

Expectation, Reliance, and the Two Contractual Wrongs

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I. INTRODUCTION: THE PLACE OF EXPECTATION AND RELIANCE IN
CONTRACTUAL DECISION MAKING

A. *Two Contractual Decisions in Need of Moral Assessment*

Expectation and reliance are concepts that continue to vie for priority as core organizing principles of contract law. The expectation and reliance interests appear to differ from each other both in how they conceptualize the essential wrong alleged in contract litigation and in how they would propose to remedy that wrong. Expectation views the wrong as the breaking of a promise, and seeks to remedy that wrong by awarding specific or substitutionary relief that will give the promisee the benefit of that promise.¹ Reliance views the wrong as the making of a promise that induced the promisee to change her position to her detriment, and seeks to remedy that wrong by restoring the plaintiff to the position she would have occupied had the defendant not made her promise.²

1. W. David Slawson, *The Role of Reliance in Contract Damages*, 76 CORNELL L. REV. 197, 217 (1990) (“The wrong in a contract case is the failure to perform the promise. . . . Thus, the expectation measure is the compensation principle applied to contracts.” (emphasis in original)).

2. Warren A. Seavey, *Reliance upon Gratuitous Promises or Other Conduct*, 64 HARV. L. REV. 913, 926 (1950–1951) (“The wrong [in promissory estoppel] is not primarily in depriving the plaintiff of the promised reward but in causing the plaintiff to change position to his detriment.”).

The question of expectation versus reliance is of considerable theoretical and practical importance. Rightly or wrongly, the reliance interest has come to be associated theoretically with the “death of contract” thesis, or the idea that promissory liability belongs in tort law alongside other forms of misrepresentation.³ And numerous practical consequences turn on the issue. Should reliance damages be a supplement or even a replacement for expectation damages for breach of contract?⁴ Should promises that are lacking in consideration or some other formal element (such as a writing) be enforceable if they induce detrimental reliance?⁵ And if so, should the remedy for such promissory estoppel be measured by the plaintiff’s expectation or reliance interest?⁶

The scholarly literature on expectation versus reliance is vast and daunting, and much of that literature is of a remarkably high quality.⁷ It is striking how little consensus there seems to be on the subject, with aggressive champions for expectation and reliance continuing to press their cases. In one sense it is almost surely true that there is nothing completely new under the sun when it comes to comparing the expectation and reliance interests. The position defended in this Article is one that has been seen dimly or hinted at in numerous previous writings on the subject, ironically by advocates of both expectation and reliance. But it has never been stated clearly as the fundamental theoretical answer to the expectation versus reliance dilemma.

3. GRANT GILMORE, *THE DEATH OF CONTRACT* 73–74 (1974) (noting that reliance and restitution are usurping the role of consideration through promissory estoppel and quasi-contract).

4. RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981).

As an alternative to the measure of damages stated in § 347, the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed.

Id.

5. *Id.* § 90 (discussing promissory estoppel); *id.* § 139 (stating that reliance can overcome “the Statute of Frauds if injustice can be avoided only by enforcement of the promise”).

6. *Id.* § 90(1) (“The remedy granted for breach may be limited as justice requires.”). This language was added in the *Restatement (Second)* as a result of commentary to the effect that Williston was wrong in believing that a promise enforced under section 90 must be enforceable to the full extent of the promised expectation. Charles L. Knapp, *Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel*, 81 COLUM. L. REV. 52, 55 (1981) (discussing this history).

7. A number of these articles are discussed in Part III of this Article. See *infra* notes 142–281 and accompanying text.

The thesis of this Article is that there are two separate and distinct wrongs implicated in breach of contract actions. The two wrongs both stem from a common premise: a promise purports to place the promisor under an obligation to keep the promise. When there are no excusing conditions, it will succeed in making the promisor obligated, so that the breaking of the promise is indeed a wrong, calling for an expectation-based response. However, in some cases the promise will not succeed in placing the promisor under an obligation, especially if an analysis of the promisor's circumstances shows that the promise is unexpectedly and unreasonably harsh on the promisor. Nevertheless, the promisor may be at fault for leading the promisee to believe incorrectly that the promisor has successfully placed herself under an obligation to perform. A reliance-based response is appropriate for undoing the harm caused to the promisee by the promisor's behavior. Even when full performance could have been excused, however, it will be argued that expectation remains the appropriate response to unreasonable or inefficient behavior already performed under the contract prior to seeking its avoidance.

An important starting point for our analysis is to focus upon contract nonperformance as involving at least *two decisions* by the promisor. A party decides whether to enter into the contract, and if she does so, she later decides whether or not to perform. Complexities could, of course, be added to this account. A contract might become literally impossible to perform, so that no second choice was ever in fact made. Also, there are additional choices made after contracting that influence the likelihood of nonperformance which might be called precautionary choices.⁸ For example, a party could decide to assign one of its more (or less) reliable employees to a particular project. In the end it will be argued that precautionary decisions should be assimilated to the performance-or-breach decision on the ground that they are choices that can lead to nonperformance.⁹ But let us focus for now upon the simple model in which one decision is made to enter the contract and a second decision is later made to perform or breach that contract.

There is an apparent link between these two decisions and the expectation/reliance dichotomy of contract theory. The reliance interest seeks to place the promisee in the position she would have occupied if the promisor had not made the first choice to enter the contract. The expectation interest seeks to place the promisee in the position she

8. Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CAL. L. REV. 1434, 1464 (1985) (discussing the effect of expectation damages on amount of precaution taken against inadvertent breach of contract).

9. See *infra* notes 93–94 and accompanying text.

would have occupied if the promisor had not made the second choice to breach the contract. Another way of putting this is that reliance is a natural idea to consider in response to wrongs committed by the promisor in making the initial choice to enter the contract, while expectation is a plausible response to wrongs committed in making the second choice to breach the contract.

Many commentators supportive of expectation as an organizing principle of contract law have stressed the greater plausibility of their account of the underlying wrong.¹⁰ Intuitively, it is wrong to break a promise that one has made. It does not obviously seem wrong to make a promise in the first place. In many cases the promise itself was eminently sensible and appropriate, but was simply broken opportunistically by the promisor. Even when the promise is imprudent, or even if it is made in bad faith, it causes no harm to the promisee as long as it is performed. Thus, at least in the case where it is possible to perform, the wrong seems naturally concentrated in the second decision.

On the other hand, the fact that a promise can be impossible to perform shows that this cannot be a complete account. Suppose that one promises to do something which, unbeknownst to the promisee, one cannot possibly do. There is no second action that can be meaningfully criticized. But the first action seems objectionable, especially if the promisee reasonably relied to her detriment on her belief that the performance would indeed be possible. That is particularly clear in cases where the promisor knew she would be unable to perform, a behavior sometimes called promissory fraud.¹¹ But the promisor could also be criticized if she knew or should have known circumstances that could create a significant chance that she would be unable to perform, but chose to make an unqualified promise anyway on which the promisee relied.

The impossibility case is not, however, the only situation in which the first decision is the one to criticize. The point of the impossibility case is captured by the common philosophical observation that "ought

10. *E.g.*, Michael B. Kelly, *The Phantom Reliance Interest in Contract Damages*, 1992 WIS. L. REV. 1755, 1802; Slawson, *supra* note 1, at 217–19.

11. *See* Paul T. Wangerin, *Damages for Reliance Across the Spectrum of Law: Of Blind Men and Legal Elephants*, 72 IOWA L. REV. 47, 58–61 (1986) (discussing promissory misrepresentation theory as spelled out in RESTATEMENT (SECOND) OF TORTS § 530(1) (1965) and applied in *Ellis v. Zuck*, 409 F. Supp. 1151 (N.D. Ala. 1976), *aff'd*, 546 F.2d 643 (5th Cir. 1977)).

implies can.”¹² If it was physically impossible to perform, then there is no second decision or human action that can be justly criticized. There may, however, be situations in which one is not under a moral duty to keep a particular promise, even though it would be physically possible to do so. The duty to keep promises is presumably not absolute, and one can imagine situations in which new information has come to light that shows the original decision to contract was a tragic mistake that would be unconscionable to enforce.¹³ Law and morals might then work to excuse the contractual duty.¹⁴

Even though the second decision to breach has been excused by virtue of the totality of the circumstances, there remains a question of accountability for the first decision to enter into the contract. At least if the promisor knew or should have known of her own personal circumstances that could ultimately render the contract unconscionably harsh, she can be faulted for entering into an unconditional promise to perform. By making an unconditional promise that failed to put the promisee on notice of the prospect of regret contingencies, the promisor may have induced the promisee to rely to her detriment. The fact that the promisor cannot be criticized for failing to perform the contract, and cannot be made to suffer the actual enforcement of that contract, does not mean that she escapes criticism for entering the contract in the first place or accountability for the promisee’s reliance.

A simple example of this form of reasoning can be drawn from the political world. As a candidate, the elder George Bush urged the electorate to “read my lips” and promised there would be “no new taxes.”¹⁵ President Bush then agreed to raise taxes, and this breach of faith with the electorate became a political issue for candidate Bill Clinton. During the Presidential debate, Clinton was asked how Bush could be criticized for breaking his promise, given that taxes needed to be raised to close the growing deficit. Clinton responded that Bush’s wrong was in making the “no new taxes” pledge in the first place.¹⁶

12. R.M. HARE, *FREEDOM AND REASON* 51 (1963) (discussing this Kantian dictum).

13. Morris R. Cohen, *The Basis of Contract*, 46 *HARV. L. REV.* 553, 573 (1933) (“Many of us indeed would shudder at the idea of being bound by every promise, no matter how foolish, without any chance of letting increased wisdom undo past foolishness.”).

14. For an argument that the existing system of remedies for breach of contract does indeed seek to incorporate some forgiveness of promises in the face of regret, see Louis E. Wolcher, *The Accommodation of Regret in Contract Remedies*, 73 *IOWA L. REV.* 797, 798 (1988).

15. Stephen D. Sencer, *Read My Lips: Examining the Legal Implications of Knowingly False Campaign Promises*, 90 *MICH. L. REV.* 428, 428 (1991) (discussing implications of Bush’s 1988 statement).

16. *Election '92: In Their Own Words: Excerpts from Presidential Debate*,

The reliance advocate can add that it is not so obvious that breaking a promise is always a wrong. Why is it wrong to make a promise and then immediately retract it, before the promisee has had a chance to change her position in reliance on the initial promise?¹⁷ And if there is no wrong in the absence of reliance, is it not clear that the wrong from breaching a promise is really measured by the reliance placed on the promise? After all, it would be anomalous to say that a promise to pay \$1 million is not at all wrong if no one relies on it before it is retracted, but becomes a grievous, \$1 million wrong if someone spends \$5 in reliance. It would be more natural to say that one has gone from no wrong to a very small wrong.

The point can be turned into an affirmative virtue for the reliance over the expectation interest. As Mark Pettit, Jr. has stressed, a crucial difference between the expectation and the reliance interest is that the former involves the state in enforcing the surplus that a promisee has extracted from a promisor who has contracted in error.¹⁸ After all, in many cases the plaintiff would have contracted with someone else if the defendant had not made her promise, so the plaintiff suffers little damage except in the case where the defendant made a serious error that the rest of the market would not have made.¹⁹ Reliance is appropriately forgiving of the defendant's error, while expectation cruelly holds the defendant to a mistaken promise even if no one has relied on it.

The scenario Pettit considers is one in which the promisor has come to regret her initial decision to enter the contract. Commentators sometimes speak as if this were the case for all breaches of contract,²⁰ but it is not. There can be many different reasons why a party would

ATLANTA CONST., Oct. 20, 1992, at A17.

17. P.S. Atiyah, *Contracts, Promises and the Law of Obligations*, 94 L.Q. REV. 193, 211-12 (1978) (questioning the moral case for enforcing wholly executory contracts).

18. Mark Pettit, Jr., *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HASTINGS L.J. 417, 418 (1987) (stating that expectation improperly enforces extra advantage from contracting with specific party rather than market).

19. *Id.* at 420-22 (discussing lost opportunities as form of reliance).

20. *E.g.*, Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1273 (1980) ("The term 'regret contingency' will be used to denote the future occurrence of a condition that would motivate breach if breach were a costless option for the promisor."). Goetz and Scott do, however, acknowledge the existence of a category of promises rendered in bad faith that might be stretched to include all opportunistic motives for breach. *Id.*

rationally choose to enter into a contract and then rationally choose to breach that same contract. The next section will explore those reasons. Since the reliance versus expectation debate is largely a matter of keeping straight the two decisions involved in contractual nonperformance cases, it is logical that one would want to look quite carefully at the reasons that caused the promisor to make two apparently inconsistent decisions. That project is undertaken in the next section. After that discussion of motives, we will have the necessary tools for Part II of this Article, which sets forth the moral and economic case for expectation and reliance and a suggestion for how those cases can be reconciled. Part III of the Article will then seek to situate this normative argument within the existing literature on expectation and reliance.

B. Six Motives for Making and Then Breaking a Particular Contract

Why might a rational person voluntarily enter into a contract and then subsequently voluntarily breach that same contract? For purposes of the reliance/expectation discussion, it is productive to distinguish among six different reasons for this apparent change in the promisor's behavior.

1. Taking Advantage of Nonsimultaneous Performances

Jack and Jill are trading baseball cards. Jack has two Sammy Sosas and Jill has two Mark McGwires. They agree that Jack will trade a Sosa card for a McGwire card, a trade they both intend to carry out at the time they make their promises. Jack gives his Sosa card to Jill, but a friend then tells Jill that Jack is very weak and will not do anything if people do something wrong to him. So Jill decides to keep both cards and refuses to have further contact with Jack.

In this case, there was nothing wrong with the making of the promise. It was a sensible trade undertaken in good faith at the time. The wrong seems clearly to be in the breaking of the promise.²¹ This would suggest the appropriateness of awarding Jack his expectation interest. Indeed, in this case it would seem that specific performance would be the ideal remedy, as this would give Jack precisely what he bargained for and expected rather than a court's guess about what sum of money would make him indifferent to receiving the cherished McGwire card.

A reliance advocate might say that the wrong is only the harm suffered by Jack in losing his Sosa card in reliance (and, one might add, the unjust enrichment of Jill by retaining the Sosa card). Therefore, the

21. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 102–03 (5th ed. 1998) (noting that opportunistic breach of contract seeks to exploit sequential character of performance).

wrong could be undone by making Jill return the Sosa card to Jack. But this seems an odd way of looking at the issue. After being promised the McGwire card, why should Jack have to settle for the return of the Sosa card? Indeed, it seems misguided to return the Sosa card, which makes both Jack and Jill worse off than they would be if the promise were fulfilled. It is true that they could now try the exchange again, but Jack might be understandably wary of Jill at this point, or Jill might now refuse to trade out of anger at having been called to account on the first transaction. If the right thing is for the promise to be kept, it seems counterintuitive to unwind the transaction instead and hope that the promise will be made and kept the second time.

One might ask why parties would structure their transaction to involve nonsimultaneous performances despite the risk of opportunistic breach of contract. There could be many reasons. Cash flow problems may dictate particular timing for payments obligations. There may be technological efficiencies from rendering services at particular speeds. It may also be hard to come up with a precise money equivalent for each stage of performance. And the parties may prefer to avoid the uncertain tug-of-war of simultaneous tender in favor of allowing the party to go second who seems to have the greater reputational stake in performing, or who can be sued more easily for nonperformance. Of course, parties frequently try to use progress payments and other devices to limit their vulnerability to breaches of this character.

In the McGwire/Sosa hypothetical, the reliance remedy might indirectly serve to promote the expectation interest. If Jill realizes that the profit has been taken out of her opportunistic strategy, perhaps she will conclude that she might as well perform on the contract. However, suppose that this trade was only part of an overall contract between Jack and Jill that also involved services such as expert advice about the cards that should be traded. Now the reliance interest, which seeks to restore Jack to the position he was in before the contract was entered, seems strikingly perverse. If Jack has received benefits under the contract, Jill now has a certain leeway to commit opportunistic breaches with no sanction at all, until the loss from those breaches begins to exceed the benefits Jack has received under the contract. The reliance interest simply is not suited to a case where the original promise is unobjectionable but the promise is being breached opportunistically because of nonsimultaneous performances.

2. *Making a Threat to Breach in the Face of Situational Monopoly Credible*

A second common pattern in which a party would voluntarily choose to enter a contract and then breach it concerns the situational monopoly arising from reliance. At the time of contracting, there might be many parties who could do a particular job, but once the defendant promises to do it, other parties are likely to go away and be unavailable on short notice. The plaintiff may also make relationship-specific investments, such as advertising that a particular singer will be appearing on a given night, which would be wasted if the defendant did not perform.²²

Interestingly, the plaintiff's reliance does not directly motivate the defendant to breach a contract. The contract is still profitable to the defendant, so she will still lose from walking away from the project. Nevertheless, it is in the defendant's interest to *threaten* to breach as a way of extorting additional consideration from the plaintiff through one-sided contractual modifications.

There are doctrines designed to deal with the problem of improperly exacted modifications of the contract. For example, there is the common law preexisting duty rule, which would say that one-sided modifications are lacking in consideration and therefore unenforceable.²³ This doctrine, however, is readily circumvented by adding some small additional duties, and in any event no longer applies to goods contracts.²⁴ There are other doctrines for policing modifications, such as the doctrines of good faith²⁵ and economic duress.²⁶ These doctrines have rather vague contours, however, and in any event it may not be terribly realistic for the relying promisee to litigate the issue. Thus, the

22. Reliance expenditures create a problem of "asset specificity," or assets that are more valuable when attached to a particular relationship than otherwise. The work of Jim Leitzel is particularly useful here. Jim Leitzel, *Reliance and Contract Breach*, 52 LAW & CONTEMP. PROBS. 87, 89, 101 (1989); see generally Jim Leitzel, *The New Institutional Economics and a Model of Contract*, 11 J. ECON. BEHAV. & ORG. 75 (1989) (discussing a model of contract including concepts such as asset specificity).

23. See, e.g., *Stilk v. Myrick*, 170 Eng. Rep. 1168 (1809) (holding one-sided modification of seaman's contract negotiated on high seas unenforceable for lack of consideration); *Alaska Packers' Ass'n v. Domenico*, 117 F. 99, 100-01, 105 (1902) (holding same as *Stilk* with similar facts).

24. See U.C.C. § 2-209(1) (1989) ("An agreement modifying a contract within this Article needs no consideration to be binding.")

25. See *id.* § 1-203 ("Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."). Comment 2 of U.C.C. § 2-209 provides that while consideration is no longer required for modifications, "modifications made thereunder must meet the test of good faith imposed by this Act." *Id.* § 2-209 cmt. 2.

26. E.g., *Austin Instrument, Inc. v. Loral Corp.*, 272 N.E.2d 533, 534, 537 (1971) (holding modification of Navy subcontract made under threat not to deliver unless price increased void for economic duress).

promisor's threat to breach the contract in the face of reliance is a genuine worry, and if her bluff to breach the contract is called, she may be forced to breach at least for a time to make her threat to extort modifications credible.

Again, when this motive is implicated, there is nothing wrong with the initial promise. In fact, the prospect of detrimental reliance is very likely the reason the parties chose to enter into a binding contract in the first place. The moral answer seems clear: the original promise should be kept. Expectation-based remedies send this message most clearly, especially if the plaintiff can go to court immediately and get an injunction ordering the defendant to perform on the original contract.

As in the first case, it might be thought that reliance would indirectly achieve the same objective. If the plaintiff can force the defendant to restore the status quo ante, before she relied on the promise, she has removed much of the defendant's leverage to extort a modification. However, there is no apparent reason to send such an indirect message when what clearly needs to be done is for the promise to be kept.

And, again, if the contract has been going on for some time, the plaintiff may have derived appreciable benefits from the transaction. The reliance interest will not start to award the plaintiff anything until the harm from the breach is greater than the benefits she has already received under the contract. This gives the defendant a good deal of leverage to use the plaintiff's vulnerability to a breach to effect a modification. Thus the reliance interest only promotes by indirection the proper goal of contract enforcement in the case where the plaintiff has received no benefits under the transaction at all. In short, where the proper moral action is for the promise to be kept, the reliable moral response is vindication of the expectation interest.

3. Refusing to Carry Through on an Agreed-upon Allocation of Risk

The reliance interest can be made to look somewhat silly by hypotheticals raising the question of risk. Suppose that the plaintiff purchases a fire insurance policy and pays the premium regularly for a period of time. When a fire occurs, the insurer, now under a new and more corrupt management, refuses to pay for the plaintiff's fire damage but does offer to return the plaintiff's premiums with interest. The wrong again appears not to be the making of the promise, which was undertaken rationally and in good faith. The problem is rather that the promise has been broken, and the restoration of the status quo ante

seems a preposterous answer to the wrong.²⁷

A reliance advocate might respond that this analysis misstates the plaintiff's reliance interest. If the insured had not contracted with this particular insurance company, it is likely that she would have contracted with another, who probably would have performed on the promise.²⁸ So her reliance interest is the amount the other insurer would have paid, not the return of premiums plus interest.

This response seems inadequate in a number of respects. For one thing, what about the case where the foregone transaction hypothesis is not in fact true? Suppose that the plaintiff is a busy and inattentive person who would normally not have procured fire insurance, but the defendant managed to catch the plaintiff at home with a telephone solicitation for insurance. Is it now acceptable for the insurance company to respond with the return of premiums plus interest?

Another problem with the "foregone opportunity" response is that it assumes the other insurer would have performed.²⁹ That is probably true *given* a moral and legal climate in which promisors are sanctioned for breaking their promises. But if the norm became that the only wrong from breaking a promise was in the promisee's reliance, it becomes less clear that the other insurance company would have performed. Would the other insurer have faced damages for breach beyond the return of premiums plus interest? The argument would have to be that if the defendant had not made its promise, another insurer would have, and if that other insurer had not made its promise, a third insurer would have, and so on ad infinitum. But the market does not have an infinite number of insurers, and the plaintiff may not have known how to contact some of the insurers that actually exist, so when one reaches some party, say the 50th insurer, that party would not really have preempted the plaintiff from pursuing the 51st. So the 50th insurer would have had no legal (and perhaps no moral) incentive to perform, in which case the 49th insurer has not deprived the plaintiff of anything valuable in preempting the 50th. So the 49th would face no damages beyond the return of premiums plus interest, and through similar reasoning no insurers are liable for damages beyond the return of premiums plus interest.

The foregone opportunity argument is really parasitic upon the idea that the preempted insurance company would have felt the duty to keep

27. The anomaly of applying reliance damages to insurance contracts is discussed in Kelly, *supra* note 10, at 1774–76.

28. See Pettit, *supra* note 18, at 422 (stating that reliance also allocates risks by virtue of its recognition of foregone opportunities).

29. Slawson, *supra* note 1, at 220 ("The profits on each such lost opportunity must be discounted by the probability that the promises concerned would not have been kept.").

its promise. Thus, it depends on the idea of a moral and/or legal duty to keep promises. If one is going to invoke such a moral or legal duty at the second stage, one might as well invoke it at the first stage and say that the first insurer's problem is in not keeping its promise, rather than in diverting an insured away from some insurer that would have kept its promise.

A critically important question is how broad the range of rational risk allocation is. Advocates of the reliance interest have typically downplayed this motive for the breaching of contracts, suggesting that it fits only a few cases such as insurance or wagering.³⁰ On the other hand, advocates of expectation have argued that most contracts contain an insurance feature,³¹ in that fixed-price arrangements allocate the risk of price changes in the way the parties prefer, thereby taking account of the relative risk aversion of the parties, their access to methods of diversifying away particular risks with futures markets, and the like.³²

This Article is not the place to decide precisely how broadly to read the risk-allocation function of contracts. However, it may be helpful to set forth three ideal types and to express a preference among the three. The narrowest reading would presumably be that the parties placed the risk of only those contingencies which they specifically foresaw and consciously chose not to exempt from the general language of the contract. The broadest reading would be that of *Paradine v. Jane*,³³ that the parties, by choosing unconditional language, have placed the risk of every contingency that they could have excluded from that language but did not.³⁴

30. Atiyah, *supra* note 17, at 217 ("It is very far from being true that all contracts, even all executory contracts, are exercises in risk allocation. Frequently, it is the interpretation of the law which converts a simple postponed exchange into a risk-allocation exercise, rather than any deliberate intent of the parties."). As to wagering, Atiyah sees no social utility in furthering that particular risk-allocation. *Id.*

31. Kelly, *supra* note 10, at 1776 ("The problem is not unique to insurance contracts. To some extent, every contract contains an aspect of insurance."). For example, Kelly argues that warranties constitute insurance against the effects of product failure. *Id.*

32. The factors entering into the decision on how risks rationally ought to be allocated by contract are discussed in Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 83 (1977).

33. 82 Eng. Rep. 897, 898 (K.B. 1647) (holding lease not excused by invasion of Prince Rupert).

34. *Id.* at 897 ("[B]ut when the party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract.").

The first description is too narrow. One of the purposes of contracting is to set clear rules of title that will handle at a minimum of cost and uncertainty not only the specifically foreseen but also the unforeseen contingencies that may arise, provided that the effect of applying the clear language to the unforeseen contingency is not too horrible. On the other hand, the latter description is too broad. The transaction costs of thinking about and providing for every remote contingency that could occur are too large to draw a confident inference that unconditional language always constitutes a deliberate placement of risk. Thus, one is led by default to an intermediate third alternative, that unconditional language constitutes an allocation of the risk of some but not all unforeseen contingencies.

Of course, this alternative is quite vague and leaves plenty of room for differences of view. The important point is that rational risk allocation and expectation fit together logically in a way that rational risk allocation and reliance do not. Thus, if one adopts a broad view of the scope of risk allocated by a contract, one will be led to favor a relatively greater scope for the expectation over the reliance interest. A narrower view of risk allocation will tend to be more compatible with a relatively broad use of the reliance interest as an organizing principle of contract law.

4. Seeking to Appropriate Information Productively Brought to Bear on the Transaction by the Promisee

Before proceeding with a description of the fourth motive for breach, it may be helpful to think about a method of categorizing the reasons we have considered so far. That categorization method looks at the role of new information and regret that each motive envisions. In Motive 1 involving nonsimultaneous performances, there was no new information about the costs and benefits of the transaction between the time of contracting and the time of performance. It was expected all along that performances would be nonsimultaneous and that this would offer a temptation to the second party in time; that was what motivated the parties to contract in the first place. If there was any new information at all, it was the information that the first party in time was less likely to sue than originally anticipated.

Similarly, in Motive 2 new information plays little or no role. The parties may very well have known from the beginning that the plaintiff would become reliant on the particular defendant, and this fear of situational monopoly is why they entered the contract in the first place. New information is possible; perhaps the parties at the time of contracting underestimated the likely dependence that the plaintiff would

experience. But the core of this motivation for the defendant's threat to breach is the fact of plaintiff's dependency, not the availability of new information reinforcing that fact.

In Motive 3 there was "new" information, which was the fact that the house did indeed catch on fire. On the other hand, in a broader sense this information was not really new, but simply the unfolding of the precise scenario for data acquisition that the parties knew all along would arise. If the insurance company acted rationally in the face of the data available to it, data which lead to predictable probabilities of future outcomes, it should have no reason to regret its initial choice to insure the property merely because the fire actually occurred. Nor does a Las Vegas casino have reason to feel regret about a particular patron's having come to the casino merely because she happened to win at roulette.

The important function of reliance is to redress the wrong of making a promise that the other party is reasonably led to believe is binding but in fact is not. A promissory duty is most likely to be considered excused in a case where the promise has proven to be much more burdensome than anticipated by virtue of some revealed mistake or change in circumstances. Genuinely new information, leading to surprise and regret, is involved in legal doctrines such as mistake,³⁵ impracticability,³⁶ and procedural unconscionability.³⁷ Thus it is no coincidence that reliance does such a poor job of handling the first three categories of cases, where truly new information, surprise, and regret do not play a central role.

35. RESTATEMENT, *supra* note 4, § 153.

Where a mistake of one party at the time a contract was made as to a basic assumption on which he made the contract has a material effect on the agreed exchange of performances that is adverse to him, the contract is voidable by him if he does not bear the risk of the mistake . . . and (a) the effect of the mistake is such that enforcement of the contract would be unconscionable

Id. Section 153(b) of the *Restatement (Second)* would also excuse performance where "the other party had reason to know of the mistake or his fault caused the mistake," but this would not be a good situation for awarding the other party her reliance damages. *Id.* § 153(b).

36. U.C.C. § 2-615(a) (1989) (nonperformance excused when performance was made impracticable "by the occurrence of a contingency the non-occurrence of which was a basic assumption on which the contract was made").

37. *Id.* § 2-302 (contract or term can be invalidated if the court finds "the contract or any clause of the contract to have been unconscionable at the time it was made"). An early statement of the distinction between procedural and substantive unconscionability is Arthur Allen Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 486-87 (1967).

In the remaining three cases new information will play an important role. It is tempting to say that reliance should be considered a plausible remedy for all such cases, but that is incorrect. Motive 4 involves the productive use of new information by the promisee, which causes the promisor, once she learns of that information, to regret her choice. It is the case that was initially brought to our attention by Anthony Kronman in his discussion of nondisclosure.³⁸ And it is a case where the defendant's breach is opportunistic and the remedy should be expectation.

Suppose, for example, that defendant is in possession of farmland that she erroneously believes has no prospect for oil. Having done satellite surveys, plaintiff knows the land is in an area highly likely to contain oil. Plaintiff purchases the land at a price that is high for farmland but low for oil-bearing land. Plaintiff then moves onto the land, starts drilling, and strikes oil. The defendant seeks to rescind the contract, offering to compensate the plaintiff for such reliance expenses as the costs of the drilling already completed.

This is a Kaldor–Hicks efficient transaction, as there are net gains in societal wealth brought about by the merger of the information and the resource.³⁹ It is also, insofar as the parties themselves are concerned, a Pareto-efficient transaction.⁴⁰ The defendant received more than the land was worth without the information, and the plaintiff paid less than the land was worth with the information.

Or consider a typical middleman transaction. Plaintiff is aware of many buyers for a certain class of rare, used widget in foreign countries. Defendant is the owner of such a widget but has no idea that the widget is worth a great deal of money in foreign countries. Plaintiff pays the defendant a price that is more attractive than that offered by any market of which the defendant was aware, but less attractive than that offered by markets of which the plaintiff is aware. Again, the plaintiff's middleman enterprise is economically valuable, moving the resource to a higher use.⁴¹ And, at least if one assumes the defendant was never going

38. Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978).

39. Christopher T. Wonnell, *The Structure of a General Theory of Nondisclosure*, 41 CASE WES. RES. L. REV. 329, 340–44 (1991) (arguing that merger of information and resource distinguishes buyer from seller nondisclosure).

40. It must be remembered that transactions are rarely Pareto efficient when the interests of all nonparties are considered. Competitors of the parties, for example, would like nothing better than to have inefficient rules disrupt the prospects for mutually beneficial trade of their rivals.

41. The economic utility of middleman enterprises is frequently missed, and the middleman himself correspondingly vilified, by virtue of the common "physical fallacy" of assuming that a particular good must have the same value by virtue of its physical characteristics, when in fact its value varies with information, time, and space. THOMAS

to discover the existence of the foreign market on her own, the transaction is Pareto efficient for the parties involved as well. Expectation damages (or specific performance, which also promotes expectation) would award the plaintiff the profit of her efficient enterprise. The reliance interest would not.

In Motives 5 and 6, we will see some instances where the plaintiff exploits the defendant's mistake to redistribute wealth to itself.⁴² In those cases, it will be argued the reliance interest may be a sensible organizing principle. What is the difference between the productive uses of information considered here and the cases where the plaintiff is simply exploiting the defendant's mistake for redistributive purposes? This is a difficult question, and only some suggestive answers can be offered here.

As a first cut, one would like to stress the importance of the question of whether the defendant would have come into the knowledge on her own very soon if the plaintiff had not intervened.⁴³ If everybody in town will know by tomorrow morning that the railroad is coming to town, there is no real efficiency benefit from rushing out today and buying up everybody's farmland. After all, there was very little time for the farmers to make erroneous land use decisions based upon their misperception that the railroad would never be coming through town. The analysis is then dominated by Hirshleifer's concern that one not waste resources in a rush to have the benefits of the inevitable knowledge redistributed from others to oneself.⁴⁴

Another factor to consider is whether the plaintiff is creating a new relevant ignorance rather than simply working with an already existing and relevant ignorance. There may be a certain number of people in the world who believe that magic beans can produce a beanstalk that will enable one to climb into the clouds and acquire treasures. This is a harmless ignorance in most cases, as those people will have little or no opportunity to take personally imprudent or socially inefficient actions with this knowledge. However, when the Magic Bean Co. goes door-to-

SOWELL, KNOWLEDGE AND DECISIONS 67-72 (1980).

42. See *infra*, notes 50-64 and accompanying text.

43. Wonnell, *supra* note 39, at 359 (stressing this point in the context of discussing *Laidlaw v. Organ*, 15 U.S. (2 Wheat.) 178 (1817), where the buyer discovered that the War of 1812 was over and quickly bought tobacco).

44. Jack Hirshleifer, *The Private and Social Value of Information and the Reward to Inventive Activity*, 61 AM. ECON. REV. 561 (1971) (private value of information searches exceeds social value when redistributive gains possible by private effort).

door trying to find the few people who hold this false belief and make sales to them, the previously irrelevant ignorance has been made relevant. The resources consumed in that enterprise are wasted. They should not be rewarded with the expectation interest, which would be the difference between the high price the gullible few would pay for the beans and the low price the sensible many would pay.

Of course, if the plaintiff is doing something akin to actual fraud, we presumably would not want to reward the plaintiff with her reliance damages either.⁴⁵ However, there may be cases where the plaintiff is not guilty of conscious fraud. The beans may be a useful product for some buyers, but may be purchased in this case because the defendant believed they would grow a beanstalk that could reach the treasure. Having made a mistake, it may be appropriate for the defendant to be accountable to the plaintiff for that mistake, by paying plaintiff's reliance expenses. But it is another thing to allow the plaintiff to profit from the defendant's mistake by awarding expectation damages.

Another example of a "new ignorance" would be a contract that contained a complex term.⁴⁶ Suppose that defendant buys goods on credit because she believes the interest rate is only six percent, but in fact, by virtue of a complex formula of credits, points, and fees, the real interest rate is nine percent. Again, this may not be fraud; there may be reasons to structure the transaction in the form of separate fees that would have persuaded even rational and informed parties to transact. But if this particular buyer purchased the goods because she believed the full interest rate was only six percent, the question then becomes whether the plaintiff should be able to exploit this mistake by recovering her full expectation damages. It might seem more fair to allow only reliance damages, and it would also avoid overdetering mistakes of this kind through threatened redistribution.⁴⁷

45. George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225, 1252 (1994).

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.

Id.

46. Christopher T. Wonnell, *Contract Law and the Austrian School of Economics*, 54 FORDHAM L. REV. 507, 534 (1986).

Ignorance of the external world and ignorance of contract terms, however, are two very different problems—the former is an inherent problem that any economic system must try to alleviate while the latter becomes a problem only when the legal system has chosen to give effect to unseen contract terms.

Id.

47. Here I do not mean to assert that there should definitely be a defense if one misread a contract. In some cases the assertion may be a cover for opportunistic

By contrast, the farmer who does not know that there is oil under her land may be under that ignorance for a very long time, perhaps indefinitely, and she is likely to make many erroneous decisions about the land as a result of her ignorance of its characteristics.⁴⁵ The plaintiff is not creating ignorance; it already existed and was already adversely affecting the use of resources before the plaintiff entered the picture. That is similarly true of the middleman if one assumes that the defendant was not likely to acquire knowledge of the foreign market in the foreseeable future because of the expertise required to access foreign offers.

This analysis suggests that the key issue is often not defendant's ignorance, but her rationality in the face of her known ignorance.⁴⁷ I may sell my ring to my local jeweler, knowing well that I am unaware of many actual places I could have sold it for more, and that the jeweler will probably know these places better than I do. If I rationally conclude that I am permanently ignorant, then I may indeed be entering into a transaction rationally despite (indeed, because of) the fact that the other person is better informed than I am. Moreover, I may enter the transaction rationally despite knowing that there is a certain probability that I will become better informed in the future, if I reason sensibly that the likelihood of this is small enough to be outweighed by the prospect of making a deal which is attractive in the absence of knowledge right now. However, those risk allocations, like others, would be upset if every time one came upon the knowledge one could escape the contract by merely paying reliance damages.

motives, and yet be difficult to disprove. The litigation costs of opening up so many transactions would also be an important practical constraint. And in many cases expectation damages will be a closer proxy to reliance than provable expenditures. The theoretical point remains that from a first-best moral point of view, the responsibility of the negligent party is more fairly characterized by the reliance than by the expectation interest.

48. The timing factor was stressed in Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J.L. & PUB. POL'Y 783, 794–803 (1992).

49. See RESTATEMENT, *supra* note 4, § 154(b) (stating that a party bears risk of mistake if “he is aware, at the time the contract is made, that he has only limited knowledge with respect to the facts to which the mistake relates but treats his limited knowledge as sufficient”).

5. *Seeking to Avoid the Contract Because of a Mistake That Makes the Contract More Burdensome to the Promisor Than Anticipated and Correspondingly More Profitable to the Promisee*

Let us now explore a fifth motive for voluntarily entering into a contract and then voluntarily breaching that contract. This is a case where the contract has proven to be more burdensome to the promisor than she expected, so much more burdensome that it exceeds any reasonable conclusions about risks consciously borne. The contract may be more burdensome because the other party's performance has proven to have less value than anticipated, or because her own performance has proven to have greater cost than anticipated. The stimulus for this motive may be a "mistake" in the sense of facts in existence at the time of contracting of which the promisor was unaware. Or it may be an unanticipated change in circumstances which occurs after the contract is entered. Indeed, at some fundamental level there is very little or no difference between the cases; circumstances presumably change because of the playing out of the forces and materials that were already in existence at the time of the contract.⁵⁰

However, in this Motive 5 we are not primarily interested in the phenomenon of efficient breach. We are talking about a case in which the transaction has become redistributive, burdensome to the promisor but correspondingly profitable to the promisee. By contrast, efficient breach typically involves a case in which a transaction has become more burdensome to the promisor without a corresponding increase in the benefit of the transaction to the promisee. The efficient breach case is considered separately as the sixth motive in the next section.

As a hypothetical, imagine a contract between Dumb and Dumber for the sale of a shiny rock that Dumb and Dumber both believe is the Hope Diamond. Dumb believes the rock is the Hope Diamond because that is what he was told by Shyster who sold the rock to Dumb for \$100 before skipping town. Dumb believes that the Hope Diamond is worth about \$400 while Dumber, who likes shiny rocks with impressive names, is not sure how much he would pay for a rock that is so famous.⁵¹ Neither party is aware that the real Hope Diamond would be worth \$10,000,000.

50. The similarity of the mistake and changed circumstances cases, in terms of the economics of expectation and reliance, has been noted in Cohen, *supra* note 45, at 1257.

51. An interesting question is whether the buyer's damages ought to be affected by how much he thought the stone was worth. Normally, a party who is deprived of a good can recover its market value at a minimum, without inquiry into whether the buyer knew about its market value. U.C.C. § 2-713 (1989) (stating that the buyer can recover difference between market value and contract price).

Dumb says to Dumber, "I guarantee that this is the Hope Diamond" and the parties agree to a contract price of \$500, half of the money payable in advance and the other half due thirty days after delivery. Dumber pays Dumb \$250, the rock is delivered, and Dumber spends \$200 building a display case for the rock that otherwise is irregularly shaped and valueless. Dumber then discovers the rock to be a fake and sues Dumb for breach of warranty.⁵²

How should damages be measured in this case? Expectation damages are presumably the difference between the \$10,000,000 value of the Hope Diamond and the \$250 in unpaid contract price, or \$9,999,750.⁵³ Reliance damages are the \$250 in down payment plus the \$200 in the useless display case, or \$450. And as a matter of logic (though not the American rule) both the expectation and reliance interests should include the attorneys' fees of being forced to sue to collect what rightfully belonged to the plaintiff, as well as any incidental damages.

Expectation damages in this case seem wholly cut off from any reasonable normative moorings. Put simply, making Dumb pay Dumber \$9,999,750 plus attorneys' fees seems absurd. Admittedly, in the case of deliberate fraud, there is a certain poetic justice in benefit-of-the-bargain damages of this kind, making the liar live up to the terms of his lie. Even there it may be more plausible to view expectation damages as a kind of punitive award,⁵⁴ one that should be subject to reasonable constraints on amount of the kind that normally attend punitive damages.⁵⁵ In the actual case, where Dumb acted in good faith, millions

52. *Id.* § 2-313(1)(a) ("Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise.").

53. Section 2-714(2) of the Uniform Commercial Code creates an obstacle to the achievement of justice in the Dumb/Dumber case by providing that the "measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted, unless special circumstances show proximate damages of a different amount." *Id.* § 2-714(2).

54. See L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: I*, 46 *YALE L.J.* 52, 61 (1936) (hereinafter *Fuller & Perdue I*) ("It is therefore possible to view the rule measuring damages by the expectancy in a quasi-criminal aspect, its purpose being not so much to compensate the promisee as to penalize breach of promise by the promisor.").

55. *E.g.*, *Cain v. Fontana*, 423 S.W.2d 134 (Tex. Civ. App. 1967). The court noted:

While the amount of exemplary damages should be reasonably proportional to the actual damages, no set rule or ratio as between the amount of actual damages and exemplary damages can be laid down, and such amount must

of dollars of punishment are certainly not warranted.⁵⁶

What has happened in the Dumb/Dumber case to make an expectation award so unappealing? In making a warranty that the stone was the Hope Diamond, Dumb did not realize that he was making a multi-million-dollar commitment to Dumber. Holding Dumb to his mistaken decision is unconscionably harsh. But Dumb was careless in making the unconditional warranty, and his carelessness has cost Dumber \$450 plus attorneys' fees. It is fair to hold Dumb accountable for his carelessness in leading Dumber to believe that he could safely rely to his detriment on the assurance that he now owned the Hope Diamond.

Actual cases in which expectation appears misplaced are not as dramatic, but one case that seems to fit the description is *Chatlos Systems, Inc. v. National Cash Register Corp.*⁵⁷ In 1974, at a fairly early stage in the evolution of computing, Chatlos Systems needed to buy a computer system. NCR's representative told Chatlos that its system could provide six accounting functions: accounts receivable, payroll, order entry, inventory deletion, state income tax, and cash receipts.⁵⁸ The price was set at \$46,020.⁵⁹ NCR installed the equipment, but did not succeed in making it fully operational.⁶⁰ The trial court, applying the "benefit of the bargain" measure of damages, awarded \$201,826.50 to Chatlos.⁶¹ On appeal, this award was upheld on the strength of expert testimony, which established that only a computer much more powerful and expensive than NCR's would be capable of performing all six functions promised.⁶²

Expectation damages in this case seem overly harsh to NCR. Almost certainly, it was not aware that it was agreeing to underwrite the expense of a vastly more sophisticated computer system than the one it was selling in the event that its own computer system could not be made to work. Expectation ruthlessly enforces NCR's mistake and awards

depend upon the facts of a particular case. Such amount depends, among other things, upon the nature of the wrong, the character of the conduct involved, the degree of culpability of the wrongdoer, the situation and sensibilities of the parties concerned, and the extent to which such conduct offends a public sense of justice and propriety.

Id. at 139.

56. The issue of benefit-of-the-bargain versus out-of-pocket damages arises in misrepresentation law as well. A good discussion appears in Wangerin, *supra* note 11, at 60-62.

57. 670 F.2d 1304 (3d Cir. 1982).

58. *Chatlos Sys., Inc. v. Nat'l Cash Register Corp.*, 479 F. Supp. 738, 741 (D.N.J. 1979).

59. *Id.*

60. *Id.* at 742.

61. *Chatlos Sys., Inc.*, 670 F.2d at 1305.

62. *Id.* at 1307. The damage award included both consequential damages and damages based upon the difference in value between the two systems.

Chatlos a large windfall in the value of a highly powered computer it probably never considered buying, a windfall that must have surprised Chatlos as much as it did NCR. Reliance damages, especially if measured correctly to include attorneys' fees, incidental expenses, and consequential damages, would appear to be a more just outcome.

It has been argued that expectation theory does not require results such as those of *Chatlos*.⁶³ The idea is that expectation theory requires only the enforcement of the actual bargain of the parties, and the bargain includes both its substantive and its remedial terms.⁶⁴ If the contract had expressly limited damages to reliance, enforcing reliance damages would be giving the benefit of the bargain to the promisee. And if the parties implicitly would have limited damages to reliance had they adverted to the possibility of failure, it is consistent with expectation theory to enforce their implied or gap-filling term.

The problem with this argument is that any remedial scheme can be made consistent with expectation theory in this way, by saying that parties would have wanted it. The interesting question is what kind of substantive and remedial scheme the parties to a contract would want to govern contractual mistakes that threaten significant redistribution. The argument of this section is that expectation damages or specific performance would not be the type of clause that most parties would prefer in the *Chatlos* or Dumb/Dumber situations.

6. *Seeking to Avoid the Contract Because of a Mistake That Makes the Contract More Burdensome to the Promisor Than Anticipated Without Becoming Correspondingly More Profitable to the Promisee*

This section explores the sixth motive a party might have for making the choice to enter a contract but then making a choice to breach. This is a case where the executory portions of the contract have become more costly to the promisor without an equivalent increase in the value of those portions of the contract to the promisee. This is the case generally

63. This argument is suggested by the questions raised about *Chatlos* in E. ALLAN FARNSWORTH & JOHN HONNOLD, *CASES AND MATERIALS ON COMMERCIAL LAW* 690 (4th ed. 1985) (asking if expectations should not include expectations regarding remedial consequences of breach).

64. Cooter & Eisenberg, *supra* note 8, at 1468 (stating that expectation theory might not always call for implementation of expectation principle of damages).

thought of as the potentially efficient breach.⁶⁵

As an example, suppose that I promise to dig holes in someone's yard for the purpose of planting flowers. I anticipate that the cost of rendering the service will be \$1000. The owner values the service at \$1500, and we set the contract price at \$1250, the money being paid in advance. Now, however, I encounter ground that is unexpectedly difficult to move, and my prospective costs increase to \$2000. Suppose further that the owner had to water the ground at her own expense in anticipation of the drilling and that the water bill was \$100. Thus, reliance damages are \$1350 (down payment plus watering expense). Expectation damages are sometimes measured by the value of the service (\$1500), and at other times by the cost of completion (\$2000).

It is not immediately obvious whether reliance or expectation is a better solution to this particular problem. It is normally thought that the willingness to pay expectation damages is what distinguishes between efficient and inefficient breaches.⁶⁶ This is most evident if expectation damages are measured by loss in value. If I am willing to breach even knowing that I will owe \$1500 in damages, this is strong evidence that the contractual duty has become inefficient, more costly to me than it is beneficial to the owner. The willingness to pay \$1350 in reliance damages would not similarly constitute proof that the contract had become inefficient.⁶⁷ I would be willing to breach even if my costs had risen only to \$1375, which would not be a large enough increase in costs to cause the Kaldor–Hicks efficiency of the overall transaction to be doubted.⁶⁸

On the other hand, it does not follow that on these precise facts, expectation has an efficiency advantage over reliance. The contract has become inefficient to perform, as costs have risen to \$2000. The only thing that efficient breach theory counsels is that performance should cease.⁶⁹ It will cease if damages are measured by expectation, but it will

65. E. ALLAN FARNSWORTH, *CONTRACTS* 761–65 (3d ed. 1999) (discussing efficient breach theory).

66. Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 285 (1970) (stating that expectation requires defendant to consider utility schedule of promisee).

67. *Id.* at 285 (noting that reliance damages create an incentive to commit a breach that would give defendant a larger share of a smaller joint gain).

68. The Kaldor–Hicks criterion, which contemplates a gain in wealth that theoretically could be redistributed to make everyone better off, derives from Nicholas Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939); J.R. Hicks, *The Foundations of Welfare Economics*, 49 ECON. J. 696 (1939).

69. It should be remembered that the various motives are being kept separate here, and that an actual case may involve a mix of motives. In particular, there may be both opportunities for efficient breach and risk allocation issues simultaneously. In that case,

also cease if damages are measured by reliance or indeed if no damages are awarded for breach. On these precise facts what is needed to promote efficient breach is not expectation damages as such but any damages that are lower than my cost of completing the contract.

However, there is a case to be made for reliance damages, as opposed to any other level of damages that would be below the cost of completion. As in Motive 5, in the flower case a serious mistake has been made. I have committed to do the work without realizing the state of the soil I would be encountering and without conditioning my obligation on the state of the soil. Perhaps it is harsh to make me go out and dig the holes no matter how high the costs prove to be, but it is still my fault that I made an unconditional promise, asserting falsely (in these circumstances) that I had thereby placed myself under an obligation to complete the project. By inducing the owner to believe that I would do the work, I caused the owner to part with a down payment and incur watering expenses. I should be accountable for those costs of my careless decision to make an unconditional contract without testing soil conditions.

In short, if we somehow knew that a breach was efficient, there would be much to be said for a reliance-based theory of recovery.⁷⁰ At least in the normal case where reliance damages are smaller than expectation, we would not need to worry about the effect of reliance on the decision to breach or perform. The optimal decision in terms of efficiency is to breach, and this decision will be reached not only by expectation damages but by any remedy that is smaller than expectation damages. Unlike lesser remedies, reliance serves to impose upon the contractor the cost of her mistake. Unlike expectation, it does not harshly enforce the mistaken choice itself; it removes the harm that is caused by the mistaken choice.

Of course, one of the big problems with this analysis is that we often do not know whether a breach has become efficient. If the courts know the amount of harm the breach would cause the promisee (\$1500) but do not know the cost of continued performance to the promisor (\$1375 or \$2000?), reliance damages no longer seem so attractive.⁷¹ The

expectation damages may be required to vindicate the risk allocation objective even if efficient breach incentives could have been brought about by lesser damages such as reliance.

70. Cohen, *supra* note 45, at 1246 (noting efficient breaches are accidents calling for reliance damages). Cohen's theories are considered at greater length *infra* Part III.C.

71. The difficulty of verifying that particular contingencies have occurred is cited

performing party might be willing to breach even when doing so is inefficient if her only accountability was for reliance (\$1350) rather than expectation damages. We seem to need expectation (\$1500) as a pricing mechanism for generating efficient incentives to perform in cases of judicial ignorance about the cost of completion.

Let us summarize the analysis to this point. We began by observing that contractual breaches are the product of at least two seemingly inconsistent choices made by the promisor, a choice to make a particular commitment and a choice to act against that commitment. The expectation interest and the reliance interest differ primarily in the choice to which they would call attention. We then asked why a party would make two such inconsistent choices, and came up with six motives that could account for that sequence of decisions.

We might divide our results into two categories. The first category would involve the first four motives examined, while the second category would involve the last two motives. In the first category we include the motives to take advantage of nonsimultaneous performances, to make credible a threat to exploit situational monopolies, to avoid a rationally placed risk, and to seize the benefits of information productively brought to the transaction by the other party. The common denominator of these motives is that the expectation interest seems to be the best way to handle the breaches they generate. In the other category we include cases where new information, not rationally placed as part of a risk but a genuine surprise, makes the contract unexpectedly harsh. In these cases we saw a much more plausible case for the reliance interest, though we remain worried about Motive 6 in situations where we are not sure the breach is efficient and where we might need expectation damages to tell us.

In Motives 5 and 6 the intuition behind reliance is fundamentally one of partial excuse, or excuse coupled with responsibility for actual harm done.⁷² It may be overly cruel to enforce a mistaken contract against a party in accordance with its full severity, but that does not mean the party should be able to represent that it is going to be bound, induce the other party to incur some harm thereby, and then escape the obligation with no accountability for the mess her promise has caused.

In discussing the six motives, we have periodically had occasion to discuss the economics of the problem, that is, the incentive structures created by legal rules and whether they conduce to private behavior that

as a reason for expectation damages in Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 468 (1980).

72. Slawson, *supra* note 1, at 219 (contrasting excused nonperformances with breaches for remedial purposes).

is also socially efficient. Thus, we have talked about the problem of efficient breach and the need for expectation damages to set a price on breaches. However, our discussion of reliance has primarily been in terms of moral criteria of partial relief from certain contracts. This might leave the impression that the reliance/expectation debate is essentially a contest between retroactive morality and prospective efficiency considerations. As the next section will argue, however, that is not the case. There is both a moral and an efficiency account for reliance, and the two closely track each other. Moreover, there is both a moral and an efficiency account for expectation, and once again the two views have a close relationship. The next section discusses these issues of the relationship between the retroactive moral claims for expectation and reliance and their prospective efficiency justifications.

II. THE MORALITY AND ECONOMICS OF EXPECTATION AND RELIANCE

A. *Expectation, Efficient Breach, and the Morality/Efficiency Linkage*

What is the proper way to analyze the question of whether reliance or expectation should be the central organizing principle of contract law? Should we think about these interests in terms of retrospective justice for wrongful actions that have already taken place? Or should we think economically, about the incentives for future actions that will be brought about through alternative legal rules?

Many commentators have been impressed by the striking degree of compatibility between these two approaches to analyzing issues of private law.⁷³ As one example, consider the issue of mental competence as a precondition of responsibility. It seems intuitively wrong to blame a person for conduct that did not emanate from a mind capable of receiving moral and legal messages.⁷⁴ And prospectively, one cannot expect legal sanctions to be useful in deterring such persons from committing harmful actions in the future.⁷⁵

73. See generally John Gray, *Indirect Utility and Fundamental Rights*, 1 SOC. PHIL. & POL'Y 73 (1984) (discussing views of utility and fundamental rights); Larry Alexander, *Pursuing the Good—Indirectly*, 95 ETHICS 315 (1985) (discussing Gray's theory).

74. Stephen J. Morse, *Crazy Reasons*, 10 J. CONTEMP. LEGAL ISSUES 189, 193–97 (1999) (discussing capacity for rationality).

75. POSNER, *supra* note 21, at 258 (stating that the insanity defense selects those who are undeterrable, though civil incapacitation of the undeterrable may be necessary).

Richard Posner has, of course, built a vast system designed to demonstrate the great extent of compatibility between economic insights and a common law that was built with retroactive justice principally in mind.⁷⁶ However, perhaps the most powerful support for the compatibility thesis is generated inadvertently by Posner's critics. Those commentators criticize many of the ideas Posner has supported, such as the theory of efficient breach, on the ground that immoral conduct is being countenanced.⁷⁷ Invariably, however, the commentators also argue that the policy would not be efficient when all relevant costs, including administrative costs, have been considered.⁷⁸ Moreover, their moral and economic critiques are not unrelated to each other; rather, it is claimed that Posner's policies would be immoral because the conduct is wrong once one considers all of the costs which simultaneously render it inefficient and worthy of deterrence. Thus, the compatibility thesis is demonstrated as much in the process of critique of the economic model as in the process of building that model.

Why should there be a close connection between retroactive blameworthiness and prospective consequentialist gains? For many years, I have been attracted to the social evolution hypothesis of Friedrich Hayek.⁷⁹ According to Hayek, efficient norms throughout history have rarely been the product of wise rulers consciously seeking social efficiency and knowing the proper means of obtaining it.⁸⁰ Instead, some societies (or subgroups of those societies) will stumble upon norms that are relatively conducive to the prosperity of the society or subgroup.⁸¹ Other societies will embrace norms of retroactive judgment that happen not to conduce as well to future prosperity. The

76. *Id.* at 271–89 (discussing correlation between moral and economic accounts of common law).

77. *E.g.*, Peter Linzer, *On the Amorality of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111, 138–39 (1981); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 961 (1982).

78. Linzer, *supra* note 77, at 139 (noting that expectation damages are an inadequate second-best substitute; specific performance would be more efficient); Macneil, *supra* note 77, at 968–69 (stating that Posner's model actually encourages inefficient behavior of breaching first and talking later); *see also* Henry Mather, *Restitution as a Remedy for Breach of Contract: The Case of the Partially Performing Seller*, 92 YALE L.J. 14, 23 (1982) (stating that breach is not efficient when all transaction costs included).

79. I have discussed these issues in previous articles. Christopher T. Wonnell, *Four Challenges Facing a Compatibilist Philosophy*, 12 HARV. J.L. & PUB. POL'Y 835, 849 (1989); Christopher T. Wonnell, *Problems in the Application of Political Philosophy to Law*, 86 MICH. L. REV. 123, 151–52 (1987).

80. Friedrich A. von Hayek, *The Origins and Effects of Our Morals: A Problem for Science*, in THE ESSENCE OF HAYEK 318, 318–19 (Chiaki Nishiyama & Kurt R. Leube eds., 1984).

81. CHANDRAN KUKATHAS, HAYEK AND MODERN LIBERALISM 174–80 (1989) (discussing the role of tradition vis-à-vis reason in Hayek).

wealthier societies will expand their influence in a variety of ways. At least in the earlier periods, the wealthier societies will be able to support larger and larger populations. Wealthier societies and groups will have their norms and practices imitated by others. Competition from the wealthier societies will tend to compel changes in the norms of the less wealthy. Conquest by the wealthy may also play a role.⁸² And wealthier societies can afford to support classes of people whose role it is to systematize, extend, and disseminate the norms of that society.

In short, one will observe the increasing dominance of those norms that happened to conduce to the pursuit of wealth for the society that stumbled upon them. The Darwinian analogy would be that animals tend to have the types of organs that conduce to their own survival and reproduction, without having consciously known how to produce them, because those animals whose organs were less conducive have been outcompeted. As Hayek has stressed, the Darwinian analogy is imperfect, because natural selection operates upon individuals and their genetic endowments, while social evolution operates upon groups and their social practices.⁸³ In neither case would one expect perfect compatibility. After all, if natural selection were perfect, the science of medicine would have no role to play. The conservative message, however, is that doctors or social engineers are likely to do better by tinkering with the evolved structures and their internal logic rather than attempting to build entirely new structures to replace those that have evolved.⁸⁴

82. Of course, this factor can cut both ways. Societies that are not particularly wealthy or civilized can succeed, at least for a time, by specializing in military conquest. One thinks of the challenge of Sparta to Athens, of the Germanic tribes to the Romans, of the Mongols to the Chinese, and perhaps in this century of the Communist world to the West. However, the greater wealth should in principle make it possible to have military power greater than the other societies, especially given the technological factor in warfare, so that a trend can be observed over time toward civilized nations overcoming purely military ones.

83. F.A. HAYEK, *LAW, LEGISLATION AND LIBERTY* 23 (1973) ("The error of 'Social Darwinism' was that it concentrated on the selection of individuals rather than on that of institutions and practices, and on the selection of innate rather than on culturally transmitted capacities of the individuals.")

84. Hayek famously wrote a postscript on the topic of "Why I Am Not a Conservative." F.A. HAYEK, *Why I Am Not a Conservative*, in *THE CONSTITUTION OF LIBERTY* 397-411 (1960). However, in the particular respect of a belief that institutions evolve rather than are created, it seems fair to characterize Hayek's views as conservative. The issue is discussed in KUKATHAS, *supra* note 81, at 178-87, which also concludes that Hayek's views differ profoundly from those of conservatives such as Oakeshott.

Recognizing the fallibility of the method, one can start with a presumption or guess that compatibility will exist between the backward-looking norms of our evolved morality and common law and the forward-looking calculus of economic instrumentalism. Importantly, to the extent that this hypothesis is valid, one can use economic reasoning as a kind of check on moral judgments and vice versa. As Randy Barnett has stressed, there can be virtues to redundancy of normative systems, where one can work back and forth between moral norms and economic judgments, with the confidence in each growing to the extent it can be reconciled with the other.⁸⁵ One can look to existing practices which seem immoral from a retroactive point of view as heuristics to identify places where some hitherto unperceived inefficiency exists in the incentive structure. One can also look at the economic analysis of a problem to clarify what one believes about retroactive justice.

Consider once again the idea that expectation damages are the appropriate remedy for breach of contract because they effectively distinguish between efficient and inefficient breaches. Posner's original example of this was a seller who had contracted to sell a product to Buyer 1 and then received a higher offer from Buyer 2 for the product and breached the contract with Buyer 1.⁸⁶ The example struck many noneconomic commentators as immoral, countenancing a kind of theft of a property right that Buyer 1 had procured.⁸⁷ The seller's behavior was antisocial, requiring litigation over damages instead of trying to work things out within the framework of the contract. The interesting thing is that this moral objection provided a heuristic that something may have been wrong with the economic analysis. The breach may not have been an efficient one after all. If Buyer 2 did indeed value the product more than Buyer 1, the original contract would not stand in the way of a second transaction between Buyer 1 and Buyer 2.⁸⁸ This was not a case where performance had become more costly to the seller without becoming more beneficial to the buyer. Performance was more valuable to Buyer 1 than anticipated because of the new resale opportunity. There were transaction costs involved in a second sale

85. Randy E. Barnett, *The Virtues of Redundancy in Legal Thought*, 38 CLEV. ST. L. REV. 153, 153 (1990).

86. POSNER, *supra* note 21, at 133 (discussing widgets valued more highly by pianola factory).

87. Patricia H. Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 ARIZ. L. REV. 733, 760-61 (1982) (stating that willful breaches should not be excused on grounds of efficiency).

88. William Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEGAL STUD. 299, 301-02 (1985) (distinguishing contracts to do from contracts to give, arguing that the former is less likely to present opportunities for efficient breach).

between Buyer 1 and Buyer 2, but those were likely to be dwarfed by the negotiation and litigation costs involved in breach and damages. The moral argument had shown the way for an improvement in the economics.

But the opposite is true as well. In some cases the efficiency analysis seemed sound in its own right, as when the defendant encountered rock during drilling that increased the defendant's costs without increasing the value of the drilling to the plaintiff or anyone else. Still, the critics said that the idea of efficient breach was amoral, allowing the defendant to profit from its own wrong. The tension between a sound economic account and a moral objection in this case can lead to the view that it is the moral intuition that needs to be refined.

What is crucially missing from the standard moral accounts of the efficient breach situation is any emphasis on the morality of *plaintiff's* behavior. In a true efficient breach setting, a plaintiff is not fundamentally interested in whether the contract is actually performed, but instead finds irresistible the temptation to *threaten* the full performance she does not want in fact as a way of exploiting the defendant's extra burden and using the defendant's desperation to avoid the burden as a source of plaintiff's extra profit. The more miserable performance has become for the defendant, the more the plaintiff has an incentive to feign a desire to insist on that performance, even if the performance has no value to him whatsoever, and to relent only in exchange for payments that had nothing to do with the project to have flowers planted in one's yard. The problem is essentially one of bad faith, as the plaintiff is using the letter of the contract in a manner inconsistent with its "spirit" or his purpose for having entered it.⁸⁹ In short, the economics of efficient breach leads us to reexamine the morality of the situation, not so much to change our morality as to realize something about the retroactive moral assessment of behavior that we already believed but had not articulated.

It is sometimes said that ex post negotiations can avoid the problem of efficient breach regardless of the legal rule of damages.⁹⁰ This is

89. Evasion of the spirit of a contract is a recognized species of bad faith. RESTATEMENT, *supra* note 4, § 205 cmt. d; Robert S. Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 201 (1968) (discussing good faith as "excluder" of various forms of bad faith such as evasion of spirit of deal).

90. Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L. REV. 711, 743 (1980) (noting that choice of contract remedy is essentially

essentially an attempted application of the Coase theorem.⁹¹ If damages are above expectation, the promisor can try to buy his way out of the contract by paying the promisee an amount between the value of the contract to the promisee and the cost to the promisor. And if damages are below expectation, say at the reliance level, the promisee can pay the promisor the extra amount needed to induce the promisor not to breach inefficiently.

There are a number of problems with ex post negotiations as a solution, and many of these problems will be discussed later in the Article.⁹² For now, however, one can simply note that these negotiations are between parties contractually locked into each other, creating a bilateral monopoly with well known problems of bluffing and high transaction costs regarding the contractual surplus.⁹³ The economic problem of situational monopoly bargaining again corresponds to the moral doubts about the subject matter of these negotiations. When damages are too high, the promisee is attempting to gauge how desperately the promisor has become trapped and contorted through its inefficient commitment, while the promisor is trying to conceal the extent of its mistake. And when damages are too low, the promisee is essentially trying to bribe the defendant to do what she had already solemnly promised to do, while the defendant is trying to assess whether the plaintiff might be more desperate for performance at this point than she was when the contract was made.

Moreover, as Robert Cooter and Melvin Eisenberg have stressed, much efficient breach analysis concerns the optimal amount of precaution to take against the possibility of an inadvertent breach.⁹⁴ For example, the defendant can decide whether to assign its more or its less reliable employee to deliver a particular crank shaft. If the efficient thing to do is to assign the less reliable employee to the particular contract and use the more reliable employee elsewhere, there is likely to be a problem with supercompensatory damages. The fear of those damages will tend to cause the firm to allocate its employees to avoid the legal penalty even if the actual economic harm from the unreliable

determined by renegotiation costs).

91. The Coase theorem posits that on certain restrictive assumptions, a Pareto-optimal resource allocation can be reached independently of the initial assignment of property rights by virtue of bargaining. WERNER Z. HIRSCH, *LAW AND ECONOMICS: AN INTRODUCTORY ANALYSIS* (2d ed. 1988). Coase's original point was made in R.H. Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1 (1960).

92. See *infra* notes 270–76, 280–81, and accompanying text.

93. POSNER, *supra* note 21, at 131 (stating that bilateral monopoly problem may interfere with ex post negotiations).

94. Cooter & Eisenberg, *supra* note 8, at 1464 (noting that expectation optimizes precautions against inadvertent breach).

employee would be greater elsewhere. And here again it is hard to see how negotiation could solve the problem. The plaintiff does not know enough about the defendant's business to be able to enter contracts that specifically permit particular employees to be used on the project.⁹⁵ And if damages are undercompensatory relative to the expectation interest, the defendant would have an incentive to exercise too few precautions unless the plaintiff could somehow figure out how the defendant could run her business more efficiently and bribe her to take the extra precaution.

In short, expectation damages have a sound basis in morality and in economics, and the two explanations tend to go hand in hand. Can the same be said for reliance damages? That question is explored in the next section.

B. *The Morality and Economics of Reliance*

Earlier in this Article, a possible moral argument for reliance was discussed.⁹⁶ The reliance interest seemed well suited to a case where the contract ought to be excused for unanticipated harshness, but where the promisor was still at fault for having led the promisee to believe that his promise was unconditional. Unlike expectation, reliance did not involve the courts in cruelly enforcing the pound of flesh that the promisee had managed to exact from the mistaken promisor. In light of the discussion of Hayek's social evolution hypothesis, the interesting question is whether these moral intuitions can point the way to efficiency benefits of the reliance interest.

The answer is that an efficiency argument can be made in the mistake scenario. Expectation essentially means that a mistake will result in significant redistribution of wealth from the mistaken to the nonmistaken party.⁹⁷ The prospect of that redistribution in turn has incentive effects. Plaintiff has an incentive to seek out and exploit mistaken parties, even

95. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 630, 647-48 (1988) (stating ex post negotiations no help when efficiency concerns precaution taking).

96. See *supra* notes 11-19 and accompanying text.

97. The point has been made in the context of restitution for mistake. Peter K. Huber, *Mistaken Transfers and Profitable Infringement on Property Rights: An Economic Analysis*, 49 LA. L. REV. 71, 99 (1988) (refusing restitution would create "an overincentive to avoid mistaken improvements"); Christopher T. Wonnell, *Replacing the Unitary Principle of Unjust Enrichment*, 45 EMORY L.J. 153, 197 (1996) (discussing incomplete divestiture of property).

if their services are not actually wanted, just to extort expectation-based settlement payments. As the economist Jack Hirshleifer has shown, there can be significant inefficiencies in racing to contract with people who are not yet informed about the alternatives available in the market.⁹⁸

Another effect is that the mistaken party will have an enormous incentive to avoid her mistakes. This might seem to be a good thing, but it is actually too much of a good thing. The expectation interest means that the private cost to the defendant of making a mistake will be much higher than the social cost, by virtue of the redistribution worked by expectation. This will give the defendant an excessive incentive to avoid mistakes, that is, an incentive to devote inefficiently large amounts of resources to ensuring that mistakes never happen, no matter how little social harm would result from the making and rapid correction of mistakes. And one way to avoid mistakes is to refuse to enter into particular types of otherwise useful contracts out of a fear that one might be mistaken.⁹⁹

Indeed, the reliance interest seems the ideal solution to this particular problem. The reliance interest is the harm that is caused by the mistaken promise itself, that is, wasted expenditures by the promisee or permanently foregone alternatives. Facing the reliance interest, the defendant will have an incentive to devote optimal amounts of resources, not maximum amounts, to the avoidance of mistakes.¹⁰⁰ The plaintiff will have no incentive to cause mistakes or seek out mistaken parties, for the defendant would be able to escape the mistaken contract upon the mere reimbursement of the expenditures plaintiff had incurred in reliance.

Of course, it is important to remember the lesson from the discussion of Motive 4 above.¹⁰¹ Sometimes contracting with people who have limited information is a productive rather than a redistributive enterprise.¹⁰² If the party was going to be uninformed for a considerable period of time, and if that ignorance was likely to cause the party to act inefficiently with respect to her resources, then the movement of the resource to the informed party can be both Kaldor–Hicks efficient and mutually beneficial to the parties. If that is true, it would be unwise to

98. Hirshleifer, *supra* note 44.

99. Wolcher, *supra* note 14, at 798 (stating that relentless enforcement of contractual expectancy can deter making of promises).

100. Cohen, *supra* note 45, at 1246–48 (pointing out that expectation encourages excessive precaution, whereas reliance encourages optimal amount).

101. See *supra* notes 35–49 and accompanying text.

102. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 112–16 (1988). The authors recognize that theoretical arguments exist that the market will produce too little or too much search for information; however, a better theory is needed for distinguishing which concrete information fits which situation. *Id.*

allow the uninformed party to escape her contractual obligations upon the payment of reliance damages. Precisely because that form of remedy would leave the informed party with no profit on the transaction, merely erasing losses, it would fail to encourage a productive activity.

It might be argued that this efficiency gain presupposes a defendant who never would have become informed, and is inapplicable to someone who has become sufficiently aware of her previous state of ignorance that she wants to avoid the contract upon the payment of reliance damages. This is a powerful but not a conclusive point. In some cases the defendant's new information may exist only because of the contract, as in the example of the farmer who only discovers there is oil on the land because of the buyer's activities after the contract. In still other cases the contract may constitute a rational placement of the risk that the defendant would not become better informed, and the defendant would then be seeking to undo that rationally placed risk by seeking relief from the contract upon mere payment of reliance damages. And in still other cases the defendant may be breaching for reasons that are unrelated to her discovery that the original contract was a mistake, and is using information obtained in the discovery process as an excuse for breach that was otherwise motivated.

Despite the potential for the constructive use of private information, there will be many situations in which contracting with a mistaken party is primarily a redistributive rather than a productive enterprise. In some of those situations, one would not want to award either reliance or expectation damages to the informed party. Suppose that the informed party realizes that she is entering contracts for the purpose of redistributing wealth from the uninformed party to herself, and to avoid complications let us further assume that this is not a speculative trade in which both parties consciously think of themselves as placing a bet that they are better informed than their trading partner. In this case it is presumably not enough for the law to fail to encourage the plaintiff's enterprise by denying expectation. One would instead want to affirmatively discourage the enterprise by denying reliance damages as well.¹⁰³

Once again, reliance damages make sense in the wake of contracts that have become unenforceable, but it matters why the contract is unenforceable. The promisor is liable for reliance damages if those

103. See Cohen, *supra* note 45, at 1252 (stating that neither reliance nor expectation is appropriate for intentionally misleading party).

reliance damages are her own fault, the product of carelessly misleading an innocent promisee into relying on what purports to be a binding contractual obligation. If the promisee is not the innocent victim of a careless promisor's mistake but rather the purposeful exploiter of known mistakes, there is no reason to award reliance damages to the promisee.

To summarize, there is indeed a close correlation between the morality and the economics of reliance, in keeping with Hayek's social evolution hypothesis. Morally, we seek to avoid the harsh exploitation of mistakes while still holding the carelessly mistaken party accountable for the actual harm caused by her having created an apparent contractual obligation. Economically, this level of sanction encourages an optimal amount of care in the decision to contract. And, as noted earlier, there is also a close correlation between the morality and the economics of expectation. The problem is how to reconcile the two sets of moral/economic intuitions, a difficult project that is taken up in the next section.

C. A Theoretical Reconciliation of Expectation and Reliance, and Some Pragmatic Administrative Doubts

We proceed with some confidence, because our tools—expectation and reliance—seem to be validated by the potent combination of backward-looking moral intuitions and forward-looking efficiency calculations. Unfortunately, melding the two intuitions is not at all easy.

Going back to our original observation that contractual breach involves at least two choices, it is clear that this fact maps directly onto the reliance/expectation dichotomy. Reliance is concerned with optimizing the amount of care undertaken in making the initial choice to contract. Expectation is concerned with optimizing the second choice as to whether to perform or breach. Economically speaking, both reliance and expectation operate as kinds of prices on behavior. The problem is that we seem to have only one policy instrument—the amount of damages to assess after a promise has been both made and broken. However, a single price cannot, except by coincidence, optimize two sets of behaviors.¹⁰⁴

On the blackboard, it might be possible to envision a remedy that represents a kind of optimal trade-off between an otherwise suboptimal amount of care in the making of promises and otherwise suboptimal decisions on whether to perform or breach. Such an idea almost certainly cannot be expected to work. For one thing, there is no

104. Shavell, *supra* note 71, at 484–88 (noting that it is hard for damages to optimize performance and reliance decisions simultaneously).

doctrinal support for a remedy that is neither expectation nor reliance but some scientifically blended compromise between the two.¹⁰⁵ Moreover, the task of identifying the optimal amount of damages that would lead to the minimum combined number of distortions for the two separate decisions seems hopelessly difficult. And even if the “optimal” mix could be found, one would still have the errors at both ends which would make the approach inferior to one that actually sought the best possible answer for each of the two policies separately.

The only hope would seem to be to use the pricing mechanism to optimize one of these behaviors, and to attempt to optimize the other one directly by judicial balancing. There is precedent for this idea in the law and economics literature and in the law itself. It has often been noted that one problem with both expectation and reliance damages is that they could potentially lead to overreliance by the promisee.¹⁰⁶ These remedies act in theory as complete insurance against losses caused by relying, and complete insurance tends to cause moral hazard problems. Sometimes nonperformance of a contract is inevitable, and we may not want promisees to act as if performance were certain by completely abandoning all backup options. The solution proposed in the literature for this problem is to assess the damages against defendant which would have occurred if the plaintiff had relied efficiently.¹⁰⁷ It is argued that the law actually embodies this norm with its requirement that reliance be foreseeable or reasonably expected.¹⁰⁸ Similar reasoning is involved in the duty to mitigate, which assesses damages against the defendant based upon the harm the plaintiff would have suffered if he had acted reasonably—or, as the economist would say, efficiently—after the

105. There are, of course, limitations on expectation damages such as the denial of attorney’s fees, the certainty and foreseeability limitations, mitigation of damages, the denial of emotional distress damages, and the like. But while these limitations may result in damages that are between reliance and expectation, there is no reason to believe they would be even the approximate mix of the two interests that would optimize the two decisions of contracting.

106. *E.g.*, Cooter & Eisenberg, *supra* note 8, at 1466–67; Richard Craswell, *Performance, Reliance, and One-Sided Information*, 18 J. LEGAL STUD. 365, 365–56 (1989).

107. Craswell, *supra* note 106, at 365–66 (“The only remedy capable of optimizing both parties’ incentives . . . is one that limits the promisee to recovering no more than the value that his expectation interest would have had if he had chosen the socially optimal level of reliance.”) (emphasis in original).

108. Slawson, *supra* note 1, at 230 (explaining how the foreseeability rule eliminates problem that expectation could lead to overreliance).

breach occurs.¹⁰⁹

These approaches require a judicial decision as to what is efficient (reasonable) reliance or efficient (reasonable) mitigation behavior, as there is no price being applied that, by an invisible hand, will tend to optimize these actions by the promisee. However, if that judicial decision has been made correctly—or, more realistically, if the errors are not too egregious¹¹⁰—the pricing mechanism can be used as the invisible hand approach to optimize the defendant's breach-or-perform behavior without the court's having to know the optimally efficient breach-or-perform action itself. This general approach seems to be the best way to proceed in trying to deal with the reliance/expectation dilemma of optimizing the two separate contractual choices.

Let us tentatively consider the following two principles:

Principle 1. Unless the parties otherwise provide and subject to Principle 2, the measure of damages following a breach of contract is the amount needed to take the promisee from the position she actually occupies—or, if the promisee has behaved unreasonably after the contract was entered, the position the promisee would have occupied had she behaved reasonably—to the position the promisee would have occupied if the promise had been fulfilled.

Principle 2. When the court judges that conditions (A) through (C) are all present, the measure of damages following a breach of contract is the amount needed to take the promisee from the position she actually occupies—or, if the promisee has behaved unreasonably after the contract was entered, the position the promisee would have occupied had she behaved reasonably—to the position the promisee would have occupied if the promise had not been made:

(A) Full enforcement of the contract would be unjust by virtue of extreme and unreasonable hardship to the promisor caused by a mistake or change in circumstances that was not within the risk provided for in the contract expressly or by implication.

(B) The promisor is nevertheless at fault for having made an unconditional promise to the promisee which the promisor could reasonably have expected to induce, and which has induced, detrimental reliance by the promisee.

(C) The promisor has not behaved unreasonably with respect to her contractual responsibilities.

These two standards have been purposely characterized as

109. RESTATEMENT, *supra* note 4, § 350(1) ("Except as stated in Subsection (2), damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.").

110. The problems of attempting to measure judicially the optimal level of reliance are discussed in Craswell, *supra* note 106, at 365–66.

“principles” rather than “rules.” They certainly contain a number of vague terms that one might view as objectionable in vesting the court with excessive discretion.¹¹¹ I have no desire to argue against this objection, and indeed share the worry about excessive judicial power.¹¹² Very likely it would be helpful to develop concrete rules that embody these principles in some more formalistic way. But the expectation interest and the reliance interest are also principles. They have proven highly productive in helping us think about and structure concrete rules but are in themselves too vague to serve as determinate legal rules. The proposed principles are a reconciliation of reliance and expectation which operates on the same general level of abstraction that they do.

The first principle sets forth the general rule of contract damages as expectation. The argument for expectation as the general rule is very strong. As noted earlier, in four of the six motives for breach of contract—profiting from nonsimultaneous performances, threatening to exploit situational monopolies, seeking to avoid contractually placed risks, and attempting to confiscate information profitably brought to the contract by the other party—reliance essentially has no role to play.¹¹³ Moreover, even when surprise and regret are key motives, it is very helpful to have expectation damages as a pricing mechanism for the decision on whether to perform or breach, and the related decision concerning the amount of precaution to take against inadvertent breach. One should abandon this pricing mechanism and go with imperfect judicial fact finding about efficient behavior under the contract only when some unreasonably large mistake makes this seem necessary.

The first principle states that it is subject to contrary agreement of the parties. This is an important point that, as Richard Epstein has stressed, tends to be forgotten in discussions of contractual remedies.¹¹⁴ We are

111. Promissory estoppel is often celebrated for the flexibility of remedy that it permits. *E.g.*, Jay M. Feinman, *Promissory Estoppel and Judicial Method*, 97 HARV. L. REV. 678, 711 (1984) (stating that promissory estoppel necessitates balancing in every case, something that cannot be done consistently with liberal assumptions); Eric Mills Holmes, *Restatement of Promissory Estoppel*, 32 WILLAMETTE L. REV. 263, 270 (1996) (noting that some states have reached the highest and most progressive phase of promissory estoppel, the “equity phase” in which remedies are flexible).

112. It has been argued that the courts applying promissory estoppel do not in fact embrace the flexibility of remedy approach. *E.g.*, Paul T. Wangerin, *supra* note 11, at 91–92 (“Judicial acceptance of the flexible damages remedy . . . has been, at most, nominal.”); Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111, 136 (1991).

113. See *supra* notes 21–49 and accompanying text.

114. Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the*

attempting to provide the kinds of remedies that the parties would rationally seek themselves to govern various scenarios of contractual nonperformance, but the parties themselves may know things about their concrete situation that would make general rules unwise.

The law has been somewhat reluctant, as evidenced by its attitude about penalty clauses, to allow parties to vary remedial rules by mutual consent.¹¹⁵ There does not, however, seem to be any categorical reason why all substantive terms of the contract should be treated with great judicial deference while all remedial terms are subject to strict scrutiny. There is probably some truth to the notion that remedial terms are often not terribly salient to many contractual parties, who probably expect that the contract will be either performed or worked out privately in the great bulk of cases.¹¹⁶ But at least where the parties are reasonably sophisticated and the ex ante stakes in remedial issues are large, the law should not use its remedial rules against the choices of the very parties whose mutually beneficial transactions the law is seeking to facilitate. The law needs standards for when parties are too unsophisticated and/or issues too improbable for formal contract terms to be treated as strong evidence of consent,¹¹⁷ and those standards should be applied to remedial terms of the contract as well as substantive terms.¹¹⁸

The two principles differ with regard to the “rightful position” that the parties should have been able to occupy.¹¹⁹ When Principle 1 applies, that rightful position is the position of a promisee who has seen the

Law of Contract, 18 J. LEGAL STUD. 105, 107 (1989) (explaining that the focus should not be on law’s external “purpose” of contract damages but on the parties’ purposes in selecting particular damage rules).

115. U.C.C. § 2-718(1) (1989). The section states:

Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.

Id.

116. *But see* Epstein, *supra* note 114, at 109 (“It is just not credible to assume that commercial parties draft toward performance but ignore breach in ways that justify more vigorous judicial intervention on remedial questions.”).

117. RESTATEMENT, *supra* note 4, § 211(3) (“Where the other party has reason to believe that the party manifesting such assent would not do so if he knew that the writing contained a particular term, the term is not part of the agreement.”).

118. 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, 594 (1977) (“The modern development of unconscionability as a unifying fairness principle presents a less costly alternative to the sweeping invalidation powers exercised under the penalty rule.”).

119. Cooter & Eisenberg, *supra* note 8, at 1435–36 (“Because there are two different conceptions of the uninjured state in a contract setting, there are also two different conceptions of compensation.”).

promisor keep the promise. When Principle 2 applies, the rightful position is the position of a person who never received a promise from the promisor. However, the two principles are the same in another respect, which is the starting point for the measuring of the distance to the rightful position. They do not take the promisee from the position she currently occupies to the rightful position, if the position the promisee currently occupies is the result of her own unreasonable behavior under the contract.¹²⁰ This is necessary because a contrary view would create a moral hazard by encouraging unreasonable behavior on the part of fully insured promisees, a problem that exists equally for the expectation and for the reliance interest.¹²¹

Let us now look more carefully at the second principle calling for reliance damages if the court judges that three conditions are present. The first condition is that full enforcement would be unjust in light of extreme and unreasonable hardship to the promisor caused by mistake or change in circumstances. This immediately eliminates Motives 1 and 2 discussed earlier, that is, nonsimultaneous performances and situational monopolies, which involve the very scenarios which induced the parties to contract in the first place.¹²² Motive 3 of escaping risk-allocation is also expressly excluded by the rule. In a fundamental sense, the new information is not indicative of having made a mistake in the prior situation where the contract was mutually beneficial *ex ante* precisely because the unavoidable ignorance created an opportunity for efficient risk allocation. Motive 4 of seizing information productively brought to bear is intended to be excluded as well because it is not “unjust” to enforce the contract in those circumstances; undoubtedly actual rules implementing these principles would want to spell out when that is the case. Thus, reliance is really applicable only in cases presenting Motives 5 and 6 above, where the original decision is regretted severely by virtue of new information.

120. I do not necessarily intend to embrace completely the idea of “efficient reliance.” Contracts are, after all, designed to facilitate reliance, and if the parties desire that reliance to be restrained, they can write that into the contract as well. See Slawson, *supra* note 1, at 229–32 (noting that parties rather than courts should determine efficient level of reliance). However, the idea seems less controversial when applied to the duty to mitigate, and the standard embraced in the text leaves the issue open by requiring only “reasonable” behavior by the promisee. *Id.* at 231.

121. For a more thorough discussion of the concept of efficient reliance, see William P. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39 (1984).

122. See *supra* notes 21–26 and accompanying text.

The test is not harshness to the promisor as such, but rather harshness in view of mistakes or changes in circumstances. Many promises are quite harsh but nevertheless rational and necessary to the promisor in light of the promisor's accurate assessment of the limited options available to her. Courts that set aside promises on this ground are sometimes said to be engaged in "substantive" as opposed to "procedural" unconscionability analysis,¹²³ and law and economics writers have properly viewed the practice as problematic.¹²⁴ It is important not to further disempower people who already have limited contractual options by denying full enforceability to the promises they make, where those promises are rational, well-informed, and not defeated by serious changes in circumstances.¹²⁵ To the extent that one wishes to think of Principle 2 as a "partial relief from unconscionability" rule, it should be understood as a partial relief from procedural unconscionability.¹²⁶

The (B) criterion in Principle 2 is that the promisor was at fault in making an unconditional promise, and that the promisee was foreseeably harmed by her detrimental reliance on the promise. The promisor would be most likely to be at fault when the mistake or change in circumstances concerned matters as to which the promisor had access to better information than the promisee. Again there would be no applicability to the promisee who knowingly exploited the promisor's mistake in order to accomplish a redistributive objective.¹²⁷ The logic of this criterion is clearly tort-like, showing that the "death of contract" scholars were not completely wrong.¹²⁸ However, it does not follow that one would want to import all of the rules of "tort" into this area, such as the allowance of punitive or emotional distress damages, or that one would want to exclude all "contract" rules, such as the statute of frauds

123. *E.g.*, Leff, *supra* note 37, at 486–87.

124. *E.g.*, Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 305–15 (1975) (stating that actual uses of unconscionability have harmed weaker parties).

125. I have argued elsewhere that the refusal of courts to fully enforce the promises made by employees has resulted in their being disempowered and harmed. Christopher T. Wonnell, *The Contractual Disempowerment of Employees*, 46 STAN. L. REV. 87, 104–15 (1993).

126. Professor Eisenberg has stressed the links between the expectation/reliance remedial debate and the substantive debate over adequacy of consideration. Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 745 (1982) (noting that the bargain principle is as much a rule about remedies as substantive entitlements).

127. *See supra* note 45 and accompanying text.

128. An early statement of the proposition that promissory estoppel was an essentially tort-like notion was Orvill C. Snyder, *Promissory Estoppel as Tort*, 35 IOWA L. REV. 28, 48 (1949) (stating that there are more likenesses with the tort of deception than with contract).

and the parol evidence rule.¹²⁹ If anything, “contract” rules that have been designed with business transactions in mind may be better suited to handle the problems of contractually related torts than “tort” rules that were designed with other paradigm cases in mind, such as personal injuries and property damage. But beyond this there is not much more to be said at a general level, and each contract and tort rule should be examined to see whether it is well suited to administering a contractually related tort.

Criterion (B) purposely does not require that the detrimental reliance be “definite and substantial.” This language was present in the section 90 promissory estoppel rule of the *Restatement of Contracts*.¹³⁰ It was deleted from the same provision in the *Restatement (Second)*, although some courts continue to apply the earlier rule.¹³¹ The theory of the deletion was that “definite and substantial” reliance was important as long as one assumed that expectation damages were the only possible remedy for promissory estoppel, while the *Restatement (Second)* was designed to accord courts discretion in awarding either expectation or reliance damages.¹³² The point is all the more true for Principle 2, which is designed to award reliance damages. If reliance is de minimis, damages will also be de minimis and the section will not be particularly important, although it will do no harm either. A substantiality rule would be required if large stakes, such as the ability to enforce a mistaken contract according to its terms, turned on whether there had been reliance, but that is not the spirit of Principle 2.

Criterion (C) of Principle 2 is the most challenging of all, and the one that gives the greatest pragmatic doubt about the ability of the system to handle this principle administratively. It requires that the promisor must not have behaved unreasonably with respect to his or her contractual responsibilities. From an economic perspective, one can view “reasonableness” as acting efficiently in the situation. Thus, one is

129. Mark P. Gergen, *Liability for Mistake in Contract Formation*, 64 S. CAL. L. REV. 1, 4 (1990) (explaining that undesirable features of tort damages make it appropriate to introduce tort-law notions within contract rather than tort law).

130. RESTATEMENT OF CONTRACTS § 90 (1932). The history of the “definite and substantial” language is discussed in Yorio & Thel, *supra* note 112, at 125–27.

131. RESTATEMENT, *supra* note 4, § 90; Knapp, *supra* note 6, at 56 (discussing changes made by *Restatement (Second)* to promissory estoppel doctrine).

132. Stanley D. Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343, 384 (1969) (“If, on the other hand, limited or partial enforcement comes to be recognized as the norm in Section 90 cases, the test of substantial reliance is likely to merge with the test of ‘injustice.’”).

essentially engaged in a cost-benefit analysis of the kind that is familiar in tort law from *Carroll Towing*.¹³³ Because Principle 2 contemplates reliance rather than expectation damages, we do not have the pricing mechanism that can distinguish between efficient and inefficient breaches as if by an invisible hand. So there is no choice but to have the court try to make the efficiency distinctions itself, as it does in tort cases under the *Carroll Towing* formula.¹³⁴

The idea is that the seriously mistaken party has a privilege to rescind upon the payment of reliance damages, but loses that privilege by inefficient behavior under the contract itself. If the principle is carried out correctly, it avoids the worst problems of the reliance interest. For example, we noted earlier that the reliance interest might allow the defendant to commit some opportunistic breaches with impunity if they were committed as part of an ongoing transaction from which the promisee had already received significant benefits.¹³⁵ No such free pass for inefficient breaches would be contemplated by Principle 2, as such inefficiency would forfeit the right to limit damages to the reliance interest.

By inefficient behavior, what is meant is a “sunk” action or failure to act that has produced more harm to the promisee’s contractual rights than benefit to the promisor. For example, the defendant failed to deliver goods on time, resulting in sales losses for the plaintiff exceeding any benefits of delay. Or the defendant promised to use a particular material, but cut corners and used a material that was slightly cheaper but significantly less valuable to the plaintiff. Reliance damages will not optimally deter these inefficient choices, so it is important that a defendant who engages in such choices must answer in expectation. These are sunk decisions, that is, the inefficiency has already occurred. The social cost can be moved around by damages but it cannot be eliminated.

An important question is whether repudiation of future duties would be covered by criterion (C) of Principle 2. The answer is that repudiation is indeed covered by criterion (C), but only if the repudiating (or rescinding) behavior is unreasonable or inefficient in the circumstances. The fact that the remaining duties under a contract are Kaldor–Hicks efficient does not mean that a repudiation or rescinding of those duties is an unreasonable or inefficient act. There might be other parties who could complete the performance as efficiently as the

133. *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

134. *Id.* The economic interpretation of *Carroll Towing* derives from Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 73–77 (1972).

135. See *supra* notes 21–26 and accompanying text.

mistaken party seeking relief, and if that is not the case, the mistaken party herself might stand willing to complete the project on terms that were mutually beneficial. Indeed, in many “relational” cases in which parties have become locked into each other by relationship-specific investments over time, the practical effect of Principle 2 is to serve as a background rule in the shadow of which contractual modifications can be negotiated when circumstances have changed.¹³⁶ On the other hand, repudiation certainly can be an inefficient act, as when an insurance company announces after a fire but before a claim has been filed that it is rescinding an insurance policy and offering to return premiums. The failure to cover the risk defeats an efficient enterprise, and no one else will be willing to offer insurance after the fire has already occurred.¹³⁷

It goes without saying that it is extraordinarily difficult for the court to make the cost-benefit decisions that criterion (C) requires, determining whether the promisor has behaved reasonably under the contract.¹³⁸ As noted earlier, that is especially true because it is not always a single decision to breach, but rather a series of decisions as to how much precaution to take against the possibility of an inadvertent breach, and each decision from that series would in principle need to be analyzed for its efficiency.¹³⁹ All of this work is done automatically by expectation damages, and if they are to be abandoned in favor of reliance, the cost-benefit decisions will now need to be made consciously.

Nevertheless, the two principles do identify the place where the concepts of expectation and reliance logically interconnect. What should be done pragmatically about the administrative difficulty of that connection is a second question, which can only be answered when we get clear on what ideal it is we are trying to approximate with practical working rules. At a pragmatic level, it would seem that Principle 2 is

136. U.C.C. § 2-209 cmt. 2 (1989) (“But such matters as a market shift which makes performance come to involve a loss may prove such a [good faith] reason [for modification] even though there is no such unforeseen difficulty as would make out a legal excuse from performance under Sections 2-615 and 2-616.”).

137. This feature of repudiations in insurance contracts (and of other contracts with insurance features such as product warranties) is stressed in Kelly, *supra* note 10, at 1776.

138. Even under expectation damages, the judiciary is required to calculate the cost side of the cost-benefit equation, and it has been argued that the risk of judicial error there is so great as to call for specific performance of at least some contracts. Bishop, *supra* note 88, at 300–02 (distinguishing contracts to give and contracts to do). The administrative problems are even worse when the judiciary is asked to calculate both the cost and the benefit side.

139. See *supra* notes 94–95 and accompanying text.

going to have its main bite at very early stages of a contractual transaction, shortly after a promisor has discovered that she has made a terrible mistake. At that point there will not have been too much time for the promisor to have made inefficient precautionary decisions under the contract itself. Indeed, if she has just discovered the information about the mistake, she probably did not make any inefficient precautionary decisions, as she assumed the contract was rational and binding and covered by expectation damages.

The principles could be given further flesh at this point, but instead those refinements will be presented in the context of considering some of the existing literature on expectation and reliance. It is said that every law review article has a section in it in which it is pointed out that everything previously written on the subject was wrong.¹⁴⁰ That is emphatically not the purpose in discussing the literature below, which is strikingly rich in quality and clearly anticipates in general form many of the ideas discussed thus far. Indeed, I regret that I cannot discuss more articles in depth in the text, although footnote references show that my debts are broader than those listed below. Space limitations require that I confine my attention to those authors who most directly address the normative and economic underpinnings of expectation and reliance, as opposed to those who are more interested in the existing positive legal rules or the history of how they have evolved.¹⁴¹ In particular, I want to address those authors whose ideas are closest in spirit to the conclusions I have reached here, and try to show in each case how my ideas fit into the context of theirs.

III. SITUATING THE TWO PRINCIPLES WITHIN THE EXISTING LITERATURE ON EXPECTATION AND RELIANCE

A. *Lon Fuller and William Perdue, Jr.*

In a classic two-part law review article, Lon Fuller and William Perdue, Jr. argued that the reliance interest should play an important role in contract law, and indeed that it did play an important role although it

140. See generally Kenneth Lasson, *Scholarship Amok: Excesses in the Pursuit of Truth and Tenure*, 103 HARV. L. REV. 926, 928 (1990) (noting that most prior scholarship is not valuable).

141. For a spirited debate on whether the early common law was dominated by concern for the expectation or the reliance interest, see Morton J. Horwitz, *The Historical Foundations of Modern Contract Law*, 87 HARV. L. REV. 917, 937 (1974) (explaining that expectation was a latecomer to the law); A.W.B. Simpson, *The Horwitz Thesis and the History of Contracts*, 46 U. CHI. L. REV. 533, 542 (1979) (claiming that Horwitz's alleged differences between eighteenth and nineteenth century English contract law are largely illusory).

was largely unrecognized as doing so.¹⁴² The article began by calling into question the centrality of the expectation interest. Expectation was understood by the law as compensation for harm, but the plaintiff had been “harmed” only relative to a position she had never occupied.¹⁴³ The reliance interest was a more compelling norm,¹⁴⁴ and might well serve as a central organizing principle for contract law as a whole,¹⁴⁵ but expectation damages were actually justifiable in the business setting as an indirect way of promoting the reliance interest.¹⁴⁶ It is difficult to prove the ways in which the promisee behaved differently because of the promise, and if only provable reliance were recoverable this would in practice tend to discourage reliance.¹⁴⁷ Among the most difficult forms of reliance to prove are the opportunities foregone because of the defendant’s promise. But often the terms of the actual contract will have been quite similar to the terms of the contract that would otherwise have been entered but for the promise, in which case expectation is a very close proxy for the reliance interest.¹⁴⁸

The difficulty of proving the amount of reliance, and the ability to use expectation as a proxy for reliance where foregone opportunities are involved, are crucial insights. Principle 2 requires courts to do as well as they can to measure reliance, but it does not preclude expectation damages as an indirect measure of reliance in any case where that is the best proxy available. However, the idea that expectation is important only when and to the extent that it is a good proxy for reliance does not appear to be sound. In Motives 1 through 4 considered before,

142. *Fuller & Perdue I*, *supra* note 54, at 53; L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 2*, 46 *YALE L.J.* 373, 373 (1937) (hereinafter *Fuller & Perdue II*).

143. *Id.* at 52–53 (stating that expectation “compensates” plaintiff for something he never had).

144. *Id.* at 54, 56–57 (claiming that restitution, reliance, and expectation interests are normatively compelling in that order).

145. *Id.* at 70 (“We might easily base the whole law of contracts on a fundamental premise that only those promises which have been relied on will be enforced.”).

146. *Id.* at 70 (“As the chief exception to this principle we should have to list the bilateral business agreement. The rationale for this exception could be found in the fact that in such agreements reliance is extremely likely to occur and extremely difficult to prove.”).

147. *Id.* at 60–62.

148. *Id.* at 62 (noting that expectation is particularly good proxy for reliance in competitive markets). An excellent analysis of the idea that particular damage interests can be pursued on the theory that they are proxies for other types of damage is presented in Avery Katz, *Reflections on Fuller and Perdue’s The Reliance Interest in Contract Damages: A Positive Economic Framework*, 21 *U. MICH. J.L. REFORM* 541, 542 (1988).

expectation is important in its own right, as the promises themselves were unobjectionable but were followed by opportunistic breaches that constitute second-decision wrongs.¹⁴⁹

If an insurance company will not pay after a fire has occurred, the insurance company may or may not have caused the insured to rely by foregoing another insurance carrier. I do not wish to quarrel with Fuller and Perdue's conclusion that the wrong is aggravated if the insurer did induce the insured to forego other options, especially if it knew the insured was doing so. But it is emphatically wrong to refuse to complete the efficient project of risk placement even if the insured was too busy to have otherwise consulted another carrier. Nor is the insurance company's behavior rendered rightful if the insured has not actually paid premiums but has merely made a promise to do so which the insurance company or the courts are willing to waive.

The central flaw is the assumption that "harm" needs to be assessed relative to the status quo ante before any dealings between the parties. It assumes that private parties ought to have no power to shift existing legal entitlements or baselines, even when the privately chosen baselines constitute an efficiency improvement on the historic ones.¹⁵⁰ But there is no basis for the assumption. Where the decision to alter the baseline is mutually voluntary, rational, and informed, the new baseline should be assumed to be a superior system of legal rights between the parties to that which had governed before. Preexisting baselines are typically variants on the live-and-let-live ideal, which as many people have noted is frequently ill-suited to a world of interdependence,¹⁵¹ and those baselines can exist without any direct input from the parties whose legal rights and duties were involved. Harm relative to rationally and voluntarily chosen baselines is not a queer form of harm at all.¹⁵² It is the harm that the insured suffers when her rational plan for preserving her financial future is undermined by the insurer's callous offer to restore the status quo ante before the rational plan had been made.

In the second part of Fuller and Perdue's article, the authors discuss a number of uses for the reliance interest which already exist in the law,

149. See *supra* notes 21–49 and accompanying text.

150. Curiously, this is not at all the assumption that Fuller himself made in a subsequent article. Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 808 (1941) (discussing idea of private autonomy).

151. E.g., Jay M. Feinman, *The Last Promissory Estoppel Article*, 61 FORDHAM L. REV. 303, 312 (1992) (pointing out the need to shift from neoclassical assumptions to a legal approach that "emphasizes the interdependence of individuals in social and economic relationships").

152. The term is taken from *Fuller & Perdue I, supra* note 54, at 52–53 ("Yet in this case we 'compensate' the plaintiff by giving him something he never had. This seems on the face of things a queer kind of 'compensation.'").

sometimes hiding under the rubric of “restitution” when in fact the benefit received by the defendant was rather fictitious.¹⁵³ These include cases where certainty concerns exclude expectation damages,¹⁵⁴ where expectation would impose an undue burden on the promisor,¹⁵⁵ where performance of the contract has been interfered with by external circumstances,¹⁵⁶ and where contracts were imperfect in expression or in legal effect.¹⁵⁷

This portion of Fuller and Perdue’s analysis is extremely congenial to the approach defended here. When a party clearly consented to undertake an obligation but the contours of that obligation were not spelled out with much certainty, one option is to try to fill in the contract with judicial gap-filling rules. At some point, however, one worries that the duties being judicially implied bear too little resemblance to those the promisor actually was willing to undertake, and that one might be unfairly enforcing a much more burdensome contract than the promisor anticipated. Still, if the promisor clearly intended to make a binding promise, and the promisee relied, it is appropriate to make the promisor accountable for that reliance, which was the product of the promisor’s having purported to bind herself to a contract that could not in fact be justly enforced. And, of course, Fuller and Perdue’s “undue burden” and “external circumstances” examples are core ideas behind Principle 2.¹⁵⁸

The last example concerned contracts that were imperfect in expression or in legal effect, which primarily concerns promises within the statute of frauds that are not evidenced by a writing but upon which promisees have relied.¹⁵⁹ This problem involves some unrelated issues about how much judicial deference ought to be paid to legislative judgments, but it is possible to say something more about this example. Serious detrimental reliance frequently may be clear and convincing evidence that some kind of a promise must have been made,¹⁶⁰ but in the

153. *Fuller & Perdue II*, *supra* note 142, at 394 (stating that “restitution” is often measured by plaintiff’s loss rather than defendant’s gain).

154. *Id.* at 373.

155. *Id.* at 377.

156. *Id.* at 379.

157. *Id.* at 386.

158. *See supra* notes 120–36 and accompanying text.

159. The trend in the case law appears to be to recognize a promissory estoppel exception to the statute of frauds only when it would be unconscionable to refuse to recognize the claim. *Phuong N. Pham, The Waning of Promissory Estoppel*, 79 *CORNELL L. REV.* 1263, 1276 (1994) (collecting cases).

160. *RESTATEMENT*, *supra* note 4, § 139(c) (documenting that one factor in deciding

absence of a writing we may not be too confident about the terms of that promise (especially given the legislative lack of confidence in the oral contract reflected in the statute of frauds). As with the certainty hypothetical, we could fill in the gaps with flimsy evidence of what the terms might have been, but this raises the prospect of creating a contract and imposing it unfairly on the promisor. Still, if we are sure that some purportedly binding promise was indeed made, it may be fair to reimburse the plaintiff for tangible reliance incurred because the defendant made a promise that purported to be binding but in fact was not.

The principal addition made here to the second part of Fuller and Perdue's famous article is a theoretical story for organizing these various existing uses of the reliance idea. In that article reliance was presented as a kind of compromise verdict when expectation seemed too generous and no damages or mere restitution did not seem generous enough.¹⁶¹ We have offered some structure to these examples, showing that the reliance interest is not a compromise but a principled response to the tort of entering into an obligation that purports to be binding but in fact is not because of the unanticipated burden enforcement would entail.

B. *Patrick Atiyah*

Professor Atiyah has been a contemporary champion for something very much like Grant Gilmore's famous "death of contract" thesis.¹⁶² Atiyah objects to the centrality that modern contract theory gives to the wholly executory contract, neither performed by either party nor relied upon.¹⁶³ Existing theory metaphysically reifies the contract as a "thing" that comes into existence prior to any actions of the parties, other than the actions of forming the agreement itself.¹⁶⁴ Under this conception, benefit derived by the promisor and detriment suffered by the promisee are theoretically irrelevant; what matters is simply the voluntary consent

whether injustice from applying the statute of frauds in the face of reliance requires enforcement is "the extent to which the action or forbearance corroborates evidence of the making and terms of the promise, or the making and terms are otherwise established by clear and convincing evidence".

161. *Fuller & Perdue I*, *supra* note 54, at 376–77 (stating in some of the certainty cases "the reliance interest represents a midway station between no liability and a complete liability for the expectancy").

162. GILMORE, *supra* note 3. Atiyah's thesis was given historical grounding in P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* (1979).

163. Atiyah, *supra* note 17, at 210 (noting that executory contract lies at very heart of contract under the classical model).

164. *Id.* at 197 (stating that the classical model treats a contract as a thing, with an objective existence prior to any actions of the parties).

of the promisor to assume an obligation.¹⁶⁵

Atiyah finds this picture of contractual obligation objectionable. The wholly executory contract does not represent a very compelling case for the use of state power. If there has been no unjust enrichment and no detrimental reliance, this should not be viewed as a paradigm of contractual obligation. Perhaps risk allocation concerns may justify the enforcement of some executory contracts, but Atiyah says that this consideration is less common than frequently believed.¹⁶⁶ The pure promise theory appeals to those who want to reward the skillful and knowledgeable, but not to those who seek to protect individuals from their mistakes.¹⁶⁷ For Atiyah, a law that makes benefit and detriment irrelevant is strange. Is it not obvious that the case for enforcing someone's promise is greater if that person has received something in exchange which motivated that promise than if the promise is made "in the air" with nothing received in exchange? And is it not equally obvious that the case for enforcing someone's promise is greater if the promisee would be affirmatively harmed by the activity of making and then withdrawing the promise, rather than simply disappointed in not receiving an expected gain?

Indeed, Atiyah looks forward to a law in which benefit and detriment will assume a more central role and voluntary consent will be less significant. If we have ordered a meal in a restaurant, we must pay for the benefit we have received, and there is no need to invent a fictional promise in which we agreed to pay. Even if the parties have agreed on the price, that price could be, in this conception, merely evidence of what the just obligation of the patron is, given what he has received.¹⁶⁸ Purely private autonomy over price leads to too much abuse through unequal bargaining power.¹⁶⁹ Similarly, we could be liable in some circumstances for the detrimental reliance others suffer through our actions without regard to our voluntary consent. While Atiyah does not

165. *Id.* at 202 (explaining that failure to consider benefit or detriment leads to "grotesque distortion" of actual normative situation).

166. *See id.* at 216–17 (stating that frequently it is the law's interpretation rather than the parties' intent that makes a contract an exercise in risk allocation).

167. *Id.* at 209.

168. *Id.* at 207–08 (pointing out that actual interest rate is good but not conclusive evidence of just and reasonable interest rate).

169. *Id.* at 193–94. My views on the mischief worked by the concept of unequal bargaining power in the employment context are presented in a previous article. Christopher T. Wonnell, *The Influential Myth of a Generalized Conflict of Interests Between Labor and Management*, 81 *GEO. L.J.* 39 (1992).

seek to banish the voluntary/involuntary distinction entirely, he aspires to a more complex theory that would include benefit and detriment and elevate the importance of those factors relative to the importance of consent.¹⁷⁰

How does our theory compare with that of Atiyah? An important point of agreement is that the executory contract is more likely than contracts which have reached later stages to be breached for Motives 5 and 6 discussed above, which are those concerning surprise, new information, and regret.¹⁷¹ By definition, an executory contract does not involve taking advantage of the fact that the other party has gone first, as in Motive 1. Nor does it involve Motive 2 of breaches motivated by situational monopoly, if the executory contract is defined to include an absence of reliance as well as performance.

On the other hand, Atiyah does not have a good explanation for a very common commercial practice. Parties want to think of themselves as fixing their obligations as of a particular point in time, before and without regard to actions taken pursuant to the arrangement.¹⁷² Dates are set for the “closing” of the deal. People shake hands or exchange signatures. The contracts themselves often recite the date at which they become effective. Atiyah’s normative views would not be affected by this practice if the principal explanation were that sophisticated parties wanted to lock in the unconscionable deals they had managed to negotiate with the unsophisticated before the latter came to their senses. But this hardly seems to be the likely explanation for a norm that has continued for long periods of time, and that includes the largest deals between corporations backed by teams of lawyers.

Two factors seem to be neglected here. The first is that Motives 3 and 4, risk allocation and the productive use of information, are implicated by the executory as well as the partially performed contract. Atiyah minimizes the risk allocation motive, but other commentators have argued that the motive is involved in most contracts.¹⁷³ And it does not require some perverse normative sympathy for the skillful and

170. Atiyah, *supra* note 17, at 222–23. Atiyah has actually been criticized for being overly reluctant to throw out the entire classical model of contract. Betty Mensch, *Freedom of Contract as Ideology*, 33 *STAN. L. REV.* 753, 768–79 (1981) (finding it “troubling” that Atiyah fears a loss of freedom from completely abandoning contract).

171. See *supra* notes 50–72 and accompanying text.

172. One indication of this attitude comes from Russell Weintraub’s survey of 182 corporate general counsels. He asked whether a party should be able to recover his lost profits as a result of a contract that was made and immediately broken before any chance for reliance; 68.3% of the respondents indicated that such profits should be recoverable. Russell J. Weintraub, *A Survey of Contract Practice and Policy*, 1992 *Wis. L. REV.* 1, 29–30.

173. POSNER, *supra* note 21, at 116 (“Ordinary commercial contracts also shift risks, and thus provide a form of insurance.”).

knowledgeable to see the benefits that arise from bringing information to bear on transactions in the Motive 4 settings.

The second explanation for the practice of locking contracts in at particular times is that the wholly executory contract is not easy to identify for either the parties or the courts. As Atiyah recognizes, people often begin to rely on contracts in subtle ways from the moment they are entered.¹⁷⁴ If one did not really have a “contract” until the other party had relied, one would have to keep tabs on what actions or omissions the other party to the contract was taking and what was motivating those actions. One would also need to know what actions or omissions (by oneself as well as the other party) a third party court would be able to discover, and what such a court would probably think was motivating those actions. This would call for costly information exchanges and ultimately a lot of guesswork. Additional information and guesswork would be required if one were to say that the “contract” is binding only to the extent of reliance as long as that remains provable, but becomes enforceable to the extent of expectation when reliance has become too subtle and diffuse to be proven other than by the proxy of expectation.¹⁷⁵

Having said this, Atiyah’s core insight—that benefit received and detriment suffered strengthen the case for enforcing a contract—is fundamentally correct, because it brings the opportunistic Motives 1 and 2 for breaching a contract into play. And it is objectionable when contracts, championed by economists for bringing about Pareto efficient changes for the parties,¹⁷⁶ are used instead as instruments for redistributing wealth from the gullible to the sophisticated. The best way to handle this is with a rule that fundamental mistakes will constitute an affirmative defense, excusing a person from contractual duties and rendering them liable only for reliance, which at an executory stage may call for little or no liability. There is no call for abandoning the fictional metaphysics of a contract as “existing” from a point in time, any more than we should stop thinking of other boundary-defining and

174. Atiyah, *supra* note 17, at 212 (“Executory contracts do not normally remain executory for very long.”).

175. Kelly, *supra* note 10, at 1782 (noting similar error risks with rule that substantial reliance is needed to justify expectation award).

176. Contracts are not really Pareto efficient in a strict sense, as third parties such as competitors of the parties can be hurt by legal rules that make the transaction between these two parties operate smoothly. It remains useful to distinguish between legal rules that are Pareto efficient relative to the parties themselves and rules that enhance the wealth of one party to the detriment of the other.

discord-reducing constructs as existing. In this respect, contract entitlements are like national boundaries fixed by treaty, statutory and constitutional entitlements, and property titles spelled out by long descriptions of boundaries. There may be moral reasons for a particular line, but there are also strong reasons of stability and cost avoidance for acknowledging the existence of a clear line that does not melt into the indeterminate mixture of reasons that inspired the entitlement.¹⁷⁷

Atiyah also looks forward to a jurisprudence in which consent will be de-emphasized relative to benefit and detriment.¹⁷⁸ The courts will decide what duties people justly owe in light of what they have received and who has been counting on them; what those people said they would be committed to is merely evidence of what that just responsibility is. The striking feature of this vision is the extraordinary confidence it reflects in the epistemic capacities of state officials who have chosen to cut themselves off from market signals. Market choices reflect the personal and concrete information of the people with a direct stake in the accuracy of their perceptions.¹⁷⁹ We have forty centuries of experience with wage and price controls designed to identify the “just price” for particular goods and services, and it is a horrible experience.¹⁸⁰ Our point here is not to quarrel with the idea that an interdependent world may call for background rights and responsibilities in which detrimental reliance plays a role, but if those rules are not to become counterproductive burdens they should yield to evidence of actual consent by the parties affected by those rights and responsibilities.

C. *George M. Cohen*

In his article *The Fault Lines in Contract Damages*, Professor Cohen argues that contractual damages are not in fact, and should not be, as impervious to fault as people generally assume.¹⁸¹ He divides contractual breaches into three categories: contracts that should not have been made, contracts that should not be performed, and contracts that should have been performed.¹⁸² He argues that reliance damages are appropriate for

177. Larry Alexander, “*With Me, It’s All er Nuthin’*”: *Formalism in Law and Morality*, 66 U. CHI. L. REV. 530, 531–51 (1999). The dispute-settling function of formality of legal entitlements is the theme of this article. *Id.*

178. See *supra* notes 168–70 and accompanying text.

179. FRIEDRICH A. HAYEK, *The Use of Knowledge in Society*, in INDIVIDUALISM AND ECONOMIC ORDER 77, 83–84 (1948).

180. ROBERT L. SCHUETTINGER & EAMONN F. BUTLER, FORTY CENTURIES OF WAGE AND PRICE CONTROLS: HOW NOT TO FIGHT INFLATION 3 (1979).

181. Cohen, *supra* note 45, at 1226.

182. *Id.* at 1233–34.

the first two categories while expectation is appropriate for the third.¹⁸³

The first two categories in Cohen's scheme correspond to the notion of "efficient breach." The first category involves a contract that was inefficient from the beginning, presumably because of some mistake that at least one party made about the value or cost of performance. The second category involves a contract that would have been efficient if circumstances had remained the same, but has become inefficient due to changes in the cost or the value of performance after the contract was entered. In these two cases, Cohen notes, we really do not want the contract to be performed.¹⁸⁴ The contractual bottleneck is essentially a kind of accident, and we should apply the rule we would apply to other accidents, of restoring the status quo ante, which is done by reliance damages.¹⁸⁵ The third category involves a breach that was privately beneficial to the breaching party but not socially efficient. These breaches should be met with full expectation damages as a method of deterring them. Indeed, in principle we could respond to such inefficient breaches with punitive damages, although for practical reasons he does not think that would work terribly well.¹⁸⁶

There is much in Cohen's scheme that is quite congenial to the approach taken here. The contract that "should not have been breached" corresponds to the first four motives for contractual breach explored here, the principal addition being to spell out the types of circumstances that should constitute this category.¹⁸⁷ If the breach is occurring because of nonsimultaneous performances, or to exploit a situational monopoly, or to escape a risk allocation, or to confiscate information productively used in the transaction, that breach is indeed a wrong that should be met with expectation damages. This position agrees that punitive damages are more attractive in theory than they probably would be in practice. One serious problem with punitive damages is that these various motives are not always easy to identify, and punitive awards could lead to overdeterrence of legitimate behavior that one might fear would be

183. *Id.* at 1246 (noting contracts that should not have been made need reliance damages); *id.* at 1257–58 (explaining contracts that should not be performed need reliance damages); *id.* at 1280 (stating contracts that should have been performed need expectation damages).

184. *Id.* at 1246, 1257.

185. *Id.* at 1246 (making this analogy and then relying on the economics of accident law as set forth in STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 127–28 (1987)).

186. Cohen, *supra* note 45, at 1314–15.

187. *See supra* notes 21–49 and accompanying text.

mistaken for one of these four motives.¹⁸⁸

A significant disadvantage of Cohen's scheme is that it seems to give up completely on the pricing benefits of expectation damages. Expectation damages would not be used as an invisible hand mechanism for distinguishing between efficient and inefficient breaches without the court's having to know how costly performance had become. When the court, using its own information, felt that the breach was an efficient one, it would assess only reliance damages. If the court was mistaken in its cost-benefit calculation, an inefficient breach would have been undersanctioned and similar breaches in the future would be underdeterred. Mistakes are especially likely once one remembers that it is not merely the final decision to breach that must be evaluated by the court for its efficiency but each preparatory decision that rendered it more or less likely that a party would be able to perform.

Of course any scheme that contemplates reliance damages as a remedy for nonperformance will suffer from this problem to some degree. After all, criterion (C) of Principle 2 calls for the court to assess whether the defendant has behaved "unreasonably" under the contract, which is a cost-benefit decision made by the court rather than an invisible hand decision made by the party under a shadow price. But Principle 2 is brought to bear only for extreme and unreasonable mistakes or changes in circumstances. In the normal run of cases, expectation damages would be applied in order to obtain the informational benefits they provide in Motive 6 cases. In that sense, Cohen's analysis suffers from the same problem as Atiyah's in deviating from expectation routinely rather than in exceptional cases.

There is still another problem with Cohen's criteria for distinguishing between the cases appropriate for reliance and those appropriate for expectation. For Cohen, the crucial factor is whether there are net social costs from forcing the parties to complete the unexecuted portions of the contract.¹⁸⁹ If there are no such social costs, the contract should be enforced with expectation damages regardless of how large the private loss to one of the parties from the contract should become.

The spirit of the present proposal is different, a difference that focuses primarily on the Motive 5 cases considered earlier. A contract may prove to be enormously redistributive without any obvious possibilities for "efficient breach." For example, in the Dumb/Dumber case, suppose that the stone has been turned over but has not yet been paid for. It does not cost society any resources to pay the contract price in cash; the issue

188. Cohen, *supra* note 45, at 1314-15.

189. *Id.* at 1313 (noting that expectation damages are common primarily because litigated breaches tend to be inefficient).

is purely redistributive. Indeed, even if the stone had not been turned over there is no obvious inefficiency in requiring this action; there is no reason to believe the fake is any less valuable in the hands of Dumber than in those of Dumb. The cost we are seeking to avoid is not (merely) the cost of additional inefficiencies that would flow from the further enforcement of unexecuted portions of the contract. It is the cost of transactions with a redistributive effect that overdeters mistakes by one party and tempts the other party to search out someone who is mistaken.

The difference is shown most clearly by the commercial practice, apparently common as judged by the many cases that have arisen, of one-sided modifications of the contract price made in the face of some mistake or change in circumstances.¹⁹⁰ If the nonprice terms of the contract are the same, it is likely that the original contract was still Kaldor–Hicks efficient, but had become very one-sided when the mistake or change in circumstances occurred. It might be in the interest of parties in relational settings, or with a strong interest in their reputation, not to be seen to ruthlessly exploit every mistake made by their contracting partners to its maximum possible extent. So the contract is modified to avoid or reduce the redistribution even though the performance had not become socially inefficient in a Kaldor–Hicks sense. As noted earlier, one can anticipate that Principle 2 could have its largest practical weight as a rule of law in the shadow of which many modifications would be entered, especially where relationship or reputational constraints compelling reasonableness were not terribly strong.¹⁹¹ Cohen’s regime would have no counterpart for this, as it sees contractual “accidents” in terms of the efficiencies saved by refusing to enforce performances that have become more costly to enforce than they are beneficial to the other party.¹⁹²

D. *Charles Goetz and Robert Scott*

In their article *Enforcing Promises: An Examination of the Basis of Contract*, Professors Goetz and Scott present an economic analysis of

190. Cases on the policing of one-sided modifications are collected in FARNSWORTH, *supra* note 65, at 276–95.

191. See *supra* note 136 and accompanying text.

192. Cohen, *supra* note 45, at 1241 (stating that contractual accidents occur when a regret contingency has made continued performance under the contract jointly unprofitable).

the institution of promising.¹⁹³ They begin by noting that most law and economics scholars writing in the area of contracts have concerned themselves with optimizing the incentive to perform or breach.¹⁹⁴ In doing so, these commentators have neglected the need to optimize the initial decision as to whether or not to make a promise in the first instance.

A promise is an advanced commitment with regard to some intended transfer or exchange. The promise is made because a transfer can be more valuable to the promisee if the promisor gave a binding advanced commitment that the transfer would be made. The promisee could adjust her own spending and/or business decision-making in the interim to take account of the confident assurance that the subsequent performance would be forthcoming, something that would not have been possible if the other party had simply waited to make the transfer without any advanced promise. Goetz and Scott refer to the benefit a promisee derives from being able to adjust her planning in this way as *beneficial reliance*, or *B*.¹⁹⁵ The problem is that these changes in the promisee's decisions, which render the transfer more valuable if the promise is kept, also tend to reduce the welfare of the promisee if the promise is broken. Goetz and Scott refer to the loss in welfare from the precontract state as *detrimental reliance*, or *R*.¹⁹⁶

The promisor makes her promise with incomplete information. As that information improves, the promisor may encounter *regret contingencies* that will make the transaction involve a loss to her and that will tempt her to breach.¹⁹⁷ The question Goetz and Scott explore is what damages for such breaches of contract would be optimal from the perspective of the incentives those rules would give prospective promisors contemplating whether to make a promise. They eventually arrive at the following formula: $D = R - [p/(1-p)]B$, where *D* is damages and *p* is the probability of performance on a scale of 0 (certain breach) to 1 (certain performance).¹⁹⁸

The intuition behind the formula is roughly as follows. The prospect of high damages for breach will tend to discourage promisors from making promises, and induce them instead to simply undertake the property transfer or exchange without advanced commitment. Deterring

193. Goetz & Scott, *supra* note 20, at 1264–66 (exploration into “which system of promissory enforcement yields the maximum net social benefits from promise making”).

194. *Id.* at 1265–66.

195. *Id.* at 1267.

196. *Id.* at 1269 (noting that detrimental reliance cannot be measured by the expenditures taken because those expenditures may have generated some utility despite the breach).

197. *Id.* at 1273 (discussing the wide range of possible regret contingencies).

198. *Id.* at 1282.

promises (or causing those promises to become hyperqualified with exceptions) is a bad thing when the promise itself would be a good thing. And the goodness of a promise is a matter of comparing the benefit from a promise that is made and kept (*B*) with the harm from a promise that is made and broken (*R*), with appropriate discounting for the probabilities of performance and breach (thus $p/(1-p)$).¹⁹⁹

Goetz and Scott broke ground in the economic analysis of contract remedies by discussing the importance of the reliance interest to economic efficiency. And they found the reliance interest important for the same reason this Article does: the need to optimize the first of two contractual decisions, that is, the decision as to whether to enter into a contract in the first instance. Finally, they stressed the importance of regret contingencies, which are exactly the situations that this Article has suggested might call for the implementation of a reliance as opposed to an expectation standard.

It should be noted that Goetz and Scott's formula is not a comprehensive analysis of the remedies that should attach for breach of contract. For one thing, it is tied directly to the idea of regret contingencies, which arise only in what we have called Motives 5 and 6. If regret is not present, there is no reason to fear that high damages will result in deterring the making of promises. Looking at the prospect of those damages, the promisor would realize at the time of contracting that she would eventually need to perform that contract rather than breach it. But this will not deter promising because the promisor would still have her expected profit on the transaction as a whole, though not the extra profit that might come from breaching after the other person has performed. If the only reasons for breach are Motives 1 through 4, then there is no reason to limit damages in accordance with the formula. Damages should be set at a level of expectation (or even higher) in order to deter such unjustified breaches.

Does the Goetz and Scott formula correctly handle breaches in Motives 5 and 6? One problem with the Goetz and Scott formula, as with Cohen's approach, is that it seems to give up completely on the idea of pricing breaches in order to optimize the second decision to perform or breach. The Goetz and Scott formula can produce very small damages. They are even smaller than reliance damages, because the promisor is being rewarded for the fact that her promise might have led

199. *Id.* at 1281 (explaining that beneficial and detrimental reliance are the external effects of the institution of promising).

to beneficial reliance if the regret contingency had not occurred. Damages this small will not lead to efficient incentives to perform,²⁰⁰ so if serious inefficiency in breaching is not to be tolerated, the court will have to do its own cost-benefit decisions on whether true “regret contingencies” challenging the efficiency of performance have actually occurred. The judicial tasks would be very great, requiring assessments not only as to whether regret contingencies justified an ultimate decision to breach, but also whether they justified the failure to take earlier precautions against the prospect of being unable to perform. Principle 2 seeks to retain the pricing benefit of expectation damages for the run of ordinary cases.

Another issue to consider is whether it is appropriate to complicate the damage formula with an assessment of beneficial reliance. Beneficial reliance is an important and still unhappily neglected concept, which Goetz and Scott were quite right to attempt to bring to the center of attention. It is, after all, the principal reason for the institution of promising, the more famous detrimental reliance being merely one of the regrettable costs of the institution.²⁰¹ However, the Goetz and Scott formula has not caught on in the literature on contract remedies, undoubtedly in part because of the complexity of a formula including beneficial reliance, detrimental reliance, and performance probabilities.²⁰² Is the complexity necessary?

The Goetz and Scott formula, with its emphasis on both beneficial and detrimental reliance, is not fundamentally a way of assessing damages for breach of contract. Rather, the formula is a system for optimally taxing (or subsidizing) the act of making promises.²⁰³ It is only a coincidence that the tax is assessed at the point of breach. In principle each promisor could be assessed a tax (or given a subsidy) ex ante based upon the likelihood of regret contingencies, the size of beneficial

200. Robert Birmingham, *Notes on the Reliance Interest*, 60 WASH. L. REV. 217, 24, 252, 258 (1985) (making this point in the context of discussing Goetz and Scott’s formula).

201. Goetz & Scott, *supra* note 20, at 1269.

202. The Goetz and Scott formula has had much more influence on the subsequent literature that asks when preliminary communications should be interpreted as binding promises. The idea is that a rational party would want to consider the beneficial reliance and detrimental reliance brought about by promising as well as the probabilities of encountering regret contingencies. Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. 481, 483–84 (1996); Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249, 1268 (1996).

203. The possibility that the formula could lead to a positive result led Professor Birmingham to argue that the Goetz and Scott formula could produce the “Kafkaesque” image of a Bureau of Promises to subsidize people to announce their intentions to transact in advance. Birmingham, *supra* note 200, at 262.

reliance if the promise is performed, and the size of detrimental reliance if the promise is not performed. The Goetz and Scott test is a damage formula only in the sense that a breach of contract is the place where officials from the legal system happen to come into contact with the parties and are in a position to assess optimal taxes.

Even more importantly, the formula does not assess the optimal *public* tax on the act of promising. After all, promisors will normally be *privately* rewarded with more valuable consideration if they make a binding promise which entails the prospect of significant beneficial reliance for the promisee.²⁰⁴ Promisees will pay less if forced to assume the risk of detrimental reliance; on the other hand, promisors will demand more if forced to assume the risk of regret contingencies. The Goetz and Scott formula is more a way of understanding the private terms of a contract than a method of assessing public taxes or damages.

The Goetz and Scott insight can, however, be used to see what kind of public tax on the act of promising is necessary. Public intervention in the act of promising is primarily required to prevent a kind of fraud. The promisor has an incentive to make a promise that looks more binding than it is.²⁰⁵ If she communicates the private information she has about the probability of her regret contingencies, she will receive less valuable consideration in exchange for her promise. The law can help by holding the promisor liable for any costs the promisee suffers as a result of regret contingencies that should have been communicated but were not, and this is done by awarding the promisee her detrimental reliance. There is no need for the law to make any deductions from this damage award based upon the beneficial reliance from a promise that is made and kept; it is the prospect of detrimental reliance that the promisor has an incentive to conceal. The law sanctions the failure to communicate private information, and the resulting deterrence should lead to the parties having an incentive to define the contours of the promise and the resulting consideration in a way that efficiently considers the reliance of the parties.²⁰⁶

204. Goetz & Scott, *supra* note 20, at 1284–85. In a wholly gratuitous promise, the promisor presumably is not looking for direct consideration in exchange, but whatever charitable impulse led her to seek to make a gift would presumably tend to lead her to want to make that gift in an efficient form in terms of reliance.

205. This “negligent promissory misrepresentation” idea will be treated in more detail *infra* text accompanying notes 238–42.

206. Goetz and Scott discuss the possibility of “precautionary adjustments” by the promisor, but do not see that the distinctive contribution of a *public* system of damages is

E. Michael Kelly

In his article *The Phantom Reliance Interest in Contract Damages*, my colleague Michael Kelly has proposed to do away with the reliance interest and embrace the expectation interest as the organizing principle of contract remedies.²⁰⁷ Citing the example of an insurance company offering to return premiums, he argues that reliance does a poor job of handling contracts concerned with the allocation of risks.²⁰⁸ He suggests that this is a serious flaw with the reliance interest in that most contracts perform in part a risk allocation function.²⁰⁹ He also expresses doubts about the definition of the wrong suggested by reliance damages, which is the making rather than the more intuitive breaking of a promise.²¹⁰

However, Professor Kelly's principal point in the article was that "the reliance interest" as administered by the courts frequently bore no relation to the theoretical ideal of reliance, but served only as an arbitrary limitation on damages. Courts systematically ignore foregone opportunities, which are an integral part of a promisee's reliance on a promise. Without foregone opportunities, one was not promoting reliance at all but something entirely different, which Professor Kelly calls the "expenditure measure" of damages.²¹¹ These are actual out-of-pocket expenditures incurred on the faith of a promise, and while they have the advantage of being relatively easy to prove, an award based upon expenditures alone cannot be justified as promoting either the expectation or the reliance interest.²¹² Foregone opportunities are difficult to measure, but the most practical assumption is often that the profit one would have made on another transaction is fairly similar to the profit one was going to make on this transaction, which makes reliance collapse into expectation.²¹³

Furthermore, the law shows its weak commitment to the genuine reliance interest by its handling of the losing contract. Suppose that a party has entered into a contract that has proven to be a losing proposition for her, but nevertheless the other party to the contract

precisely to encourage promisors to make those adjustments by communicating their private knowledge about their regret contingencies. See Goetz & Scott, *supra* note 20, at 1278-79.

207. Kelly, *supra* note 10, at 1758-61.

208. *Id.* at 1774-76.

209. *Id.* at 1775-76.

210. *Id.* at 1801. Professor Kelly had some reservations about this point, however, which are discussed *infra* notes 221-22 and accompanying text.

211. Kelly, *supra* note 10, at 1773 ("[T]he reliance interest in practice boils down to the expenditure measure.").

212. *Id.* ("The erosion of the reliance interest creates a rift between the normative theory of reliance and the measure of damages marching under that banner.").

213. *Id.* at 1768-72.

breaches and the question is what the remedy for that breach should be. The promisee would actually prefer a reliance remedy to an expectation remedy in this setting, because the reliance remedy restores the status quo ante before the mistaken contract was made, while expectation only gives the promisee the benefit of her imprudent bargain. It is precisely in this case where the law refuses to award reliance damages, allowing the promisor to deduct from the plaintiff's expenditures any amount the promisor can prove the promisee would have been unable to recoup had the contract been fulfilled.²¹⁴ The courts talk about not wanting to rescue the promisee from the effects of a rationally placed risk.²¹⁵ The result is a hybrid remedy of "reliance limited by expectation" which seems to be justifiable neither by reliance nor expectation theory.²¹⁶

Kelly argues that we can safely do without the reliance interest altogether. He acknowledges that there will be cases where the plaintiff cannot prove where she would have been if the contract had been fulfilled, but can prove her out-of-pocket costs incurred in reliance on the promise.²¹⁷ Kelly argues that a remedy of reimbursement for these costs can be justified by expectation theory, on the ground that the promisee probably would not have incurred these expenditures unless she had judged that the contract would at least have enabled her to break even and recoup her expenses.²¹⁸ Indeed, one can justify recovery for precontract expenditures as well on the expectation-based theory that these expenditures would not have been incurred unless the promisee rationally judged that the overall venture, including those precontract expenses, would at least break even.²¹⁹ The presumption of break-even

214. See RESTATEMENT, *supra* note 4, § 349. The section is entitled "Damages Based on Reliance Interest" but deducts provable losses from reliance award.

215. *E.g.*, *L. Albert & Son v. Armstrong Rubber Co.*, 178 F.2d 182, 189, 191 (2d Cir. 1949) (stating that promisor has privilege to reduce reliance damages by proven loss).

216. Kelly, *supra* note 10, at 1811-12.

217. *Id.* at 1812. One such case which awarded reliance damages because expectation was too difficult to prove with reasonable certainty was *Security Stove and Manufacturing Co. v. American Railway Express Co.*, 51 S.W.2d 572, 576-77 (Mo. Ct. App. 1932).

218. Kelly, *supra* note 10, at 1812 (noting the presumption of zero profit).

219. *Id.* at 1816-23. It is true that a party would rationally go through with a contract even if it would not cover precontract expenditures, but if one assumes that not only the contract but the overall venture was rational, then expected revenues should cover both pre- and postcontract expenses. Precontract expenses were awarded in *Anglia Television Ltd. v. Reed*, 3 All E.R. 690, 691-92 (C.A. 1971) but were denied in *Chicago Coliseum Club v. Dempsey*, 265 Ill. App. 542, 549-51 (1932).

could be rebutted by the promisor, as under present law, but this would be understood as trying to bring actual evidence to bear on what the expectation interest was, rather than the anomalous idea of expectation as a ceiling on reliance.

Kelly's article is commendably pragmatic. Its target is the reliance interest and it includes a wide variety of objections to that interest. For my purposes, however, it seems important to distinguish between the arguments Kelly directs at the reliance interest *as an ideal* and the arguments he directs at "the reliance interest" as it is incorrectly administered by the courts. Pragmatic objections to the courts' attempts to measure the reliance interest presumably call for suggestions on possible pragmatic fixes, but if the reliance interest is not the proper target in the first place, that is a different matter altogether.

Some of Kelly's arguments are directed at the ideal of the reliance interest. For example, he suggests that the reliance interest is ill-suited to handling the problem of risk allocation, a conclusion with which this Article has agreed through Motive 3. The "losing contract" would be covered within Motive 3 in any case where the contract was a losing one because of a rationally placed risk that had come to pass.²²⁰ But even if risk allocation is a part of most contracts, there are many reasons for breaching a contract other than seeking to escape a rationally placed risk.

Kelly also makes the argument that the reliance interest is theoretically ill-suited to redressing the fundamental wrong of contract, which is not the making but the breaking of the promise. This point had been made from a purely abstract standpoint in an earlier article by W. David Slawson.²²¹ Kelly seconds the general point, but adds the pragmatic worry that advocates could make a plausible case that the making of a promise was the wrong in certain situations.²²² This Article

220. The problem of reliance damages in losing contracts as defeating rational risk allocations is discussed in Robert Childres & Jack Garamella, *The Law of Restitution and the Reliance Interest in Contract*, 64 NW. U. L. REV. 433, 440–41 (1969).

221. Kelly, *supra* note 10, at 1802 (citing Slawson, *supra* note 1, at 217–19). In a fine article, Slawson argues that the proper role for the reliance interest is in cases of unilateral mistake of fact. Slawson, *supra* note 1, at 218–19. This Article's conclusions differ from Slawson's in several respects. First, the category appropriate for reliance is not limited to mistakes of fact but includes mistakes of law, indefinite and informal promises, failure to foresee regret contingencies, and other defects of the quality of consent handled by procedural unconscionability norms. Second, not all cases of unilateral mistake of fact call for reliance. Where the contract places the risk of a mistake, or where the information lacking has productively been brought to bear by the promisee, expectation should be awarded. Third, the pricing benefits of expectation will remain important for many cases of moderately sized unilateral mistakes, as noted in Motive 6. Fourth, Slawson does not discuss the need of courts to police the reasonableness or efficiency of behavior under a contract when moving on requests to rescind for unilateral mistake.

222. Kelly, *supra* note 10, at 1803–04 (noting that the malleability of language

has argued that there are two contractual wrongs. One is the breaking of a promise, where there is no ground upon which nonperformance of the promise can be justly excused. The other is carelessly inducing the other party to believe that one has entered a binding commitment when in fact one has not. Kelly correctly points out that there is an incompatibility between reliance and the first wrong, but he offers no reason to suggest there is any incompatibility between reliance and the second wrong.

The remaining issues concern measurement. Professor Kelly is correct that a recovery based upon out-of-pocket costs is not necessarily an attempt to vindicate the reliance interest; it seems sound to presume that the nonbreaching party would at least have broken even if there is no evidence one way or the other on the profitability of the contract. As for measuring the reliance interest, it is certainly true that foregone opportunities ought to be considered, although they will not exist in all cases.²²³

A more problematic idea is that the expected profit on the existing transaction should serve as a proxy for the profit the promisee would have made on the foregone transaction. I agree that this can often be a sensible way of proving the reliance interest, but it is less sensible in the types of cases that are covered by Principle 2. That principle contemplates a reliance recovery in the case of highly material mistakes made by a particular promisor. The promisee who contracted with the severely mistaken promisor frequently would not have found another severely mistaken promisor to contract with if this promise had not been made.²²⁴ Other promisors would not have offered terms as favorable to the promisee.

Part of the spirit of Principle 2, after all, is to remove from the promisee an incentive to seek out and exploit the mistaken party, except in Motive 4 settings where information is being productively brought to bear on the transaction. If the promisee's reliance damages were measured, by proxy, as the profit the promisee actually received by contracting with the mistaken party, that policy would be defeated.

affects definition of wrong).

223. There will be cases where the promisee could have pursued both the promisor's venture and an alternative, so that the promisee has lost volume rather than merely the difference between two prices. U.C.C. § 2-708(2) (1989) (lost profit remedy).

224. This will not always be the case. The mistake may have related to an unforeseeable general development (such as the failure to predict a war or natural disaster) that might have been made by others in the market as well.

This does leave a difficult question about how to measure foregone opportunities if expectation is not to serve as a proxy. Ironically, in some cases one might want to apply Kelly's expenditure measure on the proxy-based theory that the promisee probably would have entered into an alternative contract in which she would have incurred similar expenditures that presumably would have been recouped by performance of the alternative contract.²²⁵ Another idea would be to look to the market price at the time of contracting as the price that nonmistaken parties would have demanded under the alternative contract, although it is certainly true that finding the appropriate market price will not always be easy.

F. Randy Barnett and Mary Becker

In a jointly authored article, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentation*, Professors Barnett and Becker attempted to bring some conceptual order to the doctrine of promissory estoppel.²²⁶ Subsequently, both Barnett²²⁷ and Becker²²⁸ have written individual articles expounding their views on expectation and reliance.

Two potentially related questions have bedeviled the promissory estoppel doctrine from the outset. Is this a tort provision designed to compensate people who have been misled by others to their detriment, or a contract provision designed to hold people to their promises when others have relied on them?²²⁹ And are damages for promissory estoppel properly measured by reliance or by expectation? Much of the Barnett and Becker theory is descriptive. It argues that courts have in fact overwhelmingly awarded expectation damages when applying promissory estoppel, and in that sense have treated section 90 as a contract doctrine.²³⁰ However, the article also offers a framework for normative insights pertinent to the subject matter of this Article.

Barnett and Becker argue that promissory estoppel is really two

225. Pettit, *supra* note 18, at 425 n.31 (arguing that the reliance interest can in this way justify awarding both pre- and postcontract expenditures).

226. Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentation*, 15 HOFSTRA L. REV. 443 (1987).

227. Randy E. Barnett, *The Death of Reliance*, 46 J. LEGAL EDUC. 518 (1996).

228. Mary E. Becker, *Promissory Estoppel Damages*, 16 HOFSTRA L. REV. 131 (1987).

229. For an argument that contract-related defenses such as the statute of frauds and the parol evidence rule should not apply to promissory estoppel, see Michael B. Metzger & Michael J. Phillips, *The Emergence of Promissory Estoppel as an Independent Theory of Recovery*, 35 RUTGERS L. REV. 472, 551 (1983).

230. Barnett & Becker, *supra* note 226, at 445-46.

different doctrines masquerading as one.²³¹ In the vast majority of its applications, promissory estoppel is a contract doctrine. That is, it serves to enforce promises that would otherwise be unenforceable due to the doctrine of consideration, or some formal doctrine such as the statute of frauds, the parol evidence rule, or the definiteness requirement. Expectation damages are the appropriate remedy for the enforcement of promises, and thus the courts are correct to apply that remedy as frequently as they do.²³²

However, Barnett and Becker suggest that promissory estoppel also occasionally serves a tort role.²³³ Their example is *Hoffman v. Red Owl Stores, Inc.*²³⁴ Employees of the defendant assured the plaintiff that for a particular sum of money they would be able to set him up in a store.²³⁵ At the defendant's urging, the plaintiff sold his bakery, bought a small grocery store to gain experience and then sold it, obtained an option on land, and took other steps in reliance. The defendant kept increasing the amount of money plaintiff was expected to raise, and the plaintiff eventually backed out and brought suit.²³⁶ The court awarded reliance damages under the doctrine of promissory estoppel.²³⁷ Barnett and Becker suggest that the case is essentially filling a gap in tort law, by providing compensation for "negligent promissory misrepresentation."²³⁸ The defendant carelessly made it appear that the promise to establish the plaintiff in a store was more reliable than it really was.

However, they argue that it is fundamentally flawed to regard reliance as the essence of liability for breach of contract. In fact, there is a circularity in saying that reasonable reliance is what makes a promise binding, because the legal status of a promise as binding clearly has much to do with whether any reliance could be characterized as "reasonable."²³⁹ Instead, Barnett in particular has stressed that what makes a promise binding is the manifest intention to be legally bound.²⁴⁰

231. *Id.* at 445.

232. *See id.* at 446.

233. *Id.* at 489-92.

234. 133 N.W.2d 267 (Wis. 1965).

235. *Id.* at 268-69.

236. *Id.* at 269-71.

237. *Id.* at 268-71.

238. Barnett & Becker, *supra* note 226, at 492.

239. *Id.* at 446-47.

240. Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269, 314 (1986) (noting that reliance has evidentiary value in identifying consent to be legally

The promisor is bound not because someone chose to rely on her but because she manifested an intent to vest a new legal entitlement in the promisee which justified the promisee in relying on that legal entitlement if she chose to do so.

How does our theory compare with that of Barnett and Becker? The idea that promissory estoppel might be standing in for two different theories has a clear resonance with our notion of contract as embodying two separate wrongs. One is the breaking of a contract (without justification or excuse), and the other is carelessly making it appear that one is bound when in fact one is not. Barnett and Becker's "negligent promissory misrepresentation" is as good a name for the second category as any.

Barnett and Becker are also correct to stress that "reasonable reliance" depends upon some prior theory for what kind of action or statement one can reasonably rely upon. "Reasonable" here must mean more than "not imprudent"; it is reasonable in the sense of prudent to rely on all kinds of things continuing as they have in the past without our having a legal right to insist that they continue. Instead, "reasonable" is a normative concept—when is it reasonable for us to demand that some part of the world stay stationary so that one can rely upon it more confidently? Barnett and Becker answer correctly that we have a right to insist that our property rights remain stable, so what one must find is some manifestation by the promisor that she was transferring her property right or legal entitlement to the promisee.

Is it really necessary that the promisor manifest an intention to be legally bound by her promise? It might be argued that any "promise" is an action or statement that one can reasonably rely upon; indeed, that is almost the working definition of the institution of promising.²⁴¹ As Sidney DeLong has noted in an important article, however, there is a significant role for the promise that is understood not to be legally binding.²⁴² The promisee is invited to rely on the statement with the partial security that comes from the knowledge that the promisor's business reputation will be diminished if the promise is not kept but that no legal entitlements are being created by the promise. A promisee can "reasonably" rely on the nonbinding promise both in the sense of "prudently" relying and in the sense of the promisor's having a moral obligation to live up to the promise, but a legal right is not created

bound).

241. A.I. MELDEN, *RIGHTS AND PERSONS* 46, 46–54 (1977) (stating that a promise is the underwriting of endeavors by the other party).

242. Sidney W. DeLong, *The New Requirement of Enforcement Reliance in Commercial Promissory Estoppel: Section 90 as Catch-22*, 1997 WIS. L. REV. 943, 953–55.

because the promisee understood from the beginning that no such entitlement was being transferred. In DeLong's terminology, it is not reliance or even reasonable reliance that promissory estoppel protects, but "enforcement reliance," the reliance undertaken because of the promisor's manifestation that the promise would be legally enforceable.²⁴³

Charles Knapp has criticized the Barnett/Becker theory on the ground that it would exclude many promises which do not clearly manifest either the intention to be legally bound or the intention not to be legally bound.²⁴⁴ But as long as one accepts that there is a legitimate place for two institutions (the legally binding promise and the nonlegally binding promise), the issue becomes one of filling a gap when there have been no express manifestations about which of the two institutions is being invoked. There may be circumstantial evidence of the parties' intentions to invoke legal entitlements, such as the use of formalities, the presence of consideration or of known reliance too large to be undertaken without a legal commitment, or the use of the promise as part of an economic activity.²⁴⁵

Also relevant to gap-filling, though less explored, is the economic question of when rational parties would want to make a promise that was not legally binding.²⁴⁶ That seems especially likely when legal proceedings would entail great cost and uncertainty because the performance in question turned on variables (such as motives for action) that could not be easily and accurately conveyed to third party enforcers. Informal promises that employees will be treated fairly and will not be fired except for good cause might be such an example, and may explain the great hesitancy courts have had in recognizing promissory estoppel claims in that setting.²⁴⁷ Barnett has probably gone too far in following Farber and Matheson's earlier suggestion²⁴⁸ that any promise made as

243. *Id.* at 947 (contrasting performance reliance and enforcement reliance).

244. Charles L. Knapp, *Rescuing Reliance: The Perils of Promissory Estoppel*, 49 HASTINGS L.J. 1191, 1240-41 (1998) (noting that Barnett would fail to protect much reasonable reliance)

245. Barnett, *supra* note 227, at 529 (setting out a proposed Restatement that would acknowledge evidentiary proxies of intent to be bound).

246. Epstein, *supra* note 114, at 105-06 (noting that two ways to fill gaps are evidence of party behavior to show implicit agreement and rational bargain that would maximize joint gains).

247. DeLong, *supra* note 242, at 988-93 (discussing cases).

248. Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L. REV. 903, 930-31 (1985). More

part of an economic activity should be at least presumptively enforceable. The conditions for a nonlegal promise—complex facts difficult to convey accurately and at reasonable cost to a third party, serious reputational constraints on opportunistic behavior—do not seem to be terribly rare in economic activity. At least when the promises are made informally and are lacking in consideration, I do not believe that Barnett has adequately justified at least a particularly serious presumption against the interpretation of statements as nonlegally binding promises.

The largest difference between the Barnett/Becker model and the present one concerns the use of reliance within a setting where the promisor did manifest an intention to be legally bound. Expectation is the correct remedy when such promisors commit breaches of the kind described in Motives 1 through 4; but when regret, or hardship generated by surprise, is the principal motive for the breach of a promise that was intended to be legally binding, there is nothing in Barnett and Becker that would suggest the appropriateness of shifting to a reliance approach.

Barnett and Becker see *Red Owl Stores*²⁴⁹ as a case where the defendant did not manifest any intention to be legally bound, but should nevertheless be liable because it made promises which it had reason to know were less reliable than they appeared. This is a plausible reading of the case, but not a necessary one. Red Owl is an economic actor that not only knew Hoffman was making huge reliance decisions but directed him to do so. When they promised Hoffman that they would set him up in a store for \$18,000 and did not tell him that they were undertaking no legal commitment to him, a reasonable inference might be that they had manifested an intention to be legally bound. So why not enforce the promise against Red Owl? As the court noted, the contours of the promise were too indefinite.²⁵⁰ We could try to fill gaps, but the resulting contract might be unfairly harsh to Red Owl. So we award reliance damages as a sanction against Red Owl for negligently manifesting that it was creating a legally binding obligation when in fact it was not.

Are Barnett and Becker correct to insist that expectation damages are the proper remedy for most cases of promissory estoppel? Once it becomes clear that expectation and reliance both have a role within contract, there is no reason to treat promissory estoppel as a world apart; the difference between contract and promissory estoppel is formal

recently, Barnett appears to recognize that the scope of enforceable promises defended by Farber and Matheson was excessive. See RANDY E. BARNETT, *CONTRACTS: CASES AND DOCTRINE* 871–72 (2d ed. 1999) (embracing DeLong's criticisms).

249. *Hoffman v. Red Owl Stores, Inc.*, 133 N.W.2d 267 (Wis. 1965).

250. *Id.* at 272, 274–75.

superstructure that should yield to substantive policy.²⁵¹ Nevertheless, the percentage of cases in which reliance damages are appropriate may be greater in actions brought under promissory estoppel than in actions brought under traditional contract by virtue of the fact that promissory estoppel is often used as a kind of consideration substitute. Once again, the fundamental issue is the motive for particular contractual breaches.

Consider the classic illustration of the donative promise, the famous Coudert/Williston debate over Johnny and his uncle that was fought out during debates on the first *Restatement of Contracts*.²⁵² Uncle is aware that Johnny is thinking about buying a car, and promises to give Johnny \$1000, whereupon Johnny buys a car for \$500. When Uncle refuses to pay anything, should damages be measured by the \$1000 promised or the \$500, which is the most Johnny would be harmed by the act of making and then withdrawing the promise? The hypothetical is a bit odd, in that Uncle's promise might be interpreted as "I will pay for your car up to a value of \$1000," which would remove much of the tension between reliance and expectation. But let us assume that the promise should properly be interpreted as a commitment to give \$1000 regardless of how expensive the car is.

Did Uncle manifest an intention to Johnny that the promise would be legally binding? The informality and family setting raise doubts about this, although the fact that Uncle knew Johnny was going to buy a car and promised a sum certain in money, easily enforceable in law, makes it possible that Johnny could reasonably have concluded that a legal commitment was involved. Still, the gratuitous setting of the promise tells us something about Uncle's probable motive for breach. He is not taking advantage of nonsimultaneous performances if he is not bargaining for anything at all in exchange for his promise. Nor does it appear that he is exploiting a situational monopoly in order to extort a modification. We are not told why Uncle decided not to honor his promise, but perhaps he had fallen on hard financial times or had learned that Johnny was not a very deserving object of charity.²⁵³ Reasonable

251. Cohen, *supra* note 13, at 1288 (noting that the doctrinal labels of "promissory estoppel" and "contract" should yield to policies); *Fuller & Perdue I*, *supra* note 54, at 52 (pointing out that "quasi-contract" and "contract" are superstructure and should yield to policies).

252. *Proceedings at Fourth Annual Meeting*, 4 A.L.I. PROC., APPENDIX 95-96 (1926).

253. In civil law countries lacking the doctrine of consideration, a gratuitous promisor is given defenses such as ingratitude and material adverse change in the

people certainly can differ about this, but we might be sufficiently close to the borderline about whether the promise ought to be treated as legally binding in the first place that it does not take much of an excuse to suggest that forcing Uncle to pay the \$1000 would be inappropriate. On the other hand, Uncle did make it appear to Johnny that Uncle had placed himself under an obligation to pay that money, and Johnny had spent \$500 in reliance on that appearance, so the case for awarding reliance damages seems fairly compelling.

It is certainly not true, however, that reliance damages would always be appropriate under promissory estoppel. Expectation damages are appropriate whenever the first four motives for breach are present. They may also be appropriate to provide the pricing information to distinguish efficient from inefficient breaches in Motive 6 cases, or as a proxy measure of the reliance interest in cases where reliance is suspected to be large although difficult to prove. In the *Red Owl Stores* case, the defendant seemed to be engaged in Motive 2, demanding a series of one-sided modifications in the original contract as the plaintiff became more and more dependent. One would like nothing better than to hold the defendant to the original promise or its value in damages. Thus, if the contract had been sufficiently certain, one would want to award expectation. And that is true even if the case had to be brought under promissory estoppel rather than contract because Red Owl had not yet received any consideration from Hoffman in the form of money paid or promised.

G. Mark Pettit, Jr.

In his article *Private Advantage and Public Power*, Professor Mark Pettit, Jr. argues for the reliance interest as an organizing principle of contract law.²⁵⁴ He claims that the burden of proof should be placed on those who favor a particular exercise of state power, and expectation damages generally involve a larger coercive exaction than reliance, so the burden of proof to justify that exaction is on expectation advocates.²⁵⁵ He does not believe that they have met that burden.

Pettit notes that the expectation interest enforces the “extra advantage” that a promisee was able to obtain from the particular promisor above and beyond any advantage that alternative promisors would have been willing to offer.²⁵⁶ It thus involves public power in the service of private

promisor's economic situation. Melvin Aron Eisenberg, *The World of Contract and the World of Gift*, 85 CAL. L. REV. 821, 828 (1997).

254. Pettit, *supra* note 18, at 418.

255. *Id.* at 418.

256. *Id.* at 418–27.

advantage, helping promisees extract their pound of flesh from the mistaken promisor that they would not have been able to receive from the market as a whole.

Having presented this affirmative case for reliance, he then proceeds to ask whether expectation advocates have met their burden of justifying this extra exaction. He first considers Charles Fried's moral argument, that expectation follows from respect for individual autonomy.²⁵⁷ He finds the argument wanting. At best, Fried's view justifies a moral duty to keep the promises one has made rather than a legal obligation.²⁵⁸ And in any event, as Macneil has argued, the enforcement of promises is not necessarily respectful of autonomy, going directly against the will of the individual in the ex post position.²⁵⁹

Pettit then looks at efficiency arguments for expectation and finds them unconvincing. In particular, Pettit notes the dependence of the Pareto efficiency argument on the question of the proper baseline of rights.²⁶⁰ The "efficient breach" argument suggests that expectation damages are required to avoid harming the promisee while benefiting the promisor, but this notion of "harm" begs the question of the baseline of rights from which harm is measured.

A central point of agreement between this Article and Pettit concerns the fundamental case for reliance. It can be unjust to enforce the "extra advantage" that comes from contracting with a mistaken party on terms that the rest of the market would have realized were unacceptable. I have added the efficiency point that enforcing the extra advantage threatens to cause the informed party to unproductively seek out mistaken parties, and the uninformed party to become overcautious about contracting and to use excessive care in the contracting process. On the other hand, enforcing this "extra advantage" is not always unjust. In Motive 4 cases, the extra advantage is the return for bringing information productively to bear upon a transaction and should not be taken away by the application of reliance principles.

257. Fried argues for the expectation interest on autonomy grounds, since "[o]thers must respect our capacity as free and rational persons to choose our own good, and that respect means allowing persons to take responsibility for the good they choose." CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 20 (1981).

258. See Pettit, *supra* note 18, at 429.

259. *Id.* at 430 (citing Ian R. Macneil, *Values in Contract: Internal and External*, 78 *Nw. U. L. REV.* 340, 358 (1983)).

260. *Id.* at 434-35.

Pettit's argument about freedom and personal autonomy also seems to be overstated. I find once again a remarkable parallelism between efficiency considerations and deontological norms. Just as efficiency norms cohere naturally with expectation when the first four motives are implicated, I would argue that freedom norms also cohere naturally with expectation when those motives are involved.

The relationship of human freedom to contracting is tied up with the basic premise of this Article that contracts involve two separate choices. The question that needs to be answered is whether freedom is advanced when one gives effect to the expression of will at the time of contracting but not to the expression of will at the time of breach.²⁶¹ With regard to Motives 5 and 6, where the difference between the two expressions of wills concerns new information available at the time of breach that was unavailable at the time of contracting, Pettit is correct that it is difficult to say that freedom is always on the side of contract enforcement. However, the other motives are an entirely different story.

The ability of an individual to make a commitment that she will thereafter not act upon opportunistic motives is indeed a fundamental human freedom.²⁶² Her ability to carry out long-term projects is dependent upon her ability to make credible promises against her subsequent opportunistic behavior. The temptation to act on these motives is much like other temptations that threaten the integrity of the individual's long-range plan of action, such as succumbing to addictions or appetites. Ulysses had himself tied to the mast because he knew that his enduring values would be jeopardized by the types of actions he would be inclined to take under the influence of the Sirens.²⁶³ This is contract at its best: the giving of a law to oneself that one willingly commits to obey in order to promote the enduring projects that constitute one's own identity.²⁶⁴

Pettit suggests that the autonomy argument supports only a moral duty to enforce the promise and not a legal duty. But here again it is important to distinguish between the two institutions of the legally binding promise and the nonlegally binding promise. Each of these institutions nurtures an important human freedom; indeed, they are largely manifestations of the same freedom to voluntarily place chains

261. Mensch, *supra* note 170, at 759 ("Freedom logic requires a new formation process whenever performance is no longer in accord with the will of the parties. Only security logic can step in to demand enforcement.").

262. I have argued this in the context of employment contracts in Wonnell, *supra* note 125, at 133-38.

263. See JON ELSTER, *ULYSSES AND THE SIRENS* 36-37 (rev. ed. 1984).

264. G.H.L. Fridman, *On the Nature of Contract*, 17 VAL. U. L. REV. 627, 636 (1983) (noting that reliance is inconsistent with freedom rationale for contract).

upon motives that conflict with long-term projects. The freedom to make a nonbinding promise facilitates projects that would be threatened by opportunistic behavior that would be difficult to document to third party enforcers. And the freedom to make a binding promise facilitates projects that would be threatened by opportunistic behavior that is too substantial to be constrained by reputation alone. The only time when it cannot be said that personal autonomy is promoted is when the courts try to enforce a promise that was intended not to be legally binding.

Pettit then challenges the efficiency arguments for expectation damages. The traditional argument is that expectation damages are necessary if breaches are to be Pareto efficient for all the parties to the transaction. Pettit notes that this is true only if one regards the promisee as suffering harm by losing the hoped-for gain.²⁶⁵ If harm is measured by the status quo ante, breaches can be beneficial to the defendant without being harmful to the plaintiff even if only reliance damages are paid.

It is tempting simply to repeat the response to the baseline point made in the earlier discussion of Fuller and Perdue.²⁶⁶ The new baseline should be the standard of harm, because the baseline reflects the rational judgment of the parties directly affected by the rights and duties rather than the historical live-and-let-live background rule that may not be appropriate in the face of interdependence. In fact, however, Pettit's argument is somewhat different. His concern is cases of regret that may lead to an efficient breach, or our Motive 6 category. Thus one is talking about a set of entitlements that, by virtue of new information, may *not* have proven to be efficient, so the specific issue becomes why the contractual entitlements rather than the status quo ante should be the baseline for measuring harm even when the new entitlements may not reflect an efficient use of resources.

There are two questions that need to be asked about Pettit's theory of baselines and efficient breach. First, is he right that the baseline for measuring "harm" should be the precontract position in cases of regret? And second, does his conclusion that expectation is unnecessary for efficient breach follow from his premise about the baseline? I would argue that in a pure case of regret, that is, one that is not mixed with Motive 3 of rational risk allocation, Pettit is correct about the baseline point, but that his conclusion about efficient breach does not follow.

265. Pettit, *supra* note 18, at 435.

266. See *supra* notes 142–52 and accompanying text.

With regard to baselines, it is important to remember that in some cases the parties specifically wish to allocate the risk of various regret contingencies, and that a risk averse promisee may be willing to pay for the constancy of returns in the face of regret contingencies that is provided by expectation.²⁶⁷ In a pure case of regret unmixed with this motive, however, Pettit is correct about the baseline problem. A contract that reflects significant regret that has not been allocated as a risk may not be one where the new entitlements deserve to replace the status quo ante as a measure of entitlement and harm. Indeed, when Principle 2 applies, the courts will *not* leave plaintiff “unharmd” relative to the position she would have occupied if the contract had been fulfilled. Those are cases where the contract cannot be justly enforced by virtue of its unanticipated harshness, so the promisee has no moral right to have her position judged against a baseline of an entitlement to exploit that harshness.

However, it does not follow that courts should abandon expectation in any case where regret is present. We must remember that from a Kaldor–Hicks perspective, it is proper to look at the actual cost and benefit of performance *ex post*, with the benefit of the new information. The decision to perform is made at the later time, and there is no reason to ask whether the decision would have looked Kaldor–Hicks efficient under the costs and benefits as they appeared in the uninformed *ex ante* position. Expectation damages serve as a mechanism for pricing breach in light of the harm that breach will actually cause *ex post*. The Kaldor–Hicks conclusion is independent of baselines.²⁶⁸ Baselines are distributive; they tell us how much each party separately gained or lost relative to some identified “zero” point. Kaldor–Hicks efficiency tells us that the net of all gains over all losses will be a certain amount greater if the efficient action is taken at the performance stage.

Thus, to the extent that one is interested in promoting performance decisions that add to rather than detract from societal wealth, and to the extent that one is going to rely on a pricing mechanism for identifying those performance decisions, one will need expectation damages regardless of the baseline problem. The alternative is to try to do without a pricing approach to efficient nonperformance and have the court make the (*ex post*) cost–benefit judgment itself. That is indeed the

267. POSNER, *supra* note 21, at 135 (arguing that excusing breaches because they are efficient could defeat insurance function of contracts).

268. Whether expectation damages are considered a windfall or not, an award of reliance damages would encourage inefficient breaches. *Id.* at 135. There is a broader sense in which Kaldor–Hicks depends upon existing entitlements which determine willingness to pay, but this macroeconomic sense has no apparent applicability to a discrete problem of contract doctrine.

approach taken by Principle 2, but only for cases of exceptionally large mistakes. If the cost-benefit decision is made correctly, no Kaldor-Hicks inefficiency will result, although the plaintiff will be “harmed” relative to a baseline that, as Pettit correctly notes, she did not necessarily have a right to attain.

H. *Richard Craswell*

Professor Richard Craswell has written a series of articles discussing the economics of contract remedies.²⁶⁹ In these articles, he discusses the wide variety of considerations that could go into a design for efficient contract remedies. For example, we might be interested in the decision as to whether to perform or breach. For familiar reasons, expectation damages are the best way to optimize this decision, and also the related decision on how much precaution to take against the possibility of inadvertent breach.²⁷⁰

On the other hand, Craswell notes, a reasonable argument exists that we should not be worried about the effect of damage rules on the decision to perform or breach. If performance would be inefficient, the argument goes, the parties can always bargain to an efficient result *ex post*.²⁷¹ One problem is that the transaction costs of such bargaining might be high because of the bilateral monopoly setting and the possibility that the parties will bluff each other into stalemate. However, Craswell observes that there are problems with *ex post* negotiations that are independent of the extent of transaction costs at that time.

Suppose that damages were set appreciably below or above the level of expectation, but that renegotiation of the contract could occur with relatively low transaction costs. The plaintiff’s return from the contract, including money received as part of the *ex post* negotiation, would then go up and down with changes in the defendant’s business situation. This uncertainty in the plaintiff’s position would be undesirable if the plaintiff was risk averse.²⁷² In effect, the promisee would have bought a speculative investment in the promisor’s business that there is no reason to believe she was interested in making. Craswell also observes that it is not very realistic to imagine *ex post* negotiations over the level of

269. Craswell, *supra* notes 95, 106, 202.

270. Craswell, *supra* note 95, at 646.

271. *Id.* at 635.

272. *Id.* at 641-43.

precautions defendant would make; plaintiff would have no way of knowing the level of precautions in defendant's business that would produce the optimal number of inadvertent breaches.²⁷³

These arguments are all broadly supportive of expectation damages, which produce efficient performance behavior without the need for ex post negotiations. In another article, Craswell observed that expectation damages could lead to overreliance because they theoretically provide full insurance against breach and could therefore lead to moral hazard problems.²⁷⁴ However, he notes that reliance damages also lead to the same moral hazard problem.²⁷⁵ His suggestion is to award the damages that would have been recovered if the plaintiff had behaved reasonably, a conclusion embraced in both Principles 1 and 2 above.²⁷⁶ And as an incentive to induce the promisor to provide information to the promisee about the probability of breach, he would limit damages to those the plaintiff would have suffered if she had behaved reasonably *given* the information defendant had disclosed to the plaintiff.²⁷⁷

Craswell then complicated the picture further in an article entitled *Precontractual Investigation as an Optimal Precaution Problem*.²⁷⁸ Here he looked at the incentive that contracting parties have to exercise care at the time of contracting. He said that one is tempted to conclude that reliance damages would be the way of optimizing this care, because reliance is the harm caused when a person carelessly enters into a contract that causes the other party to act to her detriment. However, this is not correct; reliance damages are too small and would lead to insufficient care.²⁷⁹ The reason is that a party who fails to conduct a precontract test ought to be forced to internalize all of the expected costs of that decision. The costs are indeed the promisee's reliance if the test would have led the promisor to refrain from contracting, but what if the test would have led her to contract and in fact she did not? In that case, the person who failed to conduct the test will fail to confer an external benefit on another party, namely, the other party's portion of the contractual surplus from the contract that should have taken place but

273. *Id.* at 647–48 (noting that there is nothing new to bargain over ex post when the issue is precautions rather than new opportunity for intentional breach).

274. Craswell, *supra* note 106, at 376 (discussing expectation as full insurance scheme).

275. *Id.* at 376–77 (stating that the reliance measure makes reliance expenditures a risk-free investment).

276. *Id.* at 365–66.

277. *Id.* at 377 (arguing that this remedy would actually be easier to administer than one requiring assessment of efficient reliance from court's own knowledge).

278. Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem*, 17 J. LEGAL STUD. 401 (1988).

279. *Id.* at 410–13.

did not. Therefore, we can optimize the precaution decision only with damages that are higher than reliance in an amount reflecting this other external benefit that could have been provided by the precontract testing that was not done by the careless promisor.²⁸⁰

This story seems gratuitously complex. There is always a small externality involved in the decision as to whether to contract. If my choice is between leisure and working for an employer, I get one hundred percent of the benefit from leisure but must share with my employer (and perhaps others in direct or indirect privity with my employer) the extra profit made possible by working. No one has suggested that we therefore need to force people to work, or subsidize them beyond their contractual wages in order to bribe them to work. If anything, the law probably makes this problem worse by subsidizing leisure through welfare and taxing the income from working. The concept of trying to correct for these imperfections is administratively hopeless; one imagines a Bureau to Subsidize Transacting with Others (or perhaps a tort of unreasonably failing to contract?) that attempted to measure the external advantage of every possible time we could do business in tandem with others rather than alone.

When Principle 2 applies, Party *A* carelessly enters into a contract with Party *B* that is too unexpectedly harsh on *A* to enforce in full, but *B* has detrimentally relied on *A*'s apparently binding commitment. Reliance damages are the actual harm that *A*'s carelessness has caused to *B*. One can imagine some hypothetical Party *C* who was failing to do the same kind of precontractual inquiry as Party *A*, but in a situation

280. *Id.* at 426 ("The optimal measure in such a market will therefore always exceed the reliance measure, although it could be either greater or less than the expectation measure."). In a recent article, Craswell argued that there were so many variables relevant to the economic efficiency of contractual behavior that Fuller and Perdue's concepts of expectation, reliance, and restitution were no longer helpful. Richard Craswell, *Against Fuller and Perdue*, 67 U. CHI. L. REV. 99, 107-11 (2000). On the other hand, he still maintained that expectation describes roughly the normal remedy sought by parties, with particular variables calling for remedies above or below expectation. *Id.* at 157. Noting this complexity can be useful if the issue is whether to defer to the parties when they set remedies which appear to deviate from reliance or expectation. But if the issue is judicially set default rules, this approach seems overly despairing, for courts cannot realistically set damages which optimize vast numbers of variables. In any event, Craswell's article contains nothing in the way of variables to consider beyond those discussed in his previous articles, and the two principles here are designed to deal in as practical a way as possible with issues of optimal precautions, optimal breaches, optimal care in contracting, optimal promisee reliance, and optimal contractual risk allocation. See *id.* at 109-10.

where the inquiry would have produced the opposite conclusion, that a contract which otherwise seemed unwise really was advantageous. One can then imagine that Party *C*'s failure to test meant that *C* did not enter into a mutually beneficial contract with some Party *D*, and that *D* thereby lost its share of the contractual surplus. But it is quite the curious idea to force *A* to compensate *B* not only for the harm that *A* did to *B* by contracting but also for the harm that *C* did to *D* by not contracting. This approach seems completely opposed to the idea of working individual justice between the parties. And the suggested remedy, which is more than reliance by an amount that we cannot calculate but bears no relationship at all to expectation, is similarly without precedent.

This complexity is not necessary. If the promisor is accountable for the harm she actually caused, her remaining imperfect incentive to conduct precontract testing will be no greater than the imperfect and pragmatically uncorrectable incentive not to contract enough that already exists for everyone. With this revision, Craswell seems broadly supportive of the view that reliance damages optimize the decision on whether to enter contracts while expectation damages optimize the decision on whether to breach those contracts. He does not, however, offer any method such as the principles defended here by which one could reconcile the two perspectives into a single set of damage rules that could optimize the two sets of behaviors simultaneously. Nor does he offer a moral account of the nature of the wrongs which correspond to the efficiency conclusions.

One final point should be made about Craswell's position on expectation damages. He notes that damages which deviate from expectation mean that the plaintiff's return under the contract will vary with the fortunes of the defendant's business. In effect, the promisee has invested in the business of the promisor, something that a risk averse promisee may not have wanted to do.²⁸¹ The promisee's investment is potentially unlimited on the upside in her ability to share in the new efficiencies from nonperformance, while on the downside the promisee's losses are cabined by the expectation guarantee. Craswell's insight that non-expectation damages constitute a peculiar kind of investment suggests other inefficiencies that they would produce, even if the promisee was risk neutral.

Suppose that the opportunity for an efficient nonperformance does not simply jump into the promisor's lap but must be discovered by a costly inquiry. Or suppose that the defendant needs to consider a risky

281. Craswell, *supra* note 95, at 644 (stating that remedies for breach should seek to unbundle the investment in the defendant's business from the sales contract).

investment that, depending on how it comes out, may lead to either a highly efficient breach or a highly inefficient breach. The plaintiff's ownership stake will distort these decisions by the defendant. The defendant will not have a full incentive to conduct costly searches because she will have to pay for those searches herself while being forced to share with the promisee the resulting benefits of discovering the opportunity for efficient nonperformance.²⁸² And the defendant will have an excessive incentive to avoid the risky investment, because the plaintiff's investment stake will give her a percentage of the upside risk while the expectation guarantee means that the defendant bears the downside risk alone.

IV. CONCLUSION: A STRUCTURE FOR FUTURE DEBATES ON EXPECTATION AND RELIANCE

If the analysis of this Article is accepted as substantially valid, is the debate about the role of expectation and reliance over? The answer is that it certainly is not over. What we have identified here is not a detailed blueprint for the precise place of expectation and reliance but a logical structure of those ideals within which future debates can be productively structured.

The expectation interest is appropriate when dealing with the first four motives for breach.²⁸³ Numerous issues remain in fleshing out the appropriate implementation of this ideal. The first two motives (nonsimultaneous performances and situational monopolies) seem simple in concept, but in actual practice they can be quite difficult to identify properly. It may not be clear whether a construction contract in which progress payments have been made for portions of the work nevertheless involves one party's having rendered a larger percentage of its performance as of a particular point in time than the other. And these purely opportunistic motives may in fact be part of mixed motives that involve both exploitation of situational advantages and some degree of regret or mistake. The third motive of risk allocation is an especially significant subject for future inquiry; some consensus must be identified on how broadly it is appropriate to interpret the implicit risks that are

282. E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 *YALE L.J.* 1339, 1347 (1985) (noting problem when efficient breach opportunity is joint product of defendant's breach and his skill and industry).

283. See *supra* notes 21–49 and accompanying text.

being assumed by a contract. As to the fourth motive, we have only begun to understand that transacting with the uninformed can be a productive activity in some settings and a purely redistributive or exploitative one in others; further work in distinguishing the two should be a high priority for research.

The proper role of reliance is to remedy the wrong of carelessly making it appear that one is contractually bound when in fact one is not. Again, however, this logical place for reliance does not end the debate but provides structure for its continuance. Tort scholars are likely to have the most to contribute here, as the precise mental state required for the wrong is refined. Must it be shown that the promisor could readily have foreseen the regret contingency that occurred, so that the failure to provide for it in the contract constitutes a failure to take steps the court knows to be cost-justified? Or can one say it is sufficient that, as between the two parties, the promisor had a more realistic chance of foreseeing and providing for the contingency that arose than the promisee?²⁸⁴ Either approach could be argued to be a faithful interpretation of the basic principle; the former requires proof of negligence while the latter permits negligence to be an inference drawn in the face of limited judicial knowledge and differential party access to the information.

Finally, debates need to take place about the proper point for one to abandon the pricing benefits of expectation damages and go to a judicial finding of reasonableness under the contract instead. One certainly abandons the pricing benefits with great reluctance, given the enormity of the judicial task of actually assessing the efficiency of precautionary and performance decisions undertaken. However, at some point the problem of unfair surprise dominates the inquiry, and one needs reliance damages precisely to provide the price of the promisor's carelessness. Here the future work necessarily will take on a highly pragmatic bent, and will require commentary from persons having close familiarity with the kinds of facts that are more and less realistically to be considered within the competence of judges and juries.

With all the uncertainty and work that remains to be done, however, there is reason to be confident that the fundamental nature of the expectation versus reliance debate is becoming understood. The "death

284. The debate is a familiar one in the economics of tort law, with Posner taking the view that the court should directly evaluate the costs and benefits of allegedly negligent conduct while Calabresi and Hirschhoff argue that the court should merely identify which party is in a better position to make the cost-benefit decision. Compare Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 29 (1972) with Guido Calabresi & Jon T. Hirschhoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1060-76 (1972).

of contract” thesis which posited that expectation-based contract theory was going to melt down into a purely reliance-oriented promissory estoppel tort is quite clearly wrong.²⁸⁵ The ability of parties to set entitlements by mutual consent and bind themselves not to act opportunistically in seeking to bring about those expected entitlements serves both individual freedom and economic utility. By the same token, one cannot agree with Professor Barnett that we should look forward to the “death of reliance” as long as the impulse exists to excuse persons from highly material mistakes in contracting while simultaneously rendering them accountable for the costs of their own negligence.²⁸⁶ In short, we are becoming increasingly confident in asserting that both expectation and reliance have a permanent role within the normative world of contract. And more than this, we are becoming confident that we understand the broad outlines of why those doctrines have their place as remedial counterparts to the two different contractual wrongs.

285. Robert A. Hillman, *The Crisis in Modern Contract Theory*, 67 TEX. L. REV. 103, 114–18 (1988) (explaining that Gilmore’s death of contract thesis postulated that individualism was doomed, while contract law needs both individualist and communitarian roots); Richard E. Speidel, *An Essay on the Reported Death and Continued Vitality of Contract*, 27 STAN. L. REV. 1161, 1161–62 (1975) (critiquing Gilmore’s “contorts” idea).

286. Barnett, *supra* note 227, at 520–26 (discussing the emerging consensus that reliance is not central to contract theory). One indication that reliance is not dying is provided by the attempts by recent drafting committees to bring reliance more explicitly into the law of sales. These efforts are described and criticized in Michael T. Gibson, *Reliance Damages in the Law of Sales Under Article 2 of the Uniform Commercial Code*, 29 ARIZ. ST. L.J. 909, 996–97 (1997).

