows. Let \( h \) represent the optimal compensatory damage amount assuming perfect enforcement. If the promisor does not obstruct
both robs obstructive behavior of any benefit and perfectly insures the risk-neutral promisee against it. Moreover, dynamic multipliers have the same advantage over anti-obstruction clauses that generic fee-shifting and prejudgment interest clauses do: If it works, a dynamic multiplier applies to all post-breach obstructive behavior, whether anticipated in the contract or not.

There is, however, that crucial caveat: if it works. A dynamic multiplier works only if the promisor’s post-breach behavior is both verifiable and quantifiable. There are reasons to expect it will be neither.

First verifiability. If it is possible that the promisor will be held liable for the underlying breach though his obstructive behavior escapes detection or proof, the dynamic multiplier won’t work. The promisor gets the benefits of obstructing recovery without paying all the costs, for in some possible futures, his obstructive behavior won’t be factored into the multiplier. The same applies if there is asymmetric information about the effectiveness of an obstructive tactic – if the promisor knows that it is more effective than can be verified in court. The high costs and potential

recovery, the dynamic multiplier sets damages due at that compensatory amount multiplied by the reciprocal of enforcement. That is, the multiplier sets $s = h/p$. The risk-adjusted anticipated damages $D$ are thus:

$$D = (p)(s) = (p)(h/p) = h.$$ 

If the promisor’s post-breach actions decrease the probability of enforcement by $\lambda$, the dynamic multiplier sets $s = h/(p - \lambda)$, and the risk adjusted damage amount is:

$$D = (p - \lambda)(s) = (p - \lambda)[h/(p - \lambda)] = h.$$ 

Whether or not the promisor obstructs, anticipated damages equal the optimal compensatory amount.

41 As Judge Calabresi has observed, the formula for optimal damage multipliers is “simpler to state than to apply.” Ciraolo v. City of New York, 216 F.3d 236, 244 (2000) (Calabresi, J., concurring); but see id. at 246 n.7 (suggesting circumstances in which juries might be competent to calculate a sufficiently accurate multiplier).

42 A society of econometric superheroes could address imperfect verification of post-breach behavior by adding to the generic first-order multiplier a generic second-order multiplier. Damages for first-order breach would then be multiplied twice. The first multiplier would take account of the probability of enforcement of the first-order breach, given all that is known about the situation, while proof of obstruction would trigger a second multiplier, designed to account for the possibility that those obstructive tactics might have gone undetected or unproven.

Mere mortals, however, will find this a difficult solution. First, calculating the appropriate multiplier, would be more complex than simply multiplying by the reciprocal of the probability that the obstructive behavior in question would go unverified. Such simple multipliers work only where nonverification results in no damage award. In a dynamic multiplier regime, nonverification of obstructive behavior does not result in no award, but in an award that is too low. Second, the problem of quantification is even more intractable in the case of second-order multipliers, which require the factfinder to
inaccuracy of case-by-case verification have led proponents of multipliers recommend static, or generic, multipliers. But, while a generic multiplier is a good second-best solution to first-order underenforcement, it does nothing to address obstruction of recovery. Quite the opposite: Extracompensatory damages give the breaching promisor all the more reason to try to avoid paying for his breach – all the more reason to try to obstruct recovery.

The second difficulty with dynamic multipliers is quantifying the probability of enforcement. Even if the factfinder has perfect access to the totality of the facts surrounding the breach, including the defendant’s obstructive behavior, she still must be able to extrapolate from those circumstances the numerical probability that, at the time of nonperformance, the breach would be discovered and verified. There is no algorithm for arriving at that number. And while empirical studies might help in arriving at generic multipliers, the facts and circumstances of each case are so different they can be of little assistance in calculating dynamic multipliers. Quantification of the multiplier must be a judgment call, based on the factfinder’s background knowledge and situation sense. As such, it is not only inexact, but prey to familiar cognitive limitations and biases.

It would be wrong to draw too strong a conclusion from these observations. The point of a damage multiplier is to give the promisor the
gauge the likelihood that bad behavior that is designed to be hidden but has been discovered and proven might not have been.

43 Polinsky and Shavell are optimistic (if not downright sanguine) about the ability of factfinders to calculate the probability of liability, but even they suggest that a solution for jury error in evaluating multipliers “is for the legislature to set damages multipliers for separate categories of wrongful conduct, based on rough assessments of the different chances of escaping liability in the various settings.” 111 Harv. L. Rev. at 892-93. As for actual law, Craswell reports: “[M]ost legal systems do not use multipliers that are calculated case by case. Instead, they use multipliers set at the same level for all defendants, or fines set a the same level for all defendants, or compensatory damages with no multipliers at all.” 97 Mich L. Rev. at 2198.

44 See my discussion of Chris Sanchirico’s observations about the incentive effects of higher sanctions on attempts to avoid detection, infra .

45 See Hylton & Miceli, 21 J. Law, Econ. & Org. at 403-11 (deriving generic multipliers from empirical studies of different categories of tort litigation).

right incentives. A multiplier works, therefore, not when it accurately measures the objective probability of enforcement, but when it reflects the promisor’s perception of the probability of enforcement. While factfinders’ commonsense judgments can systematically err, some of those errors might track promisor cognitive errors. Moreover, while verification difficulties systematically push damages below the ideal, quantification errors might be equally distributed above and below it. The breaching promisor, not knowing where in that range assessed damages will fall, will assume the average or ideal measurement.47

Yet even putting verification and quantification to the side, a dynamic multiplier is unlikely to be the parties’ first choice. As will be discussed below, promisees are generally risk averse, while damage multipliers assume risk-neutrality or -preference.48 And many (though not all) of the efficiency arguments against extracompensatory remedies for first-order breach apply equally to multipliers.49 Add to these the vagaries of verification and quantification in applying a dynamic multiplier, and we should expect the parties to prefer other available means of protecting against post-breach obstruction.

2. Adverse inferences

Because it is the logic of proving breach and proximate harm that undermines the effectiveness of compensatory second-order damages, another obvious solution is an adverse inference. Thus the parties might try to incorporate mechanisms like presumptions and admissions to increase the evidentiary power of second-order breach for showing first-order breach.50

At present there is little law on when or to what extent the parties can, in a contract, shift the burden or standards of proof in litigation concerning that contract. Probably the most informed guess on the state of the law is that of Robert Scott and George Triantis, who report: “While we have not found direct authority, we believe that courts would enforce reasonable contractual burden of proof provisions. And we have found

47 See Polinsky & Shavell, 111 Harv. L. Rev. at 892.
49 See infra at 43-43.
50 For a description of how courts and prosecutors use adverse inferences to discourage obstruction in the criminal context, see Chris Sanchirico, Detection Avoidance, 10/05 draft at 45-48.
ample evidence that many contracts in fact contain such provisions.\textsuperscript{51} The contracts Scott and Triantis discuss, however, all categorically shift the burden of proof or standard of evidence; none conditions the specified burden of proof or standard of evidence on a party’s bad behavior, such as breach of an anti-obstruction clause.\textsuperscript{52}

While there is little law in the area, we should expect courts to be sympathetic to such contract terms. The party-specified remedy – a change to the way breach is proven – is so closely related to the wrong – obstruction of recovery. Moreover, the remedy has analogs elsewhere in the law. Thus the rules governing the destruction or spoliation of evidence provide for a presumption that that evidence was unfavorable to the party at fault.\textsuperscript{53} Alternatively, the same result might be achieved by applying the equitable principles of estoppel, the argument being that the defendant should not be permitted to benefit from his obstructive breach.

The threat of an adverse inference will fully deter obstructive breach when the inference increases the probability that the promisor will pay damages for the underlying breach more than the obstructive breach reduces it. This result follows from the basic statement of the promisor’s obstruct decision. The cost to the promisor of an adverse inference is liability for the underlying breach, that is, \( s_0 = s \).\textsuperscript{54} Substituting into (2), the sanction will fully deter or insure against obstructive tactics if and only if \( (p_o)(s) \geq (\lambda)(s) \), or:

\[ (\lambda)(s) \leq (p_o)(s) \]


\textsuperscript{52}Thus Scott and Triantis identify only three ways by which the parties might “clarify, reverse, or fine-tune the default allocation in their contract . . . The first approach is by direct allocation of burden; the second is by redesignating whom the plaintiff will be in the event of a dispute; and the third is by framing the substantive provisions governing, for example, the right to assign or terminate a contract.” 115 Yale L.J. at 866. I’m suggesting a fourth way: rather than direct allocation of the burden, conditional allocation. Scott and Triantis do describe an instance in which the court determined that a prima facie showing of bad faith shifted the burden of proof – though not at the behest of the contract. Id. at 876 (discussing International Harvester Co. v. Calvin, 353 So.2d 144 (Fla. 1977)).

\textsuperscript{53}See generally 29 Am. Jur. 2d Evidence § 244 (“Destruction or spoliation of evidence”). Unlike a contractually specified adverse inference, however, the evidentiary rule requires proof of scienter: “a conscious awareness of the existence of the dispute and that the act done will destroy evidence or access to evidence.” Id.

\textsuperscript{54}The reader may want to be reminded that \( s_0 \) represents the sanction for obstructive breach, \( \lambda \) the percentage-point decrease in the probability of enforcement that the obstructive breach gets the promisor, \( s \) is the cost of the remedy for the first-order breach, and \( p_o \) is the probability that the promisee will be able to recover damages \( s_0 \) for the second-order breach.
In other words, the right incentives are achieved when the chance the adverse inference will be effective (as the result of proof of second-order breach) is at least as great as the reduced probability of enforcement the promisor gains by obstruction.

The probability that the adverse inference will result in liability for first-order breach \( (p_o) \) depends on two factors. The first is the likelihood that the promisee will be able to show a second-order breach in circumstances where she would not otherwise (absent the adverse inference) be able to prove first-order breach. The second is the likelihood that the adverse inference will result in a finding of a first-order breach, which depends on the strength of the inference – whether proof of second-order breach serves as conclusive evidence of a first-order breach, shifts the burden of proof, or is only another pebble to place on the scales. An adverse inference is most likely to work as a second-order remedy where (a) detection of the second-order breach is much easier, and therefore its sanctioning more likely, than detection of the first-order breach, and (b) the inference is a strong one.

Consider, for instance, the hypothetical Recordkeeping Clause. Contractor’s failure to keep any of the required records is easy to detect – much easier than noncompliant installation. Assume that the Recordkeeping Clause also specifies as the remedy for its breach a strong adverse inference: second-order breach shifts the burden of proof, so Contractor must demonstrate compliant installation. Recall my assumption that it is very difficult to prove breach or performance after the wiring is installed. Faced with the prospect of an adverse inference, Contractor will choose to keep the required records. The benefit of hiding any breach isn’t worth the increased chances that he will be found liable for it.\(^{55}\)

\(^{55}\) Contractor’s decision might be described formally as follows. Assume Contractor does not expect to install the wiring to specification. (If he believes that he will or might install to specification, he has all the more reason to keep the records.) Suppose failure to keep records decreases the probability of breach detection from seventy-percent to twenty-percent – that is, \( \lambda = .5 \). Suppose further that failure to keep records will be detected and verifiable ninety-five-percent of the time, and always where there is independent proof of the underlying breach. (The assumption that failure to keep the records will always be verifiable in cases where there is independent proof of the underlying breach is a simplifying one, in that it allows the conclusion in the next sentence. Calculating that value is somewhat more complicated if we drop the assumption and allow for cases where it is possible to prove first-order breach without proof of second-order breach.) There is therefore a seventy-five-percent chance that obstruction will be discovered where breach cannot otherwise be proven (95% chance of proof of second-order breach - 20% chance of proof of first-order breach = 75% chance of second-order verification
The reader will probably object that, faced with the prospect of an adverse inference, Contractor would never breach in so obvious a way as not keeping any records. If he wants to avoid liability for noncompliant installation, he will falsify the records, which will be much more difficult to detect. This objection is correct, and shows why adverse inferences are not a complete solution.

But the difference between not keeping records and keeping false records is not just quantitative – different probabilities of detection and verification. An adverse inference works only if the parties can imagine states of the world in which (a) the promisee cannot otherwise prove the first-order breach, (b) she can prove a second-order breach, and (c) the resulting adverse tips the balance with respect to proof of the first-order breach. Conditions (a) and (b) jointly entail that the second-order breach must be what I have labeled independent obstruction. The adverse inference sanction is ineffective against falsification of records not simply because of the low probability of detection, but because that breach of the Recordkeeping Clause is a form of dependent obstruction. If Builder can show false records, she has already proven first-order breach, and the adverse inference can make no difference. While an adverse inference remedy can deter some forms of independent obstruction – those that are easy to detect and verify, and where the adverse inference is likely to result in a finding of a first-order breach – it is ineffective against dependent obstruction.

3. Penalties and punitive damages

The only generally effective contractual remedy for second-order breach is a penalty or punitive damages clause. How high must such a sanction be to fully deter obstructive breach? The economic answer is familiar: The lower limit is the promisor’s expected gain from breach multiplied by the reciprocal of the probability of enforcement. This is confirmed for the deterrence of obstructive breach by solving (1) for $s_o$:

\[
s_o > \frac{(\lambda)(s)}{p_o}
\]

without first-order verification). Finally, assume that the burden shifting sanction will permit Builder to show first-order breach ninety-percent of the time. Consequently, $p_o = (.75)(.9) = .675$. Under these circumstances, (4) is satisfied and Contractor will do better by keeping the required records. Not keeping the records gets him the benefit of a fifty percentage-point reduction in the probability of detection, but the adverse inference more than offsets those gains with a sixty-seven percentage-point increase in the likelihood of first-order liability.
It will be recalled that $s_0$ represents the sanction for the obstructive breach over and above any compensatory damages for the underlying breach, that is, over and above $s$. Successful punitive damages or penalty clauses, therefore, require that the total damage award be $d = s + s_0$. So long as a penalty clause or punitive damage measure satisfies (5), it will not be in the promisor’s interest to breach the second-order duty.

Unlike adverse inferences, penalties and punitive damages are fully effective against dependent obstruction. Consider Contractor’s post-breach decision whether to comply with the No-Conceal Clause, which prohibits trying to hide nonconforming work. Because breach of the No-Conceal Clause is dependent – to prove the second-order breach, Builder must first prove first-order breach – an adverse inference has no traction. Penalties or punitive damages satisfying (5) do. Suppose breach of the No-Conceal Clause decreases the probability of recovery for the first-order breach from seventy-percent to twenty-percent, so $\lambda = .5$. Assume further that if Builder can show nonconforming installation, there is a fifty-percent chance that she will discover and be able to prove Contractor’s attempts to hide it. That is, the chance of second-order enforcement is half the chance of first-order enforcement, or $p_0 = (.5)(.2) = .1$. With liquidated damages for the first-order breach set at $10,000$, (5) entails that the second-order sanction must be greater than $50,000$. This is correct. Contractor stands to gain a risk-adjusted $5,000 from breaching the No-Conceal Clause (a fifty-percent decrease in the likelihood of a $10,000 damage award). Because there is only a one in five chance that the second-order breach will be detected, the sanction must be greater than $50,000 to make it in Contractor’s interest to comply with the No-Conceal Clause.

As with dynamic multipliers, the minimum penalty or punitive damage amount depends on probabilistic variables – now $p_0$, which represents the likelihood that the promisee will be able to prove obstructive breach, and $\lambda$, the percentage-point decrease in the probability of first-order enforcement caused by the obstructive breach. In the discussion of dynamic multipliers, I pointed to significant practical hurdles (verification and quantification) when working with similar probabilistic variables. There are, however, several important differences when it comes to penalties and punitive damages. First, because the goal is not to force one party to internalize costs, but to deter his bad behavior altogether, there is less need for precision. A penalty or punitive damages clause will deter so long as the damage amount is greater than the

\[ s_0 > \frac{(.5)(10,000)}{.1}. \]
promisor’s risk-adjusted gain, no matter how much greater. If there is any doubt as to the value of $p_o$ or $\lambda$, the parties, court or jury (depending on whether the sanction is a penalty or punitive damages) can simply choose the value that results in the greater sanction.\footnote{57} In the case of a dynamic multiplier, that approach would threaten to overdeter first-order breach. Second, while the dynamic multiplier relies on a third-party ex post determination of the ex ante probability of enforcement, penalty clauses permit the parties to make that determination themselves, at the time of formation. The parties are likely to have a better native sense of the costs and benefits of obstructive behavior within the context of their relationship, decreasing the cost both of investigation and of error. Finally, setting the deterrence sanction does not require calculating the overall probability of enforcement ($p$), but only the effect of the obstructive breach on that probability ($\lambda$) and the chance the second-order breach will be sanctioned ($p_o$). It is therefore not necessary to take into account the multitude of other facts and circumstances that figure into the probability of first-order enforcement, all of which must be considered in applying a dynamic multiplier.

Penalties or punitive damages for breach of an anti-obstruction clause are the most general and effective contractual means of protecting against post-breach obstruction of recovery. Both, however, violate well-established rules against extracompensatory damage measures.\footnote{58} The results of this Article recommend changing these rules to enable effective second-order terms. Courts should carve out an exception to the rules against penalties and punitive damages that permits the parties to specify such remedies for the breach of second-order duties.

\footnote{57} Higher second-order sanctions might result in the promisor charging a higher price to cover her potential liability (especially if he is worried about mistakenly breaching the second-order duty). For practical reasons, therefore, the sky is not the limit. This is not to say, however, that the promisee won’t find securing an effective second-order duty worth the marginal price difference.

\footnote{58} Not all states follow these rules. South Carolina, for example, permits punitive damages for breach of contract accompanied by “any act characterized by dishonesty in act, unfair dealing, or the unlawful appropriation of another’s property by design,” a rule that might well cover many forms of obstructive behavior. Perry v. Green, 437 S.E.2d 150, 152 (S.C. Ct. App. 1993); see also Dodge, 48 Duke L.J. at 649-50 (describing similar rules in Idaho, Mississippi and New Mexico). It is unclear whether the courts these states treat such punitive damages as mandatory remedies or as defaults the parties could opt-out of, much less whether courts would permit the parties to specify the bad acts that should trigger them.
B. The law of deceit and contractual duties to represent performance

In the meantime, parties will have to look to other forms of legal liability to secure compliance with contractually specified second-order duties. The most obvious and effective option is to piggyback on the extracompensatory damages available in fraud.\textsuperscript{59} Where permitted, this second-best approach enables parties to adopt certain protections against obstruction. But it too faces doctrinal obstacles. I described one such obstacle in the Introduction: Virginia’s rule that where the source of the duty is contractual, there can be no liability in fraud.\textsuperscript{60} Here I want to consider the fraud approach in more detail by examining the California Supreme Court’s recent decision in \textit{Robinson Helicopter Co. v. Dana Corp.}\textsuperscript{61} \textit{Robinson Helicopter} both demonstrates the power of fraud liability for obstructive breach – the court affirmed punitive damages based on the defendant’s second-order misrepresentations – and lies at the edge of current debates on the appropriateness of fraud liability in the contracting context.

But first the idea of piggybacking on an action for fraud. Many varieties of obstructive behavior involve misrepresentation of one kind or another. Where a second-order contractual duty requires the recording, retention or sharing of information related to performance, its breach might take the form of a lie. This suggests the following strategy: tailor informational second-order duties so that the nonperformance of those duties qualifies not only as a breach of contract, but also as fraud, for which punitive damages are available. The most obvious example is a requirement that the promisor report that he is not in breach. A duty to represent performance, if backed by the law of deceit, gives the breaching promisor two options: decline to make the representation, effectively communicating to the promisee that he may be in breach, or falsely represent that he has performed, exposing himself to liability for punitive

\textsuperscript{59} One could imagine piggybacking on other causes of action instead. Thus recording artists have attempted to impose on recording companies a fiduciary duty to provide accurate sales data and auditing opportunities for the verification of royalty payments. \textit{See} \underline{\underline{____}}. Like fraud, breach of fiduciary duty can permit the recovery of punitive damages, effectively deterring obstructive behavior. A downside of fiduciary duties as compared to fraud liability is its lack of specificity. Rather than the relatively clear duty to be honest, there is the relatively amorphous duty “to act with the utmost good faith for the benefit of the other party,” giving rise to uncertainty about the scope of potential legal liability.

\textsuperscript{60} \textit{Richmond Metro. Auth. v. McDevitt Street Bovis, Inc.}, 507 S.E. 2d 344, 347 (Va. 1998).

\textsuperscript{61} 102 P.3d 268 (Cal. 2004).
damages for his fraud. Timely information about performance is secured by the extracompensatory remedies available in tort.\textsuperscript{62}

In fact, fraud liability has a potential advantage over liability in contract. While contracts are governed by principles of strict liability, liability for deceit requires proof of scienter – that the misrepresentation was intentional or reckless.\textsuperscript{63} This protects the promisor who is worried that he might mistakenly obstruct recovery, for example because of difficulties monitoring employees who are tasked with compliance. It also provides some measure of assurance against false allegations of second-order breach, since the promisee not only has to show nonperformance, but also scienter.

The facts and holding in \textit{Robinson Helicopter Co. v. Dana Corp.} illustrate how such an end-run around the penalty and punitive damages rules can work.\textsuperscript{64} Starting in 1984, Robinson Helicopter purchased clutch mechanisms from Dana Corporation for use in helicopters it manufactured. Robinson’s purchase orders required that shipments be accompanied by a Certificate of Compliance, which stated that the clutches met contractual specifications.\textsuperscript{65} Dana regularly included the certificates, though clutches shipped between July 1996 and October 1997 were noncompliant. High failure rates resulted in the discovery of Dana’s first-order breach, and Robinson sued for breach of contract, breach of warranty and negligent and intentional misrepresentation. The California Supreme Court upheld the jury award of $1.5 million in compensatory damages for the breach of contract and warranty, and an additional $6 million in punitive damages, the latter based on the jury’s finding that in providing the certificates, Dana had made false misrepresentations of fact and had knowingly misrepresented or concealed material facts with the intent to defraud.\textsuperscript{66}

\textsuperscript{62}There is yet another way that fraud liability might assist the promisor in his attempts to assure the promisee that he will not obstruct recovery. A promisor might, at the time of formation, represent a present intent to assist in recovery should he fail to perform. Whether or not that representation is accompanied by a legally binding promise, it can, if credible, assure the promisee that she will recover for any breach of the first-order duty. As I have discussed elsewhere, the law can lend credibility to promissory representations of intent to perform by imposing fraud liability when they are false. \textit{See generally Ayres & Klass, Insincere Promises.} The same goes for promissory representations of an intent not to obstruct recovery. \textit{See} Ian Ayres & Gregory Klass, New Rules for Promissory Fraud, 48 Arizona L. Rev. \_\_, \_\_ (2006).

\textsuperscript{63}\textit{Prosser and Keeton on Torts} \S\ 105, at 728 (5th ed. 1984).

\textsuperscript{64}102 P.3d 268, 270 (Cal. 2004).

\textsuperscript{65}\textit{See} Robinson Helicopter Co. v. Dana Corp., 129 Cal. Rptr. 2d 682, 686 n.6 (Cal. App. 2003).

\textsuperscript{66}102 P.3d at 987.
From the perspective of this Article, this was the right outcome. The Certificates of Compliance apparently corrected for two worries Robinson had going into the transaction. The first was the difficulty in quickly detecting certain sorts of breach. At issue in the case was the metallurgical integrity of the clutches, which was presumably difficulty or expensive for Robinson to observe. Second was that if such a breach was not detected early, Robinson would likely suffer significant noncompensable damages. Systematic clutch failures would result not only in possibly catastrophic liability, but also regulatory noncompliance, loss of reputation, and other nonrecoverables. Robinson might have attempted to capture some of these first-order harms in a liquidated damages clause. But there was the risk that a court would view the high liquidated damages amount as a penalty and therefore unenforceable. The parties therefore constructed a contract that permitted Dana the usual option of breaching and paying unliquidated compensatory damages, but effectively required that it immediately inform Robinson of such breach – by not sending the clutches or by not including a Certificate of Compliance. This second-order duty to share information about performance was structured such that any injurious breach would involve misrepresentation. In this way, the parties were able to attach extracompensatory damages, by way of liability for fraud, to the most salient form of obstruction.

There are other ways parties might try to utilize the law of fraud in their contract. Recall the hypothetical Reporting Clause. Unlike the Robinson-Dana contract, in which performance was episodic, the contract between Builder and Contractor envisions a single continuous period of performance. Rather than arbitrarily chosen daily, weekly or monthly performance reports (“I am not in breach”), Builder might prefer that Contractor be required immediately to report any breach (“I have breached”), where failure to report would expose Contractor to liability for fraudulent concealment. The Reporting Clause is cheaper than the Certificate of Compliance requirement in Robinson Helicopter, for instead of regular reports of compliance, there need be only one communication, and that only if there is a breach. This means cost savings both in the number of reports and in their value: a contemporaneous report of breach conveys to the promisor just the information she needs the moment she needs it most.

As a doctrinal matter, however, recovery for fraud might be more difficult under the Reporting Clause. While the false Certificates of

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67 See Rest. 2d Torts § 550.
Compliance at issue in *Robinson Helicopter* involved garden-variety misrepresentations (Dana said it performed when it hadn’t), breach of the Reporting Clause qualifies as fraud only under a theory of fraudulent concealment. It is an open question whether, as a doctrinal matter, fraud by silence applies when the duty to speak is purely contractual.

There is, however, a larger obstacle to the whole project of incorporating fraud liability with contractual duties to represent. There is a strong tendency in U.S. law to exclude tort liability from the contractual setting. Jurisdictions use different tests to determine whether a contract plaintiff may also sue in tort, including for fraud. Rather than canvassing and summarizing this fairly complex area of black-letter law, I will describe how the issue played out in *Robinson Helicopter*. The different decisions and opinions in that case illustrate how difficult it can be to incorporate fraud liability into contractual relationships.

At issue in *Robinson Helicopter* was whether Robinson’s fraud claims were barred by California’s interpretation of the economic loss doctrine. The economic loss doctrine generally “precludes a recovery in tort where the sale of a defective product has resulted in no property damage or bodily injury, but only economic loss to the buyer of that product.” The doctrine first emerged in the mid-1960s as a means of policing the border between, on the one hand, breach of warranty and, on the other, strict product liability and negligence. The first articulations of

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68 This tendency is of relatively recent origin. See William L. Prosser, *The Borderland of Tort and Contract*, *in* Selected Topics on the Law of Torts 380 (1953). Prosser was in favor of a wide overlap between tort and contract: “When the ghosts of case and assumpsit walk hand in hand at midnight, it is sometimes a convenient and comforting thing to have a borderland in which they may lose themselves.” *Id.* at 452.

69 For a summary overview, see Dorff, 28 Seton Hall L. Rev. at 407-11. For other examples of how these doctrines have been applied to concealment of breach cases, see Catherine Paskoff Chang, *Note, Two Wrongs Can Make Two Rights: Why Courts Should Allow Tortious Recovery for Intentional Concealment of Contract Breach*, 39 Colum. J.L. & Soc. Probs. 47, 66-72 (2005).

70 *Robinson Helicopter*, 129 Cal. Rptr. 2d at 683.

71 As Justice Traynor explained in the seminal case, “[t]he history of the doctrine of strict liability in tort indicates that it was designed, not to undermine the warranty provisions in the Sales Act or of the Uniform Commercial Code, but, rather, to govern the distinct problem of physical injuries.” *Seely v. White Motor Co.*, 403 P.2d 145, 149 (Cal. 1965) (Traynor, J.). For discussions of the subsequent development of the economic loss doctrine, see R. Joseph Barton, *Note, Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 Wm. & Mary L. Rev. 1789 (2000); Steven C. Tourek, et al., *Bucking the “Trend”: The Uniform Commercial Code, the Economic Loss Doctrine, and Common Law Causes of Action for Fraud and Misrepresentation*, 84 Iowa L. Rev. 875 (1999); Herbert Bernstein, *Civil Liability for Pure Economic Loss Under American Tort Law*, 46 Am. J. Comp. L. 111
the rule held that so long as a defect didn’t cause the purchaser physical injury or property damage, she could recover only in contract – only for breach of warranty. Early cases did not decide whether the doctrine extended to intentional torts, including fraud and misrepresentation.

In the past decade, several courts have held that the economic loss doctrine bars liability in fraud between contracting parties except for “acts considered to be independent from acts that breach the contract.”72 One finds different definitions of “independent” in the above formulation. Many courts, including the intermediate appellate court in Robinson Helicopter, pay particular attention to whether the misrepresentation occurred before or after formation – to the distinction “between fraud in the inducement of the contract, which is not barred by the economic loss rule, and fraudulent misrepresentations relating to the performance of the contract, which are barred.”73 Fraud in the inducement, these courts reason, cannot interfere with contractually chosen risk allocation. For one thing, when fraud in the inducement occurs, the contract does not yet exist; for another, fraudulent inducement means that the promisee’s agreement to the contractual allocation of risk is not truly voluntary.74 Misrepresentations in the course of performance, on the other hand, are understood to be “interwoven with the breach of contract,”75 so liability for fraud in the performance should be governed by the contractual allocation of risk.

This expansive reading of the economic loss doctrine prevents securing anti-obstruction information-sharing duties with fraud liability. The relevant misrepresentations in these cases are necessarily

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73 129 Cal.Rptr.2d at 695 (emphasis in original). See Barton, 41 Wm. & Mary L. Rev. at 1802-12; Tourek, et al., 84 Iowa L. Rev. at 895-912. Courts occasionally run together the difference between fraud in the inducement and fraud in the performance with another relevant distinction: representations that are about the quality or character of the goods sold, which are held to be non-actionable in fraud under the economic loss doctrine, as opposed to other, actionable representations. See, e.g., Huron Tool v. Precision Consulting Serv., 532 N.W.2d 541, 545 (Mich. 1995).

74 See, e.g., Robinson Helicopter, 129 Cal.Rptr.2d at 697.

75 Huron, 532 N.W.2d at 545.
“interwoven” with the breach, for the contract requires the promisor to make the representations in question. This is the result reached by the intermediate court in *Robinson Helicopter*, which held that Robinson “has neither claimed nor established any fraudulent representation or concealment that was not intertwined with Dana’s performance of its contract and warranty breaches.”\(^\text{76}\)

The California Supreme Court rejected this reading of the economic loss doctrine, cryptically explaining that “the economic loss rule does not bar Robinson’s fraud and intentional misrepresentation claims because they were independent of Dana’s breach of contract.”\(^\text{77}\) But the court declined to rule more generally on whether or when the economic loss doctrine applies to fraud in the performance. It avoided the issue by limiting its holding “to a defendant’s affirmative misrepresentations on which a plaintiff relies and which expose a plaintiff to liability for personal damages independent of the plaintiff’s economic loss.”\(^\text{78}\) While less than crystalline, this statement suggests that the Supreme Court agreed with the lower court that the economic loss rule bars recovery for most fraud in the performance, or fraud that is intertwined with the breach.

There is some irony in applying the economic loss doctrine to defeat fraud liability in cases like *Robinson Helicopter*. One of the most commonly cited reasons for excluding tort liability from contractual relationships is that it interferes with the parties’ chosen allocation of risk. As the U.S. Supreme Court has explained:

> The commercial buyer and commercial seller can negotiate a contract — a warranty — that will set the terms of compensation for product failure. If the buyer obtains a warranty, he will receive compensation for the product’s loss, whether the product explodes or just refuses to start. If the buyer does not obtain a warranty, he will likely receive a lower price in return. Given the availability of warranties, the courts should not ask tort law to perform a job that contract law might perform better.\(^\text{79}\)

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\(^\text{76}\) 129 Cal. Rptr. 2d at 697.  
\(^\text{77}\) 102 P.3d at 275.  
\(^\text{78}\) 102 P.3d at 276 (emphasis added). Other factors emphasized by the California Supreme Court likely to distinguish *Robinson Helicopter* from other cases include the impact of Dana’s breach on public safety and the fact that the improper clutches put Robinson out of compliance with FAA regulations. See *id.* at 274 n.7.  
\(^\text{79}\) Saratoga Fishing Co. v. J.M. Martinac & Co., 520 U.S. 875, 880 (1997) (citations omitted). See also, e.g., Grynhberg v. Questar Pipeline Co., 70 P.3d 1, 11 (Utah 2003) (“Whether the doctrine is asserted in terms of economic loss or independent duty, the
This rationale makes sense when the torts at issue are negligence or product liability, both of which typically provide compensatory damages only. But it makes no sense when the wrong is fraud. The parties in *Robinson Helicopter* could not have accomplished with contractual liability what they got with liability in fraud—extracompensatory damages for obstructive breach. Applying the economic loss doctrine in this context does not protect the parties’ chosen allocation of risk, but defeats it.80

Despite its defects, California’s potentially expansive reading of the economic loss doctrine agrees with the approaches of several other jurisdictions, including Michigan, Florida and Wisconsin.81 Nor is the economic loss doctrine the only bar to fraud liability between contracting parties. As I described in the Introduction, Virginia follows the rule that “[i]n determining whether a cause of action sounds in contract or tort, the source of the violated duty must be ascertained,” where a noncontractual underlying reasoning remains the same: tort law should govern the duties and liabilities imposed by legislatures and courts upon non-consenting members of society, and contract law should govern the bargained-for duties and liabilities of persons who exercise freedom of contract.”); Clark v. Rowe, 701 N.E.2d 624, 626 (Mass. 1998) (“When the economic loss rule has been applied, the parties usually were in a position to bargain freely concerning the allocation of risk.”); Spring Motors Distributions., Inc. v. Ford Motor Co., 489 A.2d 660, 672 (N.J. 1985) (“Contract principles . . . are generally more appropriate for determining claims for consequential damages that the parties have, or could have, addressed in their agreement.”).

80 The above analysis is significantly different from other arguments for excluding fraud from the economic loss doctrine. For instance, Tourek, Boyd and Schoenwetter maintain that the rule should not apply to fraud because, among other things, “[a]s a practical matter, it is difficult to see how a party can effectively anticipate and therefore negotiate the allocation of risks for every type of misrepresentation and every form of deceit that may be perpetrated by the other party to an agreement.” Tourek, et al., 84 Iowa L. Rev. at 916; see also Stoughton Trailers, Inc. v. Henkel Corp., 965 F.Supp. 1227, 1236 (W.D. Wisc. 1997) (“A party to a contract cannot rationally calculate the possibility that the other party will deliberately misrepresent terms critical to that contract.”). My argument is exactly the opposite: When it comes to contractually required representations, the parties might anticipate and prefer allocating the risk of misrepresentation in accordance with the law of fraud, but the expansive reading of the economic loss doctrine prevents them from doing so.

source means no fraud liability. New York courts have also held that “in order to state a cause of action sounding in fraud, the plaintiff must allege a breach of duty which is collateral or extraneous to the contract between the parties.” And the Nebraska Supreme Court has required that a fraud plaintiff allege “separate and distinct factual occurrences that could stand alone as a separate cause of action sounding in tort.”

Adopting a narrow reading of the economic loss doctrine and modifying these other rules would permit the parties use the law of fraud to contract for effective anti-obstruction duties. That solution, however, is second-best. Fraud liability can deter only obstruction that involves the transfer of information – hiding breach in one way or another. But this is hardly the only way to obstruct recovery. Promisors also obstruct by refusing to pay damages due, using delaying tactics, hiding or transferring assets, or taking other evasive measures. None of these is easily captured by liability for deceit. And even contractual information-sharing duties, like the Recordkeeping Clause, can be breached without misrepresentation. To fully empower the parties to contract against obstruction, the law must permit them extracompensatory breach-of-contract remedies.

IV. The argument for extracompensatory second-order remedies

The discussion thus far has been largely analytic and descriptive. The upshot: If contracting parties are to adopt meaningful contractual duties not to obstruct recovery, they must be able to choose extracompensatory remedies for the breach of those duties. That conclusion runs up against existing mandatory rules against punitive damages and penalty clauses, as well as limits on recovery for fraud in the contracting context. These rules are not without their defenders, which raises the question: Should the law make an exception for second-order

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84 Cimino v. First Tier Bank, 530 N.W.2d 606, 613 (Neb. 1995).
contractual duties and permit parties to adopt extracompensatory remedies for obstructive breach?

This Part considers that normative question from the perspective of economic efficiency. There are different opinions in the law-and-economics literature as to the general efficiency of the rules against penalty clauses and punitive damages (and by extension, rules preventing punitive damages for fraud for what are also breaches of contract). I take no side in that debate, but show that that the efficiency arguments against them do not apply to second-order duties not to obstruct recovery. The second section of this Part applies the results of this Article to reinterpret California’s brief experiment in allowing punitive tort damages for obstruction of recovery in contract.

A. The efficiency of extracompensatory remedies for second-order breach

Attempts to justify the rules against penalty clauses and punitive damages as efficient face a special problem. Most efficiency theorists are committed to choice as the sole metric of value. That is, they are committed to measuring the relative value of alternative states of the world by asking which state the affected individuals would choose. Mandatory rules against duress, incapacity and unconscionability can be squared with that commitment, for they are manifestly designed to protect consent and therefore ensure that a contract represents the parties’ actual choice. The mandatory rules against penalties and punitive damages, on the other hand, do not protect choice in any obvious way. Quite the opposite: They prevent parties who prefer extracompensatory remedies from getting them. If party preference is the best measure of value, why does the law frustrate parties who want extracompensatory remedies?


86 Samuel Rea describes the difficulty as follows:

The perplexing aspect of the penalties-liquidated damages distinction is that there is a conflict between the apparent, but express, intention of the parties and the subsequent action of the courts. Economists are inclined to believe that courts are contributing to inefficiency when they upset the agreed upon terms of a contract.

Samuel Rea, Efficiency Implications of Penalties and Liquidated Damages, 13 J. Legal Stud. 147, 148 (1984). See also Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) (Posner, J.) (“[T]he parties (always assuming they are fully
If there is an efficiency-based explanation of these rules, it will take one of two familiar forms. Either the third-party costs of extracompensatory remedies (externalities) outweigh any benefits the parties might realize, or no rational party would ever want extracompensatory contract remedy, so the rules do no harm while protecting the unwary or uninformed. The first path does not look promising. Extracompensatory remedies simply do not impose significant costs on anyone other than the parties themselves, and not many efficiency theorists have attempted an externality argument for the rules. The second approach looks like it has something going for it. There is broad agreement in the economic literature that, in most contexts, parties to a contract should prefer compensatory or subcompensatory damage measures (with some version of expectation damages often identified as optimal), and therefore should not knowingly choose punitive damages, penalties or other extracompensatory damage measures. The arguments why this is so have evolved over the years to the point where they are fairly subtle. For purposes here, a generic blueprint will suffice.

competent) will, in deciding whether to include a penalty clause in their contract, weigh the gains against the costs . . . and will include the clause only if the benefits exceed those costs.”); Goetz & Scott, Liquidated Damages…, 77 Colum. L. Rev. at 555-56 n.12 (describing how the penalty doctrine is “anomalous in terms of the theoretical underpinnings of modern contract law”).

Paul Rubin is an exception. He argues that the rules are justified because extracompensatory damages are likely to induce more lawsuits, and therefore impose additional costs on society, which pays the cost of the court system. Paul H. Rubin, Unenforceable Contracts: Penalty Clauses and Specific Performance, 10 J. Legal Stud. 237 (1981). But this is not very convincing. Rea points out that Rubin’s explanation is difficult to square with the “numerous other areas of the common law in which courts seem to encourage use of judicial resources.” Rea, 13 J. Leg. Stud. at 149. And Talley observes that Rubin fails to consider the increased incentive to settle. Talley, 46 Stan. L. Rev. at 1215. See also Schwartz, 100 Yale L.J. at 387 n.35.

See, e.g., Rea, 16 J. Leg. Stud. At 159 (“[T]he parties to a contract are unlikely to agree ex ante to damages that exceed expected loss.”); Schwartz, 100 Yale L.J. at 370 (“[P]romisees do not want contractual damage measures that would grant more than their lost expectation.”).

For more detailed versions, see Rea, 13 J. Leg. Stud. at 151-63; Schwartz, 100 Yale L.J. at 372-83; Eric L. Talley, Note, Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule, 46 Stan. L. Rev. 1195, 1212-18 (1994); Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 S. Cal. L. Rev. 629 (1988). The core argument presented here omits some considerations, such as the use of penalties as signals, their employment as strategic barriers to entry, and their effect on price and selection, as well as economic arguments that, in special circumstances, extracompensatory remedies can promote efficient investment. For a detailed overview of the literature, see Edlin & Schwartz, 78 Chi.-Kent L. Rev. passim.
Generally speaking, the greater the liability a promisor faces for breach, the more he will charge the promisee up front. But most promisees are either risk-neutral or risk-averse, so they will not want to pay more ex ante to gamble on the chance of a big ex post payoff for nonperformance. Extracompensatory damages are therefore unlikely to result in risk-shifting benefits. Nor do they create efficient incentives. The prospect of an extracompensatory remedy causes the promisee to prefer breach to performance, meaning that she will take too few precautions against nonperformance. In fact, extracompensatory damages create a moral hazard for the promisee, giving her a reason to try to induce, or even falsely allege, breach. The promisor, on the other hand, will invest an inefficient amount to ensure his performance. Finally, where renegotiation is costly or difficult – and because contracts create bilateral monopoly with respect to contractual duties, this is often the case – extracompensatory remedies result in performance when breach would be more efficient. Taken together, these bad incentives decrease the aggregate gains of trade from the transaction. That is, they decrease the size of the pie the parties have to divide between themselves, a result no one prefers.

The upshot of the generic argument: A contract for extracompensatory damages probably does not reflect the parties’ considered preferences. Whether it follows that we should keep the rules against punitive damages and penalty clauses is open to debate. Those who argue for that conclusion suggest that a penalty or punitive damages clause is therefore probably the result of mutual mistake, duress,

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90 See Rea, 13 J. Leg. Stud. at 152-54; Craswell, 97 Mich. L. Rev. at 2230; Craswell, 61 S. Cal. L. Rev. at 642-45; Schwartz, 100 Yale L.J. at 392.

91 This moral hazard problem is emphasized by Clarkson, et al., 1978 Wisc. L. Rev. at 368-72. See also Rea, 13 J. Leg. Stud. at 155; Craswell, 61 S. Cal. L. Rev. at 646-53, 656-61.

92 See Richard Posner, Economic Analysis of the Law 118 (6th ed. 2003); Talley, 46 Stan. L. Rev. at 1218-41. Dodge argues against the assumption that, where nonperformance would be intentional and efficient, extracompensatory remedies will prevent the parties from negotiating a release. “A rule that forces such negotiation will tend to be more efficient than a rule that allows one party to breach and pay damages without the other party’s consent because the costs of negotiation will tend to be lower than the costs of litigation necessary to establish expectation damages.” Dodge, 48 Duke L.J. at 632-33. See also id. at 666-76; Goetz & Scott, 77 Colum. L. Rev. at 587; Clarkson, 1978 Wisc. L. Rev. at 360-62.

93 Samuel Rea summarizes the arguments as follows: “Penalty clauses are costly because they (1) induce excessive precautions by the promisor, (2) induce deficient precautions by the promisee, (3) overinsure the promisee, and (4) expose the promisor to additional risk.” Rea, 13 J. Leg. Stud. at 156.
unconscionability or some other formation defect. The rules against penalties and punitive damages protect consent because “courts [can] use unreasonable ex ante damages as evidence of unconscionability or mistake.”94 The argument on the other side is that if most parties do not prefer extracompensatory damages, the mandatory rules against penalties and punitive damages do little or no work, but cause much mischief. The mischief comes from courts’ inability to distinguish when damages exceed what is necessary for compensation, resulting in the refusal to enforce what are in fact efficient (compensatory) damage measures.95

In attempting to apply the generic argument to second-order duties, we need to distinguish between two questions. The first is whether penalties or punitive damages for second-order breach are efficient relative to other possible remedies. As between two legal rules, the more efficient is the one that creates more value in its application.96 The generic argument against extracompensatory remedies maintains that there exists another remedy – usually identified as some variation on expectation damages – that provides more valuable incentives. That argument does not go through for second-order duties not to obstruct. As we’ve seen, the logical structure of proving second-order breach and damages means that

94 Rea, 13 J. Leg. Stud. at 160.

While he doesn’t take efficiency as a guiding norm, Melvin Eisenberg suggests another reason why penalty clauses might be systematically linked to failures of consent. Eisenberg argues that “such provisions are systematically more likely to be the products of the limits of cognition,” such as bounded rationality, rational ignorance, unrealistic optimism, and so forth. Melvin A. Eisenberg, Cognition and Contract, 47 Stan. L. Rev. 211, 227 (1995). If the analysis immediately below is correct, then extracompensatory remedies for second-order breach fall into Eisenberg’s category of intended penalties that are probably not the result of the parties’ cognitive limits and therefore should be enforced. See id. at 235.

95 Thus Alan Schwartz argues:

Courts do not have to prevent promisees from obtaining penalty clauses if promisees do not want penalty clauses. The ex ante rule is not merely unnecessary: judicial review produces mischief. Courts sometimes mistake compensatory damage measures for penalties, and so have found that particular liquidated damage clauses would inevitably overcompensate promisees when those clauses only protect the expectation. Thus, the ex ante branch of the liquidated damage rule should be abandoned.

Schwartz, 100 Yale L.J. at 370. See also id. at 383-87; Goetz & Scott, 77 Colum. L. Rev. at 578-93 (arguing that many “penalty clauses” are designed to compensate damages or create efficient incentives that remain inscrutable to courts).

96 Of course this basic definition must be supplemented before it can be used in practice, taking account, for instance, of the distinction between Kaldor-Hicks superiority and Pareto superiority. See, e.g., Richard Posner, Economic Analysis of the Law 10-16 (6th ed. 2003) But the stripped-down, and therefore more general, definition suffices for analysis here.
compensatory second-order remedies cannot make a significant difference in the parties’ decision calculus. In many instances, they don’t create any incentives, much less efficient ones. Unlike other contractual duties, second-order duties work only if backed by extracompensatory damages; there is no more efficient alternative.

This is not to say that all extracompensatory remedies that target obstructive behavior are equally efficient. If the generic argument is correct, first-order damage multipliers have significant costs as compared to other first-order remedies. While a perfectly functioning dynamic multiplier provides excellent protection against obstructive behavior, that benefit is probably not worth the price in overall transaction efficiency. The generic argument says nothing, however, about the relative efficiency of second-order penalties or punitive damages, which are the only generally effective remedy for second-order breach.

This brings us to a second and separate question: whether the generic argument shows that extracompensatory remedies are likely to be more costly than one might otherwise think. I argued in Part I that a promisor who wants the transaction to happen but faces a reluctant promisee will offer to sweeten the pot with whatever term gives the promisee the most value at the least cost to the promisor.97 If an effective contractual duty not to obstruct requires a penalty or punitive damages to back it up, and if these remedies are more costly than they first appear, then perhaps promisors would not (or at least should not) choose them over other terms. But here too the generic argument does not go through wholesale.98

The second-order contract terms I’ve been discussing share four characteristics. First, compliance is generally cheap. The affirmative second-order duties I’ve described entail only minor administrative costs – keeping records, making reports and the like. And prohibitions on bad behavior, like falsifying records or hiding breach, cost less to perform than to breach, since it takes effort to engage in those bad acts.99 Second, because performance is cheap and the benefits (the promisee’s increased likelihood of recovery) are transaction-specific, it is unlikely that the promisor will later learn that the resources will create more value if invested elsewhere. That is, opportunity costs are minimal or nonexistent.

97 Supra at _____.
98 Aaron Edlin and Alan Schwartz have recently constructed a list of contexts where extracompensatory remedies can be efficient. Aaron S. Edlin & Alan Schwartz, Optimal Penalties in Contracts, 78 Chi.-Kent L. Rev. 33, 52-53 (2003). The argument that follows suggests that they should add second-order duties not obstruct to that list.
99 See Sanchirico, 10/05 draft at 18-27.
Third, in many cases the promisor, going into the transaction, fully expects that he will comply with the second-order duty. This is not only because of the low performance and opportunity costs, but also because many second-order duties are special examples of the general virtues of honesty and good faith – behaviors the promisor might be inclined to anyway. Finally, the promisee’s reliance on second-order performance is of a different sort from her first-order reliance. She relies not on sharing in extra-legal gains of trade, but on the vindication of a purely legal and distributive right – her right to be made whole in the case of first-order breach.

With these observations in hand, we can now return to the generic argument. Two pieces of it still apply. First, extracompensatory remedies can give the promisor an incentive to invest too much in second-order performance – ensuring that records and reports are accurate, that employees don’t hide errors, etc. Where second-order performance is relatively cheap, however, this extra cost will be minimal, and there is no a priori reason to expect it to outweigh the benefits for the transaction. Second, extracompensatory second-order remedies create the usual moral hazard: the promisee prefers breach to performance. Now one difference from first-order duties is that the promisee is likely to have less opportunity to interfere with or obstruct second-order performance. For example, neither recordkeeping nor truthful reporting requires promisee cooperation – each is entirely in the power of the promisor. But the prospect of a big payoff might still cause the promisee to falsely allege obstructive breach. How much the promisor will or should worry about this depends on the accuracy of adjudication – the chance that a false suit for second-order breach will succeed.

The other elements of the generic argument have much less force with respect to second-order extracompensatory remedies. If the promisor doesn’t expect to obstruct recovery and isn’t worried about false allegations of second-order breach, the extra liability costs him very little, meaning there are fewer costs to pass along. The result is likely to be positive for a risk-averse promisee. While she might pay marginally more for a second-order penalty or punitive damages clause, the extra assurance of first-order recovery is worth the price.\textsuperscript{100} Nor need we worry so much about promisee overreliance. While first-order reliance often involves transaction-specific investment in the value-creating activity, second-order

\textsuperscript{100}This is another way of putting the familiar observation that extracompensatory remedies can be cost-effective means of communicating a high probability of performance. See Posner, \textit{Economic Analysis of the Law} 128; Rea, 13 J. Leg. Stud. at 156-57.
reliance is simply reliance only on the vindication of the legal right to first-order damages for any breach. It’s difficult to see what would count as overreliance on the legally guaranteed right to be made whole.

Finally, and most significantly, second-order breaches are typically opportunistic. The most familiar economic downside of extracompensatory damages is the threat that they will prevent efficient breach. But not all breaches are efficient. A breach is opportunistic if it creates no value, but merely transfers wealth from the non-breaching to the breaching party.\(^{101}\) Opportunism not only creates no value, but the threat of opportunistic breach sucks resources from the transaction, as “potential opportunists and victims expend resources perpetrating and protecting against” it.\(^{102}\) Discouraging opportunistic breaches, therefore, is not just efficiency neutral, but represents a net gain in social welfare. As Richard Posner puts it, “if a promisor breaks his promise merely to take advantage of the vulnerability of the promisee . . . , we might as well throw the book at [him].”\(^{103}\)

Second-order breach is usually opportunistic. I’ve observed that compliance with the sorts of second-order duties I’ve been discussing is either cheap or free, both in terms of out-of-pocket expenses and opportunity costs. Consequently, second-order breach is far less likely than first-order breach to result in efficient cost-savings – savings that are greater than the benefit to the promisee, which is her ability to recover damages due her on a first-order breach. That is, second-order breaches are typically opportunistic – the promisor’s attempt to get what she doesn’t deserve. Deterring such opportunism with extracompensatory damages can therefore represent a net gain for the parties.

As a general matter, then, attaching penalties, punitive damages and other extracompensatory remedies to obstructive breach does not cause the same efficiency losses as attaching them to first-order breach. Where the parties have specified such remedies in their contract, it is

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\(^{102}\) Muris, 65 Minn. L. Rev. at 524; see also Dodge, 48 Duke L.J. at 654-62 (arguing that punitive damages for opportunistic breach result in greater efficiency).

\(^{103}\) Posner, Economic Analysis of the Law at 118.
probably because the gains outweigh the costs. Obstructive breach is a well-defined category of opportunistic breach, one that can be singled out for permitting extracompensatory remedy without threatening the efficiency of contract law as a whole.\textsuperscript{104}

There is one more consideration to take into account before finishing with efficiency. Chris Sanchirico has recently identified a commonly overlooked cost of penalizing second-order activities like obstruction of recovery: The higher the penalty for attempts to avoid detection of a wrong, the greater the wrongdoer’s incentive to take additional steps to hide his attempts to avoid detection.\textsuperscript{105} This fact has two negative efficiency implications. Sanchirico emphasizes that the resources expended on detection avoidance are “[f]rom a societal perspective . . . is a deadweight loss.”\textsuperscript{106} More generally, increasing the penalty for detection avoidance will be ineffective if that penalty does not deter the bad behavior, but instead results in successful efforts to avoid detection of the detection avoidance. Sanchirico concludes that detection avoidance can be more efficiently prevented not by punishing it, but with technological solutions – such as increased monitoring, exploiting cognitive shortcomings of avoiders, and using defection incentives to destabilize cooperative avoidance schemes – that make detection avoidance less effective and more costly.

While they don’t map perfectly on to one another, my category of obstruction of recovery is very much like Sanchirico’s category of detection avoidance.\textsuperscript{107} If Sanchirico’s analysis is correct,

\begin{footnotesize}
\begin{enumerate}
\item[104] Others have suggested that permitting penalty clauses for opportunistic breach only, though they have proposed different tests for distinguishing opportunistic from efficient breach. See Dodge, 48 Duke L.J. at 633 n.14 (listing authors who support punitive damages for opportunistic breach). And this is not the only way courts might limit the application of punitive damages. See, e.g., Nicholas Johnson, The Boundaries of Extracompensatory Relief for Abusive Breach of Contract, 33 Conn. L. Rev. 181, 183 (2000) (“[R]ules punishing abusive breach with extracompensatory relief are indeed viable so long as their impact is limited to subcategories that are conceptually and practically severable from the general pool of transactions.”); Dodge, 48 Duke L.J. at 651-98 (recommending punitive damages for willful, as opposed to involuntary, breach). The above argument differs from all these approaches in that it does not propounding a general rule for when punitive damages are appropriate, but simply identifies one category of breach for which they may be called for.
\item[105] Chris William Sanchirico, Detection Avoidance [SSRN].
\item[106] Sanchirico, 10/05 draft at 6; see also id. at 18-27 (describing costs of detection avoidance).
\item[107] Sanchirico is mainly interested in criminal and regulatory sanctions. As a result, he focuses on how to prevent attempts to avoid punitive first-order sanctions, a problem with a different structure than trying to prevent attempts to avoid compensatory damages.
\end{enumerate}
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extracompensatory remedies for obstructive breach have an inefficiency all their own. Penalizing attempts to obstruct recovery might not deter obstruction, but result instead in expenditures to obstruct recovery for the obstruction of recovery, and then attempts to obstruct any recovery for that obstruction, and so on. Extracompensatory remedies for second-order breach should therefore be eschewed, both by the parties and by the law.

Sanchirico’s argument, however, does not take account of the fact that it becomes exponentially more difficult to avoid detection as one moves up the ladder. Fabrications become more complex and less plausible; the points of possible detection increase; the wrongdoer has fewer resources and options moving forward. A web of lies is less stable than a single lie, and the more extended and extensive the cover up, the more costly and precarious it becomes. While in some cases penalties might make it worth investing to hide one’s detection avoidance, rarely will it be worth investing significant additional resources to hide those investments. In many circumstances, even the first step won’t be worth the effort. Finally, all this is especially likely to be true where the parties have chosen to penalize obstruction. That choice is evidence that the second-order extracompensatory remedy will not cause the sort of waste – the diversion of resources to avoiding detection that might be more productively used elsewhere – Sanchirico is worried about. Such efforts shrink the joint gains of trade, a result that neither party wants.

The relevant efficiency considerations can be summarized as follows. The generic economic argument against penalties and punitive

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108 The “… and so on” in he above formulation leads Sanchirico to make an additional, more ambitious claim: that the incentive-structure of penalizing detection avoidance results in a bad infinite regress.

[W]hen we punish people more for the underlying offenses, we encourage offenders to lie. If we try to solve this problem by punishing more for lying, we encourage liars to expend more effort covering up their lies. If we try to solve this problem by increasing the punishment for covering up lies, we encourage the cover up of the cover up of lying. . . . And so on.

Sanchirico, 10/05 draft at 35. But this is almost surely false. As Sanchirico recognizes, the infinite regress appears only if the incentive structure of penalizing detection avoidance is recursive. A series is recursive, however, only if its definition applies the same function to each item in the series to arrive at the next. The incentives to engage in detection avoidance vary from one level to the next. A wrongdoer’s reasons to engage in n+1-level detection avoidance depend not only on the penalty for n-level detection avoidance, but also on the out-of-pocket cost of n+1 level detection avoidance, its chances of success, and its probability of detection. The latter factors vary stochastically from one level to the next, depending on the context. There is no a priori reason to think that there won’t be some level of detection avoidance where the next higher level will, as a factual matter, be so difficult that it won’t be worth the cost (perhaps even without a higher-order penalty) putting an end to the regress.
damages presupposes a more efficient damage measure. Because second-order duties not to obstruct make a practical difference only when backed by extracompensatory remedies, the generic argument does apply to them. Nor are extracompensatory remedies as expensive when applied to second-order duties as when they are when applied to first-order obligations. This is especially so because obstructive breach constitutes a well defined category of generally opportunistic, and therefore inefficient, behavior. Finally, where the parties have chosen to penalize obstruction, in all likelihood those penalties will not cause wasteful efforts at higher-level detection avoidance or obstruction.

**B. Application: Rereading Seaman’s Direct Buying Services v. Standard Oil**

These conclusions shed new light on California’s brief experiment with punitive damages for post-breach bad faith behavior. In 1984, the California Supreme Court held in *Seaman’s Direct Buying Service v. Standard Oil Co.* that “a party to a contract may incur tort remedies [“including punitive damages”] when, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists.”\(^{109}\) That is, punitive damages could be assessed in tort for certain post-breach denials that the contract existed. Seaman’s sowed a fair amount of confusion in California’s intermediate appellate courts, which arrived at a variety of standards for determining when post-breach behavior was so wrongful as to constitute the tort.\(^{110}\) Eleven years later, the California Supreme Court, citing among other things the greater efficiency of compensatory damages, expressly overruled Seaman’s and abandoned the experiment.\(^{111}\)

Much of the contemporary criticism of Seaman’s was based on the assumption that its narrow holding might be a first step toward the wider tortification of bad faith breach. Some of this resulted from the case’s

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\(^{110}\) For surveys of the variety of lower-court interpretations of Seaman’s, see, e.g., Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669, ____ (Cal. 1995); Dana Rae Landsdorf, Note, California’s Detortification of Contract Law: Is the Seaman’s Tort Dead?, 26 Loy. L.A.L. Rev. 213, 222-235 (1992). The furthest extension of Seaman’s by the lower courts appears to have been in Koehrer v. Superior Court, 226 Cal.Rptr. 820 (Cal.App. 3d, 1986), which “extend[ed] Seaman’s to bad faith attempt to deprive employee of contractual benefits.” Freeman & Mills, 900 P.2d at 675.

\(^{111}\) Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669, 676-77 (Cal. 1995). Dodge argues that the real turning point was as early as 1988, when the California Supreme Court declined to extend Seaman’s to employment contracts. Dodge, 48 Duke L.J. at 642 (discussing Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988)).
procedural history. The plaintiff had asked the Supreme Court to recognize the broader tort of bad faith breach, extending the rule from the insurance context to commercial claims in general. Chief Justice Bird, in a partial concurrence, said he would have held that “[a] breach of contract may also constitute a tortuous breach of the covenant of good faith and fair dealing in a situation where the possibility that the contract will be breached is not accepted or reasonably expected by the parties.”112 And, while the majority declined to rule on those grounds, it did not exclude the possibility of recognizing such a tort in a later case.113 Commentators thus read Seaman’s as representing more than it said – as putting California on the road to a broad tort of bad faith breach.114 That reading was amplified by the fact that contort was in the air in the mid-80s, and by the perception in some corners that there was a need to prevent further erosion of the principles of freedom of contract.115

Whether or not Seaman’s was part of a larger trend, what it said was relatively narrow: Tort damages are appropriate where “a contracting party seek[s] to avoid all liability on a meritorious contract claim by adopting a ‘stonewall’ position (‘see you in court’) without probable cause and with no belief in the existence of a defense.”116 Stonewalling of this

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112 686 P.2d at 1174. Chief Justice Bird further explained:

This could happen, for example, if at the time of contracting, the parties expressly indicate their understanding that a breach would be impermissible. Or, it could happen if it were clear from the inception of the contract that contract damages would be unavailable or would be inadequate compensation for a breach. Under these circumstances, a breach of the contract could well constitute a tortious breach of the duty of good faith and fair dealing.

Id.

113 686 P.2d at 1167.

114 See, e.g., Bridgman, 56 Vand. L. Rev. at 270-71 (2003); Dodge, 48 Duke L.J. at 638 n. 33; Frank J. Cavico, Jr., Punitive Damages for Breach of Contract – A Principled Approach, 22 St. Mary’s L.J. 357, 422 (“[T]he court's recognition of a tort of bad faith denial of contract engendered a theoretically limited but a practically expansive construction of a bad faith tort in the commercial context. . . . Although the Seaman's court did not explicitly recognize the tortious breach of the implied covenant in commercial cases, the court did very little to deny its applicability.”) (1990); E. Allan Farnsworth, Developments in Contract Law During the 1980’s: The Top Ten, 41 Case W. Res. L. Rev. 203, 205 (1990) (noting the potentially expansive language in Seaman’s); Freedman, 18 J. Leg. Stud. at 19 n.62 (1989); Sandra Chutorian, Note, Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm, 86 Colum. L. Rev. 377, 387-89 (1986).


116 686 P.2d at 1167.
sort is, in my terms, a species of obstruction of recovery, and the Seaman’s holding can be supported by many of the above arguments for permitting the parties to adopt extracompensatory remedies for obstructive breach. Thus court-assessed compensatory damages alone neither insure against nor deter the sort of stonewalling at issue in Seaman’s. Punitive damages, such as those available in tort, are necessary. And because stonewalling is purely opportunistic, or economically unproductive, punitive damages don’t threaten efficiency in the way they might elsewhere in contract law. Finally, where there is a measure of distrust and uncertainty going into a deal, the parties themselves might rationally prefer Seaman’s protection. A promisee who knows that the promisor faces a significant deterrent against unreasonably denying the existence of the contract knows she is more likely to recover in the case of nonperformance, and will therefore be more willing to enter into the transaction.

This does not mean that California should have kept the Seaman’s rule, which suffered from serious defects. To begin with, the experience of lower courts shows that the Seaman’s opinion failed to define the wrong with sufficient precision. The predictable result was that the threat of punitive damages deterred defendants from raising legitimate defenses and caused plaintiffs to over-litigate minor claims in the hopes of big payoffs. The California Supreme Court might have tried to fix this problem by clarifying the definition of “stonewalling” and by limiting it to highly verifiable behavior, so as to exclude both discretion and false positives. But replacing the “in bad faith and without probable cause” standard with a narrower rule would have robbed the Seaman’s rule of much of its utility. Because post-breach bad behavior comes in endless varieties, narrow or inflexible definitions invite circumvention and will be of limited effect.

Which brings us to the deeper problem with the Seaman’s approach: Like Robinson Helicopter, Seaman’s addressed obstruction of

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117 Michael Dorff is therefore wrong when, in criticizing the application of punitive damages in Seaman’s, he states that “the consequences of denying the contract’s existence would be virtually identical to the consequences of any other complete contract breach, and the parties would be expected to negotiate about the risks of a complete breach.” Dorf, 28 Seton Hall L. Rev. at 423.

118 See supra n.110.

119 See Oki Am., Inc. v. Microtech Int’l, Inc., 872 F.2d 312, 315 (9th Cir. 1989) (Kozinski, J., concurring) (“Seaman’s throws kerosene on the litigation bonfire by holding the allure of punitive damages, a golden carrot that entices into court parties who might otherwise be inclined to resolve their differences.”); Lynch & Freytag v. Cooper, 267 Cal. Rptr. 189, 195-96 (2d App. Dist. 1990) (suggesting that minor contract action was litigated overzealously due to the “allure of punitive damages”).
recovery under the rubric of torts. As a result, the court had no choice but to base the rule on its own understanding of “accepted notions of business ethics,” ignoring the industry- and context-dependence of such norms. More importantly, why should courts attempt to fashion generic anti-obstruction rules when the parties, if given the tools, could generate rules to fit their particular needs and circumstances? Tort law can provide at best a one-size-fits-all rule. The better approach to obstruction of recovery lies within the contractual framework. The parties to a transaction know best what specific promisor duties will increase the probability of performance. If they want to prohibit stonewalling or other forms of obstruction, let them specify both the relevant duty and the remedy for its breach.

V. Conclusion

The discussion in this paper has been fairly abstract, but its conclusions are of more than academic interest. Consider the Department of Defense’s two contracts with Halliburton subsidiary KBR to restore Iraqi oil infrastructure, known as “RIO” and “RIO 2”. A recent House Minority report concluded that KBR has significantly underperformed on both contracts. More importantly, it found that KBR “leadership demonstrated minimal cooperative attitudes in resolving problems,” refusing to allow the government access to information that would verify its level of performance. These findings were echoed in a *New York Times* piece on KBR’s RIO 2 attempts to drill a pipeline under the Tigris River. Early in the project, according to the *Times*, KBR learned that geological conditions would likely prevent its successful performance.

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120 In fact, the *Seaman’s* court recognized the parties’ ability “to shape the contours of their agreement and to include provisions for attorney fees and liquidated damages in the event of breach . . . [and their freedom] within reasonable limits at least, to agree upon the standards by which application of the covenant [of good faith] is to be measured.” 686 P.2d at ___. While allowing that the availability of party choice counseled caution in applying tort remedies in the contract setting, the court did not discuss whether parties might opt-out of or contractually modify the *Seaman’s* tort.

121 686 P.2d at 1167.

122 *See generally* Halliburton’s Performance Under the Restore Iraq Oil 2 Contract, U.S House of Representatives Committee on Government Reform – Minority Staff, Special Investigations Division (March 28, 2006).


KBR, which was charging the government on a cost-plus basis, did not inform the Department of Defense of its probable nonperformance, but continued work and even took steps to hide the difficulties it was encountering.\(^{125}\)

Whether or not these reports are accurate (KBR probably denies wrongdoing), they illustrate why parties might want to write into their contract second-order duties to assist in recovery for first-order breach. The RIO contracts include the statutory terms I described in the introduction, requiring KBR to permit audits and other examination of records.\(^{126}\) But ensuring performance and recovery for breach might well require more: contractual duties to keep accurate records of work done, to cooperate in investigations of performance under the contracts, and, in case of the Tigris River project, immediately to report any information indicating that performance would not be possible. This Article has shown that such contractual duties must be backed by the threat of extracompensatory remedies if they are to be effective.

The above analysis recommends several possible reforms. The most general and effective would be to create an exception to the rules that now prevent parties from contracting for penalties and punitive damages, permitting parties to attach those remedies to the breach of second-order duties.\(^{127}\) Less generally effective, but still a step in the right direction, would be to clarify the availability of contractually specified adverse inferences conditioned on second-order breach. Finally within the contract-rule framework, courts should at least permit, absent contractual language to the contrary, compensatory damages for the additional litigation costs and prejudgment interest for the delays obstructive breach causes.

Courts or legislatures could allow parties to adopt some anti-obstructive measures even without changing the law of contract by clarifying that the economic loss doctrine and other obstacles to tort liability in the contract context do not apply to fraud. Minnesota’s

\(^{125}\) The Times quotes a senior Oil Ministry official, who “said he began hearing rumors from Iraqis in the ministry in Baghdad that something had gone terribly wrong, but the company itself seemed determined not to clarify what had happened. ‘We couldn’t get a good status report,’ Mr. Vogler said. ‘We kept asking for it . . . We couldn’t get one.’” Glanz at ___. The Army Corps of Engineers colonel in charge of the project told the Times that “KBR provided him with optimistic assessments nearly to the end of the line . . . and he was convinced that the project would be a success.” Glanz at ___.

\(^{126}\) 10 U.S.C. § 2313(b) & (c); see supra at 4.

\(^{127}\) Section 2313 stipulates that it is not to be read to require government contractors to keep any records other than those they would otherwise maintain in the normal course of business. 10 U.S.C. § 2313(c)(3).
codification of the economic loss doctrine specifies that the rule “shall not be interpreted to bar tort causes of action based upon fraud or fraudulent or intentional misrepresentation or limit remedies for those actions.”

This is the right rule, for it enables the parties to craft information-sharing contractual duties to increase the likelihood that, in the case of breach, recovery will be had.

I want to conclude by suggesting three questions that deserve further research. The first is an empirical hypothesis: This Article has considered only legal sanctions for breach of second-order contractual duties. In many contexts, breach of such a duty will be subject to extra-legal sanctions that are just as, or more, important to the parties. Most obviously, in long-term contractual relationships, second-order breach may permit one side to rescind the contract and end the relationship to the other party’s serious detriment. Alternatively, in some settings breach of a second-order duty may be subject to reputational and other extra-legal sanctions sufficient to incentivize performance. The central conclusion of this paper – that in many cases the parties want second-order duties, but that to be effective, such duties must be backed by extracompensatory remedies – suggests we should expect to find such contractual terms more often where extra-legal sanctions can step in to fill the gap created by rules against legal penalties and punitive damages – namely, in long-term relational contracts and closed industries where reputation matters.

Second, having argued that the law should permit the parties to choose extracompensatory remedies for second-order breach, I have not yet discussed whether extracompensatory remedies should ever be the default. The most generally effective default remedy for second-order breach would be punitive damages. But one can imagine less radical measures, such as the wider use of adverse inferences I’ve recommended. Determining the appropriate general default rule involves a variety of considerations, none of which are specific to the question of second-order duties, but would be worth exploring.

Lastly, my argument for permitting parties to specify extracompensatory remedies for obstructive breach has been a strictly economic one: second-order contractual duties backed by extracompensatory remedies chosen by the parties are likely to be efficient. I have not considered how such measures fare under any of the several nonconsequentialist theories of contract law, many of which have

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128 Minn. Stat. § 604.10(e); see Tourek, et. al, 84 Iowa L. Rev. at 927-38 (describing history of Minnesota statute).

their own arguments for the traditional prohibitions on extracompensatory contract remedies. In addition, second-order contractual duties may raise nonconsequentialist considerations all their own. Such terms not only protect the promisee’s entitlement to first-order damages, but also modify the way legal entitlements and sanctions get enforced. Whether to permit second-order contractual duties, therefore, depends in part on whether or to what extent private parties should be ceded the authority to determine the enforcement mechanisms that support the transaction structure of contract law – the answer to which turns on considerations of political authority and legitimacy that are special to this area of contract law.