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Gregory Klass

Georgetown University Law Center, gmk9@law.georgetown.edu

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RESPONSES

TO PERFORM OR PAY DAMAGES

*Gregory Klass**

IN *The Myth of Efficient Breach*, Daniel Markovits and Alan Schwartz deploy an original mix of instrumentalist, interpretive, and moral arguments.¹ The instrumentalist arguments start from the premise that parties use contract law as a tool to maximize their individual gains from exchange, and then ask how it should be designed to best serve that purpose. Markovits and Schwartz's most significant points here are the distributive equivalence of expectation damages and specific performance and their argument for the expectation remedy. The distributive equivalence thesis holds that in a competitive market with enough sophisticated parties, anything a non-breaching party loses under the expectation remedy (or any other damage measure) she has already gained back in a lower price or other favorable terms.² The argument for expectation damages rather than specific performance rests on the familiar claim that the expectation remedy achieves efficient performance decisions with lower transaction costs than does specific performance.³ Expectation damages therefore provide greater net

* John Carroll Research Professor of Law, Georgetown University Law Center.

¹ Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach: New Defenses of the Expectation Interest*, 97 Va. L. Rev. 1939 (2011).

² Markovits and Schwartz's distributive claim, while not novel, is arguably underappreciated in the literature. See Richard Craswell, *Promises and Prices*, 45 Suffolk U. L. Rev. (forthcoming 2012) (manuscript at 16–20, available at http://www.law.stanford.edu/display/images/dynamic/events_media/Craswell%20Promises%20and%20Prices.pdf); Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369, 373–76 (1990).

³ While this thesis is common wisdom among economic thinking contracts scholars, Markovits and Schwartz add something new to the legal literature. In addition to the familiar claim that specific performance imposes higher ex post renegotiation costs because the parties are in a bilateral monopoly, they argue that it causes higher ex ante costs in reaching a deal because it requires considering more possible ex post states of the world and entails a more complex pricing formula. Markovits & Schwartz, *supra* note 1, at 1966–69.

gains of trade, from which it follows that a party stands to benefit more from the *ex ante* reduction in price with expectation damages than from the chance of extracting more *ex post* with specific performance. Markovits and Schwartz's interpretive claim, which builds on their instrumental arguments, is their so-called dual-performance hypothesis: contracts between sophisticated parties are best interpreted as imposing an obligation to perform or pay damages, rather than simply an obligation to perform. Finally, Markovits and Schwartz make two big moral claims. They defend expectation damages against critics who argue that the remedy is at odds with parties' moral obligations. The dual-performance hypothesis shows that expectation damages are in fact a form of specific performance, which is just what the moral critics say the law should provide. And Markovits and Schwartz advance the affirmative claim that not only are expectation damages compatible with morality, but also a commitment to perform or pay damages enables arms-length respectful relationships that have a moral value all their own. In this Response, I venture a few thoughts about the dual-performance hypothesis and on Markovits and Schwartz's answer to the moral critics.

The dual-performance hypothesis "holds that contracts typically impose alternative obligations on the promisor: either to supply goods or services for a specified price or to transfer to the promisee the gain the promisee would have made had those goods or services been supplied."⁴ In other words, although most contractual agreements are expressed in sentences of the form

"A shall *x*,"

where A is a party and *x* is some act or forbearance, what they actually say is that

"A shall *x* or *y*,"

where *x*, the "action term," is some act or forbearance and *y*, the "transfer term," is a payment sufficient to put the other party in the position she would have occupied had A *x*ed. Philosophers will recognize this form of argument. A good deal of twentieth-century analytic philosophy attempted to solve, or dissolve, apparently sub-

⁴ Id. at 1948 (emphasis omitted).

stantive theoretical puzzles by showing that they rested on mistakes of meaning.⁵ As Ludwig Wittgenstein put the idea in a different context: “A picture held us captive. And we could not get outside it, for it lay in our language and language seemed to repeat it to us inexorably.”⁶ These sentences, I think, express Markovits and Schwartz’s attitude toward familiar moral criticisms of the expectation remedy and the theory of efficient breach. The moral critics have been held captive by a false picture of the content of contractual promises.

If Markovits and Schwartz’s moral argument is to succeed, the dual-performance hypothesis must be an empirical interpretive claim. Parties, or at least sophisticated parties, must in fact understand their contracts to commit them not to perform the action term *simpliciter*, but to perform the action or the transfer term.

[I]f promisee sophistication is assumed, the transfer term arises out of the parties’ actual intentions and not just out of intentions that it would be rational for them to have or fair to impute to them. The transfer promise . . . is as real, as much a product of the parties’ actual intentions, as the promises that constitute the action and price terms.⁷

Dual-performance is not a mere theoretical construct. The transfer term is implied in fact by the price and other terms of the parties’ contract.⁸

The argument for this empirical interpretive claim builds on Markovits and Schwartz’s instrumentalist theses. The distributive equivalence thesis starts from the insight that, assuming sophisticated parties in a competitive market, expectation damages result in a lower price or other more favorable terms, as they permit each side to avoid performance for a price. In a contract between A and

⁵ The most famous example is Bertrand Russell’s suggestion that the sentence “The present King of France is bald” is best understood as saying that there exists a person who both is the King of France and is bald. This allowed Russell to explain, for example, how the sentence could be false, though one of its negations (“The present King of France is not bald”) is also false. Bertrand Russell, *On Denoting*, 14 *Mind* 479, 490 (1905).

⁶ Ludwig Wittgenstein, *Philosophical Investigations* 48–49 (G. E. M. Anscombe trans., 1953).

⁷ Markovits & Schwartz, *supra* note 1, at 1978.

⁸ *Id.*

B, therefore, what B loses after A's breach under the expectation remedy as compared to specific performance, B gains at the time of contracting in better terms. Expectation damages and specific performance are distributively equivalent. If transaction costs are lower with expectation damages than with specific performance, then at the time of contracting, B stands to gain more from the reduction in price she gets with expectation damages than she would from specific performance and the chance to renegotiate should A later want to avoid her contractual obligations. The parties therefore prefer the expectation remedy.⁹ Now here is the move to the dual-performance hypothesis: because B is a sophisticated party, she knows that the lower price or other favorable terms she gets under the expectation remedy are premised on the fact that, should performance become inefficient, A will choose to pay rather than perform. That is, B expects A to treat her contractual commitment as no more than a commitment to perform or pay damages. In fact, she wants A to treat it that way, for only if A does so can B get the advantage of the better terms, reduced transaction costs and greater gains of trade. From both parties' perspectives, then, A commits herself not simply to perform, but to perform or pay damages, or more perspicuously, A commits herself to perform either an action term or a transfer term.

Like Seana Shiffrin, I have my doubts about the success of this attempt to derive an "is" from an "ought."¹⁰ For one thing, it is not obvious that even sophisticated parties always recognize what terms are in their risk-adjusted individual interests. The last thirty years have seen an explosion of work in cognitive psychology and behavioral economics, not to mention the recent global financial meltdown, all of which call that assumption into question. We can-

⁹ Markovits and Schwartz do not fully explain why the law should set the default remedy to accord with the preferences of sophisticated parties rather than those who are less familiar with the law. Because sophisticated parties are more likely to know the legal default, they are more likely to opt out if it is not the term they want. Setting the default at specific performance would force sophisticated parties to reveal their preferences for expectation damages when they contract with non-sophisticated parties, thereby serving an educative function. In short, Markovits and Schwartz do not explain why the law should use a majoritarian rather than an information-forcing default. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *Yale L.J.* 87, 97-98 (1989).

¹⁰ Seana Valentine Shiffrin, *Must I Mean What You Think I Should Have Said?*, 98 *Va. L. Rev.* 159, 163 (2012).

not move so quickly from the fact that rationally self-interested parties *should* prefer dual-performance commitments to the conclusion that sophisticated parties *do* prefer them. Moreover, even if sophisticated parties want commitments of the form “A shall *x* or *y*,” it does not follow that this is what they think they are getting when they write a contract that says only “A shall *x*.” Sophisticated parties know how to write take-or-pay or alternative-performance contracts when they want them, and in many industries they commonly do so. Markovits and Schwartz do not explain why parties choose to express their contracts using language that does not correspond to their understanding of the commitment. One wants some empirical evidence for Markovits and Schwartz’s empirical interpretive claim. Markovits and Schwartz are correct to observe that “principles of fidelity are not principles of interpretation.”¹¹ Nor, however, are analytic truths about economic models interpretations of what people in the world outside those models intend or say.¹²

Still, I like the dual-performance hypothesis. Whether the claim is descriptively accurate or not, it casts new light on the theory of efficient breach. Having argued that contracts typically involve disjunctive commitments—a commitment to satisfy the action term or the transfer term—Markovits and Schwartz can quickly conclude that “the expectation remedy *is* specific performance.”¹³ The monetary award enjoins a breaching party to perform the transfer term. This suggests two surprising implications of the efficient breach theory.

First, Markovits and Schwartz’s claim that expectation damages specifically enforce the disjunctive commitment raises an obvious

¹¹ Markovits & Schwartz, *supra* note 1, at 1987; see also Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 Mich. L. Rev. 489, 490 (1989).

¹² In the Introduction, Markovits and Schwartz say that their arguments “are principally formal or analytic,” but that they “answer the current criticisms of the expectation remedy because the criticisms themselves are largely formal and analytic.” Markovits & Schwartz, *supra* note 1, at 1954. I am not sure how to reconcile these statements with their subsequent claims that the dual-performance hypothesis describes sophisticated parties’ actual intentions. Moreover, while moral criticisms of the expectation remedy often involve underdeveloped *interpretive* claims, those claims are not *analytic* in the sense Markovits and Schwartz use the term. They are not internal to an economic model of arms-length transactions.

¹³ *Id.* at 1987.

question: why should courts enjoin the transfer term rather than the action term? Specific performance of the action term, together with the ability to avoid the injunction by performing the transfer, would give parties the same incentives expectation damages do. Faced with the prospect of court-compelled performance of the action term, a party would choose to transfer if and only if the costs of performing (or being ordered to perform) the action term exceeded the other side's expected value from that performance.

If there is an instrumentalist answer, it involves transaction costs and investment incentives. Perhaps it is cheaper for courts to enforce the payment of money than to enjoin other acts or forbearances. And if the parties do not specify a dollar amount in advance, they might worry that they will need a court to sort out the exit price in any case. Such explanations, however, come from outside the model. If, for example, the parties can build the expectation remedy into the price, surely they can agree on a risk-adjusted exit price that would protect a party's expectation interest. So here is a first surprising result: the model that supports expectation damages equally supports specific performance of the action term together with an option to avoid performance for a price.

The above point is not meant as a criticism. Markovits and Schwartz are not attempting an a priori argument that expectation damages beat all comers, but a defense of expectation damages against critics who say that specific performance better reflects the parties' moral obligations. Still, taking the dual-performance hypothesis seriously tells us something about the theory of efficient breach. In that theory's nearly frictionless world, the parties might instead choose specific performance plus an option to buy one's way out of the duty to perform.

A second implication of the dual-performance hypothesis is a bit more at odds with what Markovits and Schwartz say. As Markovits and Schwartz observe, if you believe the dual-performance hypothesis, the entitlement to performance is protected not by a liability rule but rather by a property rule.¹⁴ A party cannot avoid her obligation to perform the action or transfer term without first obtaining the other side's consent. The standard theory of property and liability rules explains why this should be so. Property rules are

¹⁴ *Id.* at 1988–89.

appropriate when lawmakers can identify socially undesirable behavior with a high degree of certainty, though they find it difficult to quantify its costs.¹⁵ This describes breach of a dual-performance commitment. Because the transfer term requires only the payment of money, it is purely redistributive. In the model, money has the same value in anyone's hands, and so transfers of it do not create new value. But the redistribution is not costless. The failure to pay the transfer term undermines trust in future commitments. Markovits and Schwartz can therefore conclude that "no true breach is efficient."¹⁶ Breach of the obligation to act or transfer should not be priced, but prohibited.

But then why specific performance? There are property rules and then there are property rules. While injunctive relief is commonly classified as a form of property-rule protection, the incentives it provides are very different from those created by punitive damages or criminal sanctions. True penalties deter nonconsensual takings *tout court*. Steal a loaf of bread and you land in jail. Commit civil fraud and you risk a punitive award that exceeds your expected profit. Injunctive relief, in contrast, does not penalize the initial nonconsensual taking. Instead, an injunction clarifies what the entitlement is and establishes that any future nonconsensual taking of it will be penalized by civil or criminal contempt. Why should contract law give the promisor who has refused to act or transfer a do-over? The theory supports awarding punitive damages to the promisee who has been forced to go to court to vindicate her entitlement to performance of the disjunctive obligation.

This result dovetails with a hypothesis I have developed elsewhere: that in many transactions, parties might reasonably want a rule that would apply extracompensatory remedies to a breaching party's failure to cooperate in the recovery of damages.¹⁷ It also corresponds to the letter of California's brief experiment with punitive damages for bad faith breach. In *Seaman's Direct Buying Service v. Standard Oil Co.*, the California Supreme Court held that punitive damages are appropriate when a party, "in addition to breaching the contract, . . . seeks to shield itself from liability by

¹⁵ See Robert Cooter, Prices and Sanctions, 84 Colum. L. Rev. 1523, 1524–25 (1984).

¹⁶ Markovits & Schwartz, *supra* note 1, at 1949.

¹⁷ Gregory Klass, Contracting for Cooperation in Recovery, 117 Yale L.J. 2, 54–60 (2007).

denying, in bad faith and without probable cause, that the contract exists.”¹⁸ The same logic explains the treble damages and per-claim penalties that the False Claims Act imposes against government contractors who lie about performance,¹⁹ as well as judicial readings of the statute as imposing on government contractors an affirmative duty to disclose any material breaches.²⁰ And we can make sense of the result on the traditional account of efficient breach. Efficient breach takes as a premise that recovering damages is relatively cheap. Recovery is cheap when the breaching party willingly pays, or at least does not actively obstruct, recovery. While the efficient breach theory recommends pricing a party’s first-order entitlement to performance, it supports protecting the non-breaching party’s second-order entitlement to that price with a property rule like punitive damages.²¹

Markovits and Schwartz recognize this potential implication:

[I]f punitive damages for gross breach of contract have had a short career in American law, this is not because of any principled tension between their moralizing nature and the normative structure of the expectation remedy. Rather, courts are reluctant to award punitive damages for breach of contract because of pragmatic difficulties that are internal to the effective articulation and administration of a punitive damages regime itself.²²

But Markovits and Schwartz’s explanation of those “pragmatic difficulties” is incomplete. They argue that courts might find it “difficult to distinguish gross breaches of contract (for example, bad faith breaches) from breaches that violate only the contract it-

¹⁸ 686 P.2d 1158, 1167 (Cal. 1984). I describe the *Seaman’s* rule in more detail, and defend it against its critics, in *Contracting for Cooperation in Recovery*, supra note 17, at 38–41.

¹⁹ 31 U.S.C. § 3729 (2006).

²⁰ Michael Holt and I analyze these developments in *Implied Certification Under the False Claims Act*, 41 Pub. Cont. L.J. 1 (2011). Three important decisions in this line of cases are *United States v. Science Applications International Corp.*, 626 F.3d 1257, 1269 (D.C. Cir. 2010), *Mikes v. Straus*, 274 F.3d 687, 702 (2d Cir. 2001), and *Ab-Tech Construction, Inc. v. United States*, 31 Fed. Cl. 429, 433–34 (Fed. Cl. 1994), aff’d, 57 F.3d 1084 (Fed. Cir. 1995) (unpublished table decision).

²¹ The result can be generalized. All liability rules are ultimately backed by property rules. There is no point in pricing failure to pay the price.

²² Markovits & Schwartz, supra note 1, at 1989–90 (footnote omitted).

self.”²³ But they do not define “bad faith breach” of a dual-performance obligation. They say an example would be failing to transfer “on the impermissible ground that legal costs will deter a promisee’s lawsuit.”²⁴ On their model, however, a party’s motives for breaching both the action and transfer terms should be immaterial. Breach of the disjunctive obligation is always inefficient. There is no reason to permit a do-over with specific performance rather than simply punish the wrong.

If there is an answer here, I think it is the sense that contract disputes often result from genuine disagreements among the parties as to just what their contractual rights and obligations are.²⁵ There is no point in imposing punitive damages on a party who “takes” an entitlement because she honestly believes it does not exist—who breaches her contract because she is mistaken about what it requires of her. The threatened penalty has no purchase. The court’s function in these cases is more to resolve the legal interpretive questions than to protect the entitlement to performance. Only after the parties’ duties have been clarified should their breach be penalized.

Markovits and Schwartz’s model therefore suggests expectation damages for parties who breach because they are honestly mistaken about their contractual obligations, and punitive damages for those who knowingly breach the action term and also fail to pay the transfer amount. Would courts find it difficult to distinguish these cases? Perhaps at the margins. But there are also easy cases, and courts can use familiar tools like burdens of proof, scienter requirements, and the like to get at them.²⁶ While Markovits and Schwartz minimize the result, their dual-performance hypothesis, as well as the theory of efficient breach that it builds on, supports a much larger role for punitive damages than contract law currently provides.

The above thoughts about specific performance and punitive damages come largely from within Markovits and Schwartz’s model. I now want to step outside of it and say a few words about

²³ Id. at 1989.

²⁴ Id. at 1988.

²⁵ A possible explanation for that fact is the self-serving bias. But then cognitive biases of this sort lie outside of Markovits and Schwartz’s model.

²⁶ For more details on this point, see Klass, *supra* note 17, at 54–60.

their argument that the dual-performance hypothesis answers moral criticisms of contract law's preference for expectation damages.

Claims that there is a tension between contract remedies and morality are not trivial. Anyone who teaches U.S. contract law knows the distance between students' untutored moral intuitions and the remedies that the law provides. I read this to be the point of Justice Holmes's infamous statement that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else."²⁷ The "Holmesian heresy" is best read not as a theoretical account of how to understand contract law, as Markovits and Schwartz would have it. It is rather advice to future lawyers about how to identify, or predict, what the law is, which is what their clients will require of them.²⁸ Confusing contract law with the morality of promises causes false predictions because, most obviously, promises are subject to the principle of *pacta sunt servanda*—agreements are to be kept—while the law does not force parties to keep their contractual agreements. Especially counterintuitive is the case of the promisor who breaches to take advantage of a better opportunity, a paradigm for the efficient breach theorist. Promises are meant to exclude from the promisor's performance decision such considerations of self-interest and profit. Yet the law permits them. Thus the perceived tension between contract and morality.

Like Markovits and Schwartz, I think the moral critics have it wrong but for different reasons. Markovits and Schwartz's argument is one of four possible responses to the moral critics, and not the best of them.

²⁷ Oliver Wendell Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457 (1897), reprinted in 110 Harv. L. Rev. 991, 995 (1997).

²⁸ Justice Holmes's thoughts on how to understand the law can be found in the latter two-thirds of the article. There Holmes first describes a hermeneutics of suspicion that reveals the hidden purpose of legal rules ("[w]hen you get the dragon out of his cave on to the plain and in the daylight, you can count his teeth and claws, and see just what is his strength," *id.* at 469) and then recommends a new, more rational form of jurisprudence ("the social end which is aimed at by a rule of law is obscured and only partially attained in consequence of the fact that the rule owes its form to a gradual historical development, instead of being reshaped as a whole, with conscious articulate reference to the end in view," *id.*). Cf. Markovits & Schwartz, *supra* note 1, at 1981.

One answer to the felt tension between contract law and morality is to argue that contract law has nothing to do with the parties' moral obligations. This thesis is commonly joined with a description of contract law as a pure power-conferring rule.²⁹ Contract law's function, on that description, is to enable persons to undertake legal obligations when they choose to do so. The law imposes obligations on the parties to a contract because they have asked for them. The legal reasons for enforcement have nothing to do with the parties' moral obligations to one another. It is a category mistake to criticize contract law for being at odds with morality.

I will not spend much time on this answer, which is not Markovits and Schwartz's. I have argued elsewhere that power-conferring theories describe only one side of the contract law we have. There are good reasons to think that contract law imposes duties on parties for reasons other than the fact that they have chosen to be legally obligated.³⁰ Nor does the approach answer Seana Shiffrin's more subtle claim that no matter what the purpose of contract law, we do not want its rules to depart too far from the dictates of morality, lest it degrade our moral culture.³¹

The second answer, which is the one Markovits and Schwartz opt for, maintains that the moral critique misunderstands the content of contractual promises.³² The argument here exploits the fact that promissory obligations are largely content neutral. If a promise has the form

"I promise *s*,"

²⁹ For examples, see Dori Kimel, *From Promise to Contract: Towards a Liberal Theory of Contract* (2003); Randy E. Barnett, *Contract is Not Promise; Contract is Consent*, 45 *Suffolk U. L. Rev.* (forthcoming 2012) (manuscript at 7–9, available at <http://ssrn.com/abstract=1792586>); Michael G. Pratt, *Contract: Not Promise*, 35 *Fla. St. U. L. Rev.* 801, 801–02 (2008).

³⁰ Gregory Klass, *Three Pictures of Contract: Duty, Power and Compound Rule*, 83 *N.Y.U. L. Rev.* 1726, 1727–31 (2008).

³¹ Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 *Harv. L. Rev.* 708, 740–43 (2007).

³² This answer can also be found in, for example, Craswell, *supra* note 2 (manuscript at 46–51); Barbara H. Fried, *The Holmesian Bad Man Flubs His Entrance, The Limits of Non-Consequentialism in Contract Theory*, 45 *Suffolk U. L. Rev.* (forthcoming 2012) (manuscript at 5–7); Avery W. Katz, *Virtue Ethics and Efficient Breach*, 45 *Suffolk U. L. Rev.* (forthcoming 2012) (manuscript at 1–3, available at <http://ssrn.com/abstract=1845703>); Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 *Colum. L. Rev.* 1603, 1603–08 (2009).

where *s* stands for a proposition describing one's future actions, the speech act's moral force lies in the "I promise," not in *s*. Promises are morally binding because of the moral quality of the act of promising, not because of the moral quality of the act promised. Content neutrality allows one to grant that the moral critics might be correct to identify contracts as promises, but to argue that they misunderstand the content of those promises—they misinterpret *s*. The content of the promise includes both the right and the remedy. As Richard Craswell put the point over twenty years ago, "the rules governing such topics as remedies and excuses could effectively be treated as just a more complete definition of the exact obligation undertaken by the promisor."³³ Or in Markovits and Schwartz's formulation, "the legal remedy is an implied *term*."³⁴ Contractual promises are weaker than the moral critics think because the content includes less demanding remedial obligations than do the promises that the moral critics take as their paradigms.

I will not discuss the merits of this answer. I have already suggested some problems with Markovits and Schwartz's version of it. Instead, I want to identify two other ways of answering the moral critics. Both, I think, better describe the contract law we have and its relation to the parties' moral obligations.³⁵

The third possible answer focuses not on the content of parties' moral obligations, but rather on their source and type. Instead of proposing a new interpretation of *s*, this approach questions whether contracts in fact involve an "I promise . . ." As Hume observed, "Two men, who pull the oars of a boat, do it by agreement or convention, tho' they have never given promises to each other."³⁶ By the same token, two parties might agree to an exchange without promising performance—without expressing an intent to undertake a moral obligation by the very expression of that intent. The absence of a promise does not mean the agreement is morally inert. Non-promissory exchange agreements can generate

³³ Craswell, *supra* note 11, at 504.

³⁴ Markovits & Schwartz, *supra* note 1, at 1953 n.31.

³⁵ I examine both in more detail in Gregory Klass, *Promise Etc.*, 45 *Suffolk U. L. Rev.* (forthcoming 2012) (manuscript at 11–14, available at <http://ssrn.com/abstract=1762075>).

³⁶ David Hume, *Of Morals*, in *A Treatise of Human Nature* 455, 490 (London, Clarendon Press, reprt. 1888).

reliance-based obligations, obligations of trust, obligations of reciprocity, obligations rooted in the parties' relationship, or some combination of these and other moral reasons to perform. And these obligations might be weaker than promissory ones—not because they have a different content but because they are obligations of a different type. A non-promissory moral duty to perform might not exclude so many considerations of one's own interests from the performance decision. It might require greater flexibility in performance from both sides. And it might impose remedial obligations that differ from a promise-breaker's second-order moral obligations. If the law of contracts does not fit with promissory obligations to perform, perhaps it better fits the non-promissory obligations that attach to agreements for consideration. If so, that fit is a reason to interpret contract law as concerned less with promises than with other sorts of agreement-based obligations.

Like Markovits and Schwartz's dual-performance hypothesis, this third answer suggests that those who see a tension between contract and promise have been held captive by a false picture. But the picture comes from a different place. Markovits and Schwartz locate the confusion in the fact that parties use sentences of the form "I shall x ," when in fact they mean "I shall x or y ." I am suggesting that it lies in theorists' assumption that parties have promised performance, when in fact parties rarely use the words "I promise . . ." or their equivalent.

A fourth possible response is that moral critics assume too simple a view of the available moral functions of the law. One way of putting the perceived tension between contract and promise is that contract requires less of a party than does morality. Morality requires, for example, that the promisor forgo a better opportunity for the sake of performance, while contract law permits her to avoid performance for a price. This is a problem, however, only if we assume that if contract law has a moral function, it must be to enforce parties' moral obligations.³⁷ But contract law might have other sorts of moral functions. Here are two possibilities: First, contract law might aim to enforce not first-order obligations to per-

³⁷ "If expectation damages were merely substitutionary, courts that award them would leave promisees with something other than what they have bargained for, and hence (perhaps) would undermine contract's essential purpose." Markovits & Schwartz, *supra* note 1, at 1984.

form, but second-order obligations that arise upon the breach of those first-order obligations. There are good reasons in many contexts to leave the performance decision to considerations of reputation, relationship, community norms, and morality. A contract law that is sensitive to those reasons might attempt not to deter or punish breach, but only to clean up the mess it leaves behind. Such a contract would serve morality under the heading of corrective justice. Second, and not incompatibly, the purpose of contract law might involve not enforcing individual parties' obligations, but fostering a moral culture in which people choose to perform for the right reasons. Contract law might, for example, have an expressive function. An award of expectation damages marks the fact that one party has wronged the other, and thereby supports the social practice of making and keeping agreements.

Either of these alternative accounts of the moral purpose of contract law might recognize that contract remedies also tend to deter breach, and even see that as a good thing. But neither considers enforcement of the moral obligation to perform the *raison d'être* of contract law. The problem with the moral criticism is that it rests on an oversimplified picture of the possible moral functions of contract law.³⁸

In my view the third and fourth answers better cohere with the contract law we have than does the dual-performance hypothesis. That is a much bigger claim than I can defend here, so I will close with a thought about how it connects with my discussion of punitive damages. I have argued that, from the perspective of Markovits and Schwartz's model, punitive damages should be available for a party's knowing failure to perform or pay. If we look to the law, however, we find not only a preference for compensatory measures but also mandatory limits on parties' ability to contract for more.³⁹ What explains the gap between the law we have and the law that Markovits and Schwartz's model recommends?

³⁸ My argument here might be compared to Richard Craswell's argument that moral critics unduly assume that "promises must either (1) oblige the promisor to perform the promised actions, or (2) have no moral force at all." Richard Craswell, Two Economic Theories of Enforcing Promises, *in* *The Theory of Contract Law: New Essays* 19, 27 (Peter Benson ed., 2001). Where Craswell emphasizes an alternative economic understanding of legal remedies—as altering incentives rather than imposing and enforcing obligations—I am suggesting alternative moral understandings.

³⁹ See Restatement (Second) of Contracts §§ 356, 359(1) (1979).

One possible answer is that the penalty rule and the rule against punitive damages are simply misguided. I have argued elsewhere that courts should permit parties to attach extracompensatory remedies to the breach of terms designed to enable recovery in the case of breach, such as an obligation to share information about performance.⁴⁰ That suggestion, however, is much more modest than what I claim to be the implications of Markovits and Schwartz's model, which is that punitive damages should be available for any knowing failure to perform or pay. Still, if you adhere to their model, you might say that the existing preference for compensatory damages is simply wrong.

Markovits and Schwartz have a different answer, which involves the practical costs of punitive damages. They worry about the possibility of false positives: that courts will impose punitive damages in cases in which nonperformance was the result of mistake (and punitive awards can do no good) or even where there was no breach at all. That's not a bad answer, though Markovits and Schwartz need to do more work to make it convincing.

But there is also a third possible answer: Markovits and Schwartz's model does not capture everything that is happening in the law of contracts. Their model leaves no room, for example, for considerations of corrective justice or for society's interest in supporting the moral practice of entering into and keeping agreements, both of which might explain why courts do not award punitive damages for first-order breach. Compensatory damages are the bread and butter of corrective justice; and they support the practice by sending a message that breach is wrong while reserving expressions of greater disapprobation (punitive damages) for more significant wrongs, such as fraud in the inducement. Markovits and Schwartz's instrumental model cannot comprehend such moral arguments against punitive damages for first-order breach. Especially telling, I think, is the fact that the rules against penalties for first-order breach are not mere defaults, but mandatory limits around which parties cannot contract. The law gives parties wide latitude to define their contractual obligations to one another. This is freedom of contract. It does not, however, permit them to contract for remedies that run contrary to the social purpose of enforcing their

⁴⁰ Klass, *supra* note 17, at 11–13.

agreements. The duty to perform is chosen; the duty to pay damages is not. If this is right, it can only cause confusion to interpret contractual commitments, even between sophisticated parties, as promises to perform or pay.