

# Finding Fault with Wonnell's "Two Contractual Wrongs"

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## I. INTRODUCTION

Professor Christopher Wonnell's excellent paper, *Expectation, Reliance, and the Two Contractual Wrongs*,<sup>1</sup> makes two basic points,

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1. Christopher T. Wonnell, *Expectation, Reliance, and the Two Contractual Wrongs*, 38 SAN DIEGO L. REV. 53 (2001).

both of which I find convincing, but neither of which contract scholars generally appreciate and accept. The first point, largely descriptive and so less controversial, is that the concepts of expectation and reliance are not simply two different ways of conceiving compensation; rather, they are two different ways of conceiving contractual wrongs from both a moral and an economic perspective.<sup>2</sup> From a moral perspective, expectation damages remedy the wrong of breaching a contractual promise that should have been performed. Reliance damages remedy the wrong of encouraging reliance through a contractual promise that either should not have been made or should no longer be performed. From an economic perspective, expectation damages focus on deterring wrongful breaches. Reliance damages focus on deterring wrongful contracting behavior other than breach. The second point, normative and highly controversial, is that courts should choose between expectation and reliance remedies depending on the reason for the breach.<sup>3</sup> Several years ago, I tried to make similar points in an article that Wonnell generously includes in the pantheon he parades in the last section of his article,<sup>4</sup> so the fact that I mostly agree with him is not all that surprising.

What has been surprising to me is how strong the resistance (if only tacit) is to Wonnell's second point—that the reason for the breach matters in determining the appropriate contractual remedy in general and the choice between expectation and reliance damages in particular. Save for occasional forays into punitive damages,<sup>5</sup> and discussions of limited remedies in excuse cases,<sup>6</sup> one can search high and low in the many fine casebooks, compilations of essays, treatises, and texts on contract law published in the last several years, for example, and find nary a mention of this simple, yet powerful, idea.<sup>7</sup> Why? Perhaps it is our yearning for

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2. *Id.* at 56–58, 88.

3. *Id.* at 90–91 (proposing principles for choosing between expectation and reliance remedies), 123 (noting that the “fundamental issue” in choosing between expectation and reliance “is the motive for particular contract breaches”).

4. *Id.* at 98–133. The article of mine that Wonnell discusses, *id.* at 106–09, is George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225 (1994). Aside from responding to Wonnell's critique of my article, I will for the most part not address Wonnell's critiques of the other scholars who have written in this area. These critiques are excellent, and I do not have much to add to them. Thus, I will focus on Wonnell's own theory.

5. For the most recent discussion and defense of punitive damages in contract, see William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629 (1999).

6. See RESTATEMENT (SECOND) OF CONTRACTS § 158 (allowing restitution and reliance damages in mistake cases), § 272 (allowing restitution and reliance damages in impracticability cases) (1981).

7. For notable exception, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 130 (5th ed. 1998) (“It makes a difference in deciding which remedy to grant whether the

the elusive grand, unifying theory of contract, which for some reason requires a unitary remedial interest. If so, I think Wonnell's article should help to foster the notion that we can accommodate both expectation and reliance damages as coequal partners in a larger theory of contractual obligation, rather than viewing one measure as simply an inconvenient exception or qualification to the theoretically dominant position of the other.

Perhaps, however, the objection to what I have previously called a "fault-based" damage regime<sup>8</sup> is more pragmatic or ideological than theoretical. In this view, courts cannot or should not get into the messy business of distinguishing contractual breaches because the costs will be too great and courts will be too prone to err. Wonnell is in fact sympathetic to this view (which appears to be the dominant view among both traditional and economically oriented contract scholars), and this is probably our key area of disagreement. Our disagreement, though, may be more one of emphasis than substance—especially at the level of generality at which Wonnell is working (he mostly discusses hypothetical examples, whereas I prefer cases). As I will discuss, I think Wonnell's own analysis helps to demonstrate not only that courts can make fault-based distinctions as part of determining the proper contractual remedy, but that they should, and inevitably will, make such distinctions. I would therefore encourage Wonnell, and those who find his analysis convincing, to embrace a fault-based damage regime rather than try to cabin it as much as possible.

In the sections that follow, I will briefly summarize Wonnell's argument, then offer some friendly critiques of some of his examples and proposals. Because I largely agree with Professor Wonnell (and have stated my views on this subject elsewhere<sup>9</sup>) these comments may appear more critical than I intend them to be. I hope, however, that the comments serve to stimulate careful reading and consideration of Wonnell's article.

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breach was opportunistic."'). Posner does not, however, use this idea to distinguish between expectation and reliance damage remedies.

8. Cohen, *supra* note 4, at 1226.

9. Cohen, *supra* note 4.

## II. WONNELL'S SIX MOTIVES FOR MAKING AND BREAKING CONTRACTS

Wonnell begins his analysis with a series of six hypothetical examples designed to show that the nature of the breach determines whether courts should award expectation or reliance damages.<sup>10</sup> The first four examples involve opportunistic breaches,<sup>11</sup> for which Wonnell finds expectation damages appropriate.<sup>12</sup> The last two examples involve nonopportunistic breaches, for which Wonnell finds reliance damages at least potentially appropriate.<sup>13</sup> Wonnell has done a great service in fleshing out the notion of opportunistic versus nonopportunistic breach, and for the most part, I agree with his characterizations and conclusions in the six examples. However, I would use a somewhat different route to get to those conclusions, so I will discuss Wonnell's examples in some detail.

### A. *Opportunistic Breaches*

Wonnell's challenge in his first four examples is to show why the examples involve opportunistic breach and why expectation damages are more appropriate than reliance damages for such breaches.<sup>14</sup> In Case 1, after the promisee performs his half of a baseball card trade, the promisor decides to keep the promisee's card and not perform her half of the trade.<sup>15</sup> In Case 2, the promisee makes a relationship-specific investment, after which the promisor attempts to convince the promisee to agree to a modification of the original contract. When the promisee rebuffs the promisor's attempt, the promisor breaches.<sup>16</sup> In Case 3, an insurer breaches an insurance contract after a loss covered by the policy occurs.<sup>17</sup> In Case 4, the promisor breaches a contract after discovering that the promisee has used the contract to take advantage of information the promisee possessed but the promisor did not.<sup>18</sup>

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10. Wonnell, *supra* note 1, at 60–79.

11. Wonnell in this section explicitly labels only Case 1, *id.* at 60–61, and Case 4, *id.* at 66–71, as opportunistic, but there is at least a strong implication that he views the other two cases as involving opportunistic behavior as well. *See id.* at 99–100 (referring to Cases 1 through 4 as “opportunistic breaches”).

12. *Id.* at 60–71.

13. *Id.* at 72–79.

14. Wonnell does not distinguish among different expectation remedies or in particular between expectation damages and specific performance. In fact, he suggests that specific performance would be the appropriate remedy in one of his examples. *Id.* at 60 (Case 1). I will follow his lead in this section and focus mostly on the choice between expectation damages and reliance damages.

15. *Id.*

16. *Id.* at 62–63.

17. *Id.* at 63–66.

18. *Id.* at 66–71.

Wonnell has little difficulty showing what all four breaches have in common. In all four cases, there is no problem with the contract at the time the parties make it, and no circumstances change after the parties enter into the contract to make the contract more costly or less desirable to the promisor. Thus, in each case, the promisor has no moral or economic justification for breaching. The real question, however, is why expectation damages are superior to reliance damages in such circumstances. To answer this question, Wonnell turns to moral intuition.<sup>19</sup> Unlike some law and economics proponents, I have no objection to moral intuition. In fact, my intuition concurs with Wonnell's here. Yet one gets the sense that Wonnell is not completely comfortable (as I am not) resting solely on moral intuition, at least without some further explanation of or justification for that intuition.

Wonnell recognizes that law and economics analysis, with its focus on incentives, deterrence, and efficiency, is a natural candidate for such a supplement or complement to moral intuition. Thus, he makes some references to economic arguments in discussing his examples and in the following section of his article.<sup>20</sup> Indeed, the fact that he labels this section of the article "Six Motives for Making and Then Breaking a Particular Contract"<sup>21</sup> suggests that he is at least somewhat concerned with the promisor's incentives. In my view, however, Wonnell misses a good opportunity in this section to make concrete the connection between moral intuition and economic analysis. I think his article would be stronger if it explored this connection, because I think the two approaches point in the same direction in these cases and inform each other in interesting ways. In the following sections, I sketch out three aspects of the economic analysis of opportunistic breaches raised by Wonnell's first four examples: promisor incentives to breach; promisee incentives; and imperfect enforcement.<sup>22</sup>

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19. Wonnell's main justifications for the expectation remedy in the four examples are the following: "If the right thing is for the promise to be kept, it seems counterintuitive to unwind the transaction . . ." *Id.* at 61. "Expectation-based remedies send th[e] message [that the original promise should be kept] most clearly . . ." *Id.* at 63 (Case 2). "The problem is . . . that the promise has been broken, and the restoration of the status quo ante seems a preposterous answer to the wrong." *Id.* at 63-64 (Case 3). "[R]isk allocations . . . would be upset if every time . . . one could escape the contract by merely paying reliance damages." *Id.* at 71 (Case 4).

20. *E.g., id.* at 68-69, 75-78, 79-88.

21. *Id.* at 60.

22. Wonnell discusses several other aspects of the economic analysis of contract remedies that are more appropriate for the changed circumstance cases than for

## 1. *Opportunistic Breaches and Promisor Incentives*

From an economic perspective, when breaches are opportunistic, the goal of contract damages should be to deter the breach. Expectation damages are superior to reliance damages under this analysis because expectation damages tend to deter opportunistic breaches while reliance damages do not. To see why this is so, we must go back to the notion of opportunistic breach. Although there are different ways to define opportunistic breach,<sup>23</sup> one of the features that Wonnell's examples highlight so well is that opportunistic breaches all involve the promisor attempting to expropriate from the contractual relationship some gain determined to be illegitimate according to the intentions of the parties or some broader social norm. Thus, the basic argument against reliance damages for opportunistic breach comes down to this: reliance damages generally do not deter opportunistic breach because they are more likely to allow the promisor to keep some of this illegitimate gain. Expectation damages, by contrast, generally deter opportunistic breach by depriving the promisor of his illegitimate gain. To my knowledge, law and economics scholars have not focused on this justification for expectation over reliance damages.<sup>24</sup>

This focus on the illegitimate gain to the promisor naturally leads to the question of why the remedy should not be restitution rather than expectation. Wonnell does not consider the role of restitution in contract remedies. Of course, Wonnell is free to limit his analysis to expectation and reliance, but in my view he again misses a good opportunity to show the relationship among the three remedies and to show further why "restitution" as normally defined in contract law might not always be sufficient to deter opportunistic breach. The reason is that the "benefit" retained by the breaching promisor may exceed the benefit from the particular contract breached, and so might not be recoverable under a traditional restitution remedy. To see these points, let us consider

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opportunistic breaches. These include the possibility of renegotiation, *id.* at 83–84, and promisor precautions, *id.* at 84–85.

23. For my attempt to summarize some of the existing definitions and offer one of my own, see George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 953–61 (1992).

24. The classic economic justification for expectation over reliance damages is that reliance damages will not deter *inefficient* breaches, which involve situations where circumstances change after the formation of the contract to make the contract sufficiently more costly or less desirable to the promisor that the promisor regrets the contract, but not so much so as to make nonperformance socially desirable because the promisor's costs outweigh the benefits of the contract to the promisee. *See, e.g.*, A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 31–34 (2d ed. 1989). As noted, Wonnell addresses situations in his first four examples in which no circumstances change after formation.

Wonnell's first four examples.

In Case 1, the baseball trading card case, the promisor hopes to keep the benefit of the promisee's performance (the promisee's card) without "paying" the agreed return performance (the promisor's card).<sup>25</sup> In this example, the promisee's reliance interest is the return of his own card, which is also arguably the promisee's restitution interest.<sup>26</sup> The promisee's expectation interest is the promisor's card, which exceeds the promisor's reliance interest because under the assumption that the contract was desirable when made, the promisee must value the promisor's card more than the duplicate card the promisee gave up. What makes the example interesting is that protecting the promisee's reliance interest appears to be sufficient to deter the promisor's opportunistic breach because the reliance remedy deprives the promisor of her illegitimate gain, the promisee's card. What, then, is the economic justification for preferring the expectation remedy?

Wonnell takes a stab at an economic analysis by suggesting that the expectation remedy is Pareto superior to reliance because completing the performance by the promisor would make both parties better off than the reliance remedy of returning the promisee's card.<sup>27</sup> But this argument is not completely satisfying. If the expectation remedy would truly make both parties better off than the reliance remedy, then once a court determined that the promisor's keeping the promisee's card without trading one in return was a breach, there would be no dispute about the remedy and, therefore, no need for the court to get involved. Thus, the choice between expectation and reliance becomes at least pragmatically uninteresting. The choice becomes interesting only when either the promisee or the promisor would, for some reason, prefer the reliance

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25. Wonnell, *supra* note 1, at 60.

26. One could conceive of the restitution interest as the promisor's duplicate card on the theory that this card rather than the promisee's card is the "illegitimate gain" that the promisor is obligated to give up. Cf. RESTATEMENT (SECOND) OF CONTRACTS § 371 (1981). Under this conception, the restitution and expectation interests are the same in this example. The conception of restitution I discuss in the text comports with the idea that restitution involves a benefit conferred by the promisee on the promisor, *see id.* §§ 344(c), 370, and that it is a backward-looking, not forward-looking remedy. *See generally* Avery Katz, *Reflections on Fuller and Perdue's The Reliance Interest in Contract Damages: A Positive Economic Framework*, 21 J.L. REFORM 541 (1988) (defining restitution as putting the promisor in the *ex ante* position). The ambiguity of the restitution concept cuts in favor of the expectation remedy in this example.

27. Wonnell, *supra* note 1, at 61 ("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.").

remedy to the expectation remedy, so that forcing the expectation remedy on the parties makes one worse off (according to his own preferences). But if the promisee prefers the reliance remedy and seeks the return of his card—say out of spite or because he now wants to punish the promisor by trading with someone else (Wonnell's example does not make clear whether either party has alternative trading partners available)—I see no reason why the promisee should be forced to accept an expectation remedy. (Although Wonnell seems to suggest that the promisee not be allowed to opt for reliance, I doubt he really means it.) Thus, the only interesting case occurs when the *promisor* wants to resist the expectation remedy and thwart the original deal. Why might the promisor be motivated to do that?

To answer this question, we have to imagine why the promisor has acted the way she has in the first place. One possibility is that the promisor intended to keep the promisee's card from the beginning because the promisor thought that the promisee would be passive about enforcing her rights (as Wonnell suggests), or would not have sufficient resources to do so, or that the court would somehow make a mistake. If that is what the promisor was doing originally, then returning the promisee's card to the promisor, thus returning the promisor to her *ex ante* position, leaves her in precisely the same position to try her scam again with a new promisee who may be more passive about protecting his rights or more resource-constrained. Therefore, if there is a potential for such future gain to the promisor, the reliance remedy (which is the traditional restitution remedy as well) will not sufficiently deter the promisor's opportunistic behavior.

In contrast, the expectation remedy (or at least specific performance) makes future misbehavior by the promisor more costly by depriving the promisor of her duplicate card, which probably has much less value to her than it does to others. Granted, she might be better off in the short-run under the expectation remedy, but because she prefers the reliance remedy she must value the bargaining power that the duplicate card gives her for future scams more than the value of the card she originally contracted to get. The expectation remedy takes this bargaining advantage away, and thereby punishes the promisor. Thus, the reliance remedy in this situation would be socially bad—not so much because it could thwart an *ex post* efficient contract, but because of the undesirable incentive effects it would have on opportunistic promisors.

The other way to justify the expectation interest in Wonnell's first example is to tweak the example slightly to make the promisee's reliance interest less than restitution. Whenever reliance is less than restitution, reliance damages will not be sufficient to deter the promisor from opportunistic breach because the promisor will be able to keep



some gain from her wrongful conduct. Wonnell himself offers a variation of this sort in which he posits the baseball card trade as part of a larger contract in which the promisee has received some extra benefit from the promisor.<sup>28</sup> In this variation, the promisee's reliance interest would be zero—and so, less than restitution, defined as the benefit the promisee conferred on the promisor—until the promisee's losses started to exceed the received benefit. This example is somewhat forced, but the point is correct, and the example shows that once reliance is separated from restitution, reliance is no longer sufficient to deter opportunistic breach.

There are several other ways, however, to reach the same result that may seem less artificial. One would be to change the example from a barter transaction to a sale. If the promisee pays the promisor in advance for the card, but the promisor then uses the money for some other investment and refuses to give the card to the promisee, the promisor's benefit (the profit on the investment) could exceed the promisee's reliance. Thus, a reliance remedy would not be sufficient to deter the opportunistic breach. In contrast, the expectation remedy would impose a cost on the promisor for using the promisee's money and, therefore, more likely deter the opportunistic breach.<sup>29</sup>

Alternatively, if we change the example from a goods contract to a services contract, the underdeterrence problem with the reliance remedy resurfaces. Suppose the promisee performs services for which the promisor has not yet paid, and the promisor refuses to pay the contract price. Unlike the goods case, the loss to the promisee from performing may diverge from the value to the promisor of the performance; that is, the reliance interest again may be less than the restitution interest. If the promisor can breach and pay only reliance damages less than the contract price, the promisor would not be deterred from committing opportunistic breaches (at least by reliance damages alone), because the promisor would be able to get the services he originally contracted for at the contract price for a lower price. The point is that whenever the reliance remedy is less than the restitution interest, awarding reliance damages allows the promisor to breach and keep some illegitimate gain,

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28. *Id.* at 63.

29. Posner argues for a restitution remedy in such a case. See POSNER, *supra* note 7, at 130–31. In this case, restitution might exceed expectation and so provide a stronger deterrent to opportunistic breach. In my prior damages article, I discuss examples for which restitution might be a superior remedy to expectation. See Cohen, *supra* note 4, at 1274–78, 1290–1309.

thus insufficiently deterring opportunistic breach. The expectation remedy is superior because it deprives the promisor of this gain, and so deters opportunistic breach.

Case 2<sup>30</sup> differs from the first mainly in that the benefit the promisor seeks to expropriate is not reliance by the promisee that immediately benefits the promisor, but a renegotiated contract price, or in economic terms, a redivided contractual surplus.<sup>31</sup> After the promisee makes a relationship-specific investment, the promisor subsequently seeks to expropriate extra benefit by forcing the now vulnerable promisee to agree to a modification in the contract price, even though no circumstances other than the promisee's reliance investment have changed to justify the modification. Extortionary modifications of this kind are another classic type of opportunistic behavior, and as Wonnell recognizes, courts have responded with various doctrines that allow the promisee to escape such modifications even after fully performing. It seems straightforward to argue that in the course of relieving the promisee from the obligations imposed by the modification, courts would not, and should not, suggest that the promisee be limited to a reliance recovery on the original promise. To do so would allow the promisor to retain the benefit of the promisee's full performance at a more advantageous price than the contract price to which the parties originally agreed, simply because the promisor extorted a modification. That would encourage, not discourage, extortionary behavior by promisors.

Somewhat oddly, Wonnell takes a different tack, which (perhaps unnecessarily) complicates the problem but gets to the same place. He argues that the contract law doctrines for policing extortionary modifications are inadequate. As a result, the real problem is the promisor's *threat* to breach if the promisee does *not* agree to the modification, and the possibility that the promisor might carry out this threat to breach to make the threat credible, if the promisee resists the modification.<sup>32</sup> The threat to breach if the promisee does not agree to an extortionary modification would itself be an anticipatory repudiation of the contract,<sup>33</sup> entitling the promisee to an expectation remedy. But

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30. Wonnell, *supra* note 1, at 63–66.

31. Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981).

32. Wonnell, *supra* note 1, at 62–63.

33. See RESTATEMENT (SECOND) CONTRACTS § 250, cmt. d (1981).

But where a party wrongfully states that he will not perform at all unless the other party consents to a modification of his contract rights, the statement is a repudiation even though the concession that he seeks is a minor one, because the breach that he threatens in order to exact it is a complete refusal of performance.

Wonnell does not take this tack either, presumably because determining whether there has been a repudiation is fraught with the same difficulties as determining whether an agreed upon modification is enforceable. Instead, he focuses on a breach by the promisor after the promisee refuses the modification.

Again, however, Wonnell's example is somewhat contrived. It requires the extortionary promisor to pick a promisee victim who turns out not so vulnerable as the promisor first assumed, and so calls the promisor's bluff by suing him, rather than agreeing to the modification or acquiescing in the breach. Moreover, the promisor not only picks a victim poorly, but carries out the threat to breach even though the promisor loses (again in the short run) by this action. Wonnell posits that the promisor could gain in the long run by developing a reputation as an extortionist who carries out threats when resisted.<sup>34</sup> Of course, just why other promisees would agree to contract initially with a promisor having such a reputation is not clear, but Wonnell could have in mind existing contracts with other promisees. Assuming Wonnell's scenario is plausible, Wonnell's example poses the same problem as the first example. Namely, the reliance remedy might be sufficient to discourage the promisor from breaching because, not having received any benefit from the promisee, the promisor forced to pay reliance damages would be worse off than if he had performed once the promisee rebuffed the promisor's proposed modification. Wonnell resolves the difficulty by retreating to the moral argument that the promise should simply be kept.<sup>35</sup> But this argument is, once again, unsatisfying.

Just as under the first scenario, a better argument is that although the reliance remedy may leave the promisor without any benefit from the current contract, it may not be sufficient to deprive the promisor of his *potential* gain in *other* transactions; therefore, the reliance remedy is not sufficient to deter future opportunistic behavior. On the other hand, the expectation remedy makes future extortionary behavior much more costly to the promisor and so much less likely to occur. Suppose, for example, that the promisor has five identical contracts with five promisees, only one of whom the promisor expects to be vulnerable to an extortionary modification. In each contract, the promisee pays \$200

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*Id.* illus. 9.

34. Wonnell, *supra* note 1, at 63.

35. *Id.* ("In short, where the proper moral action is for the promise to be kept, the reliable moral response is vindication of the expectation interest.")

and makes a reliance investment of \$10 expecting to earn \$500 from the contract. Suppose, to follow Wonnell's example, that the promisor attempts to extort a modification of the contract price to, say, \$300 from the first promisee, but the first promisee refuses and the promisor breaches. If the promisor is liable only for reliance damages of \$10, even though the promisor appears to be worse off by \$10, the promisor could still come out ahead if one of the remaining four promisees agreed to the modification and the rest got reliance damages, since \$100 (the extortionary gain from the compliant promisee) is greater than \$40 (the total reliance damage payments to the resistant promisees). If, however, the promisor must pay expectation damages of \$500 to the first promisee (the most the promisor would be able to extort from any one promisee), the promisor will have much less of an incentive to play the extortion game. Even if the promisor could extract \$100 from each of the remaining four promisees, it would not be enough to compensate for the damage payment to the first promisee.

Wonnell's third example of opportunistic breach (Case 3) involves a promisor refusing to carry out an agreed-upon allocation of risk (the most common situation being an insurance contract).<sup>36</sup> The main difference between this example and the previous two is that the promisee's vulnerability is not caused by his own actions (giving a valuable good to the promisor in Case 1 or making a reliance investment in Case 2). Rather, some change in circumstances occurs that, absent the contract, would create a loss for the promisee, but that the promisor has agreed to bear under the contract. Again, Wonnell simply asserts that it would make no sense to protect the reliance interest in these cases.<sup>37</sup> He then spends most of his efforts rebutting two arguments made by reliance theorists in addressing risk allocation questions: first, that conceiving of reliance as foregone opportunity gives the same outcome as expectation; and, second, that risk allocation is not an important function of most contracts.<sup>38</sup> I agree with Wonnell's criticism of the latter point and find his discussion of the first point a theoretical distraction.

The interesting question to me is how this example compares on deterrence grounds to Wonnell's previous two examples. In contrast to the previous two examples, in Case 3 reliance damages are plainly inadequate to deter breach once the contract is made. If the insurer has agreed to pay the promisee's losses, but, upon breach, need pay back

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36. *Id.* at 63–66.

37. *Id.* at 63–64 (“The problem is . . . that the promise has been broken, and the restoration of the status quo ante seems a preposterous answer to the wrong.”).

38. *Id.* at 64–67.

only the promisee's premium, the insurer will breach every time. The real question is whether reliance damages would deter the insurer from making the contract in the first place, because the insurer, even though better off than if it had to perform under its obligation, gets no benefit from the contract with the insured if it has to return the premium. But once again, this argument ignores the fact that there are benefits to the promisor outside of this particular transaction that the reliance remedy does not include. In fact, the insurance example makes this point particularly clear. An insurance company typically contracts simultaneously with multiple insureds, a few of whom will incur losses during the policy period and most of whom will not. Insurance companies base premiums on the expected payout averaged over all insureds. If insurance companies could breach their obligations by simply returning the premiums to those insureds who incurred losses, the insurance companies would get a huge short-run windfall, because they would still get to keep the premiums from the vast number of insureds who have not suffered losses, while substituting the small return of premiums in place of huge payouts for the insureds who have suffered losses. This is a classic "Heads I win, tails you lose" situation, which would benefit insurance companies in the short run though it could lead to the collapse of the insurance market in the long run. Thus, the traditional reliance remedy (defined as return of the premiums rather than foregone opportunity) does not deter opportunistic breach by insurers. Indeed, the belief that even expectation damages do not deter opportunistic breach by insurers has given rise to awards of punitive damages for bad faith breach in insurance contracts.

Outside the insurance context, any contract with a risk allocation component (for example, a warranty) will generally involve a party who contracts with many other parties either simultaneously or sequentially and who expects that the risk will not occur in the majority of these contracts. In fact, it makes sense to define contracts with a risk allocation component as those for which these conditions exist. These include commodities contracts in a thick market for which the relevant risk is a change in the market price. In the absence of an expectation remedy, promisors in such markets would, in response to a disadvantageous price shift, simply breach their contracts, pay the small reliance damage remedy, and contract with someone else at the new price level. But the point of risk allocation contracts is to prevent such behavior, just as the point of insurance contracts is to protect insureds

against rare but catastrophic loss. The expectation remedy deters the opportunistic evasion of agreed upon contractual risks by depriving the promisor of illegitimate gain. The reliance remedy does not.

Wonnell's final example of opportunistic breach (Case 4) involves the promisor's expropriation of the promisee's private information.<sup>39</sup> In certain situations, we think that the promisee should be able to take advantage of information he has, but the promisor does not, to make an advantageous contract. The generally understood rationale for such contracts is that we want to encourage the promisee to invest in information, so we reward the promisee by allowing him to make beneficial deals with the less knowledgeable. As Wonnell recognizes and discusses, deciding when we have such situations is often difficult. But assuming that we have such a contract, then I agree that the expectation remedy is superior to the reliance remedy narrowly defined.

The problem for owners of information is that once they reveal it, they cannot take it back, at least without court intervention. Thus, absent the expectation remedy, an opportunistic promisor would have an incentive to make a contract with a promisee who has superior information, discover that information, then breach and use the information himself in a subsequent contract. To use Wonnell's example, suppose the promisee knows that a piece of the promisor's property is likely to contain oil, but the promisor does not; as a result, the promisee contracts to buy the promisor's property for a cheap price.<sup>40</sup> If the promisee then discovers oil and the promisor breaches, the promisor may not simply pay the promisee the promisee's reliance expenditures. The problem with the reliance remedy is that, once again, it bears no relation to the ill-gotten gain the promisor has taken from the contract (unless reliance is defined broadly as the value of the information the promisee discloses to the promisor after contracting). In this case, the gain comes from the information. The reliance remedy allows the promisor to acquire valuable information from the promisee at a below-market price—namely, reliance damages. We do not want promisors using contracts as a vehicle to free-ride off of the promisee's valuable investments in information because that will discourage such investments. The expectation remedy measures the value of the promisee's information to the promisee. If, faced with the prospect of paying expectation damages, the promisor originally contracted to sell his property rather than buy information about it, the promisor would be much less likely to want to pay the promisee her full value for the information than he would be to perform his contractual obligations. Thus, once again, the expectation

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39. *Id.* at 66–71.

40. *Id.* at 68.

remedy deters promisor opportunism, whereas the reliance remedy does not.

To sum up the lesson for promisor incentives from Wonnell's opportunistic breach examples, the reliance remedy inadequately deters opportunistic breach because the gain to the promisor from opportunistic behavior exceeds the promisee's reliance interest. The expectation remedy, because of its forward-looking aspect, is much more likely to deprive the opportunistic promisor of this gain. Additionally, there is an important connection in these examples between economic analysis and moral intuition to the extent that morality judges behavior good or bad depending on the likely consequences of universal adoption of that behavior. Similarly, from an economic perspective, it is when one thinks about the effects of the breach beyond the particular transaction at issue that the inadequacy of the reliance remedy to deter opportunistic breach becomes most evident.<sup>41</sup>

## 2. *Opportunistic Breaches and Promisee Incentives*

The desire to deter opportunistic breach and the resulting focus on promisor incentives leads, in my view, to a sufficient justification of expectation damages in cases of opportunistic breach. Thus, one could argue that promisee incentives in cases of opportunistic breach may simply be ignored. I believe, however, that it is important to see that concern with promisee incentives provides a complementary argument in favor of expectation damages for opportunistic breach—if only to provide a useful comparison to the nonopportunistic breach cases, for which Wonnell recognizes the importance of promisee incentives.<sup>42</sup>

If the breach is opportunistic, and so the promisor should have performed, limiting the promisee to reliance damages encourages the promisee to adopt wasteful mitigation and precautionary measures, including reducing reliance (such as in Case 2), not contracting, or contracting at a discounted price. Promisee precautions in these cases are wasteful in the sense that if the breach is opportunistic, the cheaper "precaution" or "mitigation" would be for the promisor to perform the contract than for the promisee to take protective action.<sup>43</sup> Of course,

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41. Wonnell finds the connection between economics and morality in Hayek's social evolution theory, under which surviving social institutions (such as morality) tend to be those that facilitate economic success. *Id.* at 80–81.

42. *Id.* at 83, 85–88, 89–90.

43. Cohen, *supra* note 4, at 1252–53.

even under an expectation regime, some doctrines are designed to reduce full expectation damages because of promisee incentive concerns. Moreover, promisees do not rely solely on expectation remedies to protect them against promisor opportunism. They engage in a variety of self-help measures, from progress payments, to deposits, to security, to vertical integration. My point is simply that promisee protective measures would increase under a reliance damage regime and that total costs would likely be higher than under an expectation regime with fewer promisee precautions.

Because there is no significant difference in terms of promisee incentive effects among Wonnell's opportunistic breach cases, I will offer only two quick examples. First, to take the easiest case of the four, Case 3, it is hard to believe anyone would buy an insurance policy knowing that the only remedy for the insurer's failure to pay would be the return of the premium. Second, in Wonnell's extortion threat case (Case 2), awarding only reliance damages when the promisee rebuffs the promisor's extortionary modification proposal would just make promisees more likely to agree to such extortionary modifications in the first place. For example, if after contracting, the promisee has made a \$10 reliance expenditure that is useless outside the contract, and would earn \$50 from the contract that the promisee could not earn elsewhere, the promisee would be willing to spend up to \$50 to get the promisor to perform. If the promisee could get only reliance damages of \$10 by resisting the modification, the promisee might be inclined to agree to the modification to protect his reliance investment. If the doctrines for policing extortionary modifications are as ineffective as Wonnell maintains (a point of which I am not convinced), the promisee would then be stuck with the modified contract. If the promisor contracts with many promisees, chances are that some would agree to the modification and the promisor's opportunistic conduct would not be deterred. On the other hand, if the promisee has the club of expectation damages with which to beat back the opportunistic threat and subsequent breach, the promisor's opportunistic behavior would be deterred. Expectation damages protect the promisee against the full potential extortion amount.

### *3. Opportunistic Breaches and Imperfect Enforcement*

Imperfect enforcement, including court error and transaction costs, probably motivates many contract breaches, and the risk of such imperfections can often tip the scales in favor of one contract damage remedy or another. In his article, Wonnell does not purport to rely on imperfect enforcement to justify the expectation remedy for opportunistic breach. Nevertheless, some of his explanations at least



implicitly rely on imperfect enforcement and, sometimes, imperfect enforcement can be a useful complement to his explanations. More important, imperfect enforcement becomes crucial to Wonnell's discussion of nonopportunistic breaches. Thus, as with promisee incentives, I think it is worth flagging the issue in the opportunistic breach discussion as a basis of comparison. The problem in many discussions of contract damage remedies is that only selective imperfections are discussed, and it is hard to tell why other imperfections are omitted. Because I find some of that bias in Wonnell's article (as I am sure it exists in my own work), I think it is important to try to be as careful and complete as possible in using these rationales.

One type of imperfection is the difficulty in telling whether a breach is opportunistic. Wonnell discusses this problem in the example involving information, in which he focuses on the difficulty of drawing the line between fraudulent concealment and protection of one's investment in information. But, of course, similar difficulties exist with the first three examples as well. In the baseball trading card example, the promisor might claim that the promisee breached by providing a card of the wrong quality (for example, a different year than the promisor wanted). In the extortion case, the promisor could claim that some change in circumstances justified the modification. In the risk allocation case, the promisor could claim that a particular risk was not allocated, or was beyond the accepted risk allocation range. The point is simply that in many contract cases, the bulk of the dispute is deciding in which category certain behavior belongs rather than deciding what consequences should follow from some behavior once everyone agrees on what the behavior is.

A second type of imperfection involves a problem in contract doctrine other than damages doctrine. Wonnell relies on this type of imperfection in his discussion of Case 2 when he asserts that the contract rules for policing extortionary modifications are ineffective.<sup>44</sup> But is this doctrine really less predictable than the doctrines of contract formation, interpretation, and excuse? Even if it is, the question remains why contract damage rules should be formulated taking these doctrinal imperfections as a given rather than trying to improve the errant doctrines directly. In fact, the whole area of how rules of liability and

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44. Wonnell, *supra* note 1, at 62–63.

damage rules should relate to each other is one that deserves fuller treatment.

A third type of imperfection, one that Wonnell fails to discuss, involves the costs of bringing suit. When the reliance interest is smaller than expectation (as it is in Wonnell's first four examples), there is always a risk that reliance damages will drop the plaintiff below the threshold level needed to make a lawsuit profitable. Thus, even if the reliance remedy could theoretically deter opportunistic breaches, as a practical matter the deterrent effect would be lessened once the costs of suit are taken into account.

### B. *Nonopportunistic Breaches*

Wonnell's first four examples demonstrate that there is a strong theoretical justification for the expectation remedy in cases of opportunistic breach—even stronger than Wonnell recognizes. I have tried to flesh out the theory in terms of deterrence rather than simply moral intuition, but I think Wonnell would probably find most of that theory supportive of his position. Wonnell's last two examples demonstrate the theoretical justification for the reliance remedy in cases of nonopportunistic breach. In these examples, the promisor breaches not to expropriate some illegitimate gain, but rather to avoid a loss that would result if the promise were performed. As I argued in my damages article, once the potential for promisor opportunism is gone, the contract problem becomes more like a tort problem of how to deal with accidental loss.<sup>45</sup> But to many economists there is not much difference between appropriating a gain and avoiding a loss. Thus, the theoretical question is what makes the losses "accidental" in these cases.

Wonnell's answer, with which I agree, is that the loss is the "unanticipated" result of a contractual "mistake," so full performance of the contract no longer makes sense.<sup>46</sup> If full performance of the contract no longer makes sense, then the expectation remedy, which is explicitly designed to encourage performance, seems ill-suited for the situation. The expectation remedy will over-deter promisors, in the sense that they will take too many precautions to avoid mistakes. Reliance damages, by contrast, will lead to optimal promisor precautions against mistaken contracts.<sup>47</sup>

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45. Cohen, *supra* note 4, at 1245–46, 1258.

46. Wonnell, *supra* note 1, at 72.

47. Again in discussing the nonopportunistic breach cases, Wonnell casts his argument in moral terms rather than in deterrence terms. *Id.* at 74–75 (reliance damages in Case 5 would be more "fair" and "just"), 77 (reliance remedy in Case 6 "removes the harm that is caused by the mistaken choice"). Wonnell discusses the deterrence

As Wonnell fully recognizes, however, the problem is how we decide which losses are "unanticipated" and which contracts are "mistakes." One standard we could use to make the judgment is the joint profitability standard (otherwise known as cost-benefit analysis or the Kaldor-Hicks efficiency criterion).<sup>48</sup> Under this standard, if, after the contract is entered into, a contingency arises, or information surfaces, that makes the costs of performance to the promisor exceed the benefits of performance to the promisee (that is, the contract becomes jointly unprofitable), the court should view the contingency or information as unanticipated and the contract as a mistake. On the other hand, if the contract remains jointly profitable despite the change in circumstances or information, courts should not treat the contract as a mistake.

But joint profitability is neither a sufficient nor necessary criterion for distinguishing nonmistaken from mistaken contracts. Joint profitability is not sufficient, because, among other reasons, it fails to differentiate "unanticipated" losses (as in Wonnell's Case 5) from "agreed upon risk allocations" (as in Wonnell's Case 3). For instance, the fact that an insured event comes to pass may, in some sense, make the insurer's contract with the insured who suffers a loss "jointly unprofitable," but no one would argue, by that fact alone, that courts should view the contract as "mistaken" or the loss "unanticipated." Put more broadly, opportunistic behavior can still occur in contracts that have become jointly unprofitable.<sup>49</sup> Not only is joint profitability an insufficient condition for distinguishing nonmistaken from mistaken contracts, but Wonnell makes an original contribution by pointing out that it is not a necessary condition either. Wonnell's Case 5 (a case involving a mutual mistake about the value of a fake diamond)<sup>50</sup> is in a sense "jointly profitable" because the promisor's losses from having to perform are completely offset by redistributive gains to the promisee. Yet Wonnell's characterization of the case as a mistaken contract is sensible.

If joint profitability will not work, at least as a complete standard, then how else are we to determine whether a contract is a mistake or a loss is unanticipated? The easy answer is, of course, that by definition the parties have "consented" to risk allocations but not to unanticipated

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justification for reliance in the next section of the paper. *Id.* at 86.

48. Wonnell discusses this criterion in connection with Case 4, *id.* at 68, and Case 6, *id.* at 76.

49. Cohen, *supra* note 4, at 1241-42.

50. Wonnell, *supra* note 1, at 72-74.

losses. But again, that simply raises the question of how we know what risks the parties have consented to undertake.<sup>51</sup> This question, of course, is perhaps the most important and most vexing in contract law. In some cases, the parties' intentions will be relatively certain, but in many cases they will not. In the uncertain cases, Wonnell's discussion of opportunistic breaches may help shed some light on the issue.

### 1. *Nonopportunistic Breaches and Promisor Incentives*

In Wonnell's first three examples, the opportunism problem arises from the fact that the promisor, if faced with the reliance remedy rather than the expectation remedy, could turn an apparent loss into a gain by contracting with other promisees on the original contract terms. The baseball card trader could try to find another, more passive, promisee; the situational monopolist could try to extort modifications from other promisees; and the insurer could collect premiums from other promisees who did not incur losses covered by the policy. In Wonnell's last two examples, by contrast, the promisor is not in a position to go to other promisees with the same deal to recoup its losses on the first deal and make an extra profit on top of that. Therefore, the expectation remedy is not needed to deter the promisor from opportunistically breaching, and in fact would over-deter promisors by leading them to take excessive precautions against mistaken contracts.

In Case 5, both the promisor and the promisee are (by assumption) mistaken about the value of the item the promisor sold, which turns out to be much *less* valuable (the fake diamond, the less than super computer) for *both* parties than either one anticipated. Once the promisor discovers the information, any deal he makes with subsequent promisees will be on less favorable terms to the promisor than the original deal. There is no potential for future gain to the promisor arising out of his contractual behavior, and so no justification for presuming opportunistic breach or awarding expectation damages. Contrast this case with the similar Case 4, in which the promisor sells an asset that turns out to be *more* valuable than the promisor anticipated.<sup>52</sup> This extra value is what gives rise to the possibility of opportunistic behavior by the promisor seeking to escape contractual liability to make

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51. *Id.* at 75 ("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.").

52. The famous mistake case, *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887), presents exactly this situation. The majority treats the case as a Case 5 mistake, in which neither the buyer nor the seller thought the cow was pregnant; the dissent views the case as a Case 4 information appropriation problem, in which the buyer deliberately used his private expertise to make a good deal for the cow he suspected might be pregnant.

use of the new information in future deals. Of course, it is possible that in Case 5 the promisor could achieve illegitimate gains by either behaving fraudulently in the original contract or in any subsequent contract; that is, the promisor might have known the value of what he was selling from the start and misrepresented that value to the promisee. If the promisee can prove that the promisor engaged in this type of opportunistic behavior, there is no justification for limiting the promisee's damages to reliance, or even to expectation.<sup>53</sup> But unlike the first four cases, opportunistic behavior in Case 5 cannot reasonably be presumed simply from the fact of breach by the promisor. The claim of mistake is as facially plausible as the claim of fraud.

Case 6,<sup>54</sup> the efficient breach situation, involves a service contractor whose costs unexpectedly rise above the buyer's valuation. Although this situation closely resembles the risk allocation scenario of Case 3, again the key difference is that there is no reason to presume that the promisor by breaching is able to expropriate some illegitimate gain in other contracts. Unlike the classic market contract, in this case the promisor is not breaching to sell his services to another buyer at a market price more advantageous than the original contract price.<sup>55</sup> And unlike the classic insurance contract, in this case the promisor bears some risk of loss associated with the higher cost contingency, whether or not he performs the contract. Thus, the promisor has no obvious way to breach opportunistically to achieve an illegitimate gain in another contract. It is possible that the contract nevertheless could be interpreted as having a risk allocation component. The promisee may be buying insurance not to protect against loss, but to lock in gain.<sup>56</sup> Alternatively,

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53. Wonnell, *supra* note 1, at 86–87.

54. *Id.* at 75.

55. If the contract is for goods, however, the seller's costs might increase at the same time the market price increases. *Cf. id.* at 76 n.69 (identifying problem of "mixed motive" cases), 82 (discussing the problematic application of efficient breach theory to the case of a second buyer who values the goods more than the first buyer). Thus, the possibility of opportunistic breach still exists. *See* Cohen, *supra* note 4, at 1323–28 (discussing effect on market damages rule when more than one variable changes).

56. One might argue that one of the features that makes *Peevyhouse v. Garland Coal & Mining Co.*, 382 P.2d 109 (Okla. 1962), such a controversial case is that it is possible to view the Peevyhouses' claim that they were buying insurance against the disfigurement losses caused by the contractor's digging as more plausible than a claim that they were buying insurance against lost profits from the failure to get coal royalties. Another feature of the case is the possibility that the coal company acted opportunistically by delaying in notifying the homeowners of its intention not to perform. *See* Cohen, *supra* note 4, at 1269–70.

a contractor may have a portfolio of contracts, some of whose costs turn out lower than expected and some of whose costs turn out higher than expected. Under such circumstances, buyers might agree to a fixed price on the understanding that they would get full performance if the contractor's costs unexpectedly rise and no price discount should the contractor's costs unexpectedly fall. Because there is no obvious opportunistic expropriation of gain by the promisor, however, these kinds of risk allocation contracts should not be easily presumed; rather, the promisee should bear the burden of proving that the parties intended to allocate risk this way. Otherwise, courts should view the breach as nonopportunistic and the reliance remedy as superior to expectation for creating optimal promisor incentives.

## 2. *Nonopportunistic Breaches and Promisee Incentives*

An alternative, complementary, criterion for distinguishing non-opportunistic breaches from opportunistic breaches is to focus on promisee incentives. Under this criterion, in ambiguous cases courts should be more willing to view losses as unanticipated and contracts as mistakes—and, therefore, more willing to use reliance damages rather than expectation—if doing so creates better incentives for promisees. One application of this approach would be for courts to deny expectation damages if they suspect that the *promisee* is behaving opportunistically, that is, the promisee is the most likely opportunist. For example, in the Case 6 scenario the promisee might, as Wonnell suggests, exaggerate the value of the contract to him for the purpose of extorting a larger payment from the promisor to escape the contract.<sup>57</sup> Alternatively, in Case 5 the promisee might deliberately seek to make contracts with vulnerable or ignorant promisors.<sup>58</sup> As Wonnell recognizes, however, it may be difficult to distinguish the opportunistic promisee from the promisee legitimately exploiting an information advantage, as in Case 4.<sup>59</sup> Where promisee opportunism is a potentially serious problem, courts ought to be skeptical of claims of full insurance by the promisee, because a rational promisor would worry about promisee moral hazard in deciding whether to provide such insurance.

But relevant promisee incentives do not include only promisee

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57. Wonnell, *supra* note 1, at 83. The classic case is *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921). For a discussion of how the court's analysis can be viewed as identifying proxies for promisee opportunism, see Cohen, *supra* note 23, at 990–1000.

58. Wonnell, *supra* note 1, at 88 (“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.”).

59. *Id.* at 86–87.

opportunism. They also include incentives to take precautions (such as restraining reliance), and to mitigate losses. Wonnell only briefly mentions these incentives,<sup>60</sup> perhaps because they do not seem particularly relevant to Case 5 and Case 6. In my view, however, promisee incentives of this sort are a crucial component of contract damage rules. Doctrines such as mitigation, foreseeability, and certainty all serve to improve promisee incentives to take precautions and mitigate losses. Reliance damages have the same effect. In fact, the application of the so-called limitations on the expectation remedy often leave the promisee with reliance damages or something very close to it.<sup>61</sup> Moreover, the kinds of cases in which these doctrines usually arise (such as negligent delay in delivery or negligent performance that cannot be replaced or undone) often seem to fit the description of nonopportunistic breach. Although they are not "mistake" cases, they are in some sense "impossibility" cases (full performance is no longer possible), and do involve "unanticipated" loss. Wonnell should probably have added a seventh category for these cases.

### 3. *Nonopportunistic Breaches and Imperfect Enforcement*

In discussing the efficient breach case (Case 6), Wonnell makes an important argument that although reliance damages may be theoretically preferable to expectation, once we take into account imperfect enforcement, this advantage may disappear. Wonnell's point, a standard one in the economic literature on efficient breach, is that because courts often do not know whether nonperformance is truly efficient or not, the expectation damage measure can serve as a "pricing mechanism" to sort out efficient nonperformance from inefficient breach.<sup>62</sup> If the court and the promisor can measure the promisee's expectation interest accurately, the promisor will breach and pay expectation damages only when the value to the promisor from breaching exceeds the cost to the promisee. This point plays an important role in Wonnell's "theoretical reconciliation of expectation and reliance" and his subsequent development of principles of contract remedies, and also serves as his

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60. *Id.* at 89.

61. *Compare id.* at 75 (arguing that reliance damages, if "measured correctly," include incidental expenses and, more contentiously, consequential damages), *with id.* at 89 n.105 (stating that the various doctrines limiting the expectation recovery "may result in damages that are between reliance and expectation").

62. *Id.* at 78.

principal ground for criticizing my fault-based theory of contract damages.<sup>63</sup>

I have no problem with the pricing mechanism theory as a justification for the expectation damage measure in certain cases. I believe, however, that the pricing mechanism theory has to be considered as one of a number of ways that imperfect court enforcement might affect the choice between expectation and reliance, and that its benefits must be balanced against the potential incentive costs, such as the effect of over-compensatory remedies on promisee incentives. Thus, the theory is not a sufficient justification for expectation damages in all “efficient breach” cases.

The first response to the pricing mechanism theory (also well recognized in the economic literature) is that it assumes that it is easier for courts and promisors to measure the promisee’s expectation interest accurately than it is for them to determine whether a particular breach is efficient. But one can certainly imagine cases in which the promisor’s costs of performance have increased so dramatically that we are confident that they exceed any reasonable measure of the promisee’s expectation, even though the precise expectation is hard to determine.<sup>64</sup> Granted, one could still argue that the expectation measure is justified because the expectation measure saves on information costs by requiring only one piece of information (the promisee’s expectation) rather than two (the promisee’s expectation and the promisor’s costs). In fact, however, all the court and the parties must know to apply a fault standard is that the promisor’s costs are likely to be bigger than the promisee’s expectation. The court and the parties need not accurately measure either variable.

A second response to the pricing mechanism theory is that the posited information cost savings will often be illusory. As long as contract law has excuse doctrines—such as mistake, impossibility, and frustration—then whenever the promisor sees fit to raise these defenses, the court will have to consider the promisor’s costs as well as the promisee’s expectation to decide whether or not to apply these doctrines.<sup>65</sup> Moreover, information about the promisor’s costs may be relevant not

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63. *Id.* at 88–90, 106–09.

64. See RESTATEMENT (SECOND) OF CONTRACTS § 348(2)(b) (1981) (rejecting the cost of completion remedy “if that cost is . . . clearly disproportionate to the probable loss in value” to the promisee); *cf. id.* § 351(3) (allowing exclusion of lost profit recovery to avoid “disproportionate compensation”).

65. *Cf.* Michelle J. White, *Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory*, 17 J. LEGAL STUD. 353, 357–58 (1988) (advocating that courts should abandon any attempts to determine whether or not breach has occurred or whether performance should be excused, and instead should simply apply expectation damages in all cases of nonperformance if both parties are risk neutral).



only to excuse doctrines, but also to formation doctrines (such as promissory estoppel), performance doctrines (such as good faith), and other damage doctrines (such as mitigation and foreseeability), which may require balancing the promisee's costs of mitigation and precaution against the promisor's costs. Contract law also includes many doctrines with a reasonableness component, which may require all sorts of information beyond the promisee's expectation. If one of these doctrines is potentially applicable in a particular case, contract law does very little to cut off information relevant to distinguishing among breach types when parties think it is worth the effort to produce such information. The doctrines that exist in contract law for cutting off information (such as the parol evidence rule and the objective theory of contract) are directed not at saving information costs per se, but at reducing biased information and opportunistic skewing of such information.

A related response to the pricing mechanism theory is that the greater the concern with promisee incentives, the less value expectation has as a pricing device. Wonnell argues that we can take care of the promisee incentive problem by judicial balancing, and then use the pricing mechanism to set correctly the promisor's incentives to breach.<sup>66</sup> But once we acknowledge that judicial balancing is necessary, much of the benefit of the pricing mechanism disappears. The main benefit of the pricing mechanism is to ensure that promisors do not breach when it would be inefficient for them to do so. However, if promisee incentives are such a big concern that courts find it desirable to limit the promisee's expectation recovery through doctrines like mitigation or foreseeability, the promisee's damages are reduced from "full" expectation and moved in the direction of reliance (perhaps all the way to reliance or even to less than a full reliance recovery). Once we accept those limitations, the argument that an explicit "reliance" remedy in similar cases would encourage inefficient breach seems overstated.

Another way to view this point is to recognize that in applying the contract doctrines limiting expectation, courts already have implicitly concluded that the promisee is the most likely opportunist, the least cost avoider, or the better mitigator, and that concerns about promisor opportunism are less significant. In fact, if promisee incentives are the main concern in a particular dispute, one could argue that the "pricing

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66. Wonnell, *supra* note 1, at 88–89.

mechanism” theory favors *reliance* damages, because reliance damages will be more likely than expectation to provide the optimal incentives for the promisee.<sup>67</sup> Suppose, for example, that the court is uncertain about the extent to which it should reduce expectation damages to create optimal promisee incentives, but the court is nonetheless certain that it should reduce damages to some degree. Awarding reliance damages is a good information-saving compromise to encourage promisee precaution-taking or mitigation, whereas awarding expectation damages would be more likely to provide insufficient incentives for promisees.

Additionally, it is important to remember that imperfect enforcement is not limited to the efficient breach scenario. In particular, courts may find it difficult to determine whether they have a nonopportunistic breach like Wonnell’s Case 5 (the fake diamond example) or an opportunistic breach.<sup>68</sup> Indeed, some famous mutual mistake cases pose precisely those difficulties.<sup>69</sup> Yet Wonnell does not advocate using expectation damages to avoid making difficult determinations of mistake and unanticipated loss. One reason that might explain and justify

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67. The standard economic analysis of contract remedies holds that reliance damages will not provide the optimal incentives for the promisee, because if reliance damages fully insure the promisee’s reliance investments, the promisee will overinvest in the contract and not take into account the potential nonperformance of the contract. Of course, expectation damages do no better on this score. One answer to this objection is that doctrines such as mitigation and foreseeability can be used to limit reliance recoveries as well as expectation recoveries. *Compare id.* at 88 (foreseeability and mitigation doctrines solve promisee incentive problem), *with id.* at 93 n.120 (expressing skepticism about idea of “efficient reliance” outside of mitigation). It is true that to the extent that restricting the promisee’s recovery to less than his full reliance expenditures is necessary, the “pricing mechanism” justification for reliance is weaker. But so is the pricing mechanism justification for expectation in this example, since expectation, properly limited, is already less than reliance.

68. Wonnell criticizes my damages article for insufficiently appreciating the Case 5 problem and for being too willing to award expectation damages in that case. *Id.* at 108–09. Wonnell is correct that I did not focus on the Case 5 situation, and his point that mistaken contracts can be redistributive is a good one. However, the Case 5 situation seems to fit my category of contracts that should not have been made, for which I did advocate reliance damages. Moreover, Wonnell’s greater willingness to award reliance damages in Case 5 than in Case 6 depends largely on his greater confidence in courts’ ability to identify Case 5 situations than Case 6 situations.

69. *See* *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887), discussed *supra* n.52. *See also* *Aluminum Co. of Am. v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980) (excusing Alcoa from long-term aluminum supply contract on ground that both parties mistakenly thought price index term would sufficiently protect Alcoa, with Alan Greenspan playing the part of Dumb). *Alcoa* could easily be viewed as a Case 3 risk allocation situation, in which Alcoa had a portfolio of contracts, some of which were winners and some of which were losers. *See* Victor P. Goldberg, *Price Adjustments in Long-Term Contracts*, 1985 WIS. L. REV. 527. One response to that argument is to focus on the behavior of Essex, which resold much of the aluminum at a large profit rather than using it internally as the contract contemplated, thus belying an “insurance” justification for full performance by Alcoa.

Wonnell's confidence that courts can identify Case 5 situations (as well as Cases 1 through 4) is that courts use a variety of devices for reducing uncertainty—from looking for the least cost avoider or better mitigator or most likely opportunist, to focusing on the particular context of the deal, to examining hypothetical intent based on assumed rational behavior. But all of these techniques are available to analyze the efficient breach scenario of Case 6 as well.

I do not mean to suggest that I am unsympathetic either to Wonnell's legitimate concerns regarding imperfect enforcement, or to the potential benefits of expectation as a pricing mechanism. I would address this problem somewhat differently, however. I would argue that it makes sense to presume that a contract breach is opportunistic unless the promisor can meet the burden of showing that the breach is nonopportunistic. In my view, this presumption is reasonable, not because of the desirability of the pricing mechanism,<sup>70</sup> but rather because, given the availability of expectation damages for opportunistic breach, most *litigated* breaches will likely be opportunistic even though most breaches will likely be efficient. In practical terms, this approach does not differ significantly from Wonnell's. Our main difference may come down to little more than a dispute over how high the promisor's burden should be for overcoming the presumption.

### III. WONNELL'S TWO PRINCIPLES

I need not dwell too long on Wonnell's two principles.<sup>71</sup> For the most

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70. Wonnell, *supra* note 1, at 78, 89, 91, 108. Wonnell also argues that expectation is the preferable general rule because four out of his six cases involve opportunistic breach for which expectation is preferable. This seems to me meaningless bean counting but it is not clear how much weight Wonnell really intends to put on this justification.

71. *Id.* at 90. Wonnell's two principles are:

*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:

part, these principles seem reasonable to me—though, as usual, the devil is in the details. I have already made most of the criticisms I have of the principles in discussing the earlier sections of Wonnell’s article; thus, in this section I will briefly focus on aspects of Wonnell’s principles that I have not previously addressed.

The most important aspect of the principles for me is that they both acknowledge an explicit, independent role for both expectation and reliance remedies, and explain that the choice between the two remedies requires some court analysis of relative fault and the reason the breach occurred. As I stated in the introduction to this Article, this idea is the most controversial part of Wonnell’s article and, in some sense, he spends the rest of the section trying to keep a lid on the fullest possible implications of his proposal. Thus, Wonnell makes a strong pitch for expectation as the dominant remedy;<sup>72</sup> advocates abolishing or severely restricting the penalty clause doctrine;<sup>73</sup> and throws up three hurdles to a reliance recovery (all of which the promisee must surmount).<sup>74</sup> In my view, these restrictions are something of a smokescreen to mask what some might otherwise consider a radical proposal. I do not think the proposal is radical; in fact, I think it is quite reasonable and broadly descriptive of what courts actually do. Thus, my overall criticism is that Wonnell should embrace the implications of his principles rather than try to run from them. Let me turn to a few specifics.

First, Wonnell puts in a plug for strong enforcement of liquidated damage clauses. He argues with great flair that there is no reason “why all substantive terms of the contract should be treated with great judicial deference while all remedial terms are subject to strict scrutiny.”<sup>75</sup> This Article is not the place for a full discussion of liquidated damage clauses, but several points deserve mention. The idea that courts strictly scrutinize liquidated damage clauses, but not other terms, is literally true but somewhat misleading. The reason is that often courts’ “strict

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(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.

*Id.*

72. *Id.* at 91.

73. *Id.* at 92.

74. *Id.* at 92–98.

75. *Id.* at 92.

scrutiny” of other contract terms shows up in adjustments to court-imposed damages, rather than as an explicit expulsion or revision of the terms themselves.<sup>76</sup> To the extent courts typically use damage rules to make fault-based adjustments, liquidated damage clauses can interfere with those adjustments. That fact does not mean that courts should throw out all such clauses. It does explain, however, why courts scrutinize them closely: they are seeking to preserve the discretion to police the contract for conduct such as promisee opportunism. If courts adopted the rule of strict enforcement of all liquidated damage clauses, my guess is that they would wind up relaxing the rules of formation, performance, and excuse to do the policing. Moreover, in my view, court policing of contractual opportunism is generally consistent with the parties’ intentions, and courts should not interpret the mere drafting of a liquidated damage clause as a complete rejection of court policing—though I admit that this is a controversial view and requires a fuller justification than I can give here. Suffice it to say that if courts abandoned the penalty clause rule, I would be very surprised to see many parties respond by writing contracts that contain a liquidated damage rule providing for full expectation damages in all cases.

Second, Wonnell’s principles include a requirement 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.”<sup>77</sup> Wonnell’s defense of this requirement is interesting. His intention is to distinguish the opportunistic breach cases from the nonopportunistic breach cases, and I am in agreement with his goal. But why is the “extreme and unreasonable” language necessary? Is it that the kind of cases justifying reliance damages are extremely rare?<sup>78</sup> Or that courts are too likely to err in favor of reliance damages

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76. For example, one way to interpret the famous *Jacob & Youngs* case is that the court agreed that “Reading pipe” meant “Reading pipe” and not “Reading pipe or its equivalent.” But the court limited the damages for breaching the promise to use Reading pipe to zero. *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921).

77. Wonnell, *supra* note 1, at 90.

78. *Id.* at 108 (“In the normal run of cases, expectation damages would be applied in order to obtain the informational benefits they provide in Motive 6 cases.” (emphasis added)); *id.* at 112 (“Principle 2 seeks to retain the pricing benefit of expectation damages for the run of ordinary cases.” (emphasis added)); *cf. id.* at 109 (noting 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” (emphasis added)).

rather than expectation?<sup>79</sup> If so, why not apply the same “extreme” requirement to other contract law doctrines that have the effect of limiting recoveries, such as foreseeability, mitigation, certainty, and diminution in value? Wonnell cites to the much maligned unconscionability doctrine and the problem of courts interfering excessively in freely entered contracts.<sup>80</sup> Court interference may indeed be excessive, but the point is that Wonnell’s own scheme requires courts to distinguish among breaches and assess fault. It could not be otherwise; that is what courts do.

This point becomes clear once one considers Wonnell’s principle requiring the court to determine that the promisor has not behaved unreasonably. Wonnell candidly admits that this requirement is the most troubling for his attempts to cabin fault.<sup>81</sup> Under this principle, courts must make a judgment that the promisor has not acted opportunistically before the promisor can succeed in limiting the promisee to reliance damages. But even under Wonnell’s statement of the expectation interest, courts must make similar judgments regarding promisee conduct (such as whether the promisee was reasonable in not mitigating). Clearly, fault judgments in contract damages are both difficult to do, and difficult to escape doing.

#### IV. CONCLUSION

I have tried to stress two main points in this Article. First, Wonnell’s argument for the expectation remedy in cases of opportunistic breach is stronger than he recognizes. The reliance remedy is not sufficient to deter opportunistic breach, once one considers the potential gains to the promisor from the opportunistic behavior beyond the immediate contract. Second, Wonnell’s argument for the reliance remedy in cases of nonopportunistic breach is also stronger than he recognizes. The pricing advantage of the expectation remedy is weaker than Wonnell imagines, for several reasons. First, many contract doctrines require courts to evaluate the very information they supposedly do not need to apply the expectation remedy. Second, doctrinal limitations on the expectation remedy move the expectation and reliance remedies closer together and so reduce the risk that a reliance remedy will result in an inefficient breach. Third, courts may find it more important to use the pricing mechanism to control promisee incentives rather than promisor

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79. *Id.* at 108 (“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.”).

80. *Id.* at 94.

81. *Id.* at 95–97, 108.

incentives. Thus, Wonnell’s analysis provides a stronger theoretical justification than he acknowledges for a fault-based damage regime, in which the optimal damage measure depends on a court evaluation of the reason the breach occurred—in other words, the regime we now have but somehow refuse to see. In my view, the camel’s nose of fault is already under the tent, and we might as well learn to live with it. This is not to say that Wonnell’s concerns about the difficulties of administering such a system are unfounded. Rather, these concerns suggest that our theoretical energies should now be directed away from the abstract superiority of expectation or reliance in general, and toward the development of better presumptions of opportunistic and non-opportunistic breach.<sup>82</sup> I welcome Wonnell’s contribution to this enterprise, and I hope that his efforts help move us toward a more moral and efficient contract damage regime.

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82. Wonnell makes a similar suggestion in his conclusion. *Id.* at 133–35.

