ARTICLE

THE FAULT LINES IN CONTRACT DAMAGES

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INTRODUCTION

THE fundamental premise of most theories of contract damages has been that contract damage law is a "strict liability" system; that is, the reason the breach occurs does not matter in determining the measure of damages.¹ That premise is wrong. In fact, the reason the breach occurs has always influenced courts' determination of the proper measure of damages. And economic theory supports a damage regime that takes the reason for breach into account. I call such a damage regime "fault-based."²

¹ See, e.g., Globe Refining Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544, 547 (1903); E. Allan Farnsworth, Legal Remedies for Breach of Contract, 70 Colum. L. Rev. 1145, 1147 (1970) (arguing that "[i]n its essential design, . . . our system of remedies for breach of contract is one of strict liability and not of liability based on fault"); Restatement (Second) of Contracts ch. 16, introductory note (1979) ("‘Willful’ breaches have not been distinguished from other breaches."). It is possible to define "strict liability" to mean only that the plaintiff can recover for any "breach" regardless of the reason for the breach without requiring that the size of the recovery be independent of the reason for the breach. As I discuss below, contract theorists have used the strict liability idea in developing damage rules as well as in developing what I call "rules of liability."

² I use the term "fault" in this Article deliberately yet with some apprehension. I admit that the word is not a perfect choice. I use it for the following reasons. First, it is common to place "strict liability" in opposition to "fault" regimes in discussing liability rules in torts—both for economic and traditional scholars. My argument here is that the choice between strict liability and fault-based damage regimes in contract law turns on similar considerations. Second, as my title suggests, I use fault to refer to the fact that different damage measures result from underlying tensions in the contract terrain. Third, some economists have used "fault" to describe the failure of a party to take cost-justified precautions or to refrain from opportunistic behavior. See Readings in the Economics of Contract Law 52, 71, 72, 100, 127, 162, 187 (Victor P. Goldberg ed., 1989). Finally, I recognize that many imbue "fault" with a moral component. In my view, too often the moral approach to contract has been oversimplified in the maxim that "promises ought to be kept." See, e.g., Friedrich Kessler, Grant Gilmore & Anthony T. Kronman, Contracts: Cases & Materials 1131 (3d ed. 1986) ("In general there is an inarticulate feeling that,
Traditional theories have not questioned the strict liability view of contract damages because they have focused on the goal of compensating the victim of the breach. The goal of compensation implies strict damage liability because if damages are to be measured by the plaintiff’s loss, the reason for the breach must be irrelevant. But “compensation” is a term that is susceptible of various meanings. As all students of contracts know, Fuller and Perdue defined, and the Restatement enshrined, three compensatory “interests” that contract damages protect: expectation, restitution, and reliance. Although Fuller and Perdue taught us that the pursuit of compensation requires an important choice, they did not successfully teach us how to make it. If compensation can mean all these things, how do courts decide which damage measure to use?

Holmes to the contrary notwithstanding, there is something immoral about breaking a contract and that the wrongdoer should be, somehow, punished.”). A more nuanced morality-based approach would not necessarily be inconsistent with the approach developed in this Article.

3 To say that this is the “traditional” view is not to say it has enjoyed universal acceptance. The recognition that courts in fact do take fault into account in determining damages in both tort and contract cases can be traced back at least to Ralph S. Bauer, The Degree of Moral Fault as Affecting Defendant’s Liability, 81 U. Pa. L. Rev. 586 (1933) (discussing the role of fault in applying the certainty limitation in contract damages). Even Farnsworth acknowledges that courts often depart from the strict liability ideal. See Farnsworth, supra note 1, at 1146-47 & 1147 n.9.


5 See Restatement (Second) of Contracts § 344 (1979). The goal of the expectation interest is to put the promisee in the position he would have been in had the contract been performed. The goal of the reliance interest is to put the promisee in the position he would have been in if the contract had not been made. The goal of the restitution interest is to put the promisor in the position he would have been in had the contract not been made by restoring to the promisee any “benefit” conferred on the promisor.

6 As Avery Katz recently pointed out, Fuller and Perdue neglected a fourth possible “interest”: putting the promisor in the position he would have been in had the contract been performed. Avery Katz, Reflections on Fuller and Perdue’s The Reliance Interest in Contract Damages: A Positive Economic Framework, 21 J.L. Reform 541 (1988). Katz terms the missing remedy “liquidated specific performance.” Id. at 547.

7 Fuller and Perdue relied mostly on two explanations for the variety of damage measures: (1) ease of measurement, see Fuller & Perdue, Reliance 1, supra note 4, at 66 (emphasizing that courts always “have a natural preference for the rule of recovery which offers the most easily administered standard”); and (2) the closeness of the contract to the “credit system,” that is, to the “bilateral business agreement,” id. at 63; see also id. at 66 (arguing that we should expect to see courts using reliance rather than expectation...
Many traditional theories answer that there is and should be one predominant compensatory interest protected by contract remedies: that interest is expectation. These theories either minimize or marginalize the role for the reliance and restitution interests.

damages "as we progress away from the credit system" because the policies of protecting lost opportunity and encouraging reliance are weaker; Fuller & Perdue, Reliance 2, supra note 4, at 373 (arguing that "the complex of policies which dictates a judicial protection of the expectation interest is strongest in the case of a promise which forms part of a bargain or 'deal' and which has for its subject matter some economic value dealt with on an open market").

There are, however, hints in the articles that the choice among damage measures depends upon a "fault" determination. Throughout their discussion, they point out situations in which they argue courts do or should consider the "fault" of the promisor in deciding which remedy to use. See Fuller & Perdue, Reliance 1, supra note 4, at 77 (discussing the possibility of damages greater than expectancy in cases involving "particularly inexcusable breach"); id. at 87 (arguing that the Hadley v. Baxendale principle suggests liability for "misunderstanding" might be limited to reliance damages); Fuller & Perdue, Reliance 2, supra note 4, at 375 (noting that "wilfulness" is often relevant in application of "certainty" limitation); id. at 376 n.86 (arguing that the "new business" limitation on lost profits is in part explained by the fact that most suits concerning established business involve "tortious interference" claims); id. at 377 n.89 (noting that damages against vendor of real property who cannot make out good title may depend on whether vendor acts in "bad faith" or is otherwise "blameworthy"); id. at 410 (noting that the "degree of fault" is one "factor" considered in choosing between expectation and reliance damages for misrepresentation).

See, e.g., Restatement (Second) of Contracts § 344 cmt. a (1979) ("Ordinarily, when a court concludes that there has been a breach of contract, it enforces the broken promise by protecting the expectation that the injured party had when he made the contract."); id. § 347 cmt. a ("Contract damages are ordinarily based on the injured party's expectation interest . . ."); John D. Calamari & Joseph M. Perillo, The Law of Contracts § 14-4, at 592 (3d ed. 1987) ("Our legal system starts with the premise that the expectation interest of contracting parties deserves protection."); Farnsworth, supra note 1, at 1148-49. Several recent articles on contract damages have reasserted the primacy of expectation damages and attempted to minimize or eliminate the role of reliance and restitution damages. See Robert Birmingham, Notes on the Reliance Interest, 60 Wash. L. Rev. 217 (1985); E. Allan Farnsworth, Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract, 94 Yale L.J. 1339 (1985); Michael B. Kelly, The Phantom Reliance Interest in Contract Damages, 1992 Wis. L. Rev. 1755; Henry Mather, Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller, 92 Yale L.J. 14 (1982); W. David Slawson, The Role of Reliance in Contract Damages, 76 Cornell L. Rev. 197 (1990).

Other theorists have tried to argue that the predominant purpose of contract damages is or should be to compensate by protecting the reliance interest. See Fuller & Perdue, Reliance 1, supra note 4, at 57-66; Charles J. Goetz & Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L.J. 1261 (1980); Mark Pettit, Jr., Private Advantage & Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages, 38 Hastings L.J. 417 (1987). Still others have argued for the predominance of the restitution interest. See John P. Dawson, Restitution or Damages?
But these theories have never been satisfactory. Expectation theorists struggle to explain why, if protecting the expectation interest is the goal, contract damages so often undercompensate the expectation interest. Doctrines such as mitigation, foreseeability, and uncertainty, as well as the inability of the victim of the breach to recover attorney's fees or prejudgment interest at market rates, make contract damages undercompensatory from the perspective of the expectation interest. Expectation theorists also have trouble explaining why reliance and restitution measures are used at all. Their explanations of the plethora of damage measures have usually been based on doctrinal categories, measurement difficulties, or ad hoc adjustments.

20 Ohio St. L.J. 175, 186-87 (1959); Daniel Friedmann, Restitution of Benefits Obtained Through the Appropriation of Property or the Commission of a Wrong, 80 Colum. L. Rev. 504 (1980). One recent theory that takes a more pluralistic, noncompensatory approach to damages is Louis E. Wolcher, The Accommodation of Regret in Contract Remedies, 73 Iowa L. Rev. 797 (1988) (arguing that remedies accommodate regretted contracting by the promisor by undercompensating the expectation interest, and accommodate regretted reliance by the promisee by overcompensating the reliance and restitution interests).


See, e.g., Birmingham, supra note 8; Kelly, supra note 8. Birmingham suggests defining "contract" as those promises for the breach of which expectation damages provide the remedy and "tort" as those promises for which reliance damages provide the remedy. See Birmingham, supra note 8, at 227 ("[C]ontract' ties us into one pattern of inferences and 'tort' into another."); id. at 265 ("Contract would appear more obviously alive (but less imperialistic) if we would define it in terms of the expectation interest and leave relied-on promises alone."). Whatever the merits of this proposal, it does not describe what courts in fact do.

See, e.g., Calamari & Perillo, supra note 8, § 14-9; Birmingham, supra note 8; Kelly, supra note 8. I find to be true of contract damage law what Professor Levmore found in his study of various aspects of restitution law, namely that "valuation difficulties" are an unsatisfactory explanation. Saul Levmore, Explaining Restitution, 71 Va. L. Rev. 65, 69-72 (1985).

In a recent attempt by an expectation theorist to explain away these doctrines, Professor Kelly argues: "To some extent, one can assert inconsistencies between the expectation interest and some limitations on contract damages, such as the avoidable consequences and foreseeability doctrines. These limitations, however, represent refinements of the expectation interest, not exceptions to it." Kelly, supra note 8, at 1765 n.39 (emphasis added). Farnsworth refers to "principles" that compete with the compensation principle. Farnsworth, supra note 8, at 1373-77 (discussing "mitigation principle" and "reciprocity principle" in the context of market damages).
Not only have traditional scholars accepted the strict liability view of contract damages, but the most famous, and infamous, economic theory of contract damages—the theory of efficient breach—implicitly accepts the strict liability premise in offering a justification for the expectation damage measure.\textsuperscript{14} Strict liability in the efficient breach theory is not, however, a consequence of a particular definition of compensation; rather, strict liability grows out of the theory's commitment to limited court involvement in contract damage determination.\textsuperscript{15} The beauty of the pure efficient breach theory is that a uniformly applied rule of expectation damages avoids costly court determinations of the nature of a particular breach, that is, whether a particular breach is efficient or inefficient. The reason is that a uniformly applied expectation damage remedy results in the occurrence of efficient, and only efficient, breaches with minimal court involvement. Inefficient breaches are deterred because the party contemplating breach knows that it cannot make more from breaching and paying damages than it can from performing. Efficient breaches are not deterred because the party contemplating breach knows that it can compensate the promisee fully and still be better off by breaching. The court's role with respect to damages is minimized: its only responsibility is to determine whether a contract has been made, whether a breach has occurred, and what the expectation damages are.

\textsuperscript{14} See A.M. Polinsky, An Introduction to Law and Economics 33 (2d ed. 1989) (noting that "the expectation remedy is the only remedy that creates efficient incentives with respect to breaches of contracts"); Robert L. Birmingham, Breach of Contract, Damage Measures, and Economic Efficiency, 24 Rutgers L. Rev. 273, 275, 292 (1970). The theory has also been used to compare expectation damages with specific performance.

\textsuperscript{15} See Scott E. Masten, Equity, Opportunism, and the Design of Contractual Relations, 144 J. Inst'l & Theoretical Econ. 180, 184 (1988) (arguing that the efficient breach theory assumes that the costs of courts determining whether a breach has occurred and the amount of damages are low compared to costs of renegotiation or court determination of fault). Polinsky, for example, assumes that it is reasonable for the promisor to bypass bargaining and unilaterally breach because under the alternative assumption of costless renegotiation every remedy is efficient. See Polinsky, supra note 14, at 31. Another possible assumption, however, could be that sometimes bargaining bypass is reasonable and sometimes it is not, and a court can differentiate those two situations at reasonably low cost. Polinsky's unstated assumption is that courts cannot do this.
The efficient breach theory has enjoyed surprisingly wide acceptance by such traditional scholars as Professors Farnsworth\(^\text{16}\) and Eisenberg\(^\text{17}\) as well as the *Restatement (Second) of Contracts*.\(^\text{18}\) I would attribute this acceptance not only to the theory's strong defense of the expectation damage measure as the primary measure in contract law, but also to the theory's grounding in the traditional notion of a strict liability approach to contract damages.

The problem is that although the theory of efficient breach purports to explain why courts use expectation damages rather than reliance, restitution, or punitive damages for breach of contract, it fails as an explanatory or positive theory. It does not explain when courts *actually use* expectation damages or some other measure in a particular case.\(^\text{19}\) Although law and economics scholars have long recognized that efficient breach is only one component of an economic theory of contract damages, until now no one has offered a broader theory because no one has been willing to give up on strict liability. No economic theory has attempted to explain in a systematic way how courts actually do and should go about choosing among all the different damage measures available.

This Article attempts to fill that gap by rejecting the strict liability idea and developing instead a fault-based economic theory of contract damages that accurately describes the system we actually

\(^{16}\) Farnsworth may have even recently tried—unsuccessfully it appears—to export the efficient breach idea into the international sphere. In discussing the draft of the recently proposed UNIDROIT, Principles for International Commercial Contracts, Farnsworth notes:

> Proposals based, for example, on the law-and-economics notion of efficient breach are not likely to be warmly received. (For the benefit of any American guests who should wander into our deliberations, we might well post a sign requiring that before entering one check at the door one's six shooter and one's copy of Richard Posner's book.)


\(^{18}\) See Restatement (Second) of Contracts ch. 16, introductory note and accompanying reporter's note (1979).

\(^{19}\) The theory, therefore, does not meet what Paul Samuelson has called the "first duty of an economist," which is "to describe correctly what is out there: a valid description without a deeper explanation is worth a thousand times more than a clever explanation of nonexistent facts." Paul A. Samuelson, A Brief Survey of Post-Keynesian Developments, in Keynes' General Theory: Reports of Three Decades 331, 340 (Robert Lekachman ed., 1964).
have, and normatively justifies this system as one that operates to promote efficient contracting behavior. My goals in the Article are threefold: to explain why courts have developed such a variety of contract damage measures, to understand the predominance of the expectation measure, and to connect the market damage measure to the general theory of contract damages.

The Article starts from the economic premises that all rules of contract law create incentives and that courts use different rules in different situations to encourage desirable and discourage undesirable conduct. Contract damage rules are but a subset of all contract rules: they provide one way, though not the only way, for courts to affect contracting behavior. I argue that developing damage rules that create the right incentives for both parties requires an understanding of why contracts are breached. I define and explain three broad categories of breaches: contracts that should not have been made, contracts that should not be performed, and contracts that should not have been breached. I argue that courts tend to use larger damage measures, such as expectation and high-restitution, to deter promisors from breaching contracts that should be performed, as well as from acting opportunistically in breaching other contracts. Courts tend to use smaller damage measures, such as reliance and low-restitution, to deter promisors from making accidental contracts that should not have been made, and to encourage promisors to take precautions against accidental contingencies that result in contracts that should not be performed. Use of these smaller damage measures also ensures that courts avoid overdetering promisemaking or encouraging excessive precaution-taking. Courts also use various doctrines that reduce expectation and reliance damage awards to give promisees incentives to take precautions and mitigate. The theory also explains the centrality of the market damage measure to contract law, the rela-

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20 I shall use the term "high-restitution" to refer to any restitution damage measure that exceeds expectation damages. I shall use the term "low-restitution" to refer to any restitution damage measure that is lower than reliance damages. I use these terms to highlight the fact that "restitution" means different things in different contexts.

21 Throughout this Article I will follow the convention of using "promisor" to refer to the breaching party (the defendant), and "promisee" to refer to the nonbreaching party (the plaintiff).
tionship of that measure to the strict liability ideal, and the limits of strict liability in the market context.

I use case examples throughout to show that courts are in fact using different damage measures in ways that the fault-based theory explains better than the extant alternatives. Although many may wonder how courts can do what I suggest they should do, my answer is that they are already doing it. That does not mean that I believe courts always get it right; in fact, I discuss several cases with which I disagree. But by and large, the doctrinal contours of contract damages are explainable by the theory outlined here. Moreover, discussing cases that I think courts could have handled better helps demonstrate the usefulness of the theory. Courts always do better when they have a better idea of what it is that they should be looking for. So far, contract theorists have not provided much practical help. Unless an alternative theory based on strict liability can better explain the contract damage law we in fact have, the onus is on the proponents of strict liability to show why the law as it has developed is so misguided that we should abandon the system we have, and to show how an alternative system would work better.

I. Damage Rules as Part of an Economic Approach to Contract Law

The economic approach to contract law aims to identify and justify rules that minimize the joint costs, or equivalently, maximize the joint profits of contracting. All contract law rules create incentives; the economic approach focuses on the question of what incentives these rules do and should create. Such an analysis requires an understanding of why contracts fail and what steps both contracting parties can take to facilitate successful contracts and prevent or reduce the costs of failed contracts. After describing the general economic approach to contract damages, this Part will discuss three categories of contract breach: contracts that should not have been made, contracts that should not be per-

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22 See, e.g., Charles J. Goetz & Robert E. Scott, The Mitigation Principle: Toward a General Theory of Contractual Obligation, 69 Va. L. Rev. 967, 973 (1983) (defining the mitigation principle to mean that each contractor should “extend whatever efforts in sharing information and undertaking subsequent adaptations that are necessary to minimize the joint costs of all readjustment contingencies”).
formed, and contracts that should not have been breached. These Sections form the building blocks for a theory of how contract damage rules are and should be used to create optimal incentives in different breach situations.

A. Using Damage Rules To Create Optimal Incentives

Contract damage rules are but a subset of all contract rules; thus, the same type of economic analysis applies. Both the promisor and the promisee can take various actions to reduce the size or likelihood of the loss from contract failures. Steps taken before the contract is entered into, or before the occurrence of a "regret contingency," are "precautions." Promisor precautions include promising less and more closely monitoring performance effort; promisee precautions include tempering reliance. Steps taken to reduce the potential loss after the regret contingency occurs are acts of "mitigation." Promisor mitigation includes repairing or replacing defective performance as well as refraining from

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23 See Goetz & Scott, supra note 9, at 1273 (defining regret contingency as a "future occurrence of a condition that would motivate breach if breach were a costless option for the promisor"). I distinguish between the time of making the contract and the time the regret contingency occurs merely to highlight the fact that the making of the contract itself could be a regret contingency. I have elsewhere referred to actions taken previously to either time as actions taken "ex ante." George M. Cohen, The Negligence-Opportunism Tradeoff in Contract Law, 20 Hofstra L. Rev. 941, 952 n.41 (1992).

24 Cooter defines "precaution" more broadly as "any action that reduces harm." Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. Rev. 1, 3 (1985). He lumps "mitigation" together with "precaution" because "[m]athematically, mitigation and restrained reliance are identical but for time," id. at 16 n.36, though he argues that the rules for dealing with mitigation are different because it is easier to determine whether mitigation is reasonable than whether reliance precautions are reasonable, see id. at 32 n.70. In my view, precaution and mitigation are different in a more fundamental way: they have different implications for the optimal damage measure. Cooter would not necessarily disagree, because he recognizes that "[a] complete account of the incentive effects of contract law" would include a fuller consideration of mitigation. See id. at 12 n.27.

25 See id. at 11. Tempering reliance includes actions to "keep other options open," not simply those that lower "reliance"-type investments. Other precautions include what Goetz and Scott call "quality precautions," which are conditions on promises made, and "reassurances," which are value-enhancing actions such as guarantees and investments in reputation. See Goetz & Scott, supra note 9, at 1274.

26 Goetz and Scott use the term "readjustment contingency" to refer to a regret contingency for which "mutual cooperation can reduce the expected losses." Goetz & Scott, supra note 22, at 972 n.15. For my purposes, I find it more useful to stick to the broader term.
breach;\textsuperscript{27} promisee mitigation includes finding substitute contracting partners.\textsuperscript{28}

Contract damage rules affect the incentives of the parties to take these actions. Other things equal, a higher damage measure will lead the promisor to take more precautions and mitigation steps but will lead the promisee to take fewer precautions and mitigation steps. A lower damage measure will have the opposite effect. Thus, the fundamental problem for the economic approach to contract damages is to identify how to reduce the costs associated with the apparently inevitable tradeoff between optimal promisor conduct and optimal promisee conduct.\textsuperscript{29}

Manipulating damage rules is one of only two general ways to resolve this tradeoff and create optimal incentives for both parties. The alternative, and complementary, way is to manipulate what may broadly be termed "rules of liability."\textsuperscript{30} Rules of liability in contract law include formation rules, which determine whether a valid contract has been made, such as the doctrines of offer, acceptance, consideration, capacity, and the Statute of Frauds; breach rules, which determine whether a valid contract has been breached,
such as the doctrines of interpretation, conditions, and warranties; mitigation rules, which determine which party should mitigate losses, such as the doctrines of acceptance, rejection, and cure in sales of goods; and excuse rules, which determine whether performance is excused, such as the doctrines of mistake, impossibility, and frustration. Economists have recognized that "fault-based" rules of liability can provide optimal incentives to both parties if the standard of conduct that triggers liability is set correctly. The reason is that these rules make at least one party’s liability depend on its level of precaution-taking, and because that party has an incentive to take the precautions to avoid liability, the other party has an incentive to take precautions to avoid the residual loss. For example, if two parties are negotiating a contract and one engages in conduct that suggests to the other an intention to contract, a court could deem that the contract has been formed even if the promisor did not "subjectively" intend to contract. Such a formation rule, the objective theory of contract, encourages promisors to take cost-justified precautions of refraining from such conduct by imposing contractual liability. The rule also encourages promisees to take cost-justified precautions of not relying too much on preliminary negotiations, because as long as the promisor behaves reasonably, no unintended contract will be deemed to be formed and the promisee will bear the full loss of any unconsummated deal.

But whereas economists have recognized the advantage of a fault-based system for contract rules of liability, they often have not applied the same analysis to contract damage rules. Rules of liability are generally all-or-nothing rules; damage rules are generally loss-splitting rules. A system of fault-based damage rules gives optimal incentives to both parties by adjusting the level of damages

31 See Goetz & Scott, supra note 22.
32 This theory is developed at length in Cooter, supra note 24, at 7, but the idea dates back to John P. Brown, Toward an Economic Theory of Liability, 2 J. Legal Stud. 323 (1973). Cooter discusses fault rules of liability as tort law's solution to the paradox of compensation. The negligence rule is one fault-based rule of liability in tort; strict liability with contributory negligence is another.
33 The contract example Cooter uses has to do with breach rather than formation: if contract law adopted a negligence-type rule of breach, the promisee would have to prove that the promisor's breach was somehow "unreasonable" as a precondition to recovering damages. See Cooter, supra note 24, at 31.
awarded. In the example above, suppose a court suspects that both the promisor and the promisee acted unreasonably: the promisor acted as if it wanted to contract, and the promisee made overly hasty reliance investments. Although a fault-based rule of liability provides the correct incentives for similarly situated parties in the future,\(^3\) the court could instead simply adopt a “strict” rule of liability, find that a contract was formed and breached, and reduce the promisee’s recovery by the amount of loss the promisee could have avoided by reasonably restraining its reliance. Such an adjustment to the measure of recovery is what I call a fault-based damage rule.\(^3\)

Courts can thus use fault-based rules of liability, fault-based rules of damages, or both to provide optimal incentives to contracting parties.\(^3\) But they must use fault rules somewhere in the system; that is, the contract law regime as a whole cannot be a strict liability system.\(^3\)

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\(^3\) Under a negligence rule, the promisor would pay full damages; under a contributory negligence rule, the promisee would recover nothing. But both rules would create optimal incentives for future behavior because both rules give at least one party the incentive to behave nonnegligently to avoid court-imposed liability, and the other party, recognizing the first party’s incentive, has the incentive to behave nonnegligently as well to minimize the residual losses. See Cooter, supra note 24, at 31-32.

\(^3\) A fault-based damage rule in tort law is the doctrine of “avoidable consequences,” which reduces damages by the amount the plaintiff could reasonably have mitigated. See W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, Prosser and Keeton on the Law of Torts § 65, at 458-59 (5th ed. 1984) (viewing the doctrine as a form of contributory negligence). Comparative negligence is another fault-based damage rule in tort law, despite the fact that it sounds like a rule of liability.

\(^3\) The same is true in tort as well as contract, as the authors of the leading hornbook recognize. See id. (suggesting that the doctrines of contributory negligence and avoidable consequences are “in reality the same” because both doctrines “rest upon the same fundamental policy of making recovery depend upon the plaintiff’s proper care for the protection of his own interests”).

\(^3\) See Cohen, supra note 23, at 965-66. Professor Cooter seems to ignore this point in his otherwise illuminating and closely reasoned article on which this Section heavily relies. He identifies the “fault rule” of torts and the “invariant damages” rule of contracts as two separate ways of resolving his “paradox of compensation.” See Cooter, supra note 24, at 28. In fact, however, the invariant damages rule is optimal, as Cooter at one point recognizes, only when the damages are set equal to the loss that the promisee incurs when it undertakes optimal precautions, that is, only when the damage rule is in fact a “fault” rule. See id. at 14. Cooter does not make this connection because he focuses on a liquidated damage clause agreed to by the parties rather than on a default damage rule set by the court. And when he shifts to discussing court damage rules, he ignores the possibility of courts making fault determinations in setting damage rules. See id. at 15-16.
"strictly" in the sense that they do not take into account all of the relevant conduct that courts want to encourage or discourage, then courts must use fault-based damage rules to provide optimal incentives. Although contract law has many fault-based rules of liability, it has always applied some rules of liability strictly. For example, the promisee generally need not, as a condition for recovering damages, prove that the promisor could have taken some cost-effective action to avoid or reduce the loss caused by the breach. The questions of whether and when to use fault-based rules of liability instead of, or in addition to, fault-based damage rules are important and interesting, but they are not my main con-
My point is that courts in fact use fault-based damage rules in many cases, and that this is a good thing from the perspective of economic analysis, at least where contract rules of liability are strictly applied.

B. Classifying Contract Breaches

If fault-based damage rules are and should be used at least some of the time, the next question is how courts should make the damage adjustment. Because damage rules come into play only when promisors breach contracts, the answer to this question requires an understanding of why promisors breach contracts. Promisors breach contracts for many reasons, but one can usefully divide contract breaches into three broad categories: contracts that should not have been made, contracts that should not be performed, and contracts that should not have been breached.

To sort out these categories, I will use the economic concept of joint profitability. Jointly profitable contracts are those for which the value of performance to the "paying party" exceeds the cost of

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41 In some cases, courts may not in fact choose between using fault-based rules of liability and fault-based damage rules, though they may use different doctrinal rubrics to discuss the case. For example, a court could say that the contract is breached and award reliance damages, Restatement (Second) of Contracts § 349 (1979), or a court could say that performance of the contract is excused, but nevertheless award reliance damages, cf. id. § 272(2) (allowing court to grant reliance damages together with "relief on such terms as justice requires"). From an economic perspective, it is not clear what difference this makes. In cases in which courts actually choose to use a fault-based rule of liability instead of a fault-based damage rule, courts may focus on distributional concerns, because a liability rule is all-or-nothing and a damage rule is loss-splitting. Alternatively, courts may choose based on the desire to minimize error costs: a fault-based rule of liability increases the cost of court error in setting the liability standard, whereas a strict rule of liability combined with a fault-based damage rule increases the cost of court error in setting the damages. See Cooter, supra note 24, at 33-35. The greater the discrepancy in undesirable conduct of the two parties, that is, the more confident the court is in its liability judgment, the more likely it will be to use a fault-based rule of liability.

42 As basic as this idea is to contract damage law, I have always been amazed at how little it is emphasized in both traditional and economic theories. One might speculate that this failure stems in part from the oddity that we label the subject "contracts" rather than "breaches," unlike "torts" and "crimes," which immediately focus our attention in the right place.

43 Professor Robert Birmingham first recognized the importance of distinguishing different types of contract failures for the measure of damages under an economic analysis, but he concentrated solely on the distinction between contracts that should not have been made and contracts that should not have been broken. See Birmingham, supra note 8, at 245-65.
performance to the "performing party," that is, those for which there is a "contracting surplus." These are activities that a single firm would undertake if it enjoyed all the benefits and bore all the costs of the contract. Joint profitability does not mean that both contracting parties individually earn profits from performance; it simply means that both parties could individually earn profits from performance. The profits that each party in fact earns from performance depend on the contract price, which determines how the contracting surplus is divided. If the price lies between the paying party's value and the performing party's cost, both parties earn profits; if the price lies outside these two variables, one party loses, though the other party gains more than the loser loses.

Joint profitability can help divide the world of contract breaches. People usually make contracts because they believe at the time that contracts are both jointly and individually profitable. Promisors usually breach contracts when they become individually unprofitable due to a regret contingency. A regret contingency is an event that either increases the cost of performance (including opportunity cost) to the performing party above the contract price, or reduces the value of performance to the paying party below the contract price. A regret contingency may, but need not, render a

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44 I recognize that this is already a simplification because in many contracts both parties have performance obligations.

45 Economists tend to use the term "joint maximization" rather than joint profitability. Joint maximization means that the contracting surplus is maximized, which in turn means that "allocative efficiency" is achieved, with "efficiency" being used in the Kaldor-Hicks sense. See Posner, supra note 40, at 13-14.

46 Throughout the Article, I will characterize various arguments from the text in algebraic form in the footnotes. Following common economic notation, I will use the variable $v$ to refer to the paying party's valuation, the variable $c$ to refer to the cost of performance, and the variable $p$ to refer to the contract price. Jointly profitable contracts are those for which $v > c$, and the joint contracting surplus is $v - c$. The paying party's profits are $v - p$; the performing party's profits are $p - c$. If $v > p > c$, which is typically the case when the contract is formed, both parties earn profits. If $p > v > c$, the paying party loses profits of $p - v$, but the gains to the performing party, $p - c$, outweigh these losses. If $v > c > p$, the performing party loses profits of $c - p$, but the gains to the paying party, $v - p$, outweigh these losses.

47 I will use $v'$ and $c'$ to denote changes to the paying party's valuation or the performing party's cost after the contract is entered into. A regret contingency for the paying party would mean that $v' < p$; a regret contingency for the performing party would mean that $c' > p$. A regret contingency makes the contract individually unprofitable for one party.
contract jointly unprofitable.\textsuperscript{48} If the regret contingency leaves the performance of the contract jointly profitable, then encouraging performance promotes allocative efficiency; if the regret contingency renders contract performance jointly unprofitable, then discouraging performance promotes allocative efficiency. I call contracts that were jointly unprofitable at the time they were made—that is, contracts that are themselves regret contingencies—contracts that should not have been made. I call contracts that are jointly profitable at the time they are made, but become jointly unprofitable after they were made due to the occurrence of a regret contingency, contracts that should not be performed. Finally, I call contracts that are jointly profitable at the time they are made and at the time they are breached, despite the occurrence of a regret contingency, contracts that should not be breached.

But joint profitability alone provides an incomplete account of contract breach. The most important limitation of the joint profitability concept is that it ignores the reason the regret contingency occurs. The regret contingency can result from an “accident,”\textsuperscript{49} or it can result from or accompany “opportunistic”\textsuperscript{50} behavior by the promisor. Thus, contracts that should not have been made can result from “mistakes” by one or both parties, or they can be fraudulent contracts, which result from one party intentionally misleading the other about either the true value or the true cost of

\textsuperscript{48} Jointly unprofitable contracts are those for which the value of performance to the paying party is less than the cost of performance to the performing party, that is, $v<c$ in our prior notation. If the regret contingency increases the cost of performing to a level above the contract price but below the value of performance to the paying party, that is, if $v>c'>p$, the contract remains jointly profitable. Similarly, if the regret contingency decreases the value of performance to a level below the contract price but above the cost of performance to the performing party, that is, if $p>v'>c$, the contract remains jointly profitable.

\textsuperscript{49} Accidents in the economic literature are defined as “harmful outcomes that neither injurers nor victims wished to occur.” Steven Shavell, Economic Analysis of Accident Law 1 (1987).

\textsuperscript{50} I use the term “opportunistic” rather than “inefficient” here to emphasize that the focus is on conduct that acts as a proxy for efficiency determinations. See Cohen, supra note 23, at 957 (defining “opportunism” as “any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality”) (footnotes omitted). Although opportunistic conduct generally leads to allocatively inefficient results, it may well be that a breach in a particular case could lead to an allocatively efficient result, yet a court would deem the breach “opportunistic” because of the court's desire to discourage conduct that is likely to lead to allocative inefficiency in the future.
Contracts that should not be performed and contracts that should not be breached can involve accidental regret contingencies, which are either beyond the promisor’s control or are an unintended consequence of an act within the promisor’s control. But they also can involve manipulated regret contingencies, in which the promisor deliberately misleads the promisee about the risk of the contingency.

The reason the regret contingency occurs should influence the incentives that the parties face. To reduce the costs associated with accidents, optimal damage rules should encourage precaution-taking by both parties. The promisor should be forced to bear that portion of the promisee’s losses that it was in the best position to have prevented or reduced. To reduce the costs associated with opportunistic behavior, the optimal rules must discourage the promisor’s opportunistic behavior by disgorging the promisor’s gains or otherwise punishing the promisor. There is no need to encourage precaution-taking by the promisee against the promisor’s opportunistic behavior; in fact, the point of discouraging opportunistic behavior is to reduce the need for such costly investments.

The other reason that joint profitability provides an incomplete account of contract breaches is that there are “transaction costs” involved in making and breaking contracts. Transaction costs involved in making contracts include costs of collecting information, negotiating, and drafting. Transaction costs of breaking contracts include either the costs of bargaining toward a settlement, litigation in the courts, or both. These costs differ for different

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51 These contract failures correspond to the torts of negligent misrepresentation and intentional misrepresentation respectively, where the misrepresentation renders the contract jointly unprofitable.

52 It is somewhat odd to include litigation costs under the heading of “transaction costs.” More accurately, breach of contract involves costs associated with two possible economic institutions: private bargaining and the court system, which, for purposes of this discussion, could include private arbitration or mediation.

53 A party can attempt to renegotiate, then later decide either to perform or resort to the courts. Alternatively, a party can sue, then decide to settle or perform. Bargaining that occurs after the choice to breach is often more costly than bargaining that occurs before. See Macneil, supra note 10, at 959 & n.42.
contracts and for alternatives to contracting such as internal production and government regulation.\textsuperscript{54}

The presence of transaction costs requires a revision of the three categories of contract breach to take these costs into account. Only the revision of the third category has important implications for contract damage rules, however. First, although all contracts that are jointly unprofitable when made are contracts that should not have been made, not all contracts that should not have been made are jointly unprofitable. Some jointly profitable contracts do not and should not get made because the transaction costs of contracting may exceed the contracting surplus.\textsuperscript{55} Contracts do and should get made only if the contracting surplus, taking into account transaction costs, is larger than for alternative actions. Courts will generally not enforce jointly profitable contracts that were not made because of transaction costs, to encourage the parties either to reduce the transaction costs of contracting or to seek other alternatives; thus, damage issues are not critical here.\textsuperscript{56}

Second, not all contracts that remain jointly profitable should be performed. Courts will generally enforce contracts that remain jointly profitable, despite the occurrence of a regret contingency, to encourage precaution-taking by the losing party. If, however, the

\textsuperscript{54} If these alternatives are viewed as different "institutions," the efficiency of contract making and contract breaking depends on what may be called "institutional efficiency," that is, whether making and performing contracts is the lowest cost institution, as well as on allocative efficiency, that is, whether the contract is and remains jointly profitable. This notion of transaction costs as "those costs most likely to differ under alternative institutional arrangements" comes from Victor P. Goldberg, Production Functions, Transaction Costs, and the New Institutionalism, in Readings in the Economics of Contract Law, supra note 2, at 21, 22. I use the term "institution," as Goldberg does, in the same sense as Oliver E. Williamson, The Economic Institutions of Capitalism 42, 399 (1985).

\textsuperscript{55} If the variable T stands for joint transaction costs, then contracts will not get made unless v-c>T. It should be noted that "joint profitability" could be defined to include transaction costs, so that tautologically all jointly profitable contracts would get made. But the definition I have used comports with the usual understanding of the term and keeps the transaction cost issue separate from the allocative efficiency issue. I recognize, however, that it is not always possible to keep these issues separate.

\textsuperscript{56} Courts generally express this idea by saying that they will not "make contracts for the parties." If, however, the transaction costs are such that they are not easily reduced or if no other alternatives are available, courts may enforce jointly profitable contracts that the parties did not in fact make. The classic example of this is a case in which a doctor provides emergency services and later sues when the patient refuses to pay. Because the emergency cases more often concern disputes about whether to apply liability at all rather than disputes about which damage measure to apply, I do not pursue them here.
court is convinced that the parties would agree to a different contract, but that the transaction costs of renegotiation prevent the parties from reaching that outcome, the court may rewrite or "reform" the contract. This happens most often in "mistake" cases in which, for example, one party inadvertently writes down the wrong price or quantity term. Although reformation is an important remedy, it does not involve a question of damage measures, and so I will not pursue it further here.

Third, not all contracts that become jointly unprofitable after they are made are contracts that should not be performed; joint unprofitability is a necessary but not a sufficient condition for "efficient nonperformance." Although not enforcing jointly unprofitable contracts will generally be efficient, in some cases courts may be able to reduce transaction costs by enforcing jointly unprofitable contracts. If the transaction costs associated with nonperformance exceed the loss from performance, courts should enforce jointly unprofitable contracts. These are cases in which the failure to deter breach increases transaction costs more than it promotes allocative efficiency. The best example of this phenomenon is the "efficient theft" critique of the "efficient breach" theory. If a seller sells a unique good to a buyer and a second buyer offers the seller more money for the good, at some point in the transaction a court would deem the good to be the first buyer's "property" and take steps to discourage the transaction and encourage performance, even if performance of the original contract is now jointly unprofitable. This class of cases does have implications for the proper measure of damages, which I will discuss in Part II.C.2.

57 Another example of jointly profitable contracts that should not be performed involves not transaction costs, but effects on third parties. Consider the classic Ponzi scheme, in which early investors are paid off as a result of the contributions of later victims. The contracts between the swindler and the early victims are jointly profitable; nevertheless, these contracts should not be performed. I thank Susan Koniak for this example.

58 The term “efficient nonperformance” comes from Macneil, who has also developed this qualification most carefully. See Macneil, supra note 10, at 950; Ian R. Macneil, Contract Remedies: A Need for Better Efficiency Analysis, 144 J. Inst'l & Theoretical Econ. 6, 15 (1988). One could say that joint unprofitability is a sufficient condition for "allocatively efficient nonperformance" to emphasize that the only efficiency dimension being considered is the difference between the valuation the paying party places on performance and the cost of performance to the other party.

59 See infra text accompanying notes 251-72.
II. A FAULT-BASED ECONOMIC THEORY OF CONTRACT DAMAGE LAW

The last Part established that courts can use fault-based damage rules to create optimal incentives for both contracting parties. It also demonstrated when courts should encourage contract performance and when they should encourage nonperformance. Building on the previous analysis, this Part discusses how courts can and should choose among the different contract damage measures available to create the right incentives for the three breach categories discussed above.

A. Contracts That Should Not Have Been Made

In the previous Part, I suggested that the category of "contracts that should not have been made" can be further subdivided, based on the type of contracting conduct involved, into accidental contracts and fraudulent contracts. I will discuss these two subcategories in turn.

1. Accidental Contracts

Some contract breaches occur because parties unknowingly enter into a jointly unprofitable contract; that is, the contract itself is a regret contingency. For example, an owner of real estate enters into a contract to sell the real estate, and the title turns out to be defective. From an economic perspective, such a contract is essentially an accident—an unintended, harmful interaction of the promisor and the promisee. Even if the act of contracting is in some sense "intended," the interaction that in fact results is not.


61 One could just as easily label these contracts "mistaken contracts," but "mistake" in contract comes with doctrinal baggage that might hinder our ability to make connections between "mistake" doctrine and other similar doctrines. Moreover, "mistaken contracts" does not suggest the relationship between contract and torts that I want to stress. It is no "accident" that these cases are most often viewed as lying on the contract-tort boundary and are the ones in which reliance damages are most often used.

62 One could of course distinguish the classic tort car accident scenario in that the parties in that case do not intend to interact at all. But from an economic perspective, this distinction is irrelevant. Moreover, not all tort accidents involve parties who did not intend to interact at all, for example a car driver who injures a passenger in her car.
Economists have argued that in the tort law of accidents, the measure of damages that gives the tortfeasor the correct incentives to take precautions is a measure that seeks to put the victim back in the ex ante position. There is no reason to apply a different damage measure to accidental contracts. In contract jargon, this damage measure is the reliance measure. Thus, if our only concern were to optimize the promisor's precautionary decisions concerning accidental contracts that should not have been made, there would be no reason to depart from reliance damages. A damage measure lower than reliance would lead the promisor to take too few precautions; a higher damage measure would lead the promisor to take too many precautions, in particular by making too few promises. One can easily see this latter point by imagining what would happen to promisemaking if all contract breaches were punishable by imprisonment. More important for our purposes, if the expectation damage measure were applied to accidental contracts, promisors would take too many precautions and contracting would be overdeterred.

64 Cf. Cooter, supra note 24, at 14-19 (arguing that contract damages provide the correct incentives to both parties when they equal the loss that the victim would suffer from breach if the victim's reliance were efficient, and describing limitations on the expectation measure as a means of achieving this result, but failing to identify the remedy as a reliance damage measure); Goetz & Scott, supra note 9, at 1281-83 (advocating a type of reliance damage measure for breach of "nonreciprocal" promises in part to avoid excessive promisor precautions).
65 Goetz & Scott, supra note 9, at 1297; cf. Craswell, supra note 10, at 666 (noting that "if even those [promisors] who behave perfectly efficiently will occasionally find it desirable to breach (or will take a level of precautions that occasionally results in a breach), then even the best of [promisors] will have to build the risk of liability into their price," which could result in excessive precaution-taking by promisors).
66 This is not to say that a reduction in promisemaking would be the only effect of such a contracting regime. I would predict that doctrines of formation and excuse would become much more flexible. This is the converse of Gilmore's contention that under an absolute liability regime, a restrictive view of damages would prevail. See Grant Gilmore, The Death of Contract 48 (1974).
67 See Robert E. Scott & Douglas L. Leslie, Contract Law and Theory 769-70 (2d ed. 1993); Craswell, supra note 10, at 646-50; David D. Friedman, An Economic Analysis of Alternative Damage Rules for Breach of Contract, 32 J.L. & Econ. 281 (1989); Goetz & Scott, supra note 9, at 1283. These analysts do not distinguish between accidental contracts or accidental contingencies and other contracts and contingencies, but as I argue below, I believe the argument is true only for the accidental cases.
Courts can use several doctrinal avenues to reach or approximate the reliance damage measure and provide correct promisor incentives in cases of accidental contracts. They can apply one of the three traditional "limitations" on the expectation damage measure: foreseeability,\(^6^8\) certainty,\(^6^9\) or mitigation. They can enforce the contract using the doctrine of promissory estoppel and hold that the reliance damage measure is the appropriate remedy under this rule of liability.\(^7^0\) Or they can excuse performance of the contract, on the grounds of mistake or impossibility, for example, yet hold that a reliance damage recovery is appropriate.\(^7^1\) From the economic perspective adopted here, the particular doctrinal route is irrelevant,\(^7^2\) as is the question of whether or not the doctrinal route chosen "really" protects the "expectation interest" or the

\(^{68}\) According to Restatement (Second) of Contracts § 351(3) (1979): "A court may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation." A court could thus reach reliance damages either by deeming lost profits unforeseeable, or by deeming them foreseeable, but excluding them as "disproportionate compensation." A recent accidental contract case in which the court cited to § 351(3) and suggested that reliance damages might be appropriate is Native Alaskan Reclamation & Pest Control v. United Bank Alaska, 685 P.2d 1211 (Alaska 1984) (involving a bank officer who negligently made loan that should not have been made).

\(^{69}\) See Restatement (Second) of Contracts § 352 (1979).

\(^{70}\) See id. § 90 cmt. d, illus. 8, 10. This is not to say that courts always use the reliance damage measure in promissory estoppel cases, merely in accidental contract cases. Courts often use promissory estoppel outside of the accidental contract context. For an argument that the expectation measure predominates in promissory estoppel cases, see Edward Yorio & Steve Thel, The Promissory Basis of Section 90, 101 Yale L.J. 111 (1991).

\(^{71}\) See Slawson, supra note 8, at 218-19; see also Jeffrey L. Harrison, A Case for Loss Sharing, 56 S. Cal. L. Rev. 573 (1983) (advocating splitting reliance losses when performance is excused); Leon E. Trakman, Winner Take Some: Loss Sharing and Commercial Impracticability, 69 Minn. L. Rev. 471, 506 (1985) (arguing that in impracticability cases, "each party should assume responsibility only for that proportion of performance risks and ensuing losses that are within its 'control'"). These authors differ in the extent to which they believe courts currently practice loss-splitting under the excuse rubric, but they all seem to agree—in my view wrongly—that excuse doctrines present a unique situation in contract law where loss-splitting is used and justified.

\(^{72}\) In my view, economic analyses of particular contract doctrines have often missed the big economic picture because they have forgotten their legal realist roots: they take the stated doctrine too seriously as a means of defining the legal landscape. Thus, the doctrines I have listed are rarely considered together and never viewed as essentially similar in purpose. The closest attempt is Victor Goldberg's discussion of the relationship between consequential and reliance damages. See Readings in the Economics of Contract Law, supra note 2, at 99-104.
What matters is that the court somehow winds up providing the correct incentives to the promisor by adjusting the damage measure.

Although a reliance damage rule gives the promisor the correct incentives, courts must also be concerned with providing the correct incentives to the promisee. The promisee does not have an incentive to take cost-justified precautions, such as reducing its reliance, as long as he or she is fully compensated for all reliance losses suffered. Nor does the promisee have an incentive to mitigate any losses he or she might incur. If, however, the damage measure is reduced to the amount of damage that the promisee would have suffered had he or she taken optimal precautions and mitigation steps, the promisee will have the correct incentives. The reason is that if the damage measure is independent of the promisee's actual precautions and mitigation, the promisee will bear the full losses of failing to take precautions and mitigate, and reap the full benefits of taking these steps (net of the precaution and mitigation costs).

Again, there are several doctrinal devices courts use to adjust the reliance damage measure to provide optimal incentives for precaution-taking and mitigation by promisees in accidental contract

73 The different doctrinal routes may be useful for describing different situations. For example, courts often use the uncertainty limitation to discuss the promisee's recovery of profit on the contract at issue, whereas they often use the foreseeability limitation to discuss the promisee's recovery of profit on contracts with third parties. But cf. Restatement (Second) of Contracts § 352 cmt. b (1979) (noting that the uncertainty requirement is more likely to apply to buyers claiming lost profits on other transactions than to sellers claiming lost profits on the grounds of a lost sale).

74 If reliance recovery is analogized to full insurance against loss, then the decreased incentive of the promisee to take care can be seen as an example of what economists call a "moral hazard" problem. Like moral hazard, excessive promisee reliance can be the result of negligence or opportunistic reliance by the promisee. On the problem of opportunistic reliance, see Slawson, supra note 8, at 227.

75 The Restatement rules fail to create the right incentives for the promisee to the extent that they focus on the promisee's "actual loss." For example, one comment states that if, after breach, the promisee mitigates by making "an especially favorable substitute transaction, so that he sustains a smaller loss than might have been expected, his damages are reduced by the loss avoided as a result of that transaction." Restatement (Second) of Contracts § 347 cmt. e (1979); see also id. § 347 cmt. e, illus. 12 (noting that if the buyer finds an unusually inexpensive substitute contractor to complete construction, damages are limited to those required to pay for the substitute transaction). A promisee knowing of such a rule would have no incentive to make the favorable transaction, as long as the court would deem the less favorable mitigation steps reasonable.
cases. If a court gets to reliance damages via a "limitation-on-expectation" route, it need not make any separate adjustment because the limitations themselves direct courts to take promisee incentives into account. The mitigation doctrine is, of course, explicitly designed to do this. But the certainty and foreseeability doctrines can serve the same purpose. A court could easily classify as unforeseeable losses that the promisee can reduce ex ante or mitigate ex post. Similarly, a promisee who fails to take precautions or mitigate damages risks an inference that any profits that the promisee could have earned in the contract were uncertain. The difference between these doctrines and the mitigation doctrine is the burden of proof. Although the mitigation doctrine generally puts the burden on the promisor to show that the promisee could have mitigated, the promisee has the burden of showing that its losses were foreseeable and certain, which effectively shifts the burden to the promisee of showing that prevention or mitigation of lost profits was not possible.

If a court opts to discuss reliance damages directly, it has other doctrinal mechanisms available to assure optimal promisee incentives. First and foremost, the court can restrict recovery for lost opportunities on contracts forgone. Both advocates and critics of the reliance measure have pointed to the fact that the expenditure measure courts most often use when awarding reliance damages only imperfectly compensates the promisee's "reliance interest" because lost opportunities are not included—advocates bemoan the undercompensation, and critics charge that courts are not

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76 See id. § 350.

77 Others have recognized that the foreseeability doctrine affects the promisee's incentives to take precautions such as not overrelying. See, e.g., Rardin v. T&D Machine Handling, 890 F.2d 24 (7th Cir. 1989) (Posner, J.) (denying lost profits damages for negligent handling of machine during transport); Slawson, supra note 8, at 230-31.

78 See Restatement (Second) of Contracts § 350 cmt. c (1979) (noting that where there is no well-established market for the type of performance involved in the contract, "the burden is generally put on the party in breach to show that a substitute transaction was available").

really interested in protecting the reliance interest. Both groups are wrong: denying the promisee any recovery for lost opportunities encourages the promisee to mitigate any losses by taking advantage of alternative existing opportunities: if such alternatives exist, there is no lost opportunity. It also avoids the problem of opportunistic behavior by promisees in fabricating the loss of past opportunities. The problem of promisee incentives thus remains essentially the same whether the doctrinal route is a limitation on expectation damages or a direct application of the reliance measure. What differs is the way courts and commentators characterize the loss for which recovery is most likely to be restricted. If the damage rule is reliance damages, they focus on whether to compensate the promisee for lost opportunities on contracts forgone; if the rule is expectation damages, they focus on whether to compensate the promisee for lost profit on the contract entered into.

Although denying recovery on lost opportunities allows courts using a reliance measure to encourage promisee mitigation, the doctrinal device courts use to encourage promisee precaution-taking in reliance damage cases is limiting the promisee to what I call low-restitution damages. Low-restitution is a measure that excludes from a reliance recovery expenditures that the promisee makes to third parties as opposed to payments made to and benefits conferred on the promisor. Because the low-restitution mea-

80 See, e.g., Slawson, supra note 8, at 219-22.

81 Although I view lost opportunity and lost profit as equivalent issues, some may argue that it is much rarer for courts to compensate for lost opportunity than for lost profits. This does not seem to be true if one considers tort cases because recovery of lost income from destroyed property or injured persons is quite common. See, e.g., Kessler et al., supra note 2, at 1118. To the extent that it is true in contract cases, the explanation I would offer is that when a court has decided to use an expectation measure, it has often already determined that there is a chance that the promisor was acting opportunistically. On the other hand, when the court has decided to use a reliance measure, it has often already determined an absence of promisor opportunism. If promisee opportunism is equally likely in both types of cases, it would make sense to deny the "lost opportunity" component in reliance damage cases, where there is no offsetting promisor opportunism, more often than to deny "lost profits" in expectation damage cases, where there is.

82 See supra note 20.

83 Many have recognized the similarity of restitution and reliance; since the time of Fuller and Perdue, it has been argued that many restitutionary recoveries "really" protect the reliance interest. My argument is instead that although the two remedies are often used in similar situations and may be identical, they also may not be, and when they are not there may be an economic reason to prefer one to the other. Cf. Cooter, supra note 24,
sure does not vary with the promisee’s reliance investments, it provides the promisee with the correct incentives to economize on these investments to take into account the risk that the contract is accidental.\(^{84}\)

In addition to the denial of lost opportunity reliance and the limitation to low-restitution damages, courts can use several other devices to adjust promisee incentives under the reliance damage rubric. One device is to deny recovery for any reliance that a court deems “unreasonable.” Alternatively, courts can apply the doctrines of foreseeability, certainty, and mitigation to the reliance damage measure rather than to the expectation damage measure.

A good example of the accidental contract problem is the famous English case, *Anglia Television v. Reed*.\(^{85}\) In this case Robert Reed, the actor, contracted to do a television show produced by Anglia a short time before production was to start.\(^{86}\) At the time Reed entered into the contract, Anglia had invested heavily in the project, but had been unable to come up with a suitable actor who was willing to perform in the show.\(^{87}\) Reed breached the contract several days after entering it, when Reed’s agent discovered he had already booked Reed for another engagement that conflicted with the one he had signed on to do with Anglia.\(^{88}\) The court held that although Anglia had not proven lost profits with sufficient certainty, it could recover its expenditures, including the expenditures made before the contract was signed.\(^{89}\)

The case has engendered much debate over whether the court was “really” awarding reliance damages and therefore got the measure wrong because it awarded precontractual expenditures,\(^{90}\) or whether the court was “really” awarding expectation damages and therefore got the measure right because the recovery of precon-

\(^{84}\) See Polinsky, supra note 14, at 36-37.
\(^{85}\) 1971 P. 690 (C.A.).
\(^{86}\) Id. at 691.
\(^{87}\) Id.
\(^{88}\) Id.
\(^{89}\) Id. at 692.
tractual expenditures serves as a proxy for lost profits.\textsuperscript{91} No one seems to focus on what fault-based economic theory deems the most important fact: this was an accidental contract that Reed should never have made and would never have made but for his agent’s negligence.\textsuperscript{92} Thus, the court was correct to deny lost profits and limit Anglia’s recovery to expenditures in reliance, which the court did via the certainty limitation on expectation damages. As for the precontract expenditures, the first thing to note is that the question traditional scholars have asked—whether precontractual expenditures are recoverable as part of reliance damages—is irrelevant under the theory outlined here. Instead, the relevant question is whether Anglia could have taken cost-justified precautions to prevent or steps to mitigate its losses. Anglia contributed strongly to its damages by investing in the project so heavily before securing an actor for the show, thus relying excessively, and by not hiring an actor until very close to the date production was to start, thus increasing its mitigation costs. These facts suggest that the court was probably overly generous in awarding precontractual expenditures in this case. This is one instance in which a better damage theory would have helped.\textsuperscript{93}

2. Fraudulent Contracts

If the parties make a jointly unprofitable contract not because of negligent behavior on the part of one or both parties, but because one party intentionally misleads the other about the value or the cost of performance, then the argument for reliance damages disappears in contract law, as it does in tort law. Because the promisor completely controls the occurrence of the regret contingency,

\textsuperscript{91} See Birmingham, supra note 8, at 231-32; Kelly, supra note 8, at 1816-17.

\textsuperscript{92} It is possible, of course, that Reed’s agent was lying about the fact that Reed was already booked and that the contract was an accident. I am accepting the court’s finding of fact on this point, as well as asserting that triers of fact can make these types of distinctions. One could perhaps read the case as implicitly expressing skepticism about the agent’s claim of negligence, in which case the theory discussed in Part II.A.2 would support an expectation damage recovery.

\textsuperscript{93} Other accidental contract cases in which courts, relying on Flureau v. Thornhill, 96 Eng. Rep. 635 (K.B. 1776), have used a reliance measure include cases in which the seller of real property breached after discovering, in “good faith,” that title was defective. See, e.g., Yates v. James, 26 P. 1073 (Cal. 1891); Horton v. O’Rourke, 321 So. 2d 612 (Fla. Dist. Ct. App. 1975). Interestingly, the cases have often been viewed as anomalies that are limited to the “defective title” context.
there is less need to fear overdeterrence: the promisor can simply refrain from the opportunistic behavior. And because joint costs are minimized if the promisor refrains from opportunistic behavior and the promisee takes no precautions against such behavior, there is less need for courts to adjust the damage measure to induce optimal promisee precaution-taking, for example by using a low-restitution measure or restricting the promisee's recovery to losses resulting from reasonable reliance. Furthermore, there is less reason for courts to give the promisor the benefit of the burden of proof on the question of mitigation by invoking such doctrines as foreseeability or certainty.94

The tort law damage remedy for fraud is often restitutionary or punitive. Although these remedies may also be used for fraudulent contracts, the expectation damage remedy may itself provide an appropriate level of deterrence against certain fraudulent contracts.95 The expectation damage measure is “punitive” in the sense that it often exceeds both the reliance and the low-restitution measures.96 One justification for using punitive measures is that they are necessary to provide optimal deterrence when the fraud is difficult to detect. But the expectation damage measure is also less than many punitive damage measures. One reason for limiting the punitive measure to expectation is that it reduces the incentive of the promisee to act opportunistically by fabricating claims of fraud. In addition, limiting the punitive measure reduces the costs of a court’s erroneous judgment that a contract was fraudulent.

94 Shifting the burden of proof of mitigation depending on whether the promisor’s conduct is opportunistic or unintentional is an example of what I have elsewhere termed the “negligence-opportunism tradeoff.” See Cohen, supra note 23.

95 See, e.g., Slawson, supra note 8, at 225-26.

96 Professor Farber has argued that the cost of completion damage measure may be a “punitive” form of the expectation damage measure, and has advocated the use of such a measure when detection of opportunistic behavior is difficult. See Daniel A. Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, 66 Va. L. Rev. 1443 (1980). The difference between Farber’s approach and mine is that Farber views the cost of completion measure as punitive only when it is “supercompensatory,” see id. at 1468-73; I believe that the expectation damage measure can always be viewed as punitive when it exceeds the reliance and restitution measures, unless it is possible for the promisor to mitigate in a way that the contract remains jointly profitable. In addition, Farber suggests that supercompensatory damages may be appropriate even in cases of negligent breach, see id. at 1475, whereas I think that different damage measures are often appropriate for negligent breach.
A prominent example of a case in which a court came close to recognizing this potential use of the expectation damage measure is *Sullivan v. O'Connor*. In this case, the plaintiff alleged that a doctor promised to perform cosmetic surgery that would result in a nose of a certain quality. The plaintiff sued after several unsuccessful surgeries that worsened the condition of her nose in a way that could not be improved by further surgery. The court held that the doctor had breached his contract with the plaintiff, and that it did not have to decide between the expectation and reliance damage measures, though it hinted that it favored the reliance measure. Although the case is usually cited as support for the reliance measure of damages, I think the more interesting aspect of the case is the court’s suggestion that the expectation measure could be appropriate. In discussing the rule of liability, that is, whether to enforce the contract at all, the court recognized that there were two possible explanations of how a dispute of this type might arise. First, a doctor might unintentionally use promissory language in the course of offering “[s]tatements of opinion . . . with some optimistic coloring,” which the patient either misinterprets ex

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98 Id. at 184.
99 Id. at 185.
100 The opinion concludes:
In light of the foregoing discussion, all the defendant’s exceptions fail: the plaintiff was not confined to the recovery of her out-of-pocket expenditures; she was entitled to recover also for the worsening of her condition, and for the pain and suffering and mental distress involved in the third operation. These items were compensable on either an expectancy or a reliance view. We might have been required to elect between the two views if the pain and suffering connected with the first two operations contemplated by the agreement, or the whole difference in value between the present and the promised conditions, were being claimed as elements of damage. But the plaintiff waives her possible claim to the former element, and to so much of the latter as represents the difference in value between the promised condition and the condition before the operations.

Id. at 189-90 (footnotes omitted).
101 Id. at 188 (“There is much to be said, then, for applying a reliance measure to the present facts, and we have only to add that our cases are not unreceptive to the use of that formula in special situations.”).
102 See, e.g., Restatement (Second) of Contracts § 351 cmt. f, illus. 19 (1979).
103 I therefore view this case the same way that Gilmore viewed *Hadley v. Baxendale* in *The Death of Contract*. He argued that the remarkable aspect of *Hadley*, which was also a tort case dressed up as a contracts case, was the court’s suggestion that lost profits might in some cases be allowed, not the court’s holding that they could not be allowed in that case. See Gilmore, supra note 66, at 52-53 & 52 n.122.
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ante, or opportunistically construes ex post, as a guarantee. Second, a "charlatan" doctor might opportunistically "entice" the patient, by misleading her about the potential benefits of the operation or likelihood of success, to make a contract which, had she had the right facts, she would not have made. In the vocabulary developed here, the contract could be accidental or fraudulent. But the court did not decide which scenario was more likely in the case before it. It insisted that the contract could be enforced if there was "clear proof," but did not say what there had to be clear proof of, nor did it discuss any evidence supporting its decision to enforce the contract.

One way to interpret the court's rule of liability is that it would enforce either an accidental or fraudulent contract if there were clear proof that some promissory activity occurred, but it would adjust the damage rule depending on the more likely scenario. This interpretation is consistent with the theory developed here: a reliance measure would be appropriate if the contract were accidental; an expectation measure would be appropriate if the contract were fraudulent. In support of this reading, one can point to the fact that the court discusses both the expectation and reliance measure and never explicitly chooses between them, because the damages requested by the plaintiff were recoverable under either measure. Moreover, in a footnote toward the end of the opinion, the court recognizes the relationship between the reliance measure and tort damages and suggests that "a jurisdiction which would apply a reliance measure to the present facts might impose a more severe damage sanction for the wilful use by the physician of a method of operation that he undertook not to employ."

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104 Sullivan, 296 N.E.2d at 186.
105 Id.
107 With respect to the tort of misrepresentation, "it has been suggested that the loss-of-bargain rule [expectation damages] should be applied in cases of intentional misrepresentation, the out-of-pocket rule [reliance damages] where it is innocent." Keeton et al., supra note 35, § 110, at 768 & n.39 (citing Charles T. McCormick, Handbook on the Law of Damages 453-54 (1935)).
108 Sullivan, 296 N.E.2d at 189 n.6. One could also argue that there would not be much point in allowing a contractual cause of action in addition to the malpractice cause of action if the remedies were identical. But there are other practical consequences of this decision. As the court recognized, a different statute of limitations may apply. Moreover,
the other hand, the court never explicitly makes the connection between the "enticing charlatan" and expectation damages, and the reasons it does discuss for denying expectation damages would apply to all doctor-promise cases, whether accidents or not. The court felt the tension between its fealty to the traditional strict liability theory of contract damages and its desire to adopt a more flexible approach to damages. At the very least, the theory developed here explains this tension in the opinion; at the most, it points to how the opinion could have been improved.

B. Contracts That Should Not Be Performed

Contracts that should not be performed are contracts that were jointly profitable at the time they were made, but become jointly unprofitable after formation due to the occurrence of a regret con-
tingency. I subdivide these cases into “accidental contingency” cases, in which the contingencies are unintended by the promisor; “manipulated contingency” cases, in which the promisor acts opportunistically by misleading the promisee about the likelihood or the magnitude of a contingency; and “losing contract” cases, in which the promisor breaches a contract that would have been a losing contract for the promisee had it been performed.

Economically, there is not much difference between contracts that should not be performed and contracts that should not have been made. In fact, contracts that should not have been made could easily be viewed as merely a subset of contracts that should not be performed, with the regret contingency being the making of the contract itself. Nevertheless, I think it is useful to discuss separately contracts that at one time were jointly profitable, but later become jointly unprofitable, for several reasons. First, in cases of accidental contingencies, the contract is a form of precaution against regret contingencies rather than a regret contingency itself. Second, manipulated contingencies differ from common ex ante fraud, in which the promisor knows the contract is certain, or highly likely, to be jointly unprofitable from the start, and remain so. Manipulated contingency cases, by contrast, involve contracts that could be performed if the regret contingency occurs, and will be performed if the regret contingency does not occur.

Note that I am here referring only to cases in which the regret contingency would render the contract jointly unprofitable. I am not referring to cases in which the promisor misleads the promisee about the existence of a regret contingency simply to get a better price, even though the contract would have been jointly profitable at the price that would have prevailed had the promisor fully disclosed and would remain jointly profitable after the contingency is revealed. These cases seem to me to raise somewhat different issues, some of which I discuss in Part III.A. See, e.g., Sherwood v. Walker, 33 N.W. 919 (Mich. 1887) (involving a buyer who arguably misleads seller by not disclosing possibility that cow was pregnant, a fact that would have affected the contract price); Laidlaw v. Organ, 15 U.S. (2 Wheat.) 178 (1817) (involving a buyer who misleads seller by not disclosing the fact that a war had ended, which would have affected the contract price). It may even be that the difference between swindling and selling—which so eluded Professor Leff, see Arthur A. Leff, Swindling and Selling (1976)—is that in swindling, a promisor misleads a promisee into making a deal that is jointly unprofitable, whereas in selling the promisor misleads a promisee into making a deal that is jointly profitable but gives the promisor a better price. But a full analysis of this issue must await another paper.

It is true that contracts in which the promisor misleads the promisee about the risk of the regret contingency, and the promisee would not have contracted had it known the risk, are contracts that should not have been made. But if the promisee would have contracted
Third, losing contract cases tend to involve regret contingencies that occur after the contract is made. Although losing contract cases could be subsumed under the other categories, I find it useful to consider them separately, as traditional contract law has done, because they raise somewhat unique damage issues.

1. Accidental Contingencies

Courts and commentators have long recognized that it is not cost-effective for contracting parties to bargain over all contingencies that could render the contract jointly unprofitable. Accidental contingencies are those for which the costs of including contract terms addressing them exceed the benefits. These contingencies include those for which the expected loss is very small (either because the probability of the contingency is very low, the loss if a contingency occurs would be very small, or both), or those for which the bargaining costs are very high. But although contracting parties should not bargain over these contingencies, that does not mean that they should not take other precautions against them. That is, these contingencies are no different than the accidents we commonly refer to as unintentional torts.

The contract damage rule appropriate for accidental contingency cases, therefore, is the same as the contract damage rule appropriate for accidental contract cases: reliance damages. Reliance damages give the appropriate incentives to the promisor to take precautions; higher damages would induce the promisor to take excessive precautions against the contingency, including writing contract terms to deal with contingencies that should not be dealt with in the contract. On the other hand, these damages must often be reduced to give promisees the correct incentives to take precautions and mitigate. The same doctrinal devices discussed in Part II.A.1 can be used to accomplish this result.

A good case example of an accidental contingency is United States v. Behan. In this case, the United States Army contracted even if it had known the risk, the contract would have originally been jointly profitable. And the promisor might not realize the risk of the contingency until after the contract is formed.

113 In Goetz and Scott's terminology, we do not want promisors to take excessive "qualitative precautionary adjustments." See Goetz & Scott, supra note 9, at 1278-86.

114 110 U.S. 338 (1884), aff'g 18 Ct. Cl. 687 (1883).

...to have cane mats laid on the bed of the Mississippi River at New Orleans harbor. After the contract was partially completed, the United States breached, claiming that it had decided that the mats would not serve their intended purpose. The Court allowed the contractor to recover its expenditures but not lost profits because the plaintiff had failed to "prove" the latter. The case is often cited as an example of "reliance" damages and the "uncertainty" limitation.

Justifying the denial of lost profits and the award of reliance damages on the ground of uncertainty is unsatisfactory, however. Surely the Court could have applied the contractor's "standard markup" (or an average of other contractors' markups), at least to the work done. And absent any evidence that the remaining work was significantly more difficult than the work already done, the Court could have fairly easily extrapolated the cost of completing the contract and applied the markup, thus obviating any problem of "uncertainty.

Under the theory offered here, the decision is correct and easily explained. The case provides a paradigmatic example of when courts will deny lost profits and award reliance damages. First, the United States was essentially claiming that its breach resulted from an accidental contingency that rendered the contract jointly

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115 Behan v. United States, 18 Ct. Cl. 687, 689 (1883), aff'd, 110 U.S. 338 (1884).
116 Id. at 692-93. Just what this purpose was is not disclosed in the opinion, other than the fact that it was connected with defending the harbor.
117 Behan, 110 U.S. at 347.
118 See Restatement (Second) of Contracts § 349 reporter's note, cmt. a (1979); E. Allan Farnsworth, Contracts § 12.16, at 928 n.3 (2d ed. 1990). The case is an example of what Fuller and Perdue called "essential reliance," that is, preparation for and performance under the contract in question. See Fuller & Perdue, Reliance 1, supra note 4, at 78.
119 Restatement (Second) of Contracts § 352 reporter's note, cmt. a (1979).
120 See Edwin W. Patterson, Builder's Measure of Recovery for Breach of Contract, 31 Colum. L. Rev. 1286 (1931). In fact, in modern government contracts, it is common to include a "termination for convenience" clause under which the government gets to terminate the contract for any reason but promises to compensate the contractor for expenses and profit on any work done. See, e.g., Dairy Sales Corp. v. United States, 593 F.2d 1002 (Ct. Cl. 1979).
121 This could explain why Farnsworth in the second edition of his treatise removed Behan from his section on "uncertainty." Compare Farnsworth, supra note 118, § 12.15, at 923 n.15 with E. Allan Farnsworth, Contracts § 12.15, at 883 n.15 (1982). Farnsworth noted in his section on reliance damages that claims for reliance damages in that type of case are "not common, since . . . a supplier does not often encounter difficulty in proving lost profits.” Farnsworth, supra note 118, § 12.16, at 929.
unprofitable; therefore, the contract was one that should not be performed.\textsuperscript{122} Apparently, the defense purposes the United States Army had in mind would not have been accomplished no matter who laid the mats. How do we verify that claim? One significant fact suggests that nonperformance was efficient: apparently, the United States did not contract with anyone else to have the work done.\textsuperscript{123} If it had, that would be evidence that the contract remained jointly profitable and that the United States was breach-ing opportunistically to take advantage of a lower price offered by an alternative contractor.\textsuperscript{124} Interestingly, the same fact supports the Court’s\textit{ denial} of the further claim by the United States that the contractor would have lost money on the deal had the contract been completed: the danger was too great that the United States was making this claim opportunistically to avoid having to pay any damages.\textsuperscript{125}

\textsuperscript{122} In our variable notation, the United States claimed that $v' < c$; in fact, the claim was apparently that $v' = 0$. It is possible to interpret the case as a contract that should not have been made rather than one that should not be performed. As I suggested earlier, I do not think the specific category chosen makes any difference in this type of case as far as the proper measure of damages is concerned.

\textsuperscript{123} It is interesting to note that in the Restatement illustrations that cite\textit{ Behan} in support of using a reliance damage measure, there is no indication of whether the paying party in breach contracts with an alternative builder, other than whatever inference can be drawn from the description of the buildings as being of “experimental” or “radical new” design. See Restatement (Second) of Contracts § 349 cmt. a, illus. 3 (1979) (describing a construction contract to build a factory of “experimental design” that the paying party repudiates before completion); id. § 352 cmt. a, illus. 3 (describing a construction contract to build a building of “radical new design” that the paying party repudiates before completion). It is possible to interpret an “experimental contract” as one for which the owner’s claim that $v' < c$ is plausible, though the intent seems to be to suggest only that it would be difficult to measure the lost profits of the builder. In addition, the Restatement does suggest that “[a] court may take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty, giving greater discretion to the trier of the facts.” Id. § 352 cmt. a. The Restatement does not attempt to define “willfulness,” but it is possible to interpret that term consistently with opportunistic breach as defined here.

\textsuperscript{124} The Restatement writers seem to ignore this possibility in § 352 cmt. a, illus. 2, in which the owner sells land promised to a builder of a proposed new theater to a third party. Cf. id. § 352 cmt. b, illus. 7 (noting that in breach of exclusive agency contract, sales made by new agent may be used as evidence of profits original agent would have made).

\textsuperscript{125} The United States was thus arguing that the contract was a “losing contract.” For such a view of the case, see George E. Palmer, The Contract Price as a Limit on Restitution for Defendant’s Breach, 20 Ohio St. L.J. 264, 283 n.61 (1959). I will consider the losing contract situation in Section II.B.3.
Second, the contractor saved the time and expense that it would have spent to pursue alternative contracts, thereby mitigating any profit loss. It is of course possible that the contractor would have been unable to mitigate or mitigate completely, but here the danger is opportunistic claims by the contractor of inability to mitigate. The court’s rule effectively puts the burden of proving inability to mitigate lost profits on the contractor.

Thus, the *Behan* application of reliance damages provides the correct incentives to future parties similarly situated. Reliance damages encourage future paying parties, like the United States in *Behan*, to take cost-effective precautions such as further investigation of the proposed project; this is the same purpose reliance damages serve in unintentional tort cases. Reliance damages also encourage mitigation to make up for lost profits on the part of the performing party, like the contractor in *Behan*.

A more recent case that addresses essentially the same problem as *Behan*, and, in my view, winds up with the same result via a completely different doctrinal route, is *West Haven Sound Development Corp. v. City of West Haven*. In this case, a city contracted to sell land to restaurant owners as part of an urban renewal plan, incorporated in the contract, under which the city promised to develop the surrounding land for commercial, recreational, and apartment use. After the owners, who had operated a restaurant in the city for many years, built and opened a new restaurant, the city’s voters passed a referendum requiring the city to abandon its urban renewal plan and use the remaining undeveloped property for a public park. Several years later, the restaurant closed and the owners sued the city. The owners prevailed at trial and the jury awarded $3.1 million. The Connecticut Supreme Court affirmed the judgment of liability but remanded

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126 514 A.2d 734 (Conn. 1986).
127 Id. at 736.
128 Id.
129 Id.
130 Id.
131 The court rejected the city’s arguments that it was not a proper defendant to the suit and that its performance was excused under the doctrine of impossibility. Id. at 737-40.
for a new trial on damages, even though it rejected the city’s specific arguments.\textsuperscript{132}

The court grouped the owners’ damage claims into three general categories. The owners sought recovery of (1) the loss of the “going concern value” of the restaurant business ($1.9 million); (2) the “investment in land, fixtures, and in the cost of constructing [the] new restaurant” (about $900,000); and (3) “expenses incurred by the plaintiff after the breach in an attempt to keep its restaurant afloat” (about $200,000).\textsuperscript{133} These categories represent expectation, reliance, and mitigation damages respectively. The first question the court addressed was whether the owners were entitled to lost profit damages, that is, their expectation. The plaintiff’s expert measured the going concern value by estimating future profits before the breach and discounting to present value.\textsuperscript{134} But, as the court noted, the expert did not attempt to measure the value of the business after the breach.\textsuperscript{135} The court recognized that the plaintiff was essentially “theoriz[ing] that since it had been forced to go out of business, its business was worth nothing as a going concern as a result of the breach.”\textsuperscript{136} The court rejected this theory because the owners could have reopened the restaurant elsewhere.\textsuperscript{137} With respect to the second category of damages, reliance, the court held that awarding reliance expenditures plus expectation damages was double-counting; that is, the reliance expenditures were part of the value of the business as a going concern.\textsuperscript{138} The court stated that the owners could seek recovery of the reliance expenditures instead of lost profits, but not in addition to lost profits.\textsuperscript{139} Moreover, the court noted that the proper reliance measure was not the actual expenditures but the value of the investments at the time the breach occurred.\textsuperscript{140} With respect to the

\textsuperscript{132} The city had argued that the plaintiff had not proved that the breach had caused its damages, that the plaintiff’s expert witness should not have been allowed to testify about the value of the restaurant at the time of the breach, and that the plaintiff had not proved its damages with sufficient certainty. See id. at 740.

\textsuperscript{133} Id. at 743.

\textsuperscript{134} Id. at 743-44.

\textsuperscript{135} Id.

\textsuperscript{136} Id. at 744.

\textsuperscript{137} Id.

\textsuperscript{138} Id. at 746-47.

\textsuperscript{139} Id. at 747.

\textsuperscript{140} Id. at 747-48.
third category of damages, expectation, the court held that the owners could recover for expenses in mitigation, even though the mitigation failed, as long as they were reasonable.\footnote{141} Finally, the court directed the jury on remand to consider the question of whether the damages were foreseeable.\footnote{142}

Although the court reached the right outcome, the doctrinal thicket through which the court had to hack obscures the essential economic similarity between this case and \textit{Behan}.\footnote{143} Once again, an accidental contingency, the referendum vote, rendered the contract jointly unprofitable. Once again, from the fact that the city did not enter into new urban development contracts in the same area, we can infer that the contract was jointly unprofitable; indeed, it was forbidden from doing so by the voters. Moreover, the restaurant's efforts to stay afloat at its current location were unsuccessful. Thus, as in \textit{Behan}, the reliance damage measure provides the correct economic incentives to future promisors and promisees similarly situated.

The court effectively adopted the reliance measure.\footnote{144} The court's long-winded discussion of lost profits damages amounted to denying the plaintiff recovery of these expectation damages without expressly saying so. The court did this by presuming that the plaintiff could mitigate its lost profits by reopening its restaurant elsewhere; thus placing the burden on the plaintiff to prove otherwise.\footnote{145} Unless the plaintiff could prove that the location of the

\footnote{141} Id. at 748.  
\footnote{142} Id. at 748 (citing Restatement (Second) of Contracts § 351(1) (1979)).  
\footnote{143} The court does, however, quote from a case that in turn quotes from \textit{Behan} to establish the general principle that reliance damages are recoverable. See id. at 746 (quoting Tompkins, Inc. v. Bridgeport, 110 A. 183, 191 (Conn. 1920) (quoting United States v. \textit{Behan}, 110 U.S. 338, 341 (1884)))).  
\footnote{144} Even if I am wrong that the court effectively adopted a reliance measure, I believe that the court applied the same measure of damages that it would have applied in an unintentional tort case—say if someone had accidentally burned down the restaurant.  
\footnote{145} The fact that the court effectively put the burden on the plaintiff to show that it could not mitigate its lost profits is evident in the court's statement that the plaintiff's expert "should have been asked to value the plaintiff's business... after the breach. Because the plaintiff presented no evidence to establish the value of its business as a result of the breach, there was insufficient evidence to support the jury's finding on damages." \textit{West Haven Sound Dev.}, 514 A.2d at 744-45 (footnote omitted); see also id. at 745 n.5 (stating that when a plaintiff seeks to recover lost profits, it "must place two values into evidence," namely the value before the breach and the value after the breach). It is interesting to note that the court imposed this burden on the plaintiff without placing it within any of the
restaurant was so unique that the same restaurant could not earn as much money elsewhere in the city—a showing that would be extremely difficult to make, especially given the owners’ success at a prior location—the plaintiff could not recover lost profits. Even if the plaintiff could make such a showing, the court held open the possibility of denying such damages as unforeseeable.

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Even if the plaintiff could make such a showing, the court held open the possibility of denying such damages as unforeseeable.

146 The court expressed some skepticism that the plaintiff would be able to make such a showing. It stated:

It is clear to us that many of the factors considered by [the plaintiff’s expert] in projecting the plaintiff’s future profit stream... were such as could not have been lost by the plaintiff in consequence of the breach.... While we recognize that the location of a restaurant may be an important component of its value as a going concern, we think that its name, its reputation for good food and quality of service, the expertise of its management, are equally important components of value.

Id. at 744.

147 See id. at 748. A recent case involving very similar facts in which the court used the foreseeability doctrine to deny lost profits damages is Kenford Co. v. County of Erie, 537 N.E.2d 176 (N.Y. 1989). In that case, the county breached a contract to develop a domed stadium on land owned by a developer. Id. at 176-77. The developer had bought options on the land before contracting with the county with the intention of trying to sell the stadium idea. Id. at 177. After the county signed the contract, under which the developer was to donate part of the land to the county and manage the stadium, the county solicited bids for building the stadium and found that they were significantly in excess of the amount the county had available to spend. Id. In an earlier opinion, the New York Court of Appeals had affirmed the lower court’s judgment denying lost profits damages from the management part of the contract on foreseeability and certainty grounds. Kenford Co. v. County of Erie, 493 N.E.2d 234 (N.Y. 1986) (per curiam), rev’d, 537 N.E.2d 176 (N.Y. 1989). In its second opinion in the case, the Court of Appeals reversed the lower court by denying lost profits from the expected appreciation of the land values on foreseeability grounds. Kenford Co., 537 N.E.2d at 180. That left the developer with mitigation damages from its failed attempt to find alternative financing, as well as reliance damages. The reliance damages that the lower court had allowed consisted of “expenses incurred as preparatory to the aborted management agreement” but not “any sums expended for land acquisition expenses... or for interest paid on the mortgages, since these sums would have been paid even without the breach” and because the lower court thought (wrongly) that the plaintiff would be compensated for these sums by its lost profits on the land appreciation. See Kenford Co. v. County of Erie, 489 N.Y.S.2d 939, 949 (App. Div. 1985), aff’d, 493 N.E.2d 234 (N.Y. 1986) (per curiam), rev’d, 537 N.E.2d 176 (N.Y. 1989). Professor Kelly criticizes the case to the extent that it denies the developer the precontractual land acquisition costs, see Kelly, supra note 8, at 1844, but because the breach resulted from an accidental contingency and the developer was arguably in a better position to take precautions against this loss, the theory discussed here supports limiting the developer’s damages exactly as the New York courts did.
Finally, even if the foreseeability limit would not apply,\textsuperscript{148} the reliance damages the plaintiff could prove would in all likelihood have been larger than the lost profits it could prove.\textsuperscript{149}

The court's discussion did not focus on the promisor's incentives, but it was sensitive to the need to provide the right incentives to the promisee, and implicitly recognized that reducing the expectation damage measure could achieve this result.\textsuperscript{150} The court made similar points in its consideration of the reliance and mitigation damages. In discussing the reliance damages, the court noted that the plaintiff's actual out-of-pocket expenditures might be too high a measure because the deal might have been a loser for the restaurant even before the city breached.\textsuperscript{151} By making the plaintiff responsible for any decrease in the value of the purchased assets before the breach, the court provided an incentive for similarly situated owners to take precautions against bad deals in the future.\textsuperscript{152} And in discussing the mitigation damages, the court stressed that the plaintiff could recover only those expenses reasonably incurred.\textsuperscript{153}

\textsuperscript{148} Probably the court's finding that the plaintiff had proved its lost profits with sufficient certainty, see West Haven Sound Dev., 514 A.2d at 741-43, would preclude the city's using that doctrine to argue that the difference between the restaurant's earnings at its present location and at another location were too "uncertain."

\textsuperscript{149} The plaintiff proved $1.9 million in lost profits and $0.9 million in reliance expenditures. Id. at 743. If the restaurant could have earned at least $1 million at a different location, the reliance expenditures would have been greater, if not reduced further in the ways the court suggests.

\textsuperscript{150} Id. at 745 n.5 (referring to the doctrine of avoidable consequences to justify disallowing lost profit recovery).

\textsuperscript{151} Id. at 747.

\textsuperscript{152} See id. Of course, the out-of-pocket expenditure measure could also yield too low a measure of damages if the value of assets purchased, for example the land, had increased since the time of purchase. The fact that the court does not expressly refer to this possibility might be viewed as further evidence of the court's skepticism that the plaintiff's current location was so unique as to justify a lost profits recovery.

\textsuperscript{153} Id. at 748. Although I have discussed only cases in which the buyer's valuation drops as a result of an accidental regret contingency, a similar analysis would apply to cases in which the regret contingency increased the performing party's costs so as to render performance jointly unprofitable. In one famous group of nineteenth century construction cases, the structure was destroyed before completion as the result of some natural disaster, such as wind, fire, or muddy foundation. Although the courts refused to excuse performance, the owner's damages were usually limited to a recovery of its down payment or progress payments. See Gilmore, supra note 66, at 77-79 & nn.200, 202 (citing School Dist. No. 1 v. Dauchy, 25 Conn. 530 (1857); Adams v. Nichols, 36 Mass. (19 Pick.) 275 (1837); Stees v. Leonard, 20 Minn. 494 (1874); School Trustees v. Bennett, 27 N.J.L. 513.
2. **Manipulated Contingencies**

Not all regret contingencies deserve equal treatment, even when they result in jointly unprofitable contracts. If the promisor deliberately misleads the promisee about the risk, reliance damages are no longer appropriate because they may not be sufficient to deter the promisor from withholding information about the risk.\(^{154}\) Disgorging the promisor's gain from the withheld information would provide appropriate deterrence, but it is difficult to know, for example, what the contract price would have been, or whether the contract would even have been made, had the promisor provided the information to the promisee. Once again there is a role for the expectation damage measure: it serves as a "penalty default"\(^ {155}\) to encourage promisors to divulge information and bargain about risks that could render the contract jointly unprofitable. The idea is not, as the efficient breach theory would have it, to encourage future promisors to breach and pay expectation damages, but rather to encourage them to refrain from opportunistic behavior and thereby reduce the joint costs of the regret contingency.

A case in which such a use of the expectation damage measure might have been appropriate is *Chicago Coliseum Club v. Dempsey.*\(^ {156}\) Jack Dempsey, the heavyweight boxing champion, contracted with a boxing promoter to fight Harry Wills, one of the leading contenders.\(^ {157}\) Dempsey was to receive $800,000, plus 50% of the net profits over $2,000,000, plus 50% of the revenues from movie concessions and royalties.\(^ {158}\) Four months after entering into the contract, Dempsey breached because he had decided to contract to fight the other leading contender, Gene Tunney.\(^ {159}\) The promoter first sought and received an injunction against Dempsey.

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\(^{154}\) See, e.g., Landes & Posner, supra note 79, at 160-63; Shavell, supra note 49, at 146-51.


\(^{156}\) 265 Ill. App. 542 (1932).

\(^{157}\) Id. at 544-45.

\(^{158}\) Id. at 545.

\(^{159}\) Id. at 547.
in Indiana, then sued for damages in Illinois.\textsuperscript{160} The Appellate Court of Illinois rejected the promoter's claim for lost profits damages on uncertainty grounds and also rejected the promoter's claim for precontract expenditures and attorney's fees in connection with the injunction.\textsuperscript{161} It limited the promoter to reliance damages incurred after the signing of the agreement.\textsuperscript{162}

Several commentators have criticized the Dempsey case for its failure to award, or at least more closely approximate, expectation damages. Some contrast the case with Anglia, which allowed recovery of precontract expenditures, perhaps as a proxy for expectation damages.\textsuperscript{163} Others have suggested that the court, if it had really wanted to, could have looked to gate receipts from the Dempsey-Tunney fights to approximate lost profits.\textsuperscript{164} The court might have been influenced by the fact that Dempsey was "answerable to [the Indiana] court for a violation of the injunctive order."\textsuperscript{165} I agree that there might be a case to be made for a more generous damage recovery, though for different reasons.\textsuperscript{166}

Although the opinion does not reveal the salary Dempsey earned from fighting Tunney, the initial contract might have become jointly unprofitable, in which case nonperformance would be efficient.\textsuperscript{167} In that case, if the availability of Tunney is properly

\textsuperscript{160} Id. at 547-48.  
\textsuperscript{161} Id. at 550-52.  
\textsuperscript{162} Id. at 552-54.  
\textsuperscript{163} See Birmingham, supra note 8, at 231-32; Kelly, supra note 8, at 1815-25.  
\textsuperscript{165} Dempsey, 265 Ill. App. at 551. In fact, the injunction against Dempsey was not enforced, and Dempsey wound up fighting, and losing to, Tunney. See Dawson et al., supra note 164, at 88.  
\textsuperscript{166} I do not know of another commentator who thinks that both Dempsey and Anglia may have been wrongly decided. This famous pair, in my view, deserve a place alongside the other famous pair of contract damage cases that the theory developed here suggests were both wrongly decided, Peevyhouse and Groves. See Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109 (Okla. 1962), cert. denied, 375 U.S. 906 (1963); Groves v. John Wunder Co., 286 N.W. 235 (Minn. 1939).  
\textsuperscript{167} The promoter alleged that it would have earned gross receipts of $3,000,000 and net profits of $1,600,000. Dempsey, 265 Ill. App. at 549. Of the promoter's alleged $1,400,000 ($3,000,000 - $1,600,000) in expenses, it appears that $1,300,000 ($800,000 + .5 x $1,000,000) would have gone to Dempsey. Id. at 545. Thus, the joint profits, under these assumptions, would be $2,900,000 (less any "costs" incurred by Dempsey). If the joint profits from the Tunney fight would have been more than $2,900,000, then the initial contract would be jointly unprofitable because the opportunity costs of forgoing the
viewed as an "accident" because, for example, its likelihood was remote, then the reliance damages awarded by the court were appropriate.\textsuperscript{168} If, however, at the time he signed the contract to fight Wills, Dempsey had been actively negotiating and continued to negotiate with Tunney, but the fighters had not come to terms and Dempsey signed with Wills to get a "bird-in-the-hand," then the Tunney contingency would be one that Dempsey and Wills' promoters should have bargained over.\textsuperscript{169} The failure to bargain over such a contingency is not a rational means of reducing joint negotiating costs by ignoring unlikely occurrences, but rather an opportunistic attempt to convince the promisee that the deal is more solid than it really is. The expectation measure would be appropriate as an "information-forcing" device to encourage bargaining over known contingencies.\textsuperscript{170} Under the expectation measure, a party in Dempsey's position would probably find it cheaper to bargain for an option or liquidated damage clause. This could be true even if the bargaining resulted in no deal with Wills: Dempsey might have been able simply to wait until the Tunney contract were resolved before contracting with Wills. Thus, the expectation damage measure would not overdeter a promisor in Dempsey's position. Either no contract or a contract expressly dealing with

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Tunney fight would have exceeded the value of the Wills fight. If the initial contract remained jointly profitable (Dempsey would have an incentive to breach if he would earn more than $1,300,000 from the Tunney fight, even if the joint profits were less than $2,900,000), then, as demonstrated in Part II.C, expectation damages would be appropriate to encourage performance. Although Dempsey involves a "superior alternative," it differs from the "efficient breach" cases discussed in Part II.C.2 in that Wills could not have taken advantage of the alternative contract.

\textsuperscript{168} Note the difference between this interpretation of the case and the efficient breach theory: if the breach truly were efficient, then reliance damages, not expectation damages, would have been appropriate.

\textsuperscript{169} Dempsey's biography suggests that Dempsey had been negotiating to fight either Wills or Tunney for almost three years, wavering back and forth between the two. The situation was complicated by the fact that some in the boxing hierarchy did not want Dempsey to fight Wills because Wills was black. If, as Dempsey insisted, his hands were tied by this hierarchy, that would support the accidental contingency interpretation and reliance damages. See Randy Roberts, Jack Dempsey: The Manassa Mauler 213-19 (1979).

\textsuperscript{170} Ayres and Gertner try to explain the foreseeability limitation on damages as an information-forcing device designed to encourage "shippers" (promisees) with greater than average potential losses (high valuations) to reveal their potentially large losses to "carriers." See Ayres & Gertner, supra note 155, at 101-04. What I am arguing for is essentially the mirror image: using a larger damage measure to encourage the promisor to reveal information about a potential gain from an alternative contract.
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the Tunney contingency would arguably have been superior to the contract that Dempsey made to fight Wills.

A case presenting a similar potential for a manipulated contingency is *Peevyhouse v. Garland Coal & Mining Co.*\textsuperscript{171} A coal mining company contracted to lease and strip mine part of the plaintiffs' farm.\textsuperscript{172} The plaintiffs insisted that as part of the contract the mining company agree to restore the land after the mining operation was complete.\textsuperscript{173} After the mining company stopped mining, it refused to do the restoration work.\textsuperscript{174} The cost of completing the work far exceeded the diminution in market value of the property.\textsuperscript{175} The court limited the plaintiffs' recovery to the diminution in value.\textsuperscript{176}

Like *Dempsey*, it is possible that a regret contingency had rendered performance of the contract jointly unprofitable, because even the farmers' subjective valuation of the restorative work might not have exceeded the cost of doing it. The contingency was either the fact that performance was more costly than originally anticipated, or the mining was less profitable than originally anticipated, or both. And like *Dempsey*, the contingency might have been manipulated rather than accidental; in particular, this would be the case if the mining company from the beginning had no intention of doing the resurfacing because it knew of the likelihood of excessive cost.\textsuperscript{177} Unlike *Dempsey*, even if the occurrence of the contingency was accidental, there was still, as I have argued elsewhere, a danger that the mining company opportunistically manipulated the contingency.\textsuperscript{178} Suppose the regret contingency did not manifest itself all at once, but rather the company gradually became aware of an increased risk that the value of the mining venture had decreased or the cost had increased. If the mining company knew it would be liable only for diminution in value dam-

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\item \textsuperscript{171} 382 P.2d 109 (Okla. 1962), cert. denied, 375 U.S. 906 (1963).
\item \textsuperscript{172} *Peevyhouse*, 382 P.2d at 111.
\item \textsuperscript{173} Id.
\item \textsuperscript{174} Id.
\item \textsuperscript{175} Id.
\item \textsuperscript{176} Id. at 114.
\item \textsuperscript{177} For evidence that casts some doubt on this interpretation, see Lon L. Fuller & Melvin A. Eisenberg, Basic Contract Law 218-19 (5th ed. 1990) (quoting unpublished materials of Richard Danzig).
\item \textsuperscript{178} See Cohen, supra note 23, at 982-83.
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ages, it might not have the incentive to report the contingency immediately to the farmers. Delaying the report of the difficulty to the farmers might benefit the mining company because further mining could potentially increase the company’s mining profits and could increase the cost of performing the restorative work, thereby making it more likely that a court would view that damage measure as excessive. At the same time, one could speculate that increased mining was not likely to reduce the market value of the property significantly beyond the small drop that had already occurred. Awarding cost of completion damages would discourage promisors in the mining company’s position from delaying notice of the contingency and would instead encourage them to bargain with the promisees over how to deal with the problem at the earliest sign of potential trouble, when the joint costs were relatively low.\(^{179}\)

3. Losing Contracts

A third group of contracts that should not be performed presents unique problems. These cases are often termed “losing contract” cases. This term is odd, however; all contract breaches occur because the contract is a “loser” for one side, yet not all are considered “losing contracts.” Moreover, not all “losing contracts” are jointly unprofitable, and not all jointly unprofitable contracts are “losing contracts.” What defines a “losing contract” case is that the breaching party is not the “loser” but the party who appears to be advantaged by the contract; that is, the (apparently) wrong person breaches. This problem can occur in contracts that are jointly profitable as well as contracts that are jointly unprofitable, though the restitution remedy is often appropriate in both cases.\(^{180}\)

Losing contract cases are often grouped into two classes, depending on whether the paying party or the performing party breaches. From a compensation perspective, the issue that arises in these cases is whether the “losing” nonbreacher can recover more as a result of the breach than it could if the breaching party had performed. If the performing party breaches, one question that

\(^{179}\) The delay problem here is similar to the problem discussed in In re Montgomery’s Estate, 6 N.E.2d 40 (N.Y. 1936). See infra notes 191-200 and accompanying text.

\(^{180}\) In losing contract cases, therefore, the court need not decide whether the contract is jointly profitable. The joint profitability determination matters when the court must choose between expectation and reliance.
Fault Lines in Contract Damages

arises is whether the paying party can get restitution of the prepaid contract price, even though the “value” of the performance to the paying party has dropped below that price.\textsuperscript{181} Because the most famous cases of this type are contracts for the sale of goods in a market with many substitutes available, I will reserve consideration of this situation until I consider market damages.\textsuperscript{182} In other cases involving a breach by the performing party, the paying party may seek recovery of its reliance expenses, even though the value of the performance has dropped below the value of those expenses. Alternatively, if the paying party breaches, the question is whether the performing party can get restitution of its cost of performance, even though that cost exceeds the contract price.\textsuperscript{183} This Section considers two famous losing contract cases—one performing party breach and one paying party breach—in which the contract became jointly unprofitable. Part II.C.3 will discuss losing contract cases in which the contract should have been performed.

From the economic perspective developed here, the issue in losing contract cases, as in other contract cases, is determining which damage measure provides the correct incentives for the two parties. It is common to focus on the promisee’s incentives in losing contract cases. If the contract becomes a loser to the promisee because of some contingency against which the promisee could have taken precautions, then we have already seen that fully reimbursing the promisee for its reliance expenses or costs of performance will not give future promisees the right incentives. But if the promisor’s opportunistic behavior contributes to making the contract a loser for the promisee, courts tend to use a high-restitution damage measure to deter such behavior. Two cases will suffice to demonstrate these points.

The classic example of a court’s sensitivity to promisee incentives in the losing contract context is the much-discussed \textit{L. Albert &
Son v. Armstrong Rubber Co. The buyer contracted to buy machines to recondition old rubber and constructed foundations for them. The seller breached by delivering two of the machines late. The buyer justifiably rejected all four of the machines and sought the cost of the foundations as reliance damages. Noting that allowing the buyer-promisee to recover reliance damages in this context "imposes the risk of the promisee's contract upon the promisor," the United States Court of Appeals for the Second Circuit held that the promisee's right to this recovery was "subject to the privilege of the promisor to reduce it by as much as he can show that the promisee would have lost, if the contract had been performed."

What makes L. Albert an interesting and difficult case from an economic perspective is that two regret contingencies occurred. First, the end of World War II made reconditioned rubber less valuable to the buyer. That is what made the contract a loser for the promisee-buyer (and probably jointly unprofitable as well) and led the buyer to seek reliance damages. Second, the promisor-seller delayed its delivery of the machines. If the second contingency had not occurred, the buyer would not have recovered anything from the seller; in fact, the buyer most likely would have breached and been liable to the seller (for the seller's reliance damages, under the theory developed here, because an accidental contingency—the end of the war—rendered the contract jointly unprofitable). The buyer in that case would have borne the losses from its investment in the foundations as a "risk of the contract," which would have given future buyers the right incentives to take precautions by tempering their reliance. The question in the case is, as the court recognizes, whether the buyer should be able to shift this risk to the seller because of the seller's breach, that is, because the buyer is a promisee rather than a promisor.

The economic argument for shifting this risk is that we want to provide the right incentives to the seller not to breach by delaying delivery. Whether to allow reliance damages in this case thus

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184 178 F.2d 182 (2d Cir. 1949) (L. Hand, J.).
185 Id. at 184-85, 189-91.
186 Id. at 184-85.
187 Id. at 189.
188 Id.
depends on whether it is more important to give the seller the incentive to take precautions against delay or to give the buyer the incentive to take precautions against a decline in demand for its product. An argument that it is more important in this case to give the buyer the right incentives, and therefore to deny reliance damage recovery to the buyer, is that the seller already had the incentive to perform in a timely manner. If the seller had not breached, it would have been able to sue the buyer for damages had the buyer breached. By breaching, therefore, the seller suffered its own reliance losses, for which it could not recover. Because the seller incurred this loss, future sellers in similar positions would have an incentive to take precautions, especially if they knew that the contract had turned out to be a loser for the other side.

The court did not deny the buyer reliance damages outright but put the burden of proof on the seller to show that the contract was a loser for the buyer. It seems a reasonable compromise to require the actually breaching seller to show essentially that the buyer would have breached anyway if the seller had not. If the promisor can meet its burden by proving the existence of a regret contingency that would likely make the contract a loser for the promisee, as it probably would have been able to do in this case, the promisee will not be able to recover its reliance damages. If there is no such objective evidence to which the promisor can point, the court is entitled to be skeptical of its claim.\footnote{Expectation theorists applaud \textit{L. Albert} and cite it as evidence that courts "really" protect the expectation interest rather than the reliance interest. See Birmingham, supra note 8, at 229-31; Kelly, supra note 8, at 1811-14 & 1814 n.187. These theorists ignore the restitution cases in which courts reject the expectation limitation. Restitution theorists have trouble explaining \textit{L. Albert}. See Palmer, supra note 125, at 283 (questioning the correctness of the decision and trying to distinguish it on the grounds that the breaching seller did not receive a benefit from the buyer).}

\textit{L. Albert} demonstrates that in some losing contract situations, the court can focus solely on the promisee's incentives, and need not focus on the promisor's incentives, because the contingency giving rise to the promisor's breach is accidental. There was no evidence in \textit{L. Albert} that the promisor-seller behaved opportunistically in breaching; indeed, the seller probably regretted the breach very much, even if it wound up not having to pay the buyer's reliance damages. But not all losing contract cases arise
because of a double-accident problem like the one in *L. Albert*. In other losing contract cases, there is a danger of opportunistic behavior by the promisor. These cases may present what I have elsewhere called a "negligence-opportunism tradeoff." Courts must decide whether it is more important to deter the promisor's potentially opportunistic behavior or the promisee's negligence in failing to take precautions. In several famous cases, courts have come down in favor of deterring opportunism and have awarded what I call high-restitution damages—that is, restitution damages in excess of expectation damages.

One classic case that has attracted much comment and criticism is *In re Montgomery's Estate*. In that case, a lawyer contracted to perform certain services in the settlement of a widow's estate for a fixed sum of $5000. After the lawyer had done most of the work, the widow, who was the executrix of the estate, discharged him and hired another lawyer. The lawyer sued and recovered the reasonable value of the services he performed, which exceeded the contract price. The New York Court of Appeals affirmed. It found that the widow had "voluntarily" discharged the lawyer "without cause," which entitled the lawyer to a recovery in quantum meruit not limited to the contract price.

The fault-based economic theory supports the court's damage award. To understand why, one must inquire into the reason why this contract was a "loser" for the lawyer. Apparently, the lawyer deliberately entered into the contract at a rate that would not fully compensate for the value of his services in the hopes of establishing good will and getting future business. That is, the contract was in effect a "loss leader." It would seem that in this case, the client

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190 See Cohen, supra note 23, at 943, 983-90.
192 Id. at 40.
193 Id.
194 Id. at 42.
195 Id. at 41.
196 Id. at 40-41.
197 See id. at 42 (Lehman, J., dissenting) ("In fixing [the] price below the actual value of the stipulated services, the [lawyer] may have been moved by the hope that this retainer might lead to more profitable retainers in the future."); see also id. at 41 (noting that "other elements entered into the agreement which induced the attorney to make a contract to perform the work for less than a reasonable fee").
could not possibly act opportunistically because the lawyer was
taking the risk that the client would be satisfied with his services.
If the client were not satisfied, the lawyer understood that the cli-
ent would simply terminate the contract and the lawyer would lose
his gamble. Nevertheless, the possibility of opportunistic behavior
existed.

The problem arises not because of the fact of termination but
because of the timing of the termination. No one would dispute
that the client should be allowed to terminate the contract when
she determines that the service provided is unsatisfactory, even if
the lawyer had committed no identifiable error so that the dis-
charge was "without cause." But if recovery is always limited to
the contract price, the paying party has the incentive to delay ter-
mination beyond the time at which it would occur if the paying
party were liable for the "full" price. The reason for the delay is
that the paying party would compare the benefit she receives under
the "losing" contract to the actual, artificially low price charged
rather than to the opportunity cost of the work performed, that is,
to what a "reasonable" performing party would charge for the
same work. If, however, a high-restitution measure is used, the
paying party will compare her benefits to the "true" costs in decid-
ing whether to terminate; termination will occur "on the merits" at
an earlier time.¹⁹⁸

One might object at this point by saying: "What's so bad about
the paying party's behavior here? After all, the parties bargained
for a low rate; why shouldn't the paying party be able to take
advantage of that low rate any way she wants?" One answer is that
it is possible for the paying party to abuse the low rate. The pur-
pose of the low rate is arguably to get the paying party to hire
someone she would not otherwise have hired, so that the perform-
ing party has the opportunity to convince her that he is worth his
normal price. If, after inspection, the paying party decides that the
performance is not worth its full cost but is worth only the dis-
counted price, then delaying the firing of someone she would
otherwise have fired sooner abuses the low rate.

¹⁹⁸ It is important to note that there is no incentive to delay if the paying party discovers
that the performing party is "very bad." Compare the argument concerning *Peevyhouse* in
Part II.B.2: there is no incentive to delay if the regret contingency happens all at once. The
delay incentive occurs when negative information accumulates gradually.
Another answer relies on the concept of mitigation and lost opportunity. The earlier the termination occurs, the more likely the performing party will be able to reduce its losses by procuring a substitute contract. Early termination supports joint maximization to the extent that the extra amount the performing party is likely to earn on the substitute contract exceeds the surplus over the "bargain" rate that the paying party is forced to yield under the high-restitution remedy. Again, this suggests that the parties would agree to a high-restitution remedy ex ante. Moreover, the transaction costs of termination are likely to be lower the earlier the termination occurs. Both parties will have invested less in the relationship at that point and the chances of an amicable settlement may be greater.

Thus, Montgomery supports the use of a high-restitution remedy in losing contract cases in which the contract price is artificially low and the promisee (paying party) may delay termination opportunistically. High-restitution damages encourage early termination in these cases. There are still two possible objections to this defense of high-restitution damages. First, there is the rule that a fully performing party cannot get restitution but only the contract price. That rule seems to give the paying party the incentive not to terminate early but rather just the opposite: to "tough it out" until the end of the contract. For example, if the value of the services always exceeds the "bargain" rate until the end of the contract, it will be in the paying party's interest to continue until the end, even though had the paying party faced the "true" cost it would not have finished the contract. One facile answer to this objection is that this is a risk that the performing party has to live with because of the difficulty of detecting opportunistic behavior. Another answer is that to the extent that a paying party who allows the performing party to perform fully is more likely to pay rather than breach, transaction costs associated with breach and litigation will be reduced. Yet another answer is that many paying parties will foresee significant enough detriment in continuing the contract to the end that they will find it worthwhile to terminate early. Finally, the full performance rule is manipulable enough that a court could apply the rule if it believed the paying party was not acting oppor-
tunistically, and could award high-restitution damages if it believed the paying party was acting opportunistically.  

The other possible objection to the “encourage early termination” defense of high-restitution is that if the paying party follows the incentives created by the high-restitution remedy and terminates optimally early, she will still have to pay the higher restitution rate rather than the lower contract rate. This seems to deprive the paying party of her bargain and to discourage the making of loss-leader-type contracts. There are, however, doctrinal escape hatches for courts that feel the paying party is not acting opportunistically. First there is the requirement that the paying party receive a “benefit.” Second, there is the “divisibility” rule that denies restitution to contracts that can be divisible. Finally, if it appears that the performing party is encouraging or provoking termination to take advantage of the higher restitution remedy, the

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199 The most famous example of how this exception can be manipulated is Oliver v. Campbell, 273 P.2d 15 (Cal. 1954) (en banc), which like Montgomery involved a client who terminated his lawyer near the end of his performance. The case was a divorce case, and the client terminated the lawyer after trial but before the judge had rendered his final judgment. Id. at 17. The California Supreme Court held that the lawyer had fully performed and limited his recovery to the contract rate of $850, which was significantly less than the reasonable value of the lawyer's services—$5000. Id. The dissenting judges argued that the lawyer had not fully performed because the contract did not limit the lawyer's services to the trial of the case, and the lawyer thought the judgment would be reversed on appeal. Id. at 21-22 (Schauer, J., dissenting). The opinion does not reveal why the lawyer charged such a low fee—it could have been a loss leader contract like Montgomery, a result of the lawyer's negligence in estimating the length and difficulty of the proceedings, or a case in which the client contributed to the high cost of performance. But whatever the reason, there was evidence that the client did not act opportunistically by delaying termination. The client apparently expressed no dissatisfaction with the lawyer's performance until he learned what the judgment was likely to be after the trial. At that point, he immediately complained to the lawyer and fired him. See id. at 21 n.1 (Schauer, J., dissenting). The dissenting judges might have been influenced by the fact that the client, just before he fired the lawyer, demanded that the lawyer allege that the opposing counsel in the case had suborned and bribed witnesses. Id. (Schauer, J., dissenting). The lawyer refused to do so because there was no evidence of such activity. See id. (Schauer, J., dissenting). Although such opportunistic behavior might justify a higher recovery, it is possible to interpret the client's request as merely part of an emotional outburst of dissatisfaction with the likely outcome of the litigation.

200 The Montgomery court, for example, would not have applied the restitution recovery rule had it determined that the client's discharge of the lawyer was “involuntary.” See Montgomery, 6 N.E.2d at 41.

201 Restatement (Second) of Contracts § 370 (1979).

202 Id. § 373 cmt. c.
court may be able to infer that opportunism by the paying party is absent, and use the discretionary character of restitution to justify the lower damage measure.\textsuperscript{203}

This is not to say that courts will always get it right. But it does give them something to look for: if the paying party would have terminated the contract at that point even had the contract rate been the "market" rate, the court should deny high-restitution. This will often be the case when it appears that the termination was "for cause," for example. The point is that the law of restitution as applied to losing contract cases can be reconciled with the rest of contract damage law under the fault-based economic theory developed in this Article.

Although this Section and Part II.A have identified five different categories of contract cases and explored in perhaps excessive detail cases that fall within the general rubric of contracts that are or become jointly unprofitable, the basic economic rules that emerge and explain the broad doctrinal landscape are very simple: reliance damages or low-restitution damages are the appropriate measures, as long as the regret contingency is accidental; expectation damages or high-restitution damages are appropriate if the potential for opportunistic behavior by the promisor exists.

C. Contracts That Should Not Be Breached

Part I defined the final category of breaches, contracts that should not be breached, in terms of joint profitability. A contract that remains jointly profitable, despite the occurrence of a regret contingency, is a contract that should not be breached. But there is an important determinant of joint profitability that until now I have overlooked, or rather whose absence I have implicitly assumed. Often, even if a regret contingency occurs, the promisor is in a position to mitigate the promisee's losses so that the contract remains jointly profitable. In discussing contracts that should not have been made and contracts that should not be performed, I have implicitly assumed that the promisor cannot mitigate; thus, the only incentive for the promisor that matters is the incentive to

\textsuperscript{203} Id. § 373 cmt. d ("Since a contract that is a losing one for the injured party is often an advantageous one for the party in breach, the possibility should not be overlooked that the breach was provoked by the injured party in order to avoid having to perform.").
take various precautions or to refrain from opportunistic behavior. The inability of the promisor to mitigate has also helped to make the analogy to tort accidents more persuasive, because in most tort accidents the tortfeasor is not in a position to mitigate the victim's losses.\footnote{There is one large class of exceptions that I can think of: professional malpractice. It is no surprise, then, that malpractice is viewed both as a contract problem and a tort problem. When mitigation is possible, malpractice damages are essentially contract damages. For example, if in \textit{Sullivan} a surgeon could have performed corrective surgery to give Alice Sullivan the nose she desired after the first surgery went awry, I have no doubt that the court would have adopted a "cost of completion" damage measure, augmented by the unanticipated pain and suffering costs Sullivan bore.}

If, however, the promisor can mitigate, so that the total cost of performance to the performing party remains below the paying party's valuation, then there is no longer a need for courts to choose a damage measure explicitly designed to give the promisor the correct incentives to take precautions. Nor is there a need for courts to distinguish between accidental and intentional contingencies. In these cases, therefore, the strict liability approach to contract damages returns in a limited way: the reason for the breach does not matter if there is a possibility that the promisor can mitigate, and so perform.

A damage measure that provides the correct incentives for the promisor to mitigate losses from regret contingencies that occur will also provide the correct incentives for the promisor to take precautions and refrain from manipulating contingencies in the first place. If it is cheaper for future promisors to take precautions than to mitigate, they will do so; if it is cheaper for future promisors not to take precautions but to "allow" the regret contingency to occur and then mitigate, they will do that. And if future promisors take precautions, but the regret contingency nevertheless occurs and the promisors can mitigate, they will have the incentive to do so. The fact that the damage rule chosen influences not only the promisor's ex ante precaution decisions but also the promisor's ex post mitigation and performance decisions marks the departure of contract damage rules from tort damage rules. The issue becomes neither which promises should be made nor which precautions should be taken, but which promises should be kept.
A promisor's failure to mitigate can take several forms. In one, the promisor fails to take some action, such as repairing or replacing defective performance. In a second, the promisor takes some action, usually contracting with another party even though the promisee would be able to do so. I call the first category of breaches "defective performance," and the second category of breaches "superior alternatives." I will take these up in turn. Finally, I will return to the losing contract problem in the context where the promisor may be able to mitigate and perform.

1. Defective Performance

Suppose a regret contingency occurs so that the contract is now a losing proposition for the promisor, but the contract remains jointly profitable, so that it should be performed. Absent an appropriate remedy, the promisor has an incentive to breach by rendering and failing to correct defective or incomplete performance. The damage rule that gives the promisor the correct incentives to mitigate, or simply to perform and keep promises that should be kept, must take away that incentive. The expectation damage measure serves this function.

To see this point, consider the two general classes of regret contingencies that do not render the contract jointly unprofitable.\(^{205}\) In the first class, the cost of performance rises above the contract price, but not above the paying party's valuation. The performing party would now like to breach, and so is the promisor. In this situation, a damage measure that forces the performing party to pay the full cost of performance if it breaches will take away the performing party's incentive to breach. The minimum damage measure that does this is a cost of completion measure, because the cost of completion is by assumption less than the paying party's profits. A lost profits measure will also encourage the promisor to mitigate because the promisor's mitigation costs are, again by hypothesis, lower than these damages. Both the cost of completion and lost profits measures are expectation measures.\(^{206}\)

\(^{205}\) See supra note 47 and accompanying text.

\(^{206}\) In terms of our simplified model, this case involves \(v>c'>p\), with \(c'\) being the new, higher cost of performance, including mitigation by the promisor (performing party). The cost of completion measure is \(c'-p\), assuming that the paying party has not yet paid the contract price and could mitigate itself if the performing party breaches. See Restatement
In the second class, the paying party's valuation decreases below the contract price, but not below the performing party's costs. Now the paying party has the incentive to breach, and so is the promisor. In this situation, a damage measure that forces the paying party to pay the full cost of its "performance" (that is, payment) if it breaches will take away its incentive to breach. The minimum damage measure that does this is once again a "cost of completion" measure that forces the paying party to bear the losses of a completed contract even if it breaches. Alternatively, forcing the paying party to pay the full contract price will take away the paying party's incentive to breach. Both measures again are expectation damage measures.207 The key point is that a general rule of reliance damages, which are usually less than expectation damages, will result in insufficient promisor mitigation and allocatively inefficient breaches.208

With respect to the promisor's incentives, then, the economic analysis seems to leave us in a quandary. It seems that courts must choose either to award expectation damages and accept the costs of excessive promisor precautions, or to award reliance damages and accept the costs of insufficient promisor mitigation, and thus inefficient breaches.209 Increasing damages from reliance to expectation increases the likelihood that the promise is kept, but reduces the likelihood the promise is made in the first place, while increasing the likelihood of excessive precaution-taking.210 How then do we decide on the preferred measure of damages?

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207 In this case, \( p > v' > c \), with \( v' \) being the new, lower valuation. The "cost of completion measure," which is not used in practice outside of the market damage context, is \( p - v' \). The lost profits measure is \( v - p \). Under either measure, the paying party has no incentive to breach, because even though it loses \( c' - p \) by mitigating and performing, it loses at least the same amount by breaching.

208 See Birmingham, supra note 8, at 258-60.

209 See Birmingham, supra note 8, at 261-62; see also Scott & Leslie, supra note 67, at 772 ("In sum, minimizing the costs of regret contingencies requires the parties 1) to take precautions against such risks before they occur and 2) to adjust cooperatively once they do. Unfortunately, there is an inherent tension between these two objectives. . . . Thus, more flexible damage rules are necessary to encourage mitigation and cooperation.").

210 See Birmingham, supra note 8, at 250.
This problem disappears once we abandon the notion of strict liability in damage rules. A promisor contemplating breach will know that it will pay expectation damages if it breaches when it could have mitigated. It thus has an incentive to breach only when the contract should not have been made or should not be performed, in which case it will pay only reliance damages. A promisor contemplating making a contract or investing in precautions will know that it will be held only to a reliance damage measure, not to an expectation damage measure, if a court determines that the contract should not have been made or should not be performed; it will therefore not be overdeterred from contracting, nor will it be led to take excessive precautions.

The choice of damage measure is further complicated by the fact that courts must consider the incentives of the promisee as well as the incentives of the promisor. Even if the promisor can mitigate, the promisee might be able to mitigate more cheaply. Just as courts adjust the reliance measure to give the promisee the right incentives to mitigate jointly unprofitable contracts, they must also adjust the expectation measure to give the promisee the right incentives to mitigate jointly profitable contracts when it is the better mitigator. The doctrinal devices most often used to adjust the promisee’s incentives through the damage measure are again the foreseeability, certainty, and mitigation doctrines. In addition, the diminution in value measure, by denying the promisee (paying party) both a lost profits recovery and a recovery of mitigation expenses, encourages the promisee to mitigate in particular ways, either by accepting the defective performance or by selling the subject matter of the contract on the market.

211 See Goetz & Scott, supra note 22, at 980.

212 A numerical example may be helpful here. Suppose the contract has a value \( v \) of 100 to the paying party and has an original performance cost \( c \) of 20 to the performing party. Suppose further that the contract price \( p \) is 50 so that the paying party expects profits of 50 (100-50) and the performing party expects profits of 30 (50-20), for joint profits of 80. Now suppose a regret contingency renders performance defective and increases the performing party's total cost of "complete" or "perfect" performance, including mitigation, to 55 \( (c') \). The contract remains jointly profitable \( (100>55) \) and should be performed even though the performing party now loses 5 in profits \( (50-55) \). Thus, the performing party has an incentive to breach absent a damage remedy and so can be viewed as the promisor. But the performing party may not be the superior mitigator. Suppose that the paying party (promisee) would lose only 5 units of value from accepting the defective performance \( (v'=95) \). From the perspective of allocative efficiency, it would
A good example of a defective performance case in which the costs to the performing party increased is *Johnson v. Healy*.\(^{213}\) In *Johnson*, a builder sold a home to a buyer for $17,000.\(^{214}\) Several years later the house settled as a result of improper fill beneath the building site, about which the builder knew nothing.\(^{215}\) The settling caused displacements in some foundation walls and damage to sewer lines.\(^{216}\) When the buyer first complained to the builder about the problem, the builder offered to repurchase the house for the contract price plus the expense of repairs then estimated by the buyer at $5000.\(^{217}\) The buyer rejected this offer, and sued on the grounds of innocent misrepresentation and negligence.\(^{218}\) The trial court found for the buyer on the misrepresentation count and for the builder on the negligence count.\(^{219}\)

As for the damage measure, the buyer had asked for cost of completion damages of $882.50 for the repair of sewer lines and $27,100—more than the contract price of the house—for the cost of constructing a new foundation.\(^{220}\) The buyer also incurred $5112 of additional expenditures in connection with the house, a substantial (but unidentified) portion of which he claimed were "repairs attributable to the faulty settlement of the house."\(^{221}\) The trial court awarded damages of $5000, apparently a compromise fig-

\(^{213}\) 405 A.2d 54 (Conn. 1978) (Peters, J.).
\(^{214}\) Id. at 55.
\(^{215}\) Id. at 55-56.
\(^{216}\) Id. at 55.
\(^{217}\) Id. at 58.
\(^{218}\) Id. at 55, 58.
\(^{219}\) Id. at 55.
\(^{220}\) Id. at 58.
\(^{221}\) Id. It is actually not clear from the court's opinion whether the buyer claimed any of these expenditures as damages, though I cannot imagine why the buyer's lawyer would have omitted these expenditures, or why the trial court would have considered them had the buyer's lawyer not claimed them.
The builder argued on appeal that the trial court erred by not adopting a diminution in value measure of damages.\textsuperscript{222} The Connecticut Supreme Court affirmed the trial court’s liability judgments, but remanded for a new trial on damages.\textsuperscript{223} The court treated the innocent misrepresentation claim as the equivalent of a claim of breach of express warranty, and characterized the rule of liability as “strict” in the sense that the builder was being held liable simply for his statement that there was nothing wrong with the house, not because of his state of mind or his failure to take precautions.\textsuperscript{224} The contract damage rule the court used, however, was anything but strict. First, the court affirmed the trial court’s judgment that the cost of replacing the foundation should not be allowed as damages.\textsuperscript{225} The court rejected the cost of completion measure because the cost of repairs substantially exceeded the contract price, which suggested to the court that insisting on such repairs would result in “unreasonable economic waste.”\textsuperscript{226} The court also added that “[c]ontract restraints are particularly appropriate when damages are awarded, as in this case, for misrepresentations which, though actionable, are totally innocent.”\textsuperscript{227} Second, the court held that the proper damage measure was diminution in value, but that because this measure is “notoriously . . . difficult to apply,” the “[r]easonable costs of repair” could serve as an “approximation” of this measure.\textsuperscript{228} The court then noted that although “reliance damages” are often used when other measures are hard to calculate, the $5112 in expenditures by the buyer was not an acceptable proxy for diminution in value because the list of expenditures did not distinguish between repairs incident to the breach and improvements. Finally, the court deemed the builder’s settlement offer and the buyer’s rejection of it irrelevant and ordered a new trial on damages.

\textsuperscript{222} Id.
\textsuperscript{223} Id.
\textsuperscript{224} Id. at 58-59.
\textsuperscript{225} See id. at 56. It is for this reason that I think it makes sense to include this “tort” case in a discussion of contract damages.
\textsuperscript{226} Id. at 58-59.
\textsuperscript{227} Id. at 58 (citing Levesque v. D&M Builders, 365 A.2d 1216 (Conn. 1976)).
\textsuperscript{228} Id.
\textsuperscript{229} Id. at 59.
The theory developed in this Article supports the court's result, but explains it in a more sensible and straightforward way. Johnson provides a paradigmatic example of how courts use damage rules to achieve loss-splitting that provides optimal incentives to promisors and promisees. The court effectively said that this contract was one that should have been performed, and that the buyer was entitled to the cost of completion, but only the "reasonable" cost of completion. That is, the buyer was entitled only to those costs of completion that left the contract jointly profitable, which would probably include the sewer repair and other repairs incident to the settling. Moreover, the breach was caused by an accidental contingency against which the builder could not have taken any reasonable precaution. Though this fact is usually irrelevant in cases of contracts that should be performed, in this case it is relevant to the extent that there is no reason to allow the trial court to apply broad discretion and give the buyer the benefit of the

230 The court's approach demonstrates, in my view, some of the shortcomings of traditional contract damage analysis. The court felt compelled to reject the cost of completion measure because it was not awarding "full" completion. Because the traditional alternative to the cost of completion measure is the diminution in value measure, that was the measure the court adopted. The court then stated that reasonable costs of repair can serve as a proxy for diminution in value when measurement is difficult. Id. at 59. Why measurement would be difficult in this case, especially given the builder's offer to repurchase the house at the contract price plus nonfoundation repair costs, is not clear. Then, perhaps to justify its use of one damage measure to serve as a proxy for another, perhaps to legitimize its limitation to "reasonable" repair costs, the court cited Fuller and Perdue and seemed—to me, at least—to refer to the costs of repair as "reliance" damages. See id. (citing Fuller & Purdue, Reliance 1, supra note 4). I would suspect that this usage of "reliance" would surprise many contracts scholars. But see Robert E. Hudec, Restating the "Reliance Interest," 67 Cornell L. Rev. 704, 705 n.3 (1982) (citing case as a reliance damage case). The primary point, however, is that the traditional doctrinal labels and analyses may obfuscate as much as they clarify, and that not all judges may be able to navigate as nimbly through the thicket as the author of Johnson, Justice Peters, a former contracts professor.

231 In the jargon of economics, the court awarded the cost of completion so long as the marginal cost was less than the marginal benefit. The last act of repair necessary to make performance perfect exceeded its likely value to the buyer.

232 The court does not mention the sewer repairs at all in its discussion of "reasonable costs of repair." It mentions only the $5112 in "additional" expenditures. See Johnson, 405 A.2d at 58-59. I do not know whether the court intended to suggest that the sewer repairs were unreasonable, though my hunch is it did not.

233 It is possible that the builder would have been able cheaply to test the soil before building and that failure to do so was negligent. I am, however, accepting the trial court's finding, affirmed by the Connecticut Supreme Court, that the builder was not negligent. See id. at 57-58.
doubt in proving its repair costs; rather, it makes sense to hold the buyer to a strict burden of proof.

On the other hand, by denying recovery for the cost of constructing a new foundation, the court effectively said that a perfectly completed contract was either jointly unprofitable or that the buyer was the better mitigator of that part of the loss, if any, representing the difference between a partially repaired house and a perfectly repaired house. There was no reason to use a stronger form of the expectation measure because the builder did not act opportunistically; in fact, the buyer might have been acting opportunistically by exaggerating his losses. The fact that the buyer rejected the builder's offer to buy back the house supports this conclusion: either the partially repaired house still had some idiosyncratic value for the buyer, in which case the buyer was in a better position to preserve that value; or the buyer thought he could get a better price by selling on the market; or the buyer incurred no extra loss but simply sought to exploit the possibility of imperfect court enforcement leading to higher damages.

A second example of the defective performance problem is Walters v. Marathon Oil Co., in which the court used the lost profits measure rather than a cost of completion measure to ensure optimal promisor mitigation. The Walters, a couple with no prior gasoline market experience, began negotiations with Marathon in late 1978 about locating a combination food-store and service station on a vacant gasoline service station site. The Walters bought the service station and made improvements, based upon promises made to them as well as continuing negotiation by Marathon's rep-

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234 The court's statement that “contract restraints,” meaning in this context flexible damage rules, are especially appropriate when the builder’s misrepresentation is “totally innocent” suggests that the court might be willing to apply a harsher measure in a case in which the builder’s conduct appears more opportunistic. See Johnson, 405 A.2d at 58.

235 The opinion gives no information about the specific damage the settling did, other than the damage to the sewer lines. Nor does it suggest what, if any, possible future damage could arise from further settling.

236 The case is also an example of the “negligence-opportunism tradeoff” in that the court effectively punished the party that was most likely acting opportunistically—the buyer—even though the builder might have been negligent in making the promise he did. See Cohen, supra note 23, at 943, 983-90.

237 642 F.2d 1098 (7th Cir. 1981).

238 Id. at 1099.
resentatives. After the Walters submitted a proposal to Marathon, but before the proposal was accepted, Marathon suspended consideration of all new dealership applications because of the oil crisis caused by the Iranian revolution. Basing liability upon the doctrine of promissory estoppel, the district court awarded lost profits to the Walters. The United States Court of Appeals for the Seventh Circuit affirmed, finding that the Walters had made reasonable, though failed, efforts to mitigate, and that lost profits were within the discretion of the district court to award.

Walters has figured prominently in the ongoing debate about whether courts should award reliance damages or expectation damages in a promissory estoppel action. Both sides in the debate have enlisted the case. Those who believe that expectation damages prevail in promissory estoppel cases as long as lost profits are easy to measure find support for their position in Walters. Those who believe that reliance damages are generally appropriate for promissory estoppel cases also cite the case for support, arguing that forgone opportunities were more easily measured than in most other promissory estoppel cases.

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239 Id.
240 Id.
241 Id.
242 Id. at 1100-01.
243 See, e.g., E. Allan Farnsworth, Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations, 87 Colum. L. Rev. 217, 237 n.68 (1987) (distinguishing Hoffman v. Red Owl Stores, 133 N.W.2d 267 (Wis. 1965), on the grounds that in Walters the terms of the agreement were known because the application was submitted); Yorio & Thel, supra note 70, at 144 n.223 (citing case for the proposition that "[w]hen a definite promise is proved and lost profits can be determined with reasonable certainty, courts award expectation damages measured by the franchise profits that would have been earned but for the promisor's breach").
244 The court does stress the fact that "the amount of the lost profits was ascertained with reasonable certainty." Walters, 642 F.2d at 1100-01. In an accompanying footnote, the court apparently tries to distinguish Goodman v. Dicker, 169 F.2d 684 (D.C. Cir. 1948), a promissory estoppel case denying lost profit damages, by reference to another case in the same circuit that stressed the importance of being able to measure profits. Walters, 642 F.2d at 1101 n.1. This is strange because, as the court admits, the profits in Goodman were in fact measured, but denied. Id. The court's other reason for rejecting Goodman is that awarding profits and expenditures would result in "double damages." Id. But that is true only for expenditures saved or resalable at the purchase price, not for expenditures sunk.
245 See Birmingham, supra note 8, at 236-37. As Professor Birmingham notes, the court justifies the lost profit remedy by stating that "in reliance upon [Marathon's] promise, [the Walters] had foregone the opportunity to make the investment elsewhere." Walters, 642 F.2d at 1100. In this case, the conclusion that the Walters lost a chance to contract with
In the theory developed here, this debate is irrelevant. Promissory estoppel is merely a rule of liability, and courts are no more prone to adopt a uniform damage rule here than for any other contract rule of liability. The fault-based economic theory focuses on the choice of whether to award lost profits rather than on doctrinal labels. What bears on this choice is the type of behavior we want to discourage. Courts sometimes use lost profit damages to discourage opportunistic breaches. In Walters, however, the breach does not appear to have been opportunistic. Marathon was apparently not looking for a better price in light of changed market conditions. It did not contract with an alternative service station owner; instead, it put a moratorium on all new contracts. This move made economic sense because the industry supply curve had shifted inward due to the Iranian crisis. As a result, Marathon and the other oil companies had to reduce supply and raise price. That is arguably why the Walters could not get an alternative contract. Everyone was cutting back on production. Nonperformance in this case thus appears to have been efficient.

But there are reasons to think that the contract remained jointly profitable despite the occurrence of a regret contingency—the Iranian crisis—that increased Marathon’s cost of performance. First, there is no indication that Marathon had changed its previously favorable opinion of the Walters’ competence and financial stabil-

other oil companies seems plausible. Even though several companies rejected them after the Iranian crisis, if the crisis was the reason for the rejection rather than the Walters’ inexperience, then it is quite possible that but for Marathon’s promise the Walters could have had a contract in place with one of the other companies before the crisis hit. On the other hand, it is also possible that the negotiations with Marathon were not unusually long (the court notes that “[p]aper work apparently proceeded normally,” id. at 1099) and that the Walters could easily have wound up negotiating for the same length of time with other oil companies, without their making the “promises” upon which the Walters could hang a promissory estoppel claim before the crisis hit; that is, the Walters might not have really lost an alternative opportunity. Id. at 1099-1100. Thus, the forgone opportunity argument is not a completely satisfactory justification for the award of lost profits damages.

246 The alternative explanation, stressed by Marathon on appeal, was that the Walters could have found an alternative supplier if they had “asserted legal rights, and complied with Department of Energy regulations.” Id. at 1099. The court does not make clear what these rights and regulations were, or how likely it really was that the Walters could have found an alternative, because it decides that the Walters’ lack of sophistication excused them from having to mitigate to that degree.
ity; rather, the company simply instituted a blanket moratorium. The fact that the site had already been a gas station also supports the inference that the contract remained jointly profitable, because the risk of failure was lower than it would otherwise be.

Most important, however, was the fact that Marathon probably could have mitigated any losses resulting from the Iranian crisis. Marathon certainly needed to adjust to changed market conditions by cutting back its production. But did it need to do that by reneging on its promise to the Walters? Put another way, is it clear that this contract was jointly unprofitable? The answer is no. It is not clear that the extra “cost” to Marathon of performing this contract for a year would have exceeded the value of the contract to the Walters, namely the $22,200 of lost profits. Marathon might have been able to achieve the entire production cut it needed by declining to enter into new contracts, by allowing old contracts to lapse, by more aggressively pursuing breaches, or by increasing its wholesale prices (including the prices it would have charged to the Walters) and having them passed along to consumers. Given all these options, it is hard to know whether this particular contract would have been a loser. But under an expenditure measure, reneging on the Walters deal would have been an artificially cheap way for Marathon to adjust. Thus, despite the fact that Marathon did not intend to contract with anyone else, there is reason to believe that the breach was opportunistic because Marathon was the better mitigator, yet tried to take advantage of an undercompensatory remedy. The court’s ruling is essentially a prediction that future

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247 In the famous promissory estoppel case Hoffman v. Red Owl Stores, 133 N.W.2d 267 (Wis. 1965), in which a franchisor reneged on its promise to grant a franchise after repeated assurances to and investments by the potential franchisee, the likelihood is greater that the contract was one that should not have been performed. The franchisee-applicant apparently did not have sufficient capital at his disposal to make the deal jointly profitable. See id. at 270-71. The court’s decision to award reliance damages in Hoffman is most defensible under the theory developed here if one interprets what happened in that case as an unintentional miscommunication about the capital requirements for starting the franchise rather than an opportunistic attempt to wrangle more money out of Hoffman after forcing him to commit to the deal.

248 This fact also explains why lost profits and lost opportunities were so easy to measure. The district court relied heavily on the quantity of gasoline sold at the site in 1978. Walters, 642 F.2d at 1100.

249 One could add to this justification for labeling the breach opportunistic the arguments that Marathon (1) should have known that the Walters would have a hard time
parties in Marathon's position, when faced with the likelihood of lost profit damages, would not refrain from promising, would not qualify their promises, and would not breach, but rather would find adjustment mechanisms to respond to market supply curve shifts—mechanisms that cost less than the franchisee's lost profits. Of course, it is difficult to know whether the court got it right, but that is the best justification for what the court tried to do, and a court that explained its decision this way would create no obviously inefficient incentives.250

2. Superior Alternatives

The second class of contracts that should not be breached involves a regret contingency that increases the opportunity cost of performance to the performing party or the paying party, rather than increasing the actual cost to the performing party or decreasing the actual value to the paying party. In this type of case, much discussed in the literature debating “efficient breach,” the regret contingency is the appearance of a superior contracting partner after the contract is made. Although superior alternative cases may, like Dempsey, involve contracts that should not be performed, if the promisee can take advantage of the alternative, these cases become contracts that should not be breached.

Suppose, to take a common example, that a seller breaches a contract for some unique good to sell to a second buyer who values the good more highly than the first buyer.251 The efficient breach

mitigating in light of the likelihood that other oil companies would also need to be cutting back; and (2) might have been tempted to breach if it perceived the Walters to lack the financial resources to sue successfully.

250 Recall that the lost profits measure would give the promisor the incentive to take ex ante precautions if these were cheaper than mitigation. In this case, there was no obvious, low-cost precaution that Marathon should have taken. Perhaps Marathon should have investigated the situation in the Middle East more carefully, or perhaps it should have been more circumspect in making assurances to the Walters. But the Iranian crisis could arguably be viewed as an unforeseeable event; that is, the investment in precautions did not exceed the expected loss ex ante. And absent the Iranian crisis, Marathon's assurances might have landed it a good contract it would not otherwise have had.

251 See Polinsky, supra note 14, at 28; Posner, supra note 40, at 119. I recognize that this example might not be completely realistic because specific performance is often available in this situation. See U.C.C. § 2-716(1) (1990). Although the focus of this Article is on the choice among damage measures, rather than the choice between expectation damages and specific performance, many of the arguments in favor of specific performance apply equally to the arguments that I will make in favor of high-restitution damages. But specific
theory argues that the expectation damage measure provides the correct incentive for the promisor to breach in this situation. The expectation damage award gives the first buyer its valuation under the first contract. The seller has an incentive to breach and sell to the second, higher valued buyer because the difference between the seller's profit on the second contract and the damage payment exceeds the seller's profit on the first contract. According to this theory, a higher damage measure would deter efficient breaches. This Part argues, to the contrary, that courts in this situation often use a high-restitution measure, which disgorges the profits on the superior alternative contract from the breaching party. The expectation damage measure does not sufficiently deter promisors from breaching contracts that they should perform, because the promisor may not bear the full costs when deciding whether to perform or breach.

performance may not be available. Specific performance is a discretionary remedy, and there are situations in which the court may choose not to award it; for example, the first buyer may not sue until the second buyer has already used or resold the good. In addition, the court may find that the damage remedy is "adequate," which precludes specific performance. See Restatement (Second) of Contracts § 359 (1979). Finally, one could easily recast the example as a service contract, in which specific performance is much rarer because of the problems of court supervision. See id. §§ 366, 367. I will consider the case of fungible goods for which substitutes can be purchased on the market in Part III.

I will use a simple numerical example to help illustrate this and other points. Suppose \( v = 10 \), \( c = 4 \), and \( p = 6 \). Under the original contract, the first buyer's profit would be \( 4 (10v - 6p) \) and the seller's profit would be \( 2 (6p - 4c) \), for joint profits of 6. If the second buyer values the good at 12 (\( v' \)) and is willing to pay the seller 12, the seller has an incentive to breach. The seller will have to pay expectation damages of 4 to the first buyer, but the seller will earn profits of 8 (\( 12v' - 4c \)) on the second contract, for a net profit of 4 (\( 8 \text{[gross profits]} - 4 \text{[damages]} \)), which exceeds the profit of 2 it would earn on the first contract. The joint profits of the parties would now be 8, with the seller gaining the entire benefit of the new opportunity.

Previously we examined the low-restitution damage measure, which is less than the reliance measure; here, as in Part II.B.3, we examine the high-restitution measure, which is greater than the expectation measure. What if the restitution damage measure lies between the expectation and reliance measures? In such cases, courts may choose the lower restitution measure when the breach does not appear opportunistic and the higher expectation measure when it does. Compare Gassner v. Lockett, 101 So. 2d 33 (Fla. 1958) (awarding damages measured by the breaching seller's profit on resale of property rather than higher market damages when breach was in "good faith") with Murarka v. Bachrack Bros., 215 F.2d 547 (2d Cir. 1954) (awarding damages measured by the promisee-buyer's lost profits rather than the lower profits the breaching seller earned by selling to a third party).
The implicit assumptions of the efficient breach defense of expectation damages are that the appearance of the superior alternative makes the contract jointly unprofitable and that the seller is in a better position than the buyer to “mitigate” to take advantage of this opportunity. But if the first buyer could resell to the second buyer, which it could for almost any transaction in goods or real estate, these assumptions no longer necessarily hold true, and the expectation damage measure may no longer provide the correct incentives to the promisor.\(^{254}\) The contract remains jointly profitable because the first buyer can take advantage of the new opportunity. In fact, in such a case, the expectation damage measure itself becomes ambiguous, because the first buyer’s “expectation” could be deemed to include the profits of reselling to the second buyer.\(^ {255}\) Usually, however, a damage measure that disgorges from the breaching party the profits on an alternative contract is deemed “restitution”\(^ {256}\) and I will maintain that usage here. But the impor-

\(^{254}\) In service contracts, the question is somewhat different. If, for example, a paying party breaches to hire a substitute performing party, the question is whether the first performing party could have done the same work and the paying party is simply seeking more advantageous contract terms, or whether the substitute performer is superior independent of the particular terms of the first contract. This question is at the heart of Patton v. Mid-Continent Systems, 841 F.2d 742 (7th Cir. 1988). See infra notes 285-307 and accompanying text. Similarly, if the performing party breaches to work for a substitute paying party, the question is whether the performing party is simply seeking a better contract price. For a case suggesting the appropriateness of a high-restitution measure in such a situation, see Triangle Waist Co. v. Todd, 119 N.E. 85, 85 (N.Y. 1918) (Cardozo, J.) (noting that the employee breached to take a higher paying job because “she believed herself worth more than she had received”).

\(^{255}\) To return to the previous example, supra note 252, the first buyer’s profits after the appearance of the second buyer would no longer be 4\((10[v]-6[p])\), but rather 6\((12[v]-6[p])\) because the first buyer would “mitigate” and resell to the second buyer. If the seller had to pay damages of 6, representing the first buyer’s “expectation,” it would be deterred from breaching because it would now gain net profits of only 2\((12[v]-4[c]-6[\text{damages}])\) by breaching and paying damages. Thus, the seller would be no better off by breaching, and if it would incur costs of breaching, it would be worse off. See infra notes 260-63 and accompanying text. In this case, the joint profits would again be 8 after the appearance of the second buyer, but the first buyer would reap the entire additional gain.

\(^{256}\) This is not always the case. Sometimes courts will use the alternative contract as evidence of “market value” or “lost profit” in determining the expectation measure. See, e.g., Roth v. Speck, 126 A.2d 153, 156 (D.C. 1956) (noting that in breach by employee to take a higher salaried job, the higher salary “may be presumed to be the fair value”); Triangle Waist Co., 119 N.E. at 86 (“If one agrees to sell something to another, and then, the next day, sells it to someone else at an advance, the new transaction is not to be ignored in estimating the buyer’s loss.”); Arabesque Studios v. Academy of Fine Arts Int'l, 529 S.W.2d 564, 569 (Tex. Ct. App. 1975) (noting that if an employee breaches a contract,
tant point is that there is a choice that must be made between the two damage measures, and this choice depends on whether the promisor-seller or the promisee-buyer is the better mitigator.

The choice of the expectation damage measure assumes that the seller is the superior mitigator, or at least is in a better position to decide who is the better mitigator. In fact, however, the expectation damage measure does not always give the correct incentive to the promisor to decide between performance and nonperformance.\textsuperscript{257} The efficient breach theory supports the expectation damage measure by assuming that transaction costs under the expectation measure are zero\textsuperscript{258} whereas transaction costs under the restitution measure are positive, namely the additional transaction between the first buyer and the second buyer.\textsuperscript{259} But the transaction costs under the expectation damage measure are not zero. First, the seller must bargain with, and may search for, the second buyer. Second, and more important, nonperformance is always costly. The efficient breach theory assumes that by adopting a strategy of "breach first, ask questions later,"\textsuperscript{260} the promisor can effectively bypass both bargaining and the courts.\textsuperscript{261} In reality,

the jury may consider the profits made by the employee's new employer in measuring damages); Sprague v. Sumitomo Forestry Co., 709 P.2d 1200 (Wash. 1985) (holding that resale price may be considered as evidence of market price under U.C.C. § 2-708).

\textsuperscript{257} This problem leads me to believe that breach is often not a "cry for help," Scott & Leslie, supra note 67, at 794; rather, it is a call to battle.

\textsuperscript{258} According to Polinsky:

An important assumption in the following analysis is that if S [the seller] wants to breach the contract, B1 [the first buyer] will not find it worthwhile (because of bargaining costs) to attempt to stop S from breaching or to repurchase the widget from B2 [the second buyer] after the breach.

Polinsky, supra note 14, at 31. I interpret this statement to mean that once the seller declares it is breaching and offers the first buyer expectation damages, the first buyer will simply acquiesce and so there will be no bargaining, no litigating, and thus no additional transaction costs.

\textsuperscript{259} See, e.g., Posner, supra note 40, at 119.

\textsuperscript{260} See Macneil, supra note 10, at 968 (arguing that the "whole thrust of the Posner [efficient breach] analysis is breach first, talk afterwards").

\textsuperscript{261} This strong version of the theory would postulate that once the expectation damage rule is in place, contracts become "self-enforcing." See L.G. Telser, A Theory of Self-Enforcing Agreements, 53 J. Bus. 27 (1980). If the promisor's potential breach is efficient, the promisor simply pays the promisee expectation damages as a settlement. Paul Rubin has modified this version somewhat by arguing that once the expectation damage remedy is in place, contracts are "expectedly self-enforcing," meaning that although no party expects to have to breach ex ante, breaches will occur when circumstances change unexpectedly. See P. Rubin, Business Firms and the Common Law 53, 57 (1983).
however, nonperformance necessarily entails negotiation, litigation, or both. And although the promisor bears the full cost of performing, it does not bear the promisee’s costs of either renegotiating or litigating.\textsuperscript{262} Thus, the promisor may not have the incentive to make the correct choice from the perspective of institutional efficiency among the options of performing, renegotiating, and litigating.\textsuperscript{263}

\textsuperscript{262} Professor Farber has argued that the fact that the promisee does not recover all litigation costs, such as attorney’s fees and prejudgment interest at market rates, can support “supercompensatory” damages. See Farber, supra note 96. His focus is not on the restitution measure, however; rather, he examines supercompensatory damages as a means of implementing the “expectation ideal.” Farber recognizes that supercompensatory damages are problematic because they distort promisee incentives. For example, he notes that modifying rules on attorneys’ fees could cause excessive investment in litigation. See id. at 1455 n.49. He also recognizes that awarding supercompensatory damages could discourage promisees from investing in breach detection. See id. at 1474.

\textsuperscript{263} Let us return once again to our numerical example. Recall that under the expectation damage measure, the promisor has an incentive to breach because it earns profits of 4 rather than 2, and joint profits increase from 6 to 8. Suppose that the promisor would incur costs of 2 from renegotiating and costs of 1 from litigating. Thus, the promisor has an incentive to litigate rather than renegotiate, and the promisor will litigate rather than perform because litigating yields profits of 12 (new contract price) – 4 (cost of performing) – 4 (expectation damage payment) – 1 (litigation costs) = 3 > 2 (profits under original contract). Now suppose that the promisee incurs costs of 1 from renegotiating and costs of 3 from litigating, and the promisor does not bear these costs under the expectation damage measure. Now the joint costs of either renegotiating (2+1=3) or litigating (1+3=4) exceed the additional joint benefit of nonperformance (12–10=2); thus, the contract is one that should be performed. (Alternatively, the original contract yields joint profits of 10–4=6; the new contract, including costs of nonperformance, yields profits of 12–4–3=5 if renegotiation occurs, or 12–4–4=4 if litigation occurs. Macneil has speculated that the transaction costs involved in breaching will often swallow up any efficiency gains in alternative transactions. See Macneil, supra note 10, at 954 n.28.) Yet the promisor has an incentive to breach.

Moreover, as between litigating and renegotiating, the promisor chooses to litigate, which is the costlier of the two institutional choices. This may seem to be an anomaly resulting from unrealistically chosen cost values: the promisor’s renegotiating costs exceed its litigation costs; the promisee’s litigation costs exceed its renegotiation costs. But litigation may provide information to the promisor about the promisee—as a result of compulsory discovery—that the promisor would not discover in bargaining, and that would weaken the promisee’s bargaining position. For example, the promisor might discover that the promisee was in a financially weak state and could not endure extended litigation. To the extent that the expectation damage remedy encourages breach and litigation, it hardly seems an “attempt[ ] to strengthen the market mechanism,” as advocates of the efficient breach theory claim. See, e.g., Birmingham, supra note 8, at 286 (emphasis added). Note that a rule that shifts the promisee’s litigation costs to the promisor would deter the promisor from litigating but would not deter it from renegotiating.
Even if the promisor were to bear the promisee's costs of negotiation and litigation as part of the expectation damage measure, the promisor would still not necessarily have the right incentives. First, if the parties wanted to maximize joint profits ex ante, they would compare the seller's costs of searching for and bargaining with the second buyer, combined with the joint costs associated with seller nonperformance, against the costs associated with the first buyer searching for and bargaining with the second buyer. They would agree to require performance only if the buyer's search and bargaining costs were lower. But the seller does not have the incentive to make an optimal unilateral determination ex post, because only under the nonperformance option does the seller get the benefits from the second buyer.264

Second, the potential for active search for the second buyer raises a separate issue because the seller and the first buyer may search simultaneously.265 The problem is one of rent-seeking and overinvestment in search because neither party takes into account the search costs borne by the other. The benefit of the alternative contract becomes a "prize" for which both the seller and the first buyer may compete.266 Under the expectation damage remedy, if

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264 Assume in our numerical example that total litigation or renegotiation costs are .5 and that the seller must pay for the first buyer's costs as well as its own. Now suppose that the seller and the first buyer would each incur costs of 1 to search for and bargain with the second buyer. From the perspective of joint profit maximization, it is better for the seller to perform because the total costs are lower. Yet the seller has an incentive to breach because it gets profits of 12 (second buyer's price) - 4 (cost of production) - 4 (expectation damage payment to first buyer) - 1.5 (total litigation costs plus search and bargaining costs) = 2.5 > 2 (profits under first contract). The problem is that in making the cost-benefit calculation, the seller's decision is skewed toward breach because only under breach does the seller get the benefit of the second buyer. The parties could, of course, solve this problem by explicitly contracting over how the superior contract contingency would be handled, including the possibility of splitting the gains. But this option may be excessively costly.

265 The second buyer may also search for the seller, which reduces the need to provide incentives for the seller to engage in postcontract search. Of course, the second buyer must worry about the possibility of a tort suit for intentional interference with contractual relations if it knows of the first buyer. See Keeton et al., supra note 35, § 129.

266 Information acquisition can be analogized to a "lottery" in which investments in information are "tickets." Promisors' incentives to invest increase with the "prize" at stake (the profits of the alternative opportunity) as well as the rate of return on these investments (for example, the likelihood of having damages reduced or eliminated by a court). The problem with the lottery is that the parties may jointly (and even individually in some cases) spend more on buying tickets than the value of the prize. See Gordon
the first buyer beats the seller to the punch, it reaps the benefits of the alternative contract; the seller, knowing this, may invest even more to beat the buyer. As a result of these competing investments, the seller may not always make optimal search decisions.\footnote{267} In other areas of the law, such as patents, the law reduces the costs associated with rent-seeking by restricting the number of parties allowed to search for new information.\footnote{268} The high-restitution damage remedy achieves the same result in contract law by restricting the freedom of the promisor to engage in post-contract searches for alternative contracting parties who would be willing and able to bargain with the promisee.\footnote{269}

My point is not that the superior alternative contingency never renders a contract jointly unprofitable, so that nonperformance is efficient. In fact, as I suggested above, Dempsey may be just such a case. Rather, my point is that the superior alternative contingency is not a uniform phenomenon, and so does not support a single damage measure; in fact, it does not support an expectation damage measure at all. In particular, where it appears that the promisee was in a position to take advantage of the superior alternative, the courts tend to use a high-restitution measure, though they sometimes talk in terms of whether the opportunity to bargain with an alternative party has become the promisee’s “property,”\footnote{270} or

\begin{itemize}
\item Tullock, Efficient Rent Seeking, in Readings in the Economics of Contract Law, supra note 2, at 35.
\item This point has not been well recognized in the economic literature on contract remedies, and even when it has been recognized, the rent-seeking aspects of costs may be ignored. For example, Richard Craswell views investment in seeking out superior alternative partners postcontract as “a kind of ‘precaution’ that encourages good outcomes rather than avoids bad ones.” Craswell, supra note 10, at 649 n.43. The search for superior alternatives pre-contract is certainly a precaution; the search post-contract may be a precaution, but viewing it simply as such is incomplete.\footnote{268} See Edmund W. Kitch, The Nature and Function of the Patent System, 20 J.L. & Econ. 265, 278 (1977).
\item This is a problem repeatedly emphasized by Victor Goldberg. See, e.g., Victor P. Goldberg, Note on Price Information and Enforcement of the Expectation Interest, in Readings in the Economics of Contract Law, supra note 2, at 80. He develops the theory discussed in this paragraph to explain the market damage formulation of the expectation damages rule. See id. at 80-83 (arguing that the market damage measure represents a “property right in the price” that reduces excessive investment in price information by encouraging timely contracting). Goldberg does not explicitly extend the theory to expectation damages in nonmarket contexts.\footnote{269}
\item Critics of the efficient breach theory have used the term “efficient theft” to focus on the fact that when entitlements are well-settled, courts do not allow the unentitled party
whether the contractual relationship falls into a special category such as "fiduciary," rather than address the damage issue directly. On the other hand, where it appears that the promisor was clearly in a better position to take advantage of a significantly superior alternative, so that nonperformance is truly efficient, courts again tend not to use the expectation damage measure, but rather tend to use the reliance measure or one of the doctrinal limits on the expectation measure discussed in Parts II.A and II.B. It should thus be apparent why the efficient breach theory, with its unfortunate focus on the superior alternative case, has proved to be such an unsatisfactory explanation of expectation damages.

A classic example of the use of the high-restitution remedy in a superior alternative situation is Timko v. Useful Homes Corp. In that case, a couple bought two lots in a tract from a developer for unilaterally to take another's entitlement, conditioned on a court assessment of "compensation," simply because the unentitled party can put the resource to a higher valued use. See Calabresi & Melamed, supra note 30; Daniel Friedmann, The Efficient Breach Fallacy, 18 J. Legal Stud. 1, 5-6 (1989); Macneil, supra note 10, at 967. The economic explanation is that we seek to encourage the use of the market, including private bargaining, when that institution is relatively cheap to use. In fact, economists have argued that the deliberate bypass of the market or bargaining explains and justifies punitive, criminal, and other "supercompensatory" sanctions. David D. Haddock, Fred S. McChesney & Menahem Spiegel, An Ordinary Economic Rationale for Extraordinary Legal Sanctions, 78 Cal. L. Rev. 1 (1990). As Macneil argues, the efficient breach theory assumes that it is relatively easy to tell when property rights shift so that "breach" is easily distinguished from "theft." Macneil, supra note 10, at 965-67. However, "[d]uring that period of change, which in real life is complex both in behavior and law, legal entitlements themselves are changing in complex ways—various benefits and burdens of ownership and obligation are shifting, but not all at once." Id. at 967.

See, e.g., Snepp v. United States, 444 U.S. 507 (1980) (per curiam) (holding that former CIA employee was a fiduciary and requiring him to disgorge all profits from a book that he published without honoring his promise to obtain prepublication clearance). Farnsworth, who criticizes Snepp, recognizes that disgorgement damages apply to breaches by fiduciaries, but views these contracts as different from "ordinary commercial dealings," in part because "the law of fiduciary relations, unlike that of contractual relations, is distinctively concerned with deterrence and ethical standards." Farnsworth, supra note 8, at 1358. I agree that disgorgement damages are not always appropriate, but I disagree that "fiduciary" contracts tell us nothing about the appropriate damage remedy for "ordinary commercial dealings."

A key issue that arises in superior alternative cases is how to establish workable presumptions and to allocate burdens of proof. My own view is that courts seem to give the benefit of the doubt to the promisee when the promisee presents evidence that it could have taken advantage of the superior alternative. The theory presented here would support such a result.

168 A. 824 (N.J. 1933).
$1000, to be paid in installments plus a down payment.\textsuperscript{274} The developer was acquired by a successor corporation, which conveyed the lots to a second buyer for $1100.\textsuperscript{275} The first buyers discovered the breach when they offered to pay the balance due in return for a deed and were refused.\textsuperscript{276} They then demanded the $1100.\textsuperscript{277} Instead, the developer—now under new management—repurchased the lots for a price not disclosed in the opinion, credited the repayment price to the second buyer on other lots she had purchased, and offered the deed to the first buyers.\textsuperscript{278} The court allowed the first buyers to recover the $1100.\textsuperscript{279} The court characterized the contract as creating a trust in which the developer held the property on behalf of the first buyers.\textsuperscript{280} It then characterized the resale to the third party as wrongful conduct amounting to an intentional fraud to justify its remedy.\textsuperscript{281} The court noted that if the resale had been accidental, that is, due to oversight or a mistake, it would have allowed the developer to tender specific performance of the original contract.\textsuperscript{282}

The case is an example of a superior alternative contract because evidently the first buyers preferred the $1100 to the property; that is, had they been given the opportunity to resell at $1100, they would have done so. It is possible that the opportunity to resell to the third party was unique: she had bought other lots and might have been willing to pay a premium to get contiguous property. But there is no reason why the first buyers were not in just as good a position to resell as the developer was. Thus, the court’s remedy provides the correct incentives to future parties in the developer’s position to refrain from breaching to resell to a higher valued buyer.

One might ask why the court did not deny high-restitution damages and instead encourage the first buyers to seek specific per-
formance (assuming its availability), especially because the developer might have had to incur a loss to repurchase the property, and the first buyers would still be in a position to resell (yet again) to the second buyer. There are several possible answers. First, it seems inefficient in cases such as this to encourage the developer to repurchase the property simply to have the first buyers resell it. Second, the extra transactions with the second buyer might have soured her on the property altogether or reduced the price that the first buyers might have gotten from her in the first place. Finally, the specific performance remedy might not discourage excessive search by the promisor or other opportunistic behavior described above; thus, the court’s emphasis on the fact that the resale in this case was intentional rather than accidental is justifiable under the theory developed here.

A more recent case in which the high-restitution remedy might have been appropriate, but was not considered, is *Patton v. Mid-Continent Systems*. In this decision written by Judge Posner, two truck stop owners entered into a franchise contract in 1971 with a provider of credit cards. The contract gave the franchisees “a specified territory, and authorized [the franchisor] to franchise additional truck stops in that territory only if the franchisees, upon being informed by [the franchisor] that additional coverage was required and upon being given the ‘first opportunity’ to meet the requirement, failed to obtain the additional facilities needed.”

In 1974, the franchisor franchised an additional truck stop in the plaintiffs’ territory. The breach began as “an honest mistake resulting from the ambiguous description of the territory in the franchise agreement,” but the franchisor did not correct the breach.

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283 See Restatement (Second) of Contracts § 360 cmt. e (1979).
284 A case in which the court rejected a high-restitution measure, perhaps because there was no possibility of opportunistic behavior by the promisor, is *The Isle of Mull*, 278 F. 131 (4th Cir. 1921), cert. denied, 257 U.S. 662 (1922). In that case, a shipowner breached a contract with a charterer because the ship was requisitioned by the British government at a price above the contract price. Id. at 132. The court held the charter frustrated and denied the charterer the government’s payments for the remainder of the charter. Id. at 138. The decision is difficult to justify under a compensatory view of restitution, see Friedmann, supra note 9, at 518 n.70, but makes sense under the theory developed here.
285 841 F.2d 742 (7th Cir. 1988).
286 Id. at 744.
287 Id.
288 Id.
even after the plaintiffs repeatedly called the breach to its attention starting in 1976.289 A second breach occurred in 1980.290 The franchisor wrote to one of the plaintiffs requesting increased coverage.291 The franchisee responded that he was working with a real estate broker to establish the desired coverage but wanted action taken regarding the earlier violation.292 The franchisor responded that it would cancel the other franchise if and when the plaintiff provided the desired coverage.293 After waiting seven weeks and receiving no response, the franchisor informed the plaintiff that he had failed to exercise his right of first refusal and that the franchisor would award a new franchise to another company.294

The jury awarded the plaintiffs both compensatory (lost profits) and punitive damages, and the franchisor appealed.295 After holding that the jury could have found that the franchisor breached the contract with respect to both additional franchises in the territory, the court turned to the question of damages. The court rejected the jury’s compensatory damage award and remanded for a new trial, in large part because the plaintiffs had not successfully proved that the breaches caused the losses alleged.296 The court then rejected the award of punitive damages because the plaintiffs did not show by clear and convincing evidence that the breaches were “malicious, fraudulent, oppressive, or even grossly negligent.”297 In reaching this conclusion, the court distinguished between opportunistic breaches, for which punitive damages could be recovered, and efficient breaches, for which compensatory damages were appropriate.298 The court held that neither breach was opportunistic, and that it was “quite possible that [the first breach] was effi-

289 Id. at 751.
290 Id. at 747.
291 Id. at 744.
292 Id.
293 Id.
294 Id.
295 Id.
296 Id. at 751.
297 Id.
298 Id. The court defined opportunistic breaches as those in which “the promisor wants the benefit of the bargain without bearing the agreed-upon cost, and exploits the inadequacies of purely compensatory remedies.” Id.
cient in the sense that it increased [the franchisor's] profits by more than it caused anyone losses."\textsuperscript{299}

Unfortunately, the court never considered whether high-restitution damages would be appropriate, under either the "compensatory" or "punitive" rubric. It is unclear, therefore, whether the plaintiffs could ask for such damages on remand. Perhaps the fault lies with the plaintiffs' lawyers, who apparently never raised the issue, though it would not have been difficult for any judge—least of all Judge Posner—to have supplied a theory in support of the jury's verdict or offered guidance to less than stellar counsel.

In any event, high-restitution damages are quite common in cases involving breaches of exclusive agreements similar to the one at issue in this case.\textsuperscript{300} The reason is straightforward under the theory presented here. An exclusive franchise, or other similar contract, is premised on the assumption that the franchisee is in the best position to take advantage of new customer opportunities within his territory and will invest optimally in finding and seizing such opportunities if he can reap the full rewards without having to worry about competition from the franchisor. It is possible that after the contract is signed, a "superior alternative" could arise; for example, the franchisor could find an additional franchisee that would complement the original franchisee and increase total sales in the territory beyond what the original franchisee could have achieved alone. But the mere fact that the franchisor breaches by contracting with another franchisee and makes more money by doing so does not necessarily mean that the original franchisee could not have made the extra sales. The franchisor may have opportunistic reasons for breaching; in particular, the terms of its contract with the second franchisee might be more favorable to the franchisor. Even if the new franchisee has lower production costs, that may be because it is free-riding on the investments made by the first franchisee.

\textsuperscript{299} Id.

\textsuperscript{300} See, e.g., Uinta Oil Ref. Co. v. Ledford, 244 P.2d 881 (Colo. 1952) (allowing an exclusive distributor to recover net profits on all sales made by the refinery in the distributor's territory); Automatic Laundry Serv. v. Demas, 141 A.2d 497 (Md. 1958) (implying an exclusive right and remanding for an accounting for profits); cf. Restatement (Second) of Contracts § 352 cmt. b & illus. 7 (1979) (noting that in measuring damages for the breach of an exclusive agency contract, the court may take into account the sales made by the new agent after the breach in determining damages).
The high-restitution remedy is appropriate when it is reasonable to presume that the original franchisee could have made any extra sales that occurred.\(^{301}\) The whole point of the remedy is to relieve the plaintiff of the burden of showing which specific sales would have been made. In light of the purposes of exclusive contracts, and the risks of opportunistic breach in contracts with superior alternatives, it would seem that such a presumption is reasonable in a case like *Patton*. Perhaps the jury had a similar intuition in its decision to award punitive damages.

The franchisor could of course rebut such a presumption. But Judge Posner points to no evidence suggesting that the plaintiffs would not have been able to land all of the credit card customers who were patronizing the new truck stops had the franchisor honored its agreement.\(^{302}\) There is no evidence, for example, that the plaintiffs were providing inferior service\(^{303}\) or that the new truck stops offered facilities that the plaintiffs did not have or could not have added. It is true that the plaintiffs did not respond to the franchisor's request for additional coverage in 1980 as rapidly as they might have. But as Judge Posner recognized, the plaintiffs were "naturally hesitant to provide additional coverage" given the unresolved prior breach, because if the franchisor "could not be depended on to adhere to the territorial provision in the franchise agreement [the plaintiffs'] chances of being able to recoup [their]"

\(^{301}\) See Farnsworth, supra note 8, at 1367 ("Use of the promisor's profit to measure the promisor's gain in these cases is easier to defend if one assumes that, had the promise been performed, the promisee would have made a similar profit.").

\(^{302}\) In discussing one of the plaintiff's lost profits claims, Judge Posner noted that although profits declined from 1976 to 1977, the plaintiff's credit card sales grew by 58%. *Patton*, 841 F.2d at 748-49. The plaintiff tried to respond by arguing that absent the franchisor's breach, the credit card sales would have grown even more. Id. at 749. Judge Posner rejected this argument because there was "no evidence to support this unlikely conjecture." Id. Nor was there any evidence to support Judge Posner's conjecture.

\(^{303}\) Judge Posner tries to draw a negative inference from the fact that one of the plaintiffs closed his truck stop and went into the lawn-maintenance business. Id. In response to the plaintiff's argument that he was entitled to damages measured by the difference between his current salary and the salary of the average truck stop owner, Judge Posner responded that he might not have earned the average because "otherwise why did he not get a job as a truck-stop manager after he closed his own stop?" Id. It is, of course, possible to draw a different inference from these facts: the plaintiff's truck stop offered some unique advantage, which the plaintiff could not easily replicate in a new truck stop venture. For example, the plaintiff's truck stop might have been in a particularly profitable location.
investment in any new facilities would . . . be diminished."

Moreover, the court had accepted the jury’s implicit finding that the franchisor’s “announcing the forfeiture of the right of first refusal seven weeks after [one of the plaintiffs] wrote [the franchisor] that he was working with a real estate broker but wanted a resolution of the [first] violation was too peremptory in the circumstances.”

Nor was there any evidence that the franchisor’s breaches were more likely to be efficient than opportunistic. It is true that the first breach, as Judge Posner notes, apparently started as an honest mistake. If the breach had been rectified immediately upon notice, the case would be an accidental contingency case, and there would be no justification for high-restitution damages. But the franchisor did not rectify the breach. And although it is possible that the reason the franchisor did not do so was that total credit card sales in the territory were greater than they would have been absent the breach, it is also possible that the franchisor was simply looking for a way to avoid having to breach its contract with the infringing franchisee. The franchisor might also have been “exploit[ing] the inadequacies of purely compensatory remedies,” which Judge Posner had already concluded might have yielded no damages to the plaintiffs. With respect to the second breach, it is possible that the franchisor saw an opportunity to enter into a new franchise contract on more favorable terms than its contract with the plaintiffs, or perhaps the franchisor just wanted the extra franchise fee. Because of the difficulties of proof in a case like this, much depends on the burden of proof and the presumptions the court is willing to make. The theory developed here argues for presuming that the promisee can take advantage of superior opportunities, unless the promisor can prove otherwise. Such a presumption

304 Id. at 747.
305 Id.
306 Id. at 751. Interestingly, Judge Posner notes that “the major inadequacies [are] that pre- and post-judgment interest rates are frequently below market levels when the risk of nonpayment is taken into account and that the winning party cannot recover his attorney’s fees.” Id. He ignores other problems such as difficulties of proof, which could lead to a compensatory remedy being inadequate, and which support the high-restitution measure advocated in this Article.
307 A case in which the court made use of a similar rebuttable presumption in favor of high-restitution damages is Roth v. Speck, 126 A.2d 153 (D.C. 1956). A hairdresser
would have led the court to award disgorgement damages in Patton.

3. Losing Contracts

Part II.B.3 introduced the losing contract problem and discussed two famous cases addressing the damage issues that arise in that context. But some losing contracts are contracts that should have been performed, and courts may use the high-restitution measure in these cases to provide the correct incentives to the promisor to perform. In effect, these situations, in which the performing party's costs rise above the contract price and perhaps the paying party's valuation, are not really "losing" contracts at all, but rather "artificial" situations created by the potentially opportunistic behavior of the promisor.

The easiest case to explain is that in which the breaching party contributes to making the contract a losing one. The classic example of this problem is *Boomer v. Muir.* In this case, a general contractor hired a subcontractor to build a dam as part of a hydro-electric power project. The subcontractor was to be paid monthly. Although the general contractor was the paying party, it had several performance obligations under the contract, including the following: it was to supply all the materials for constructing the dam, supply an air compressor that would be sufficient to operate the subcontractor's steam shovels, and excavate a cut-off trench in a timely manner. Soon after starting work on the contract, the subcontractor began to complain that the general contractor was

breached a one-year employment contract and took a substitute job. Id. at 154-55. The hairdresser's salary in the first job was the greater of $75 per week or a commission of 50% of the gross receipts from his work. Id. at 154. The salary on the second job was $100 per week. Id. The hairdresser claimed that he left his job "because conditions in plaintiff's shop were unbearable; that he complained to plaintiff on numerous occasions; that he had asked for more money but that salary was not the main reason for his leaving." Id. at 155. The court held that the proper measure of damages was the difference between the $100 per week salary and the $75 per week salary, unless the hairdresser could prove that his commissions at the first job would have exceeded $75 per week. Id. at 156. To the extent the hairdresser could offer such proof, it would certainly support his claim that his breach was not simply an opportunistic attempt to get a higher wage.

309 Id. at 571.
310 Id. at 572.
311 Id. at 571-72.
not fulfilling these obligations, and a year later it left the job.\footnote{312} At
that point, only $20,000 remained to be paid under the contract.\footnote{313} Yet the subcontractor won a money judgment of over $250,000
based on its costs of performance, which the court affirmed.\footnote{314} The
court held that the subcontractor was not limited by the contract
price in its suit.\footnote{315} The court based its holding at least in part on
the fact that the general contractor had contributed to increasing
the subcontractor’s costs.\footnote{316}

The fault-based economic theory offers a satisfactory explana-
tion of \textit{Boomer}.\footnote{317} A fixed price contract—if enforced—fully
insures a paying party against unexpected cost increases incurred
by the performing party. Ordinarily, this makes sense because the
performing party is in a better position to take precautions against
the increased cost contingency. But if the paying party can also
affect the cost of performance, a moral hazard problem arises. The
paying party has no incentive to economize on the other party’s
costs of production if the paying party is not liable for those costs.
In this case, the subcontractor was vulnerable to the general con-
tractor’s indiscriminate running up of the subcontractor’s costs,

\footnote{312} Id. at 572.
\footnote{313} Id. at 578.
\footnote{314} Id. at 579.
\footnote{315} Id. at 578-79.
\footnote{316} In support of its decision, the court noted:
If [the subcontractor] had valid claims for damages arising under the contract by
reason of the fact that his cost of operation had been wrongfully increased, it would
seem inequitable to limit him to the recovery of the contract price upon a rescission
for [the general contractor’s] failure of performance.
The jury might well have found that [the subcontractor’s] cost of operation had
been substantially increased by [the general contractor’s] continuing breaches.
There is substantial evidence that [the subcontractor] suffered delays and increased
costs by [the general contractor’s] failure to deliver materials to the job as rapidly as
required. There is evidence that [the subcontractor’s] costs were considerably
increased by failure of [the general contractor] to excavate the cut-off trench as
rapidly as should have been done. There is evidence that the diversion of air from
the compressors to other portions of the work and the delay in restoring the burned
air compressors hampered [the subcontractor] and increased his costs.
Id. at 578.
\footnote{317} For a recent discussion of \textit{Boomer} that makes some of the same points but also treats
the case as a “loss leader” contract like \textit{Montgomery}, see Wendy J. Gordon & Tamar
Frankel, Enforcing Coasian Bribes for Non-Price Benefits: A New Role for Restitution, 67
S. Cal. L. Rev. (forthcoming Sept. 1994). The opinion itself provides no direct evidence
that the subcontractor deliberately charged a price below its expected costs in the hopes
of getting further business, though that is a possible explanation of what happened.
whether the general contractor's behavior was due to mere neglect or opportunistically retaliatory for perceived or actual wrongs perpetrated by the subcontractor. It is true that the court does not expressly limit the subcontractor to recovering only so much of the excess cost attributable to the general contractor's behavior.\(^{318}\) On the other hand, the court points to no other reason for the subcontractor's costs being so high, and makes reference to a jury instruction that directed the jury not to include in its damage award "any loss or damage suffered by [the subcontractor] as the result of his own failure to perform . . . in a reasonably efficient manner."\(^{319}\) Moreover, to the extent it would be difficult to disentangle the excess costs resulting from the subcontractor's own failures and the general contractor's failures, the court made a defensible economic judgment in giving the plaintiff the benefit of the presumption,\(^{320}\) because it is more important to deter the potentially opportunistic behavior of the promisor.\(^{321}\)

\(^{318}\) Professor Palmer advocates limiting the recovery in cases like Boomer to increased costs due to the defendant's breach. See Palmer, supra note 125, at 281.

\(^{319}\) Boomer, 24 P.2d at 579. Of course, the jury could have found that the subcontractor could have performed the work in a reasonably efficient manner, yet ignored the fact that the subcontractor might have been negligent either in choosing this job in the first place without more carefully examining the potential costs, or in not bargaining for a more flexible price term. For a debate about the ability of courts and juries to determine the impact of the performing party's inefficiency on its losses, compare Robert Childres & Jack Garamella, The Law of Restitution and the Reliance Interest in Contract, 64 NW. U. L. REV. 433, 445-49 (1969) (suggesting that the losses resulting from inefficiency can be calculated) with Timothy J. Sullivan, The Concept of Benefit in the Law of Quasi-Contract, 64 Geo. L.J. 1, 19 (1975) (arguing such measurement is difficult).

\(^{320}\) We have already seen the important role that burdens of proof play in contract damage cases in the discussions of L. Albert, see supra text accompanying note 189, and Patton, see supra notes 301-07 and accompanying text.

\(^{321}\) Professor Palmer takes a more critical view of the case: Doubtless [the subcontractor's] costs were increased by [the general contractor's] failure to keep him adequately supplied with materials, but there was no evidence as to the amount of such damage. The importance of the case is that [the subcontractor] was allowed to recover the market value of his labor and materials without the necessity of proving damages, without regard to whether they were commensurate with the recovery allowed, and especially without regard for the fact that this apparently was a losing contract for [the subcontractor] from the start. Palmer, supra note 125, at 269 n.25. I do not know the source for Professor Palmer's last speculation. Other critics of the case include Joseph M. Perillo, Restitution in the Second Restatement of Contracts, 81 Colum. L. Rev. 37, 45 (1981) (arguing that Boomer ignores the parties' contractual risk allocations and suggesting that support of the decision may be based on the erroneous assumption that "contractual breach necessarily involves fault").
A second famous losing contract case in which the court awarded high-restitution damages to a promisee-subcontractor in excess of the contract price is United States ex rel. Susi Contracting Co. v. Zara Contracting Co.\textsuperscript{322} In this case, the general contractor hired a subcontractor to build an extension to an airport.\textsuperscript{323} The subcontractor encountered unexpected soil conditions that increased its cost of performance.\textsuperscript{324} As a result, the subcontractor demanded more money from the general contractor.\textsuperscript{325} Although the general contractor had asked for and received additional compensation from the United States, for which it was constructing the airport, it refused to pay the subcontractor extra compensation.\textsuperscript{326} A dispute ensued and the general contractor took over the completion of the contract.\textsuperscript{327} The subcontractor sued and won a judgment that included compensation above the contract price for the increased cost of excavation due to the soil conditions.\textsuperscript{328} The United States Court of Appeals for the Second Circuit affirmed the judgment that the general contractor, and not the subcontractor, had breached, and affirmed the restitutionary damage award.\textsuperscript{329}

Although the court's result is consistent with fault-based economic theory, the court rejected the rationale most consistent with the theory. The subcontractor had made three arguments in support of its claim of extra compensation: (1) the extra work was compensable under the contract, (2) the subcontractor was entitled to the advantage of the extra compensation the general contractor received from the United States, and (3) a recovery in restitution is not limited by the contract price.\textsuperscript{330} The court rejected the first two rationales and accepted the third, thus abstracting the case from its context and giving its holding a more absolute tone than the economic theory suggests would be warranted.\textsuperscript{331} The court rejected the second rationale, which the trial court had accepted, because it

\textsuperscript{322} 146 F.2d 606 (2d Cir. 1944).
\textsuperscript{323} Id. at 607.
\textsuperscript{324} Id.
\textsuperscript{325} Id.
\textsuperscript{326} Id. at 607-08.
\textsuperscript{327} Id. at 607.
\textsuperscript{328} Id. at 607-08.
\textsuperscript{329} Id. at 612.
\textsuperscript{330} Id. at 609.
\textsuperscript{331} See id. at 609-12.
thought that rationale was precluded by the language of the contract.\textsuperscript{332} In my view, the court’s reading of the contract was unnecessarily strict.\textsuperscript{333}

Under fault-based economic theory, the fact that the government reimbursed the general contractor is crucial. The reimbursement introduces a second contingency in the case, as in L. Albert, but a beneficial contingency rather than a regret contingency. The question is which party is entitled to this benefit. Awarding the benefit to the general contractor would encourage opportunistic behavior by the general contractor. When the government decided to pay extra to the general contractor for the increased cost of performance, the subcontractor had apparently done or was about to do the extra work. It is hard to believe that the government would have made the payment had it known that the general contractor was simply going to pocket the extra money rather than doing the extra work itself or paying the extra money to the subcontractor. But even if one believed that the government should suffer the consequences of its own incompetence—that is, the perhaps unnecessary payment—for not sufficiently conditioning this extra payment despite the general contractor’s possible misrepresentation, the general contractor also had the incentive to behave opportunistically toward the subcontractor. If the general contractor

\textsuperscript{332} Id. at 609-10.
\textsuperscript{333} The relevant contract provision read:

No representations have been made to the Sub-Contractor as to any sub-surface or latent conditions at the site; nor has the Sub-Contractor been induced to enter into this sub-contract in reliance upon any representations shown on the drawings or indicated in the specifications as to any sub-surface or latent conditions at the site. The Sub-Contractor agrees that it will make no claim against the Contractor for damages in the event that, during the progress of the work, the Sub-Contractor encounters sub-surface and/or latent conditions at the site materially differing from those shown on the drawings or indicated in the specifications, or unknown conditions of an unusual nature differing materially from those ordinarily encountered and generally recognized as inhering in work of the character provided for in the plans and specifications.

Id. at 609 n.2. Although this provision clearly is meant to force the subcontractor to bear the risk of harsh soil conditions generally, I see no reason why the clause should apply when the government reimburses the general contractor for these extra costs. One could easily read it to mean that if a loss from harsh soil conditions occurs, then as between the general contractor and the subcontractor, the subcontractor should bear this loss; if, however, \textit{neither} party need bear a loss from this contingency—if there is no joint loss—then the clause is inapplicable.
could show that the subcontractor was in breach, yet be allowed to pay only the lower contract rate, it could make a nice extra profit, again without doing the extra work itself. This potential for a windfall gain gave the general contractor an incentive to search for or induce minor breaches by the subcontractor and invest heavily in litigating the case. The fact that the court easily dismissed the general contractor's assertions that the subcontractor had breached supports this interpretation. In any case, if the parties had thought about this problem ex ante, it is doubtful that the general contractor would have preferred a high contract price combined with the right to a possible windfall from the government to the lower contract price that would result if this windfall had to be at least partially passed on to the subcontractor. By awarding high-restitution damages, the Zara court arguably implied the contract term the parties would have wanted.334

D. Summary and Conclusions

1. The Fault Lines in Contract Damages

The fault-based economic theory of contract damages set forth in this Part offers a justification for and explanation of the multiple-damage-measure system we in fact have, grounded in the need to provide optimal incentives to both contracting parties. The theory suggests that contract damage law contains several "fault lines," the contours of which have long been recognized but never completely understood. The first concerns the tension between giving the promisor and the promisee the right incentives. We might call this the "compensation-limitation fault line." If the regret contin-

334 One possible objection to this rationale, pointed out to me by David Skeel, is that future Zaras might not have the incentive to seek the extra compensation from the government in the first place—perhaps through use of some special clout or expertise—if they cannot reap the benefits. There are several possible responses. First, the general contractor might be able to convince the government to compensate it more than the subcontractor’s increased costs, in which case the general contractor could keep the excess. Second, a court might find some way to punish a general contractor who failed to "mitigate" by neglecting to seek extra payment from the government. Third, general contractors might find that they save more in lower subcontracting costs (both contract price and costs arising from later friction) from acting as a go-between with the government than they would save by refraining from so acting. Finally, to the extent that the general contractors do have expertise due to repeat dealings with the government, we might expect them to be in a better position to deal with the contingency explicitly in the contract.
ergency is accidental and renders performance jointly unprofitable, then courts often adjust the damage measure—whatever it may be—downward, which gives the promisee the correct incentives to take precautions and mitigate. On the other hand, if there is a danger of opportunistic behavior by the promisor or if the contract remains jointly profitable because the promisor can mitigate, then there is less likelihood of, and justification for, adjusting damages along this fault line.

The second fault line concerns the tension between giving the promisor the right incentives to take precautions and to mitigate—the “expectation-reliance fault line.” The reliance measure gives promisors the right incentives to take precautions against accidental contracts and regret contingencies that render the contract jointly unprofitable. The expectation measure deters opportunistic behavior and encourages promisor mitigation and performance of jointly profitable contracts. Courts tend to choose between these two measures depending on which scenario is more likely present.

The third fault line concerns the need to use a restitution measure to redress inadequacies in the ability of the expectation and reliance damage measures to provide the correct incentives to promisors and promisees in certain cases. On the one hand, low-restitution may be appropriate if the reliance measure would underdeter promisees in cases involving contracts that are jointly unprofitable because of accidental contingencies. This problem creates the “low-restitution-reliance fault line.” On the other hand, high-restitution may be appropriate if the expectation measure would underdeter promisors in cases involving losing contracts or superior alternatives that the promisee could have taken advantage of. This problem creates the “high-restitution-expectation fault line.”

2. The Usefulness of the Theory

The fault-based economic theory of contract damages not only provides a more complete understanding of the cases but also helps answer questions that have long puzzled theorists of contract damages. First, many have wondered why contract damages are so
The answer is that damages are undercompensatory when undercompensation is necessary to provide the parties with better incentives to take precautions or mitigate; that is, compensation is an incidental concern. Undercompensation ensures that promisors are not overdeterred and that promisees are not underdeterred.

The real puzzle is not why damages are undercompensatory, but why theorists are obsessed with compensation—or at least identifying a unified conception of compensation—in the first place.

One explanation stems from Professor Farnsworth's extremely influential article on contract damages. In that article Farnsworth argues that our legal system “is not directed at compulsion of promisors to prevent breach; rather it is aimed at relief to promisees to redress breach.” Farnsworth supports this argument in two ways. First, he unquestioningly accepts the strict liability...
approach to contract damages and asserts that "this would be a strange design indeed if it were a system directed at the compulsion of promisors." But we have already seen that strict liability is a myth. In addition, Farnsworth argues that society does not treat the breach of contract as a crime, nor does it impose punitive damages for breach. The problem with this argument is that it suggests that the only choices are between a "compensatory" damage regime, and one that is "punitive" or "compulsory." But there is another alternative, grounded in the goal of deterrence, which the theory in this Article advocates. The absence of a punitive or compulsory damage regime does not demonstrate an absence of a desire to achieve deterrence. Nor is the goal of deterrence necessarily inconsistent with the goal of compensation, as we know from tort law. Finally, the goal of deterrence does not imply that the only contracting conduct society would ever want to deter is breach.

the law of contract remedies has not been compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from breach."

Farnsworth, supra note 1, at 1147.

Id. at 1146-47. Economic theorists have sometimes made similar arguments. See Robert L. Birmingham, Breach of Contract, Damage Measures, and Economic Efficiency, 24 Rutgers L. Rev. 273, 281 (1970) (noting that "conduct deemed reprehensible seems almost to receive approbation if not encouragement from the law" by citing the fact that the law does not award punitive damages for breach of contract); Charles J. Goetz & Robert E. Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 Colum. L. Rev. 554, 558 n.19 (1977) (arguing that the notion that the purpose of contract damages is to prevent breach is "belied by the absence of punitive measures designed to reduce the incentives to breach. On the contrary, it is clear that the central purpose of contract damages is compensatory and not punitive."). Efficient breach theory is, however, consistent with the purpose of deterring inefficient breaches.

Farnsworth recognizes this fact by acknowledging that "[t]here may, of course, be circumstances in which the law's use of the expectation measure will afford some compulsion for a promisor to perform his promise," yet he maintains that the expectation measure "is not designed to achieve that end." Farnsworth, supra note 1, at 1149.

Birmingham notes that

[c]ontract law is not intended to punish. But ... it is not, in its aspect of protecting the expectation interest, intended to compensate either. It overcompensates. Or, if it does not, the loss it is compensating is not very important. [It is important not to] confuse deterrence and punishment. Criminal law deters by punishing. Tort law deters by compensating (punitive damages aside). Both deterring and compensating are significant for tort law. Both are significant for contract law too. But contract law, understood to protect the expectation interest, compensates only incidentally as it goes about deterring.

Birmingham, supra note 8, at 244.
A second puzzle about which scholars since Fuller and Perdue have wondered is why the expectation damage measure is so prevalent in contract damage cases.\textsuperscript{343} The theory developed here suggests that there are two justifications for using expectation damages: to deter opportunistic behavior by promisors and to encourage promisor mitigation and performance when the promisor is the superior mitigator. Although sometimes promisors act opportunistically by effecting fraudulent contracts that should not have been made or by manipulating regret contingencies in contracts that should not be performed, we might speculate that such cases are relatively rare. A more compelling reason that the expectation damage measure is so commonly used in contract cases is that many contract breaches occur despite the fact that performance remains jointly profitable and the promisor can mitigate; that is, many breaches—at least litigated ones—are inefficient. This is particularly true of cases in which there is a market for substitute performance, which I will discuss in Part III. The other reason the expectation damage measure is so commonly used in breach of contract cases is that in many cases promisors breach opportunistically by trying to exploit some rule of liability or damage rule in a contract that should have been performed.\textsuperscript{344} Litigated cases are more likely to involve opportunistic behavior than settled cases.\textsuperscript{345}

In such cases all that is needed to provide optimal deterrence to breaching promisors is to deny the limitation or to reject the "no

\textsuperscript{343} Even Fuller and Perdue conceded—somewhat begrudgingly—that the expectation damage measure is the "normal" rule, though they qualified this concession by putting the word "normal" in quotation marks. See Fuller & Perdue, Reliance 1, supra note 4, at 52, 57, 63, 65.

\textsuperscript{344} Opportunistic breaches include attempts by either party "to chisel on [their] performance obligation by denying that the contract assigned the particular risk to [them]." Goetz & Scott, supra note 22, at 977. The promisor "may chisel by contesting facts, exploiting arguably ambiguous terms, or refusing to provide full compensation upon breach." Id.; see also Scott, supra note 337, at 1176 n.71 (same).

\textsuperscript{345} I do not mean to suggest that all contract disputes in which a rule of liability is disputed and the court awards expectation damages necessarily involve opportunistic behavior by the promisor. In tort law, economic scholars have recognized that under the negligence rule as actually applied, negligent accidents will still occur, that is, perfect deterrence will not be achieved. The explanations include mistakes by parties and courts, the stochastic element of care, and the due care standard, which is overinclusive in that not all people can meet the standard. See Posner, supra note 40, at 167, 175, 179-80. For similar reasons, nonopportunistic breaches will still occur under "fault-based" rules of liability combined with an expectation damage rule.
liability" or "reduced liability" argument, and instead apply full expectation damages. The threat that a court might award full expectation damages tends to deter promisors from acting opportunistically.

A third question that arises is why punitive damages are not more common in contract cases. This question might seem to pose a problem for the fault-based economic theory. If we really do have a fault-based damages regime, then once courts determine that a contract is one that should be performed, why limit the promisee to expectation or restitution? Why not award some punitive measure? It is true that the expectation or restitution damage measures are not the only way to give the promisor the optimal incentives, but are simply the minimum amount needed for effective deterrence. Nor would a punitive damage measure discourage optimal mitigation by the promisee, as long as the remedy remains independent of the level of mitigation.

The theory adopted here does not rule out the possibility of a damage regime with a greater punitive component, but it does suggest the dangers of such a system. The main problems with punitive damage remedies are that they discourage promisemaking by promisors and encourage opportunistic behavior by promisees. Punitive remedies may discourage promisemaking because they increase the costs of court error in making the fault determination. In addition, punitive remedies discourage promisemaking because they lead promisors to increase the contract price, which the law of demand suggests will in turn lead to fewer contracts being entered into. Some would argue that this is the effect punitive damages in the products liability area have had. This problem is reduced to the extent that courts enforce contractual limitations of liability. Finally, punitive remedies create a temptation in the promisee to look opportunistically for ways to assert that a breach has occurred to take advantage of a remedy that exceeds the value of perform-

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346 See, e.g., Restatement (Second) of Contracts § 352 cmt. a (1979) ("A court may take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty, giving greater discretion to the trier of the facts.").

347 See Craswell, supra note 10, at 666-67. But see Birmingham, supra note 8, at 264 (arguing that we need not be concerned with getting the number of promises right in the case of bargained-for promises because the promisor can simply raise the price in response to an increase in the damage measure).
Of course, if punitive damages were the "normal rule," one would expect "exceptions" to crop up to deal with promisee opportunism problems, but this regime would again be fault-based.\footnote{Cf. Kenneth W. Clarkson, Roger LeRoy Miller & Timothy J. Muris, Liquidated Damages v. Penalties: Sense or Nonsense?, 1978 Wis. L. Rev. 351, 368-72 (arguing that a similar problem exists when liquidated damages exceed actual damages). The problem of promisee opportunism could explain cases like City of New Orleans v. Firemen's Charitable Ass'n, 9 So. 486 (La. 1891), in which the court dismissed a suit by the city against the fire company it had contracted with, alleging that the fire company had breached by understaffing and failing to keep adequate equipment on hand in violation of the contract's terms. The court relied on the fact that the city did not prove it suffered any damages as a result of the fire company's breaches, id. at 488, but the court could have been concerned that allowing the city to recover would encourage similarly situated parties to seek out trivial breaches, and perhaps even delay notice, to secure a damage award. For a more critical view of the case, see Friedmann, supra note 9, at 524-25.}

A final question that economists might ask is why it would not be better to have a general rule of expectation damages and allow parties to contract around that default rule. The "majoritarian default" answer is that if the expectation-reliance-restitution combination satisfies the preferences of more contracting parties than the pure expectation rule, the transaction costs of contracting around the rule are saved. There is no reason to think that most contracting parties would be willing to pay for full expectation protection even in cases of efficient nonperformance, or that most contracting parties would not be willing to pay for greater than expectation protection even in cases of opportunistic breach. Thus, the only possible justification for a uniform expectation damages rule is that it is easier for courts to apply. But this is a delusion. Recall that damage rules are inevitably intertwined with rules of liability. Insisting on a uniform rule of damages simply puts greater pressure on courts to apply. But this is a delusion. Recalling that damage rules are inevitably intertwined with rules of liability. Insisting on a uniform rule of damages simply puts greater pressure on courts to be more creative in developing rules of liability, which would eat into, and arguably eliminate, any possi-
ble administrative cost savings over a multiple-damage-measure regime. Another problem with contracting around the expectation measure is that requiring parties to contract out of a flat damage rule and adopt a multiple-damage-measure system is to increase contract complexity because the parties must spell out the situations under which the different damage rules apply. Not only would this complexity increase the ex ante costs of contracting, it would make it less likely that courts would interpret the contract sufficiently flexibly to respond to changed circumstances ex post.\textsuperscript{350}

III. A Fault-Based Economic Approach to Market Damages

A. The Theory: Market Damages as a Fault-Based Presumption

Part II developed a fault-based economic theory of contract damages, which posits that courts choose among different damage measures to redress incentive problems that lie along one of several "fault lines," and that this choice is sensitive to the reason the breach occurs. The previous Part did not address "market damages," that is, a damage measure based on the difference between the contract price and the market price of a substitute performance, whether or not actually made.\textsuperscript{351} The market damage measure lies at the center of the contract damage solar system. Not only did the formal law of contract damages arguably get its start here,\textsuperscript{352} but market damages are probably the most widely used

\textsuperscript{350} See Goetz & Scott, supra note 22, at 983-84.


\textsuperscript{352} Professor Horwitz has argued that the entire "modern law of contract" starts with the recognition of expectation damages in cases involving executory futures contracts entered into for the purpose of "protecting against changes in supply and price in a market economy." Morton J. Horwitz, The Historical Foundations of Modern Contract Law, 87 Harv. L. Rev. 917, 936-37 (1974). Others have argued that expectation damages were used much earlier. See A.W.B. Simpson, The Horwitz Thesis and the History of Contracts, 46 U. Chi. L. Rev. 533, 555-61 (1979). But because damages were usually left to the discretion of the jury, it makes sense to start from the time when a formal law of damages developed. Note that efficient breach theory does not start with market damages. But see Thomas H. Jackson, "Anticipatory Repudiation" and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, 31 Stan. L. Rev. 69 (1978) (applying efficient breach theory in the market damage context).
and certainly the most universally accepted measure of contract damages. The latter quality stems from the fact that the market damage rule is one of those wonderful rules of law that can be justified under several different rationales, so that many theories can claim it for their own. Market damages also seem to present the best case for a strict liability approach to damages and the weakest case for a fault-based approach; in fact, the most important cases used to support the strict liability approach to contract damages all involve the market damage measure. The aim of this Part is to show how the market damage rule fits within the fault-based economic framework, to explain the rule’s relationship to the strict liability theory of contract damages, and to argue that strict liability has limited application even in those cases in which a market damage measure might be used.

To understand market damages, one must understand the regret contingency that gives rise to these damages, namely a rise or fall in the market price for the good or service under contract. The existence of a “market price” simply means that there are third parties willing and able to buy and sell the good or service contracted for. If good substitutes for contractual performance exist, the market price is often the price of these substitutes. And if, at the time of contracting, the parties have good information about available substitutes, the market price will also be the contract price. After the contract is entered into, market prices may change due to changes in either supply conditions, demand conditions, or both. An increase in the market price is a regret contingency for the seller, who would now prefer to sell elsewhere; a decrease in the market price is a regret contingency for the buyer, who would now prefer to buy elsewhere.

A change in market price is a special kind of regret contingency because of its relationship to joint profitability. Recall that joint unprofitability is a necessary, but not sufficient, condition for efficient contract nonperformance. Although an increase in market price raises the seller’s opportunity cost, it need not correspond with an increase in the seller’s own production cost; rather, it may increase the buyer’s valuation (or do neither, or do both). And although a decrease in market price reduces the buyer’s “opportunity value,” it need not correspond with a decrease in the buyer’s own valuation; rather, it may lower the seller’s production cost.
the market price change does not accompany either a change in the contracting buyer's own valuation or the contracting seller's own production costs, the contract remains jointly profitable regardless of the magnitude of the market price change.

To see this point, suppose that the seller's cost of production remains less than the buyer's valuation after the market price change. It is clear that the contract remains jointly profitable and should be performed if the market price remains in between the buyer's valuation and the seller's cost of performance. But even if the market price exceeds the buyer's valuation or falls below the seller's cost of performance, the contract remains jointly profitable as long as the promisee can "mitigate" by entering into a substitute transaction on the market. If the market price rises above the buyer's valuation and the seller nevertheless performs, the buyer can simply resell, and the buyer's "valuation" can be reinterpreted to include the resale. On the other hand, if the market price falls below the seller's cost and the buyer nevertheless performs, the seller can simply fulfill the contract by buying the good or service at the lower price, and thereby effectively lower its cost.

The fact that a contract remains jointly profitable regardless of the magnitude of the market price change is important because

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353 Let \( m' \) denote the changed market price. We are assuming that \( v \) and \( c \) remain unchanged, and we know that \( v > p > c \). If \( v > m' > p > c \), then the seller regrets the contract; if \( v > p > m' > c \), then the buyer regrets the contract. But in both cases, the original contract remains jointly profitable and should be performed.

354 In market damage cases, the promisee is typically the buyer in the case of a price rise and the seller in the case of a price decrease. The promisor, the party for whom the price change is a regret contingency and who therefore has an incentive to breach absent legal sanctions, is typically the seller in the case of a price rise and the buyer in the case of a price decrease.

355 It may seem an odd use of the term "mitigate" to refer to actions by the promisee to enter into a market transaction after the promisor performs, because these actions do not seem to reduce a "loss" that would otherwise occur. But if loss includes a forgone opportunity, then a failure by the promisee to take advantage of this opportunity is an economic loss, and an action to take advantage of the opportunity does indeed mitigate this potential loss.

356 In terms of our notation, \( m' > v > p > c \). We can reinterpret \( m' \) as \( v' \) if the buyer can resell. This is essentially the same argument that was discussed in the Part II.C.2, supra. See supra note 255 and accompanying text.

357 In this case, \( v > p > c > m' \), and \( m' \) can be reinterpreted as \( c' \) if the seller can buy the substitute to fulfill the contract.
jointly profitable contracts should generally be performed. If market price is the only economic variable that changes, there is no joint sunk loss, merely a "windfall" gain to one party and loss to the other. It is this sense in which the market price shift is a unique regret contingency. Suppose that the expected change in market price is zero, that is, the market is as likely to rise as to fall. Then there is no need to use damage rules to provide the correct incentives to the promisor to take precautions against market price changes, and so there is no tension between providing the promisor the correct incentives to take precautions and to perform. The expectation-reliance fault line disappears. Nor is there any reason to be concerned with excessive reliance by the promisee. Because the contract remains jointly profitable, the promisee suffers no reliance loss: either performance occurs or the promisee gets market damages, which enable it to complete performance on the original terms by making a substitute market transaction. The only question is one of optimal mitigation by the promisee and the promisor, that is, who should get the benefit of the change in the market price.

The market damage rule generally provides both the promisor and the promisee with the correct performance and mitigation incentives when the market price is the only economic variable that changes. The rule embodies the presumption that joint costs are minimized when performance of the original contract occurs: it gives the promisee-buyer the right to decide whether to resell after

358 Promisors always have the incentive to take precautions against their own individual losses, including losses resulting from price fluctuations. Risk-averse promisors might want to take such precautions against price fluctuations as flexible contract price terms, contracting with a supplier (for sellers) or a final user (for buyers), or diversifying.

359 The more common argument is that if a market damage measure is used, then reliance damages equal expectation damages and so there is no need to choose between them. See Fuller & Perdue, Reliance 1, supra note 4, at 62. The reason is that the promisee's "reliance loss" can be interpreted as the lost opportunity to enter into an identical contract at the original market price with a different promisor who would not have breached. The lost opportunity on this forgone contract is the same as the lost profit on the actual breached contract, and both are equal to the contract-market differential. This argument about the equivalence of expectation and reliance is important only if compensation is viewed as the paramount concern in contract damages and the debate is over what compensation means. Under the approach developed here, the question whether the market damage measure "really" protects the promisee's expectation or reliance interest is irrelevant. The question is rather whether the market damage measure gives both parties the correct incentives.
performance in the case of a market price increase, and it gives the promisee-seller the right to decide whether to buy on the market to complete performance in the case of a market price decrease. That is, the rule presumes that the promisee is the least cost mitigator of this regret contingency and also presumes that a promisor who breaches to transact on the market is opportunistically attempting to rewrite the contract's price term. These presumptions make sense as long as the promisee is as capable as the promisor of transacting on the market, because the costs associated with promisor nonperformance are saved. Thus, the rule provides the promisor with an incentive to perform by disgorging any profit that would result from breaching to take advantage of a changed market price. In this sense, the market damage measure is restitutio

ary, and the use of this measure therefore eliminates the restitution-expectation fault line.

The market damage measure also provides the correct mitigation incentives to the promisee in the event the promisor does breach, because the market damage measure is independent of the promisee's mitigation decisions. A buyer-promisee will mitigate its potential lost profits after breach by covering as long as its valuation exceeds the market price; if the market price rises higher than the buyer's valuation, the buyer will not cover, though the market

\[ m' - p \]

for market price increases and \[ p - m' \] for market price decreases.

360 It is this presumption, I would argue, that makes the usual “efficient breach hypothesis” example of a seller selling to a higher-valued buyer sound so odd. It is hard to distinguish a case of a seller breaching to sell to a higher valued buyer from a case in which a seller breaches to sell at a higher market price—which after all is simply a buyer willing to pay more. Thus, in the most important class of contract damage cases, those involving market damages, the law presumes that for a seller to breach in this situation is inefficient. The efficient breach hypothesis has unfortunately focused on a relatively unimportant residual class of cases to justify expectation damages—a classic example of a tail wagging the dog.

361 But see David H. Vernon, Expectancy Damages for Breach of Contract: A Primer and Critique, 1976 Wash. U. L.Q. 179, 185-86 (arguing that under the market damage measure, a breaching party is indifferent between performance and breach). The market damage measure is \[ m' - p \] for market price increases and \[ p - m' \] for market price decreases.

362 See Farnsworth, supra note 8, at 1370. It is interesting to note that Fuller and Perdue, who made the famous observation that market damages can be justified as both an expectation and a reliance measure, do not make the connection between market damages and restitution.

363 See id. at 1374 (arguing that if damages are awarded under the disgorgement principle, mitigation is not discouraged because covering does not deprive the buyer of its right to damages).
damage measure will give the buyer the promisor-seller's profits on the seller's presumed resale.\(^{364}\) A seller-promisee will mitigate its potential lost profits after breach by reselling on the market as long as its costs are less than the market price; if its costs are higher, the seller will not resell, though the market damage measure will give the seller the promisor-buyer's profits on the buyer's presumed substitute purchase.\(^{365}\) The market damages rule thus establishes a presumption that the promisee can cheaply cover or resell on the market after breach and that such a substitute transaction is reasonable, and limits recovery accordingly.\(^{366}\)

More important, however, the market damages rule obviates the need for a court to make any fault determinations. All a court needs to know is the contract price and the market price; it need not know the seller's production cost, the buyer's valuation, or even whether these variables are larger or smaller than the market price. It also need not inquire into the promisor's precise motives for breach, nor into the reasonableness of any mitigation or failure to mitigate by the promisee.\(^{367}\) We can now see why the market damage rule is the epitome of the strict liability approach to con-

\(^{364}\) In terms of our notation, if \(v > m' > p > c\), the buyer-promisee will mitigate if the seller breaches; if \(m' > v > p > c\), the buyer-promisee will not mitigate because it values performance less than the market.

\(^{365}\) In terms of our notation, if \(v > p > m' > c\), the seller-promisee will mitigate if the buyer breaches; if \(v > p > c > m'\), the seller-promisee will not mitigate because its cost of performing exceeds the market valuation of that performance.

\(^{366}\) Thus, the market damage rule, like the doctrines of foreseeability and certainty discussed in Part II, effectively shifts the burden of proof of mitigation, which usually is on the promisor, to the promisee. See Restatement (Second) of Contracts § 350 cmt. c (1979).

\(^{367}\) Recall that courts can use one of two basic devices to assure optimal mitigation. They can adopt a damage measure that is independent of the level of the promisee's mitigation. Or they can adopt a fault rule that examines ex post whether the mitigation (or failure to mitigate) was reasonable. For example, suppose the contract price \((p)\) is 8 and the buyer expects to earn 12 \((v)\), but the seller breaches when the market price rises to 10 \((m')\). Under the market damage rule, the buyer gets 2 whether it covers or not, so the buyer has an incentive to cover and earn an extra 2 \((12-10)\) in addition to its damage payment. The same is true for any damage measure independent of the buyer's cover decision, for example if the damage rule is that the buyer gets lost profit damages of 4 whether it covered or not. If, however, the damage rule is that the buyer gets 4 damages if it does not cover but only 2 damages if it does cover, the buyer has no incentive to cover.

Alternatively, if the damage rule were that the buyer gets 4 unless the buyer fails to cover, and the court decides that failure to cover was "unreasonable," the buyer would again have an incentive to cover. And if the court reimburses the buyer only for "reasonable" cover, the buyer has an incentive to cover at 2 rather than at, say, 5.
tract damages. As long as the mitigation presumptions imbedded in the market damage rule hold, and as long as the only variable that changes is the market price, there is no need to use any other damage measure, and so there is no need to inquire into the nature of the breach. The market damages rule neutralizes all of the fault lines of contract damages.

Alas, the world is not so simple. First, the market damage rule’s mitigation presumptions may not hold. As a result, the market damage rule could either overdeter or underdeter promisors. The market damage rule could overdeter promisors by encouraging performance in cases in which the promisor is in a better position to take advantage of changed market conditions than the promisee. Recalling the cases in which the buyer’s valuation and the seller’s cost remain unchanged, but the market price rises above the buyer’s valuation or falls below the seller’s cost, the use of the market damage rule in these cases depends on the assumptions that the promisor has no advantage in making substitute market transactions, or that any advantage is outweighed by the joint costs of non-performance. If these assumptions do not hold, there would be a case for limiting the promisee’s recovery, for example to lost profits, to encourage the promisor to mitigate by making the substitute transaction and paying damages rather than performing. On the other hand, the market damage rule could underdeter promisors in cases in which performance of the original contract maximizes joint profits despite a change in market price, yet it is difficult for the promisee to mitigate after the promisor breaches because the promisee is in a vulnerable position. In these cases, it may be desirable to award lost profits in excess of market damages. If the promisee does mitigate, but the mitigation is more onerous

368 Perhaps the best example of this type of transaction is a contract for securities, which in fact is where the market damage measure made its first appearance.

369 The lost profit damage measure for a buyer promisee would be \( v-p \); the lost profit damage measure for a seller promisee would be \( p-c \). The lost profit measure would not deter the seller from breaching when \( m'>v>p>c \), and would not deter the buyer from breaching when \( v>p>c>m' \). The seller would not perform in the first case because \( m'-(v-p) \) [profits under nonperformance] = \( m'-v+(p-c)>p-c \) [profits under performance]. The buyer would not perform in the second case because \( v-m'-(p-c) \) [profits under nonperformance] = \( c-m'+(v-p)>v-p \) [profits under performance].

370 The lost profit measure would deter the seller from breaching when \( v>m'>p>c \), and would deter the buyer from breaching when \( v>p>m'>c \).
than expected, there is a justification for the promisee recovering as “incidental” damages any additional expenses it incurs. 371

The point is that if the failure of the market damage rule's mitigation presumptions represents a serious problem, then courts must make judgments about whether mitigation is possible, which party is better able to do it, and whether any mitigation that occurs is reasonable. Once this happens, the strict liability aspect of the market damage rule evaporates. The choice of whether or not to use the market damage measure now requires a “fault” determination, even if the determination is merely to choose between two different “expectation” measures like market damages and lost profits. This choice suggests an additional fault line in contract damages: the “market-lost profit fault line.”

It may be that, when the only economic variable that changes is the market price, the failure of the market damage rule’s mitigation presumptions is not a serious enough problem to warrant an abandonment of a strict application of the market damage rule. 372 But there is a more important source of complexity. Very often when the market price changes, the buyer’s valuation or the seller’s costs change as well. The change in the buyer’s valuation or the seller’s costs may be correlated with the market price change. For example, a market price increase may result from an increase in the cost of some input, which may affect the contracting seller to the same extent that it affects all sellers in the market. A market price decrease may result from the development of a substitute product that makes the product contracted for less desirable to all buyers in the market, including the contracting buyer. But the change in the buyer’s valuation or the seller’s costs may also be

371 Goetz and Scott refer to the recovery of these expenses incurred in mitigation as the “affirmative branch” of the doctrine of avoidable consequences. Goetz & Scott, supra note 22, at 973 n.18.

372 In fact, in one of the most well-known and widely criticized cases in which the court limited the promisee’s recovery to a lost profits measure, there was no plausible claim that the promisor was in a better position to mitigate. See Nobs Chem. v. Koppers Co., 616 F.2d 212 (5th Cir. 1980). The case is discussed in Scott, supra note 337, at 1168-69, and Farnsworth, supra note 8, at 1377 n.143. For a more recent case in which the court denied market damages in favor of a lower lost profits measure despite the fact that the promisee could easily have mitigated, see Foster v. Bartolomeo, 581 N.E.2d 1033 (Mass. App. Ct. 1991) (involving a homeowner who breached his option contract with developer-buyer after discovering that the house was worth more than the contract price).
partly or completely independent of any change in market price. The seller’s plant could burn down, its machine could break down, or the seller could provide a defective product at the same time the market price either increases or decreases. The product could become useless to the contracting buyer, or the buyer could lose its major customer for the final product, even though the product contracted for remains valuable to many other buyers. In a world in which other economic variables besides the market price are changing, a strict application of the market damage rule becomes less defensible.

It is not my purpose here to offer a complete account of all the possible ways that the market damage rule must be integrated with other damage measures when the buyer’s value or the seller’s cost changes simultaneously. Rather, I will attempt to show how the fact that other variables might be shifting reintroduces the fault lines in contract damages that the “pure” market price shift eliminated. To do this, I will consider cases in which the market price increases at the same time the seller’s cost of production increases and cases in which the market price decreases at the same time the buyer’s valuation decreases.

Consider again the mitigation question. We have already seen that the failure of the market damage rule’s mitigation presumptions may lead the rule to overdeter and underdeter promisors even if the only change is a shift in the market price. The problem is often exacerbated when other economic variables change as well. If the market price increase exceeds the seller’s cost increase, or the market price decrease exceeds the buyer’s valuation decrease, the situation is much as if the only variable changing were the market price. The contract remains jointly profitable and should be performed as long as the promisee can mitigate cheaply by transacting

\[ m' > c > v > p, m' > v > c > p, v > m' > c > p, \text{ and } v > m' > p > c'. \]

The cases in which the market price increases more than the buyer’s valuation decreases are \[ p > c > v ' > p', \]

\[ p > v ' > c > m', p > v ' > m' > c, v ' > p > c > m', \text{ and } v ' > p > m' > c. \]
on the market. By presuming promisee mitigation is efficient, market damages encourage the promisor to perform. They work well if the mitigation presumption holds true.

If, however, the market price increase is less than the seller's cost increase, or the market price decrease is less than the buyer's valuation decrease, the contract may remain jointly profitable, but a new mitigation question arises. So far, the question has been whether the promisor should be discouraged from breaching to use the market to take advantage of a price change. The market damage measure discourages such breaches by disgorging potential gains from the promisor. Now the question is whether the promisor should be discouraged from breaching to avoid using the market to perform by procuring a substitute performance if it is cheap to do so. Here the market damage rule no longer serves a dis-

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375 If the market price rise exceeds the seller's cost increase but does not exceed the buyer's valuation, or if the market price falls below the decrease in the buyer's valuation but does not fall below the seller's costs, then the contract clearly remains jointly profitable. In these cases, \( v > m' > c' > p \), \( v > m' > p > c' \), \( p > v > m' > c \), and \( v' > p > m' > c \), no substitute market transaction should occur, and if the promisor performs, the market damage rule's mitigation presumption is irrelevant.

If the market price rise exceeds the seller's cost increase and the buyer's valuation, then the contract is still jointly profitable if the buyer can easily resell on the market. In this case, we have \( m' > v' > p \) and \( m' > v > c' > p \), both of which can be reinterpreted as \( v' > c' > p \), and \( m' > v > c' > p \), which can be reinterpreted as \( v' > p > c' \), so the contract remains jointly profitable. This is true despite the fact that in the first group, the seller would incur losses of \( c' - p \) by performing.

If the market price falls more than the buyer's valuation decrease and the seller's costs, then the contract is still jointly profitable if the seller can easily buy the cheaper substitute. In this case, we have \( p > c' > v' > m' \) and \( p > v' > c > m' \), both of which can be reinterpreted as \( p > v' > c' \), and \( v' > p > c > m' \), which can be reinterpreted as \( v' > p > c' \), so the contract remains jointly profitable. This is true despite the fact that in the first group, the seller would incur losses of \( c' - p \) by performing.

376 The cases in which the market price increases less than the seller's cost increase and remains below the buyer's valuation are \( c' > v > m' > p \) and \( v > c' > m' > p \). Note that in these cases the seller would not breach to take advantage of the market price increase. The seller can perform, however, by buying substitute goods on the market. If the seller buys substitutes, both cases can be reinterpreted as \( v' > c' > p \), so the contract remains jointly profitable. This is true despite the fact that the seller would incur losses of \( m' - p \) by performing.

The cases in which the market price decreases less than the buyer's valuation decreases and remains above the seller's costs are \( p > m' > v' > c \) and \( p > m' > c' > v' \). Note that in these cases the buyer would not breach to take advantage of the market price decrease. The buyer can perform, however, by reselling the goods on the market. If the buyer resells, both cases can be reinterpreted as \( p > v' > c' \), so the contract remains jointly profitable. This is true despite the fact that the buyer would incur losses of \( p - m' \) by performing.
gorgement function. It would be irrational for the seller to breach to sell at a market price below its cost or for the buyer to breach to buy at a market price above its valuation. Rather, the sole purpose of the market damage rule in these cases is to encourage promisor market mitigation, which it does by presuming the promisor is the more efficient mitigator (taking into account the costs of nonperformance).

But the overdeterrence and underdeterrence problems previously identified with the market damage rule are now greater. The promisor will be overdeterred if the promisee is in a better position than the promisor to procure a market substitute (contrary to the presumption of the market damage rule).\(^{377}\) And to the extent that the promisor's costs of using the market are more likely to increase as other costs of performance increase or the valuation of performance decreases, the overdeterrence danger is greater. On the other hand, the promisor will be underdeterred to the extent that the market damage rule does not force it to bear all of the promisee's nonperformance and mitigation costs when it makes its decision to mitigate or breach.\(^{378}\) The underdeterrence danger is greater

\(^{377}\) Actually, the market damage rule could underdeter in this case as well. If the promisee is the better mitigator, then in reality the contract is no longer jointly profitable, and the optimal damage measure is reliance, which could be either greater or less than the change in market price. If the market price does not change, reliance damages would certainly be greater. A situation in which this question could arise is the so-called "lost volume seller case" involving a consumer who breaches a contract with a retail seller. In these cases, a consensus seems to be forming among economic scholars that the best remedy is not a lost profits expectation measure, as contemplated by U.C.C. § 2-708(2), but some relatively low damage measure designed to compensate the seller for its lost retail expenditures in "hooking" a buyer, that is, a reliance measure. See Cooter & Eisenberg, supra note 337, at 1473-74; Victor P. Goldberg, An Economic Analysis of the Lost-Volume Retail Seller, 57 S. Cal. L. Rev. 283, 291 (1984); Scott, supra note 337, at 1166-68. The theory presented here supports such a measure as long as the contingency giving rise to the buyer's breach is accidental and the buyer is not acting opportunistically.

\(^{378}\) In an early attempt to apply efficient breach theory to market damages, Jackson asserted that once market damages are in place, those breaches that do occur are mostly efficient because there is less reason to think market damages are undercompensatory than nonmarket damages. For example, the doctrines of foreseeability and certainty, which limit expectation damages, are less important in market damage situations. See Jackson, supra note 352, at 86 n.59. But as I argued in Part II, these "limitations" on damages are often interpreted in a way that is sensitive to providing the promisor the correct incentives. The more important noncompensated costs of breach, such as promisee's attorney's fees, prejudgment interest below market rates, imperfect court enforcement, and measurement difficulties, are often present in market damage cases. See Scott, supra note 337, at 1177 & n.72.
because the promisor's benefit from breaching is no longer the market price change; rather, the benefit is the cost savings from not having to transact for a substitute performance on the market. The market damage measure alone does not disgorge the full benefit. If these problems with the market damage rule are in fact greater when other economic variables besides the market price change, it becomes harder for courts to make the fault-based determination of which party is the better mitigator. It may well be that in these cases, courts attempting to give the parties the correct mitigation incentives are more likely to use fault-based rules of liability, including excuse doctrines, than fault-based damage rules. But the key point is that the combination of imperfect mitigation assumptions and changing economic variables make the strict liability approach hard to defend.

So far, we have focused on the market-lost profit fault line, which is unique to market damage cases. But the fact that the seller's costs and the buyer's valuation may change concurrently with market prices resurrects the expectation-reliance fault line as well because the problem of joint unprofitability returns. If the seller's costs increase more than both the buyer's valuation and the market price, and the market price also increases more than the buyer's valuation, the contract becomes jointly unprofitable. Or if the buyer's valuation decreases more than both the seller's costs and the market price, and the market price also decreases more than the seller's costs, the contract becomes jointly unprofitable.

Actually, the benefit could be even greater because the promisor may opportunistically claim that the promisee has breached, which, if the claim is successful, could reduce the promisor's losses to zero. The solution to this problem, however, might be to adjust rules of liability to take into account promisor opportunism, not to adjust the damage rules. Damage rules alone can only do so much.

See Victor P. Goldberg, Impossibility and Related Excuses, in Readings in the Economics of Contract Law, supra note 2, at 221, for such a theory of impossibility. On other rules of liability for dealing with mitigation, see Goetz and Scott, supra note 22, at 989-1000, 1004-11.

The jointly unprofitable cases can be represented in our notation as \( c' > m' > v > p \), and \( p > c > m' > v' \). In the first case, neither the original buyer nor an alternative buyer ("the market") is willing to pay the seller's cost of performance. In the second case, neither the original seller nor an alternative seller ("the market") is willing to sell at any price below the buyer's valuation. These contracts should not be performed if allocative efficiency is the only concern. If we take the joint costs of nonperformance into account, it may be desirable to encourage performance of some of these contracts.
Because the market damage measure may exceed the reliance measure, using such a damage rule when performance is jointly unprofitable may, as we saw in Part II, overdeter promisors.

Finally, a change in market price may even, in certain circumstances, resurrect the high-restitution-expectation fault line. First, the market price may change not only at the time of the breach but again after the breach occurs. Courts may then have to decide which "market price" counts in the market damage measure. If we have a situation in which only the market price is changing, so the contract remains jointly profitable, the question becomes whether to use the market price at the time of breach to disgorge the breaching promisor's gains, or whether to use the market price at a later time to avoid "overcompensating" the promisee. Choosing the first interpretation of market price, which is consistent with the theory advocated here, is in a sense choosing a high-restitution measure over an expectation measure. Second, a losing contract scenario may arise, in which the party ostensibly benefitted by a change in market price breaches. If the promisor has received some benefit from the promisee, a court may have to choose between restoring that benefit to the promisee (a high-restitution measure) or awarding "market damages" of zero (an expectation measure). In the two-market-price case, using the market damage rule is restitutionary; in the losing contract case, not using the market damage rule is restitutionary. Thus, strict adherence to the market damage rule does not eliminate the high-restitution-expectation fault line.

We have now seen how the market damage rule connects to the strict liability theory of contract damages and how this connection is severed when economic variables other than the market price change. It seems that courts cannot avoid considering the nature of the breach even when a market for substitute performance

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382 Those who are used to reciting Fuller and Perdue's famous conclusion that when there is a market for substitutes, expectation equals reliance, may find this assertion bizarre. In fact, the theory outlined here shows the limits of Fuller and Perdue's observation. Even if there is a market for substitutes, if any alternative contract that the promisee might have entered into would have become jointly unprofitable after the market shift occurred, then in my view it makes no sense to say that the forgone opportunities on other equivalent contracts equal the lost profits on this contract. (I considered, and rejected on the facts presented, a version of this argument in the discussion of the Walters case, supra Part II.C.1.) Thus, it makes no sense to say that expectation equals reliance.
exists. Nevertheless, the existence of a market does aid the court's inquiry in several key ways.

In some cases, the court can infer whether the contract remains jointly profitable from the conduct of the parties. If the market price changes, the promisor breaches to make a substitute purchase or sale on the market, and the promisee covers or resells on the market, then the court can infer that the contract was jointly profitable, presume that the promisor's breach was opportunistic, and apply the market damage measure as a disgorgement remedy without making any further inquiry. Both sides would not enter into substitute transactions on the market unless the market price remained in between the buyer's valuation and the seller's performance cost, that is, unless the contract remained jointly profitable. On the other hand, if neither party enters into a substitute market transaction, that must mean the contract is jointly unprofitable. If the market price rises above the buyer's valuation, but less than the seller's costs, or falls below the seller's costs, but above the buyer's valuation, then neither party has an incentive to contract on the market. In this case, the court should not use the market damage measure, but a lower damage measure such as reliance or low-restitution, or perhaps a zero-damage rule such as excuse.

383 One problem that arises frequently, especially in employment and other service contracts, is how close the substitute must be to constitute a "market" transaction.

384 In these cases, the fact that both parties are willing and able to enter into substitute market transactions serves an evidentiary function: it reinforces the presumption that the promisor's breach was opportunistic by offering proof that the motivating change in circumstances was truly a market change and not a change affecting only the promisor. This observation suggests that there is a flip side to the argument made by Goetz and Scott that the presence of a market for substitute performance reduces the ability of a promisee to act opportunistically and the need for mitigation rules. See Goetz & Scott, supra note 22, at 972 ("[W]here a developed market for substitute performances exists, the potential for opportunism is negligible . . . ."); id. at 984 (noting that the presence of a market for substitute performance "eliminate[s] much of the need for mitigation rules because the parties can often make optimal adjustments autonomously by, in essence, purchasing them from the lowest bidder in the marketplace"). The flip side is that the use of the market for substitute performance makes it more likely that the promisor's breach was opportunistic and reduces the need for fault-based damage rules.

385 If the market price rises, the seller-promisor would have an incentive to breach and sell on the market only if \( m' > c' \); the buyer-promissee would have an incentive to cover only if \( v > m' \); thus, \( v > m' > c' \). If the market price falls, the buyer-promisor would have an incentive to breach and buy on the market only if \( v > m' \); the seller-promissee would have an incentive to resell only if \( m' > c \); thus, \( v' > m' > c \).
If only one party enters into a market transaction, or if only one market transaction can be proved, the court must make a further inquiry. Suppose first that the promisor breaches to make a better market transaction but the promisee does not cover or resell. The court can still use the market damage measure if it concludes that the promisee could easily buy or sell on the market. But the promisee’s failure to transact on the market after breach does not answer the question. If the situation is one in which the market price does not rise above the buyer’s valuation or fall below the seller’s costs, \(^{386}\) the promisee’s failure to mitigate could result from either a strategic ploy to get larger lost profit damages or a legitimate inability to mitigate. If the situation is one in which the market price rises above the buyer’s valuation or falls below the seller’s costs, \(^{387}\) then the promisee’s failure to transact on the market is a rational decision that tells us nothing by itself about whether the promisee would have made the opposite market transaction \(^{388}\) had performance occurred. Courts must make judgments in these cases, either by making case-specific determinations, or by making presumptions based on categories of contractors or the subject matter of the contract (goods, services, land).

Suppose instead that the promisor breaches and avoids making a market transaction, but the promisee mitigates on the market. One can infer from this combination that performance of the original contract is a loser for the promisor, but one cannot infer that the promisee is the better mitigator. In these cases the market damage measure is least likely to create satisfactory incentives. Once again, courts must make judgments about whether the breach was a strategic attempt to shift some of the costs of a losing contract onto the promisee, or a legitimate request for the promisee as the least cost mitigator to make the substitute transaction and send the promisor the damage bill. \(^{389}\)

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386 These cases are \(v>m'>c'>p, v>m'>p>c', p>v'>m'>c,\) and \(v'>p>m'>c.\)

387 These cases are \(m'>c'>v>p, m'>v>c'>p, m'>v>p>c', p>c>v'>m', p>v'>c>m',\) and \(v'>p>c>m'.\)

388 If the market price rises, the promisee-buyer would buy on the market after breach, but would sell on the market if performance had occurred. If the market price falls, the promisee-seller would sell on the market after breach but would buy on the market if performance had occurred.

389 This is Scott and Leslie’s “cry for help.” See Scott & Leslie, supra note 67, at 794.
The market damage rule is a special case, though admittedly one with broad applicability. The presence of a market for substitute performance sometimes obviates the need for fault determinations and sometimes aids the court in making them. But the market damage rule does not justify a strict liability approach to contract damages. The rule must be seen as part of the menu of contract damage rules from which courts choose. The theory described here integrates the market damage rule with contract damage rules generally.

B. Market Damage Cases and Strict Liability

In this Section, I examine three old cases in which the promisor breached after the market price changed. In the first two cases, the courts applied a market damage measure to limit the promisee’s recovery. Although both cases could be read as broadly supporting a strict liability approach to contract damages, a closer reading shows that the courts in fact were sensitive to the circumstances surrounding the breach and cut short this inquiry only when it would serve no further deterrent purpose. In the third case, the court rejected the market damage measure in favor of a restitution measure. This case is inconsistent with the strict liability approach. The theory developed here can help us to understand all three cases.

I. Globe Refining Co. v. Landa Cotton Oil Co.

Justice Holmes’ famous opinion in *Globe Refining Co. v. Landa Cotton Oil Co.* is often cited for the proposition that contract law is a system of strict liability and contract damages are independent of the reason the breach occurred. It is true that in the opinion Holmes states: “If a contract is broken the measure of damages

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390 190 U.S. 540 (1903) (Holmes, J).
391 See First Nat’l Bank v. Cann, 503 F. Supp. 419, 438 (N.D. Ohio 1980), aff’d, 669 F.2d 415 (6th Cir. 1982); B.B. Walker Co. v. Ashland Chem. Co., 474 F. Supp. 651, 662 (M.D.N.C. 1979); Pogge v. Fullerton Lumber Co., 277 N.W.2d 916, 919 (Iowa 1979); E. Allan Farnsworth, supra note 118, § 12.8, at 875; Farber, supra note 96, at 1443 n.4; Timothy J. Sullivan, Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change, 61 Minn. L. Rev. 207, 219 n.76 (1977). None of these sources suggests limiting the application of the strict liability principle to market damage cases, and the last two cases cited above involve the breach of a construction contract by the performing party.
generally is the same, whatever the cause of the breach.” Holmes also repeats a more tentative version of the famous line from his “Path of the Law” speech from which the efficient breach theory draws its life blood: “The old law seems to have regarded it as technically in the election of the promisor to perform or pay damages.” This statement supports the strict liability idea to the extent that it implies that courts should set a strict measure of damages and should never adjust this measure to provide extra deterrence of the promisor. Nevertheless, the case can be read to support two much narrower propositions. First, recovery of market damages is ordinarily sufficient to deter opportunistic breach without inquiring into the motives of the breaching party. Second, recovery limited to market damages provides better incentives for the promisee to mitigate than a rule of lost profits.

The facts as given in the opinion are very simple, though—as is so often the case—frustratingly incomplete. We can to some extent supplement the facts Holmes provides with the facts given in the trial court record, however. The buyer contracted in July, 1897 to buy ten tanks of crude cotton-seed oil at a price of $0.1575 per gallon for shipment in late August and early September. The buyer was to supply its own tanks and pay for transportation from the seller’s mill in Texas. After filling two full tanks and part of a third, the seller notified the buyer on September 14 that it would not deliver any more oil. On that date, the market price for

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392 *Globe Refining*, 190 U.S. at 544; see also id. at 547 (“The motive for the breach commonly is immaterial in an action on the contract.”).
393 Id. at 543 (emphasis added). The more famous line is: “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.” Oliver W. Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897).
394 *Globe Refining*, 190 U.S. at 541.
395 Id. at 542.
396 The failure of the seller to fill the third car completely was apparently due to the seller’s negligence. See Plaintiff’s First Supplemental Petition, Transcript of Record at 7.
397 See Plaintiff’s First Amended Petition, Transcript of Record at 2. The seller claimed that it refused to perform because the buyer had breached by (1) sending dirty tank cars and requiring the seller to pay to clean them, (2) trying to force the seller to pay for railroad freight charges, (3) refusing to pay on the buyer’s drafts, and (4) refusing to accept some of the shipped oil. See Amended Original Answer, Transcript of Record at 11-13. The buyer disputed all of these assertions, and none seems particularly plausible.

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crude oil in Texas was $0.03 higher than the contract price. The week later, the buyer sent a telegram suggesting that it had covered, and two months later followed up with a letter, which included an itemized bill for around $1000. The charge included the difference between the cover price and the contract price ($0.015), plus freight charges for unfilled tank cars.

By the time of trial, the buyer had increased its damage claims by several thousand dollars over the amount claimed in the letter. The seller argued that the buyer was claiming these extra damages "fraudulently for the purpose of giving the United States Circuit Court jurisdiction." The trial court agreed and dismissed the case, rejecting the buyer's argument that the jury should be allowed to decide the factual issues in dispute before the court determined whether it had jurisdiction. The court stated that "the measure of damage was the difference between the contract

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398 Compare Plaintiff's First Amended Petition, Transcript of Record at 1 (contract price was 15 3/4 cents per gallon) with id. at 3 (market price at the time of the breach was 18 3/4 cents per gallon).
399 See Bill of Exceptions Nos. 2 & 3, Transcript of Record at 23 ("No reply we have bought oil your account and hold you for difference.").
400 Id. at 23-24.
401 See id. at 23-24. The letter states:

We enclose you herewith bill for difference in price on oil bought to fill the undelivered portion of your contract for 10 tank cars of prime new crude and the mileage we paid to the various lines to get cars back into our service. We would thank you to send us New York exchange to cover. All of these tanks have not been returned and we shall expect you to reimburse us for any additional mileage we may have to pay.

Id. at 23. The substitute purchase of 47,353 1/3 gallons, see id. at 24 (listing purchases of 46,200 gallons and 1153 1/3 gallons), was 700 gallons less than the 48,053 1/3 gallons the buyer later claimed in its lawsuit. See Plaintiff's First Amended Petition, Transcript of Record at 4. The reason for this discrepancy is apparently that at the time the buyer wrote the letter, it was assuming that a "tank" held 6600 gallons (6600 x 7 [undelivered tanks] = 46,200), whereas at the time of suit, the buyer claimed that the tanks could in fact hold 6,700 gallons, or 100 more than was assumed in the letter. The bill does not allege any other losses besides the ones listed. Of the $1021.28 bill, $710.30 represents the contract-cover differential of $0.015 ($0.1725-$0.1575) on the 47,353 1/3 gallons purchased, $18.90 represents "[s]hortage as per statement" (it is not clear to what this refers) and $292.08 represents freight charges on six tanks. Id. at 24.

402 Globe Refining, 190 U.S. at 542-43; see also Plaintiff's First Amended Petition, Transcript of Record at 2-5 (detailing losses totaling around $5000).
403 Globe Refining, 190 U.S. at 541. The basis of jurisdiction was diversity, and the amount in controversy needed to exceed $2000.
404 Id.
price of the oil and the value of same at the time of the alleged breach thereof, and that it would not consider any testimony not bearing upon this issue in the pleadings." 405

Holmes was also sympathetic to the seller’s jurisdictional argument. To him, it was “obvious that the pleader has gone as far as he dared to go and to the verge of anything that could be justified under the contract, if not beyond,” and thus the “allegations must be read with care.” 406 Holmes began his analysis in the opinion with this jaundiced view of the buyer’s allegations, and any doubt that it colored his entire picture of the case is resolved by the end of the opinion. There, Holmes noted that if the judge accepted the view of the case that the buyer had expressed in the first letter sent from the buyer to the seller (arguably that damages were limited to the contract-market differential), “the pretence of jurisdiction was at an end.” 407 Holmes then curtly rejected the buyer’s argument that the letter was a mere offer of compromise.408 Thus, far from being insensitive to the motives of the parties (or the considerations of “morality” he liked to criticize), 409 Holmes seemed to view the potential for opportunistic behavior as crucial to the outcome.

405 Judgment, Transcript of Record at 15. The trial court expressed no opinion on what it thought the relevant market price was. If the relevant market price was $0.1875, then the market-contract differential was 48,053.33 x $0.03 = $1441.60, which is less than $2000. The buyer tried to argue that the market price was $0.20 on the date it learned of the breach, see Plaintiff’s First Amended Petition, Transcript of Record at 3, which would have put the damage claim at $2042.27. But the $0.20 figure represented the price on Memphis oil, not Texas oil, because the freight charges were lower from Memphis. Bill of Exceptions Nos. 2 & 3, Transcript of Record at 26. Thus, $0.20 might have been an appropriate cover charge, if the buyer had reasonably covered with Memphis oil; it is not an appropriate market price unless Memphis was the only place where substitute oil was available.

406 Globe Refining, 190 U.S. at 542.

407 Id. at 547.

408 Id. As the facts from the trial record discussed above show, the trial court might have accepted the buyer’s argument that the letter was offered as a compromise and still dismissed the case for lack of jurisdiction by basing damages on the contract-market differential. Today, the U.C.C. expressly allows the buyer-plaintiff to sue for market damages even if it covers at a lower price. See U.C.C. § 2-711(1) (1990).

409 See Holmes, supra note 393. On Holmes and morality, see Daniel R. Ernst, The Critical Tradition in the Writing of American Legal History, 102 Yale L.J. 1019, 1046-62 (1993) (book review). Ernst argues that Holmes attacked the view that moral culpability was the sole test of liability; rather, he thought the proper inquiry was to “determin[e] which litigant represented the preponderant social force in the great historical struggles of the day.” Id. at 1049. Moreover, Holmes recognized that moral standards were relevant to determining legal liability. The moral standards he found relevant, however, were the accepted standards of the community, rather than an abstract ethical system. Id. at 1058.
of the case. But the opportunistic behavior that mattered to Holmes was that of the buyer, not the breaching seller.

In between the pronouncements on the buyer’s pleadings comes Holmes’ largely academic dissertation on contract damages. I am interested here not so much in Holmes’ adoption of the so-called “tacit agreement” test for consequential damages as I am in Holmes’ statements about strict liability. The first statement comes amid a discussion that is worth quoting in detail:

But a man never can be absolutely certain of performing any contract when the time of performance arrives, and in many cases he obviously is taking the risk of an event which is wholly or to an appreciable extent beyond his control. The extent of liability in such cases is likely to be within his contemplation, and whether it is or not, should be worked out on terms which it fairly may be presumed he would have assented to if they had been presented to his mind. For instance, in the present case the defendant’s mill and all its oil might have been burned before the time came for delivery. Such a misfortune would not have been an excuse, although probably it would have prevented performance of the contract. If a contract is broken the measure of damages generally is the same, whatever the cause of the breach. We have to consider therefore what the plaintiff would have been entitled to recover in that case, and that depends on what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made.410

The “event which is wholly or to an appreciable extent beyond the [promisor’s] control,” whose risk the promisor “obviously is taking,” and for which the “extent of liability . . . is likely to be within his contemplation,” is probably a change in the market price.411 Under this interpretation, “such cases” and later “that case” would refer to contracts for fungible goods sold on a thick market. If so, we have seen that there is a strong argument for adopting a presumptive rule of market damages, whatever the cause of the breach. Holmes’ fire example demonstrates this point.

410 Globe Refining, 190 U.S. at 543-44 (emphasis added).

411 Later in the opinion, Holmes rejected one of the buyer’s claims for “special damages” by responding that the seller had notice only “of a fact which would depend upon the accidents of the future.” Id. at 546. The “accident” could simply be a change in market price.
If, as Holmes postulates, the immediate cause of the breach is a fire in the seller’s plant, the seller could often procure substitute goods and fulfill the contract. If the seller does not do so because it thinks it might be able to claim excuse, the seller’s breach could be an opportunistic attempt to evade the payment of the contract-market differential, which is precisely the risk that the seller had contracted to bear. Holmes is arguably attempting to show the even-handedness of a strict application of the market damage rule: he would reject excuse and apply market damages in the fire case just as he rejects consequential damages and applies market damages in the case of a breach simply to take advantage of a changed market price, which may be this case. Whether the seller is breaching to use the market or to avoid the market, the market damage rule generally provides the seller with the right incentives. Thus, it is possible to interpret Holmes’ statement about the measure of damages being independent of the cause of the breach to be limited to market damage cases, where the strict liability principle is most defensible.

The second statement of the strict liability principle is contained in a response to the buyer’s allegation

that the defendant, contemplating a breach of the contract, caused the plaintiff to send its cars a thousand miles, at a cost of a thousand dollars; that defendant cancelled its contract on the second of September, but did not notify the plaintiff until the fourteenth, when, if the plaintiff had known of the cancellation, it would have been supplying itself from other sources; that [defendant] did so wilfully and maliciously, causing an unnecessary loss of two thousand dollars.413

Addressing this contention, Holmes first notes that the alleged fact “has no relation to the time of the contract. Therefore it cannot affect the damages, the measure of which was fixed at that time.”414

After making this somewhat sweeping statement—which if read

412 Holmes’ position on excuse was arguably consistent with prevailing precedent at the time. See, e.g., Stees v. Leonard, 20 Minn. 448 (1874). Although some have suggested that the same conclusion might not be reached today, see Kessler et al., supra note 2, at 947, if I am right that Holmes is talking about cases in which the market price increases at the same time the fire occurs, excuse would probably not be allowed today either. See, e.g., U.C.C. § 2-615 cmt. 4 (1990).
413 Globe Refining, 190 U.S. at 542 (emphasis added).
414 Id. at 547.
literally would wipe out the entire doctrines of modification and mitigation—Holmes abruptly states: "[t]he motive for the breach commonly is immaterial in an action on the contract. It is in this case."415

415 Id. (citations omitted). Holmes at this point cited three sources for the strict liability principle: Grand Tower Co. v. Phillips, 90 U.S. (23 Wall.) 471, 480 (1874) ("The particular reasons or motives which the company or its officers may have had in not furnishing coal to the plaintiffs were not in issue."); John D. Mayne & Lumley Smith, Wood's Mayne on Damages § 45 (1880); and 2 Theodore Sedgwick, A Treatise on the Measure of Damages § 603 (8th ed. 1891) [hereinafter Sedgwick, Damages, 8th ed.]. The strict liability statement in Grand Tower, a fascinating and (in my view) underdiscussed case, is consistent with my interpretation of Globe Refining. In Grand Tower, the seller breached a coal contract in a rising market and the Court, rejecting the application of a liquidated damage clause that would have limited the buyer's remedy as well as a lost profit measure that would have enhanced it, awarded market damages. 90 U.S. (23 Wall) at 479-80. Market damages were sufficient to deter opportunistic behavior by future sellers. Thus, the Court correctly refused to allow the buyer to introduce letters by the seller's president suggesting that the seller breached to take advantage of the rising market: these letters would have added nothing to the market damage rule's presumption of seller opportunism. See id.

Wood's Mayne essentially refers to Sedgwick. The evolution of the strict liability view in Sedgwick's treatise is interesting. The second edition of the treatise, which was the last edition on which Theodore Sedgwick himself worked before he died, stated the general principle that the motives of the breaching party are irrelevant to determining damages (though he also acknowledged that some exceptions existed). See Theodore Sedgwick, A Treatise on the Measure of Damages, 203-08 (2d ed. 1852). The principle was introduced primarily to explain why punitive damages are not allowed in contract. Sedgwick justified the principle mostly on the ground that it was necessary to maintain the distinction between contract and tort causes of action. See id. at 206. But Sedgwick did not think that strict liability was a great idea. In a footnote, he stated:

I am far from desiring to express any opinion in favor of the doctrine of the text: on the contrary, if the plaintiff in an Anglo-Saxon court of justice shall ever be permitted to state his complaint according to the actual facts, and not be compelled to use an unmeaning formula, I can see no reason, greatly as legal relief would be thus extended, why exemplary damages should not be given for a fraudulent or malicious breach of contract, as well as for any other wilful wrong. . . . But it does not appear to me that as yet the principle has been engrafted in any regular or practical way on the common law, unless in the exceptions subsequently stated in the text. In this work, my only object is to expound the rules of law as they appear to me to exist.

Id. at 208 n.†. Sedgwick's treatise remained largely unchanged throughout subsequent editions, largely due to the fact that Sedgwick's son, who continued the treatise after his father's death, was reluctant to make major changes. See Arthur G. Sedgwick & Joseph H. Beale Jr., Preface to the Eighth Edition of Sedgwick, 2 Sedgwick, Damages, 8th ed., supra, at v., v-x. At the time of the eighth edition, however, the younger Sedgwick concluded that the law had changed significantly in the 11 years since the publication of the seventh edition, particularly the forms of pleading, and that these changes justified substantial revisions in the treatise. See id. Although these changes might have caused the senior
Holmes' repetition of the strict liability principle here is puzzling. The buyer was not alleging that the seller made the decision to breach "wilfully and maliciously." The buyer does not allege, for example, that the seller on September 2 sold the oil to another buyer at a higher market price, tried to renegotiate the terms of the deal once the buyer had committed substantial resources and was in a vulnerable position, or tried to send ambiguous breach signals to the buyer in the hopes that it could later argue that the buyer should have covered on September 2. Rather, the buyer alleges that the seller's conduct after the decision to "cancel"—namely the failure to inform the buyer of the cancellation—wilfully and maliciously exacerbated the damages.

But the problem is more with the buyer's allegation than with Holmes. It is not clear what the buyer meant by its claim that the seller "canceled" the contract. Even if the seller had sold the oil on that date, it could still have satisfied the contract by making a substitute market purchase. It is unlikely that the seller's delay was "malicious." The seller probably did not withhold notice out of spite toward the buyer, or simply to run up the buyer's wasted expenditures. The seller would get no benefit from the latter activ-

Sedgwick to herald the impending demise of strict liability in contract damages, the younger Sedgwick stressed that it was still important to maintain the contract/tort distinction:

But the inherent difference between a breach of an agreement between parties, and that sort of a breach of duty which we call a tort, is as old as the law itself. It is believed, too, that as a general rule the measure of damages in one case is necessarily different from the measure of damages in the other. To put the plaintiff in the same position as if the contract has not been broken is the object in cases of contract; whether the contract is broken by accident or by fraud can make no difference. As long as the action is brought to obtain compensation for the loss of the contract, the circumstances attending the breach cannot affect the result.

2 Sedgwick, Damages, 8th ed., supra, § 602 (emphasis in original). The prophetic footnote, penned by the senior Sedgwick, is nowhere to be found in the eighth edition, cited by Holmes.

416 On the ambiguous signal problem, see Goetz & Scott, supra note 22, at 989-92.

417 The buyer apparently equated "cancellation" with "breach." See Brief for Plaintiff in Error at 6 ("We are at a loss to see why we would not get all moneys advanced on the contract, after the defendant had determined to cancel same, i.e. twelve days pass from the time he breaches the contract before he informs us of the fact . . . ."). The buyer's appellate brief argues simply that the seller "had made up his mind on the 2nd of September and did on that date refuse compliance with the contract." Id. at 2. To say the least, it is a tortured use of the words "cancellation" and "breach" to refer to a mental state without any accompanying conduct.
ity. Rather, the seller probably had plenty of oil on hand, and as the buyer itself alleged in its brief, merely "kept the fact of its breach to itself, speculating on the price of oil going down and if so he [would] comply with it."\(^{418}\) If this is what the seller was doing, its motive was certainly irrelevant. It was simply taking its chances on the market price: if the price fell, the seller would perform; if it continued to rise, the seller would lose its gamble. Moreover, if the seller's delay increased the cost of mitigation to the buyer, the seller risked liability for that extra cost. Damages greater than market damages, plus any mitigation costs,\(^ {419}\) were not necessary to deter any "wilful" behavior by future sellers.

In fact, it was important that damages not be greater than market damages plus reasonable mitigation costs to provide the correct incentives to future buyers to mitigate. Although Holmes does not focus on this point, the real question in the case is why the buyer did not cover so as to avoid all of its claimed lost profits and wasted expenditures, as the market damage rule presumes it was able to do. The reason most supportive of the buyer's position is that there might not have been a spot market for oil available that would have enabled the buyer to cover in time to avoid breaching its contracts with its customers. The buyer tried to make essentially this argument by claiming that it could not buy substitute oil in Texas on September 14 at any price because the market was "disorganized."\(^ {420}\) But it is highly improbable that the buyer could

\(^{418}\) Id. at 13.

\(^{419}\) Holmes is not clear about whether he would have been willing to allow recovery for the buyer's reasonable mitigation expenses in excess of the costs under the original contract—what would today be called "incidental" damages. See U.C.C. § 2-715(1) (1990). Most of the damages claimed by the buyer were not extra expenses from mitigating but expenses that the buyer would have incurred had the seller performed. The buyer did claim that it "was required to pay additional freight in order to rearrange the destination of the various tanks and other points." \textit{Globe Refining}, 190 U.S. at 543. Holmes appears not to respond specifically to this claim. It is not clear that this claim refers to extra mitigation expenses, see Amended Original Answer, Transcript of Record at 10, and it could be that Holmes rejected it because the allegation was insufficiently specific. See \textit{Globe Refining}, 190 U.S. at 546. In any case, the claim was for $350, which, when added to the market damage measure calculated above, would still have left the buyer short of the $2000 necessary for federal jurisdiction.

\(^{420}\) The buyer alleged that

by reason of the disorganized condition of the market and defendant's failure to notify plaintiff of said real breach of contract at time of breach, plaintiff was wholly unable to get the oil at all. . . . But plaintiff was wholly unable to procure same at all
not have mitigated in time to fulfill its obligations. First, the fact that the buyer might not have been able to get substitute oil in Texas does not mean that the buyer could not have made a timely cover purchase elsewhere. The buyer's president testified that his company had bought oil in Selma, Alabama, on September 8, and in Memphis, Tennessee, on September 13. Second, the buyer did not allege that no oil was for sale on the spot market on September 14 because all the available oil was already committed by contract to other buyers. Third, the buyer did not allege that it had no spare tanks in other locations that it could have used to cover, nor that it had no surplus oil on hand, nor that it could not shift oil from less time-constrained contracts to time-sensitive ones, nor that it could not have purchased refined oil from other refineries to meet its obligations.

If the buyer could have covered or mitigated in time, why might it not have? The most plausible explanation is that the buyer thought the market price was too high to make covering worthwhile. This interpretation is supported by several statements made by the buyer's president in his deposition testimony. If the mar-

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421 On repeated occasions, the buyer's brief asserts that oil could not be procured anywhere. See Brief for Plaintiff in Error at 3, 4, 6, 10, 18, 19. This broad assertion does not appear in the pleadings, nor does it find support elsewhere in the record.

422 Bill of Exceptions Nos. 2 & 3, Transcript of Record at 26.

423 The buyer's president stated:

"Shortly after the deal was made with the defendant oil began to advance until in the last part of August it reached as high as 18 cents . . . . During the first part of September of the said year the price of oil had still further advanced and we could not get any oil in Texas at what we thought was a reasonable price, the mills preferring to hold their oil. And we would have been compelled to pay 19 and 19 1/2 c. for the oil . . . ."

". . . . At the time that the defendant refused to deliver us the oil as stated there was very little oil offering for the reason that the mills were advancing the price of seed on each other, and we could not get anything like the amount of crude oil for shipment that we could dispose of as refined oil, the oil for prompt shipment was very scarce, and the mills were inclined to sell for future delivery . . . . The market in Texas was at least 18 3/4 and it would have been hard to have gotten oil at this."

Id. at 26-27 (emphasis added); see also id. at 28 (stating that "we wrote our attorney . . . that we could not have replaced this oil . . . under 18 3/4 c., or probably 19 or 19 1/2 c. per
market price exceeded the buyer’s valuation, such valuation including lost profits and potential damage payments to the buyer’s customers, it would be rational for the buyer not to cover. But in this case, by definition, market damages would more than compensate the buyer for its losses, and Holmes is correct that any recovery for any of these losses “would be making the defendant pay twice for the same thing.” If the market price was less than the buyer’s valuation, the buyer should have covered, and the market damage measure would encourage the buyer to do so. If the buyer thinks it will be able to claim lost profits if it does not mitigate, it has an incentive not to mitigate; this is the buyer “fault” that the market damage rule seeks to discourage. Finally, if the buyer simply wanted to wait until the market price fell before it covered—arguably what happened in the case—it should be forced to bear the risk of any lost profits it incurs as a result of its deliberate delay. The buyer thus provided no plausible reason why the Court should not have applied the market damage rule.

The reading of the case offered here makes Holmes’ comments about strict liability seem more a reasonable response to the particular circumstances before him than a strong commitment to a broad principle. The result in the case is amply supported by the fault-based economic theory of market damages. Market damages discourage future sellers from breaching opportunistically to take advantage of an increase in the market price, encourage future buyers to mitigate at least cost, and discourage future buyers from opportunistically jacking up damage claims to get federal jurisdiction.

2. Acme Mills & Elevator Co. v. Johnson

Another case that is sometimes thought to support the strict liability idea is Acme Mills & Elevator Co. v. Johnson. In Acme gallon”). But cf. Brief for Plaintiff in Error at 12 (arguing that the allegations and proof “showed that plaintiff could not procure the shortage of oil at any price when first informed of the breach of contract”).

424 Globe Refining, 190 U.S. at 546.

425 133 S.W. 784 (Ky. 1911). The case is linked with the efficient breach idea in Kessler et al., supra note 2, at 1061-69, and Dawson et al., supra note 164, at 31. It is linked with the refusal to recognize a general right to restitution in 1 George E. Palmer, The Law of Restitution 442 (1978), and Friedmann, supra note 9, at 513 n.47.
Mills, a farmer contracted on April 26 to sell 2000 bushels of wheat for $1.03 per bushel to be delivered after the wheat was threshed.\footnote{Acme Mills, 133 S.W. at 784.} The farmer threshed the wheat some time after July 25, at which time the market price of wheat was $0.975 per bushel.\footnote{Id. at 785.} The farmer, however, did not deliver the wheat to the buyer.\footnote{Id.} Instead, the farmer had sold the wheat on July 14 or 15 to another buyer for $1.16 per bushel.\footnote{Id.} The buyer asked for lost profits of $240.\footnote{Id.} The Supreme Court of Kentucky upheld the verdict denying this amount.

It is interesting to begin by noting that unlike Globe Refining, there is no statement in the opinion to the effect that the motive for breach is irrelevant.\footnote{Id. Why the buyer asked for $240, which reflects a $0.12 cent differential ($0.12 times 2000 equals $240) rather than $260, which would have reflected the $0.13 differential between $1.03 and $1.16, is not stated in the opinion. Perhaps the $20 represented the buyer's expected costs of resale. If so, it is not clear why the buyer did not seek high-restitution damages of $260 to disgorge from the farmer his "ill-gotten" gain from breach.} The court simply states that the general rule is market damages and that "[t]here is no reason why this rule should not apply to the facts of this case."\footnote{Id.} The court then goes on to justify the application of the market damage rule:

The evidence clearly established the fact that the threshing was not completed until about the 29th of July. There is nothing in the evidence tending to show that appellee fraudulently delayed the threshing of the wheat for the purpose of permitting the market price of the wheat to go down. Indeed, all the circumstances pointed to an advance rather than a decline in the price, and appellee had no reason to anticipate that the market would decline. As he finished threshing on the 29th of July, and the wheat was to be delivered from the thresher, and appellant was not to accept and pay for the wheat until the time fixed for delivery, that is the time which determines whether or not appellant was damaged. If appellee had sold his wheat on July 14th or 15th, at $1.16, and the price

\footnote{426 Acme Mills, 133 S.W. at 784.}
\footnote{427 Id. at 785.}
\footnote{428 Id.}
\footnote{429 Id.}
\footnote{430 Id. Why the buyer asked for $240, which reflects a $0.12 cent differential ($0.12 times 2000 equals $240) rather than $260, which would have reflected the $0.13 differential between $1.03 and $1.16, is not stated in the opinion. Perhaps the $20 represented the buyer's expected costs of resale. If so, it is not clear why the buyer did not seek high-restitution damages of $260 to disgorge from the farmer his "ill-gotten" gain from breach.}
\footnote{431 Nor does the court endorse the efficient breach view that it is generally desirable to give a contracting party the right to breach. It is true that the buyer, whose appeal the court rejected, argued that the seller "had no right to violate his contract by selling the wheat to another at a price far in excess of the contract price," but the court never rejected that proposition outright. Id.}
\footnote{432 Id.}
on July 29th was $1.50 per bushel, appellant would not be contend-
ing that the measure of his damages was the difference between
the contract price and the price appellee received for it on July
14th or 15th, but would insist that he was entitled to the difference
between the contract price and $1.50 per bushel. Besides, appellee
was not required by his contract to deliver to appellant any particu-
lar wheat. Had he delivered other wheat of like quantity and qual-
ity, he would have complied with the contract. When he sold his
wheat on July 14th or 15th for a price in excess of the contract
price, and therefore failed to deliver to appellant wheat of the
quantity and quality contracted for, he took the chances of being
mulcted in damages for the breach of the contract.433

None of the court's arguments supports the strict liability princi-
ple. First, the court is concerned with establishing the date of the
threshing. Why is the threshing date important? We must start
with the observation that the buyer in this case was in all likelihood
a middleman rather than a final user. Thus, the loss (if any) it suf-
fered from the seller's breach was its profits on resale. These
would probably be higher the higher the market price because its
resale costs would be no higher for higher priced wheat. Thus, if
the farmer had threshed the wheat by July 14 and sold on the spot
market for $1.16, but delayed notifying the buyer, the buyer was
arguably damaged by $0.13 per bushel by the farmer's delay.434 If,
however, the farmer did not thresh until after the market price
started falling, the farmer must have entered into a future sale at
$1.16, not a spot market sale. But if $1.16 represented the market
price for futures contracts on July 14, an equivalent sale was avail-
able to the buyer. If the buyer had entered into a contract for
resale at $1.16—surely easy for a middleman—it would have
earned the same $0.13 that the farmer did.435 In light of this expla-
nation, the court's statement that there was no evidence that the

433 Id. at 785-86.
434 Unlike the contract in *Globe Refining*, which the Court in effect interpreted to allow
the seller to delay notification of its decision to breach before the date performance was
due, the contract here set the date of delivery as the threshing date rather than a fixed
time. Thus, the contract could not be interpreted as giving the farmer the option of
threshing and selling to another buyer, but delaying notice.
435 I therefore disagree with the characterization of the case that claims that "the seller
[took] risks with the buyer's welfare and then retain[ed] the full benefits of the resale for
himself, rather than offering to divide his profits with the buyer in some fashion." Kessler
et al., supra note 2, at 1068.
farmer intentionally delayed the threshing does not seem quite right;\textsuperscript{436} it would have made more sense to say there was no evidence that the farmer sold the wheat on the spot market and delayed notifying the buyer until the market price dropped. But the key point is that the court was acutely sensitive to whether the farmer was behaving opportunistically.

In the remainder of the paragraph, the court offers several arguments apparently aiming to show that the farmer did not breach simply to take advantage of the higher market price; he was not deliberately “betting on the market.” The court notes that “all the circumstances pointed to an advance rather than a decline in the price,”\textsuperscript{437} which suggests that the farmer was not breaching opportunistically to take advantage of the higher market price. The court underscores this inference with its example of what would have happened had the price continued to rise, though ostensibly it is using this example to demonstrate the buyer’s disingenuousness.\textsuperscript{438} In case we miss the point, the court follows this statement with the observation that the farmer could have obtained substitute wheat and chose not to.\textsuperscript{439} The court seems to be suggesting that a farmer breaching simply to take advantage of the high market price would have bought substitute wheat and fulfilled the contract. The court concludes with the stern warning that the farmer “took the chances of being mulcted in damages.”\textsuperscript{440} Mulcting is the last thing the strict liability theory has in mind.\textsuperscript{441}

If the farmer did not breach to take advantage of the higher market price, then why did he breach, and why did he not procure substitute wheat? The farmer claimed that there were “rumors to

\textsuperscript{436} If the buyer had entered into a resale contract at $1.16 for delivery at a certain date, based on the assumption that the farmer would thresh by a certain date, then the issue of whether the farmer intentionally delayed threshing would become important. But even here, as in \textit{Globe Refining}, there is no obvious gain to the farmer, other than pure spite, from intentionally delaying threshing.

\textsuperscript{437} \textit{Acme Mills}, 133 S.W. at 785.

\textsuperscript{438} See id.

\textsuperscript{439} Id.

\textsuperscript{440} Id. at 786.

\textsuperscript{441} “Mulct” is defined as follows: “A penalty or punishment imposed on a person guilty of some offense, tort, or misdemeanor, usually a pecuniary fine or condemnation in damages. A forfeit, fine, or penalty. To sentence to a pecuniary penalty or forfeiture as a punishment; fine; hence to fine unjustly; to punish.” Black’s Law Dictionary 1014-15 (6th ed. 1990) (citation omitted).
the effect that appellant had suspended business and was unable to pay for the wheat.”\textsuperscript{442} Although the court found that the rumors were unfounded, it did not say that the farmer was lying in his claim that he was responding to them. This would explain the farmer’s decision not to buy substitute wheat: if he did not think the buyer would be able to pay, why bother getting a substitute?\textsuperscript{443} The court does not say the farmer’s belief was reasonable—indeed the implication seems to be that the farmer was foolish to breach and lucky that the damages were not greater. The court’s point is that the farmer did not act opportunistically, and so there was no need to “inulct” him by awarding greater than expectation damages, which in this case were zero. The lawsuit was likely borne of the buyer’s belief that the farmer had deliberately deprived him of the chance to make a greater profit, as well as the farmer’s belief that the buyer could not pay. The opinion concludes that both parties were wrong. Although the court may have been overly sympathetic to the farmer’s interpretation of events, the opinion does not support strict liability.\textsuperscript{444}

3. Bush v. Canfield

The final case in our brief survey of market damages is Bush v. Canfield,\textsuperscript{445} a losing contract case that still seems to enjoy wide-

\textsuperscript{442} Acme Mills, 133 S.W. at 785.

\textsuperscript{443} An alternative explanation is, of course, that the farmer thought the buyer was in a better position to make a substitute purchase. Even if one takes the view that this argument should rarely be accepted in market damage cases once the costs of nonperformance are taken into account, a case involving an individual farmer and a middleman buyer is as attractive a case for deeming the buyer the better mitigator as one is likely to get.

\textsuperscript{444} Nor does the case support the efficient breach perspective that the farmer should be encouraged to breach to sell to a higher-valued buyer. Professor Dawson seems to view Acme Mills as being inconsistent with Timko v. Useful Homes Corp., 168 A. 824 (N.J. Ch. 1933). See Dawson, supra note 9 at 186; supra text accompanying notes 207-208. The cases are distinguishable on at least two grounds. First, because Acme Mills involved fungible goods, it was possible for both the farmer and the middleman to take advantage of the change in market price, with one party using substitute wheat. In Timko, only one party could reap the benefits of reselling the lots to the higher-valued buyer. In addition, the farmer’s intent in reselling the wheat was ambiguous in Acme Mills; the developer’s intent in reselling the lots was—at least according to the court—unambiguously wrongful in Timko.

\textsuperscript{445} 2 Conn. 485 (1818).
spread acceptance, yet is flatly inconsistent with the strict liability theory. In this case, the buyer contracted to buy 2000 barrels of flour at a contract price of $7 per barrel, for a total of $14,000. The buyer made a down payment of $5000 and was to pay $3000 four months after the date of the down payment and $6000 six months after the date of delivery. After the buyer had paid the down payment, but before he made the other payments, the market price dropped to $5.50 per barrel and the seller breached for undisclosed reasons. If the seller had performed, the buyer would have received flour worth $11,000. Instead, the seller apparently claimed that it could breach, keep $3000 from the deposit (the extra profit to the seller from the market drop), and refund only $2000 to the buyer, which would put the buyer in its ex post expectancy position of a $3000 loss. The trial court instead refunded the $5000 to the buyer, and the Connecticut Supreme Court affirmed this judgment.

The case is inconsistent with the strict liability view because the court did not protect the buyer's expectation interest by awarding market damages. From an ex post expectation perspective, the buyer was put in a better position than if the contract had been performed. From an ex ante expectation perspective, the court did not seem to enforce the "market bet" made by the parties. Traditional scholars tend to distinguish the case doctrinally by categorizing the case as a "restitution" case without trying to reconcile it with the strict liability idea.

446 The acceptance is largely academic. The case has rarely been cited by other courts, perhaps because the problem presented is unlikely to recur, or perhaps because the decision is so obviously correct that no one is interested in challenging it or pushing its limits.

447 Bush, 2 Conn. at 485.

448 Id.

449 Id. at 485-86. The fact that the seller breached after a price drop makes this case similar to Acme Mills. The main differences are that there was no evidence that the seller resold the flour at a price above the contract price, and that the buyer paid the seller a deposit.

450 Id. at 493.

451 Id. at 494.

452 One casebook suggests that the case is inconsistent with Acme Mills. See Kessler et al., supra note 2, at 1201.

453 See Scott, supra note 337, at 1158, 1170-72.
But the theory developed in this Article explains *Bush* by focusing on providing the right incentives to the parties, not on overcompensation or undercompensation as such, or on traditional doctrinal categories. *Bush* is not a case in which the breaching seller sought to use the market to take advantage of a price increase but one in which the breaching seller sought to avoid the market to save the costs of performing what appeared to be an advantageous contract. The question in the case, therefore, is whether the market damage rule provides the seller with the correct incentive to make the mitigate-or-breach decision. The answer is no.

The first question to ask is why the seller breached this contract. The answer must be that the seller's expected profits from nonperformance exceeded its expected benefits from performance. Usually a seller would get no benefits from nonperformance as long as its costs of performance remained lower than the contract price. In this case, however, because the buyer had paid a deposit, the seller was able to argue that it should keep the part of the deposit corresponding to the contract-market differential. The seller would compare this benefit, less any expected litigation costs, to the net profits from performance. But if performance, including going into the market to buy the flour, cost anything more than the market price plus expected litigation costs, the seller's net profits from performance would be lower than its benefit from nonperformance (the retainer of the contract-market differential). This could happen if the market price drop or the seller's costs of covering were large enough or if the seller's expected litigation costs were low enough.\footnote{To return to our model from Part III.A, the seller in this situation will not breach if \( v > p > m' > c \), that is, if it can produce the flour more cheaply itself than it can by covering on the market. Because the seller breached, if no other variables changed, that must mean that \( v > p > c > m' \). In this case, “c” could be interpreted as the total cost of covering on the market \( (c=m'+\text{other cover costs}) \). If the seller performs, its profits are \( p-c \). If the seller breaches and is allowed to keep that portion of the deposit corresponding to the contract-market differential but incurs no litigation costs, its profits are \( p-m'>p-c \). If expected litigation costs \( (L) \) are positive, then the seller will breach if \( p-m'-L>p-c \), that is, if \( c>m'+L \). Breach will occur in this case even though performance remains not only jointly profitable \( (v>c) \) but individually profitable \( (p>c) \) for the seller.\footnote{If it is possible that the situation in the case was that \( v>c>p>m' \), that is, that the seller's costs of covering had increased so that when added to the market price, the total costs of performing exceeded the contract price. In this case, performance would have been impossible.}}
buyer's costs of cover under the market damage rule, it is underdeterred from breaching.

Of course, the response to this problem could simply be to add the buyer's cover costs to the market damages in determining the amount the seller must subtract from the deposit. But in Bush, such an approach would have been undesirable and unnecessary because it was reasonable to presume that the seller was the superior mitigator. The key is the recognition that this was a credit transaction. The down payment served double duty as collateral for an extension of credit to the buyer, who did not have to pay the balance on the date of delivery, but rather six months later.\textsuperscript{455} Thus, the contract cannot be viewed simply as a bet on the market; it was also a loan contract. If the buyer had to make such a large deposit and get a loan from the seller, the seller should have realized that the buyer probably would not have been in a position to cover when the seller breached without getting its deposit back,\textsuperscript{456} that is, it could not raise capital on such short notice. As long as the seller retained the $5000, its cover costs were probably cheaper than the buyer's, and the seller should have either mitigated itself or returned the money.\textsuperscript{457} Thus, Bush's rejection of the market damage rule is not a doctrinal anomaly but is easily explained under the fault-based economic theory.

\textsuperscript{455} It is interesting to note that Kronman and Posner omit this fact from their hypothetical variation of the case in their book. See Anthony T. Kronman & Richard A. Posner, The Economics of Contract Law 228 (1979).

\textsuperscript{456} This is just a variation on Levmore's "wealth dependency" theory of restitution. See Levmore, supra note 12, at 74-79.

\textsuperscript{457} It is possible that the situation was exactly the reverse, namely that the buyer was financing an undercapitalized seller. But unless the buyer was an equity investor in a joint venture with the seller, it is not clear why the buyer should bear the risk of any misfortune befalling the seller from badly investing the buyer's money. In any case, it seems reasonable to put the burden on the breaching seller to prove that the buyer intended to bear these risks. Finally, even if Bush is incorrectly decided under this rationale, that does not support the strict liability theory.
Conclusion

Both traditional and economic scholars have missed a real opportunity to provide insight into the law of contract damages because they mistakenly embrace the strict liability principle. That principle, ostensibly derived from the desire to make contract damages compensatory, ignores the ambiguity of compensation in contract that Fuller and Perdue first identified. Strict liability fails to explain in a satisfactory way the wide variety of damage measures that courts actually use. And, most important, from an economic perspective, strict liability fails to provide the correct incentives to the contracting parties. Support for the strict liability principle in contract damages seems to have enjoyed a resurgence in recent years because of the theory of efficient breach and the attempts of many traditional scholars to restore expectation damages to their "rightful" prominent position. This Article has sought to counter that trend. I argue that the strict liability theory of contract damages should be abandoned and replaced with a fault-based economic theory of damages, the pieces of which have long been in place. It is time to stop trying to exorcise fault from contract damages and to start making the fault principles that are an inherent part of contract damages work more efficiently.