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Against Supercompensation: A Proposed Limitation on the Land Buyer's Right To Elect Between Damages and Specific Performance as a Remedy for Breach of Contract

*Jonathan Levy**

I. INTRODUCTION

The commentary on contract remedies is replete with arguments over whether specific performance is or is not efficient, and whether it should or should not be adopted as the default remedy for breach. What the commentary lacks, however, is the recognition that nowhere in American jurisprudence is specific performance the sole option available to a promisee. Wherever specific performance is available, the default remedy of expectation damages, calculated as of the date of breach, is also available. Thus, it is this choice among the remedies that should be evaluated for its efficiency, not the remedies individually. I will argue that giving promisees the choice between expectation damages and specific performance is, for transactions that take place in time-variant markets, an inherently supercompensatory and, therefore, inefficient remedy.

In most cases of breach of contract, the promisee-plaintiff[1] must settle for monetary damages. The court will estimate, subject to a variety of limiting doctrines, the dollar-value that the promisor-

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1. For reasons addressed below (see *infra* note 8 and accompanying text), this Article focuses solely on breaches committed by contract promisors, not promisees. Nonetheless, many of the points raised have relevance for promisee breaches.

defendant's performance would have had to the promisee.[2] This estimation generally is made by starting with the "market or use value" of the performance[3] at the time of the breach,[4] and then capitalizing that amount from the time of breach until the judgment, according to a predetermined interest rate.[5]

But when a promisor-seller breaches a contract for the sale of land, the promisee-buyer has the option to sue for either monetary damages or specific performance of the contract.[6] If the promisee elects specific performance, the court will order the promisor to perform as per the terms of the contract[7]—thus furnishing the promisee with the value of performance as of the date of execution of the judgment. This ability to elect among remedies gives the promisee who contracts in a volatile market the power to wait and watch the market before filing her claim. If a rising market drives up the value of performance, the promisee can choose specific performance and receive the value of performance at the time of judgment. If, on the other hand, the market declines, she may sue for damages and receive the value as calculated based upon the market price at the time of breach. The promisee who follows this strategy is able to reap the benefit of a rising market without bearing the risk that the market may fall. Thus, the choice between two compensatory remedies becomes, in fact, a supercompensatory remedy.

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2. 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.8, at 188–89 (2d ed. 1998) (noting that the contract plaintiff "is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed"); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981) (defining the promisee's expectation interest); Thomas A. Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to* Hadley v. Baxendale, 63 FORDHAM L. REV. 665, 678 (1994) ("An important principle of contract damages is to protect the aggrieved party's expectation interest by putting that party in the same position as though the contract had been performed.").

3. Jeffrey Standen, *The Fallacy of Full Compensation*, 73 WASH. U. L.Q. 145, 150 (1995) (internal quotation marks omitted).

4. 3 FARNSWORTH, *supra* note 2, § 12.1, at 148 (noting that in setting the damage amount, "the circumstances at the time for performance, rather than those at the time of making the contract, are determinative"); Larry A. DiMatteo, *A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages*, 38 AM. BUS. L.J. 633, 698 (2001) ("Full compensation under American law is often viewed as the difference between the contract price and the market price at the time of breach or between the contract price and the price of substituted goods (normally as limited by the market price at the time of substitution).").

5. RESTATEMENT (SECOND) OF CONTRACTS § 354; *see also* Am. Computer Inst. Inc. v. State, 995 P.2d 647, 656 (Alaska 2000) (explaining the purpose of awarding prejudgment interest).

6. *See* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. e; 3 FARNSWORTH, *supra* note 2, § 12.6, at 179; Kevin C. Kennedy, *Equitable Remedies and Principled Discretion: The Michigan Experience*, 74 U. DET. MERCY L. REV. 609, 628 (1997); Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351, 355 (1978) (contracts for the sale of land are "[t]ypical situations" where "courts are prepared to order specific performance").

7. *See* RESTATEMENT (SECOND) OF CONTRACTS § 357 cmt. a.

My analysis will focus for two reasons on the breach-of-contract case wherein a seller has breached a sale-of-land contract. First, unlike in other breach-of-contract cases, plaintiff buyers in breached land-sale contracts have a per se right to elect between specific performance and damages;[8] second, the land market is time-sensitive, as it experiences well-documented swings within relatively short periods of time.

In Part II, I will flesh out the argument that the election between specific performance and monetary damages results, on average, in compensation to the plaintiff in an amount greater than her expectation. In Part III, I shall present a series of economic arguments intended to show the inefficiency of remedies that provide compensation above expectation—remedies that I shall refer to as "supercompensatory." These arguments will be followed, in Part IV, by a broad analysis of the scholarship and doctrine of contract remedies, which will show, first, the great lengths that courts go to prevent supercompensation in other contexts, and second, that the courts have no similar aversion to compensation less than expectation. Finally, in Part V, I shall propose a solution to the problem of supercompensation through the opportunistic election between specific performance and expectation damages.

II. THE PROBLEM: THE PLAINTIFF'S ABILITY TO DELAY ELECTION BETWEEN DAMAGES AND SPECIFIC PERFORMANCE RESULTS IN SUPERCOMPENSATION

For four hundred years, monetary damages measured in terms of the promisee's expectation have been the dominant remedy in breach of contract cases[9] and expectation remains "'the basic principle for the measurement of [contract] damages.'"[10] Under the expectation

8. *See, e.g.*, James E. Leahy, *Land Contracts Revisited*, 69 N. DAK. L. REV. 515, 524, 526–27 (1993) (stating that "[a] vendor requesting specific performance must overcome several obstacles," discussing these obstacles, and noting that breached-against land vendees generally are granted specific performance as long as they are not guilty of "'over-reaching,' 'unfairness,' and 'sharp practices.'"); Standen, *supra* note 3, at 224 ("[H]istorically most jurisdictions protected such sentimental values in regard to land, to the point at which specific performance of land contracts and constructive trusts, a restitutionary device, were routinely imposed for conversions of real property." (footnotes omitted)).

9. 3 FARNSWORTH, *supra* note 2, § 12.20a, at 338 ("The preeminence of the expectation principle as a basis for awarding damages in breach of contract goes back to the sixteenth century.").

10. Michael B. Kelly, *The Phantom Reliance Interest in Contract Damages*, 1992 WIS. L. REV. 1755, 1756 (alteration in original) (quoting 3 E. ALLAN FARNSWORTH ON CONTRACTS § 12.8 (1990)); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 344 cmt. a ("Ordinarily, when a court concludes that there has been a breach of contract, it enforces the broken promise by protecting the expectation that the injured party had when he made the contract. It does this by

measure, courts seek to award damages sufficient to put the plaintiff in "as good a position" as she would be in if the contract had been performed.[11] Although, theoretically, expectation damages include idiosyncratic preferences,[12] in practice, they generally are "measured in terms of the market or 'use' value of the damaged interests."[13]

Once a court has determined the market value of the plaintiff's loss at the date of breach,[14] that amount is often capitalized according to a predetermined interest rate, to account for lost investment opportunity during the time elapsed between the breach and the final judgment.[15] The applicable interest rate varies by jurisdiction. In cases where federal law applies, but the rate is not set by statute, courts have applied the federal government rate on short-term, risk-free obligations.[16] In some jurisdictions, the rate may be somewhat higher. For example, an Alaskan statute sets the rate at "three percentage points above the 12th Federal Reserve District discount rate in effect on January 2 of the year in which the judgment . . . is entered."[17] In either case, prejudgment interest is intended "merely [to] compensate the plaintiff for being denied the opportunity to invest and earn interest on the amount of damages" and "is not intended to punish the defendant's misbehavior."[18]

In cases where the breached contract was for the purchase or sale of land, plaintiffs, in addition to having a right to recover expectation damages, also have the option to receive specific performance of the

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attempting to put him in as good a position as he would have been in had the contract been performed . . . .").

11. 3 FARNSWORTH, *supra* note 2, § 12.8, at 188–89 (The contract plaintiff "is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed"); *see also* Diamond & Foss, *supra* note 2, at 678 (discussing the principles of contract damages).

12. RESTATEMENT (SECOND) OF CONTRACTS § 344 cmt. b.

13. Standen, *supra* note 3, at 150.

14. 3 FARNSWORTH, *supra* note 2, § 12.1, at 148 (explaining that factors "at the time for performance, rather than those at the time of making the contract," determine the damage amount); *see also* Anthony D'Amato, *Post-revolutionary Law and Economics: A Foreword to the Symposium*, 20 HOFSTRA L. REV. 757, 763 (1992) (pointing out that if a seller breaches and sells the performance to a newly discovered alternative buyer at a higher price, then the seller is not liable for that higher amount in a suit for breach).

15. *See* RESTATEMENT (SECOND) OF CONTRACTS § 354; *see also* Am. Computer Inst. Inc. v. State, 995 P.2d 647 (Alaska 2000) (explaining the purpose of prejudgment interest).

16. *See, e.g.*, McCramm v. U.S. Lines, 803 F.2d 771 (2d Cir. 1986) (applying the average interest rate paid on six-month U.S. treasury bills); ITT World Communications v. W. Union Tele., 598 F. Supp. 1435 (S.D.N.Y. 1984) (applying the average interest rate paid on six-month U.S. treasury bills).

17. ALASKA STAT. § 09.30.070(a) (2002).

18. Matthews v. DeSoto, 721 S.W.2d 286, 287 (Tex. 1986).

contract.[19] This doctrine of treating contracts for the sale of land differently is derived from the special status afforded to land by English courts,[20] which "viewed [land] . . . with particular esteem" such that "[e]ach parcel, however ordinary, was considered unique."[21] This special treatment of land has crossed the Atlantic and carried through to the present day, leading the writers of the *Second Restatement of Contracts* to comment:

> Contracts for the sale of land have traditionally been accorded a special place in the law of specific performance. A specific tract of land has long been regarded as unique and impossible of duplication by the use of any amount of money. Damages have therefore been regarded as inadequate to enforce a duty to transfer an interest in land to a third person . . . .[22]

Once a contract plaintiff wins a suit for specific performance, the court will order the defendant to "render the promised performance,"[23] with the aim of producing "as nearly as practicable the same effect that the performance due under a contract would have produced."[24] Thus,

> [a]t least in theory, specific performance and damages are simply two means of accomplishing the same result. Specific performance protects the plaintiff's expectation interest in a contract by delivering the promised performance[, while expectation] damages . . . protect the same interest [by] forcing the defendant to pay the monetary equivalent of the promised performance.[25]

Standing alone, both monetary damages and specific performance serve to compensate a plaintiff according to her lost expectations. But as soon as the plaintiff receives the option to elect between the two remedies, the aggregate effect tends toward supercompensation.

In *Semelhago v. Paramadevan*,[26] for example, the Canadian Supreme Court faced squarely the supercompensatory nature of election between

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19. RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. e; 3 FARNSWORTH, *supra* note 2, § 12.6; Kennedy, *supra* note 6, at 628; Leahy, *supra* note 8, at 527–28.

20. 3 FARNSWORTH, *supra* note 2, § 12.4, at 159–64; Robert Stack, *A Revised Remedy: Trends and Tendencies in the Law of Specific Performance Since* Semelhago v. Paramadevan, 6 APPEAL 60, 62 (2000) (Can.).

21. 3 FARNSWORTH, *supra* note 2, § 12.6, at 174–75.

22. RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. e.

23. 3 FARNSWORTH, *supra* note 2, § 12.5, at 165.

24. RESTATEMENT (SECOND) OF CONTRACTS § 357 cmt. a.

25. Emily L. Sherwin, *Law and Equity in Contract Enforcement*, 50 MD. L. REV. 253, 260 (1991); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 359 cmt. a (noting that both specific performance and monetary damages address the expectation interest).

26. Semelhago v. Paramadevan [1996] 2 S.C.R. 415, 419 (Can.), *available at* http://www.lexum.umontreal.ca/csc-scc/en/pub/1996/vol2/html/1996scr2_0415.html (last visited Jan. 23, 2004).

damages and specific performance. Semelhago had entered into a contract with Paramadevan to purchase a home.[27] Paramadevan breached this contract and the land market soared.[28] Semelhago sued, electing based on a statutory entitlement[29] to receive damages in lieu of specific performance, amounting to the value of the land as of the time of the trial.[30] However, in the time that elapsed between the breach and the trial, the value of the property at issue had risen from a contract price of $205,000 to $325,000.[31] Semelhago was allowed to recover for the $120,000 post-breach increase in the property's value,[32] notwithstanding that (1) he clearly was not emotionally attached to the property in such a way that pecuniary compensation would have been insufficient—after all, he affirmatively elected to receive money rather than the actual land[33]—and (2) if the land market had dropped instead of risen, he could, at least under the *Second Restatement of Contracts* rule,[34] just as easily have elected to receive expectation damages, thus avoiding the market loss by taking compensation based on breach-date valuation.

The ability to reap supercompensation through election between expectation damages and specific performance arises from two factors. First, specific performance gives the value of performance as of the date of judgment while expectation damages gives it as of the date of breach. Second, the doctrine of election of remedies gives plaintiffs the flexibility to wait and watch the market before choosing which remedy to pursue. The *Second Restatement of Contracts* section on election of remedies, in keeping with the general trend against preclusion by election,[35] articulates the election rule as follows:

> If a party has more than one remedy [available, then her] manifestation of a choice of one of them by bringing suit or otherwise is not a bar to another remedy unless the remedies are inconsistent and

27. *Id.*

28. *Id.*

29. Courts of Justice Act, R.S.O., ch. C-43, § 99 (1990) (Can.) ("A court that has jurisdiction to . . . order specific performance may award damages in addition to, or in substitution for, the . . . specific performance.").

30. *Semelhago*, [1996] 2 S.C.R. at 419.

31. *Id.* (giving amounts in Canadian dollars).

32. *Id.* at 427. However, so troubled was the Canada Supreme Court by this result that it prospectively abolished the rule that specific performance is per se available in cases of breach of land-sale contracts and held that "[s]pecific performance [of land-sale contracts] should not be granted as a matter of course absent evidence that the property is unique." *Id.* at 428–29.

33. *Id.* at 419–20.

34. RESTATEMENT (SECOND) OF CONTRACTS § 378 cmt. a (1981).

35. *See id.* at 227 introductory cmt.

> the other party materially changes [her] position in reliance on the manifestation.[36]

The election need not "be made within any particular time," and "a change in remedy may often be made by amendment of the complaint, even at an advanced stage of the action."[37] This degree of flexibility is reflected in a line of cases in which courts have found consistently that post-breach increases in land value do not, in and of themselves, nullify the plaintiff's right to specific performance.[38] This leniency in allowing plaintiffs to elect their remedy has led to a "standard practice" for those pursuing suits for specific performance "to include in the pleadings an alternative claim for damages."[39]

The plaintiff's freedom to choose to receive her expectation either measured at the date of judgment (i.e., specific performance) or measured at the date of breach (i.e., damages adjusted for interest) gives her "a lottery ticket that [by the time she is forced to elect] may already have shown itself to be a winner."[40] Such a choice allows her to "reap where [she] has not sown"[41] by gaining returns from an increasing market without bearing any risk that the market should fall.

Having demonstrated the supercompensatory nature of election between specific performance and damages, in Parts III and IV, I shall argue against supercompensatory remedies in general, and in Part V, I shall propose a solution to the problem of supercompensation in the context of actions for breach of land-sale contracts.

III. ECONOMIC CRITICISMS OF SUPERCOMPENSATION

As recent scholarship demonstrates, economic analysis has been unable to conceive of a single perfect damage measure that "induces both sides to behave efficiently on a variety of dimensions both before (ex ante) and after (ex post) a potential breach."[42] Indeed, different contracts between different parties "emphasize different policies, [rendering] a single, invariable standard of liability . . . inappropriate."[43]

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36. *Id.* § 378.

37. *Id.* § 378 cmt. a.

38. For a detailed review of this line of cases, see W.E. Shipley, Annotation, *Change of Conditions After Execution of Contract or Option for Sale of Real Property as Affecting Right to Specific Performance*, 11 A.L.R. 2d 390, § 6 (1950).

39. Donald H. Clark, *"Will That Be Performance . . . or Cash?":* Semelhago v. Paramadevan *and the Notion of Equivalence*, 37 ALTA. L. REV. 589, 603 (1999).

40. Stack, *supra* note 20, at 69.

41. Buffalo Coal & Coke Co. v. Vance, 76 S.E. 177, 179 (W. Va. 1908).

42. Ian Ayres & Kristin Madison, *Threatening Inefficient Performance of Injunctions and Contracts*, 148 U. PA. L. REV. 45, 87 (1999).

43. Diamond & Foss, *supra* note 2, at 693.

This Part argues that although the optimal damage remedy may in some cases fall below the injured party's expectation, in no case will it fall above this amount.

The analysis will be an economic one, and as such will deal with minimizing the transaction costs involved in engaging in promissory exchange.[44] According to the assumptions of economics, transaction and information costs are the sole barriers to achieving an efficient distribution of resources. In their absence, contracting parties automatically would know all of their contracting options, instantly enter into all and only the best options, and costlessly negotiate so that each contract takes place on efficient terms.[45]

In the real world, however, transaction costs are nonzero, meaning that in some cases parties will fail to enter into efficient contracts because transaction costs are prohibitively high.[46] The primary deterrent effect of these additional costs is on potential contracts that promise only limited profits for either side—i.e., situations where positive gains from trade are possible, but the gains would be low enough that transaction costs prevent the contracts from being worthwhile.

Thus, a goal of contract law can be conceived as the determination of what contract terms parties would agree to if negotiations were costless, and then the establishment of default rules that mirror such terms.[47] By pursuing this goal, the law can render aspects of the negotiation unnecessary, thereby decreasing average negotiation costs and enhancing welfare through (1) increasing the total number of promissory exchanges by decreasing the number of potentially value-adding transactions that go unrealized because transaction costs outweigh potential gains, and (2) increasing, on average, the profits that

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44. Sherwin, *supra* note 25, at 280 (arguing that law and economics scholars "are not concerned with the ultimate distribution of gains resulting from an efficient breach between parties; they care only about the transaction costs of negotiation").

45. *See* Melvin A. Eisenberg, *The Principle of* Hadley v. Baxendale, 80 CAL. L. REV. 563, 572–77 (1992).

46. Alan Schwartz, *The Myth That Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damages Measures*, 100 YALE L.J. 369, 377 (1990) ("When . . . bargain[ing] is costly, the parties sometimes may not agree although positive gains from trade exist.").

47. *See, e.g.*, Kronman, *supra* note 6, at 368–69 (arguing in favor of the uniqueness test for entitlement to specific performance on the basis that it diminishes pre-contracting negotiation costs); *see also* Ayres & Madison, *supra* note 42, at 46–47 (arguing that due to their costs, renegotiations are "presumptively inefficient"); *cf.* Sherwin, *supra* note 25, at 278–79 (stating that because contracting parties generally are able to negotiate out of inefficient legal default rules, such as the availability of specific performance and damages, the "real impact" of such rules is their "effect on the transaction costs of collateral negotiation").

result from those contracts that would be entered into even if further negotiation were necessary by reducing the costs of negotiation. Because I am concerned only with contract remedies, the analysis shall focus on transaction costs relating to "negotiating . . . sanctions for breach."[48] In particular, the discussion shall focus on (1) the precontracting costs of negotiating a damage remedy that provides an optimal allocation of risk between the parties, (2) the need for the contract to be sufficiently flexible to allow the parties to react efficiently to the emergence of an alternative buyer, and (3) the precontracting information-gathering costs to the promisee incurred in obtaining information before entering a given contract.

A. *Risk Allocation: Supercompensatory Remedies Misallocate Risk*

One of the fundamental roles of contracts is to allocate risk between parties.[49] One driving force that motivates parties as they sculpt the terms of any contract is the desire to minimize joint risk. The following analysis will show that supercompensatory remedies fail to minimize transaction costs relating to the negotiation of a proper risk allocation because supercompensation necessarily misallocates risk.

In general, people are risk adverse.[50] In other words, every person has a utility function with two characteristics: (1) as the person's level of resources increases, her utility (that is, her happiness) also increases, and (2) the higher a person's level of resources rises, the less utility she receives from the next additional unit of resources. Figure 1 shows the general shape of utility functions with these characteristics.

48. Sherwin, *supra* note 25, at 279.

49. *See* Diamond & Foss, *supra* note 2, at 690–91 ("[I]n formulating the default rule for consequential economic damages it is appropriate to consider how the parties, bargaining reasonably, would allocate risk with respect to those damages." (footnotes omitted)); DiMatteo, *supra* note 4, at 684 (noting that contract terms that allocate risk should be enforced strictly); Kelly, *supra* note 10, at 1772 ("The expectation interest permits the parties to allocate risks among themselves and enforces that allocation.").

50. Schwartz, *supra* note 46, at 392.

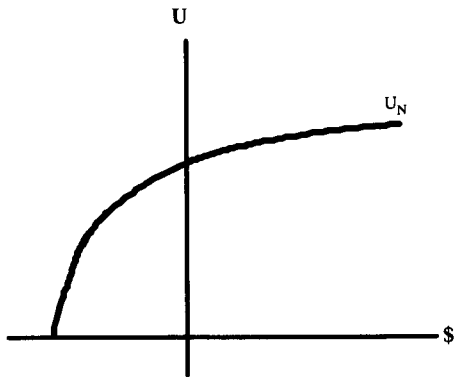

Figure 1. The general shape of a utility function.

In order to emphasize the impact of damage remedies on risk allocation, I will, for the moment, assume the probability of breach to be exogenous. In other words, neither the buyer nor the seller can invest in diminishing the likelihood that the contract will be breached. In legal terms, this can be phrased as a focus on non-willful breaches, breaches where the breaching party may desire to perform fully but is prohibited from doing so. An example would be a contractor who contracts to construct a building, but who learns only after entering the contract that the soil at the designated spot is incapable of supporting the planned structure. In Part III.B, these arguments will be generalized to cover willful breaches.

Suppose that *B*, the buyer, contracts to buy something from *S*, the seller.[51] Assuming (1) zero litigation costs,[52] (2) zero judicial error, and (3) no partial breach, *S* and *B* will have expected utilities from the contract equal to

$$E(U_B) = L(U_B(e-p)) + (1-L)(U_B(d-r)),$$
$$E(U_S) = L(U_S(p-c)) + (1-L)(U_S(-d-c)),$$

51. This analysis will consider only breaches by the seller.

52. For a thoughtful discussion of this assumption, see Schwartz, *supra* note 46, at 395–403. Even if this assumption were eliminated, there is no reason to believe that litigation costs have a different effect in cases involving breaches of land-sale contracts than in cases involving other types of breach. Thus, litigation costs cannot provide an explanation for why greater compensation is afforded in land-sale cases than in other cases.

where (1) $E(n)$ denotes the expected value of n, (2) $U_i(n)$ denotes the utility that individual i would have if she possessed n resources, (3) L denotes the probability that the contract will be performed, (4) p denotes the contract price, (5) e denotes the buyer's expected benefit from performance, (6) d denotes the damage remedy, (7) r denotes the buyer's cost of reliance on the contract in the case of breach, and (8) c denotes the seller's cost of the performance, which for convenience I have assumed to be incurred both in cases of breach and in cases of performance, an assumption that has no substantive effect on the calculation. Naturally, $e > p$, otherwise the buyer would have no incentive to enter into the contract.

To simplify these expected utility formulae, it is possible to define two more functions, R_B and R_S, the buyer's and seller's "risk loss," respectively, such that,

$$E(U_B) = U_B(L(e-p) + (1-L)(d-r)) - R_B,$$
$$E(U_S) = U_S(L(p-c) + (1-L)(-d-c)) - R_S.$$

Figures 2 and 3 tell this story graphically, with Q_n representing the difference to person n, measured in money, between performance and breach. For convenience, the zero point on the horizontal axis has been defined as the amount of money the party had before entering into the contract.

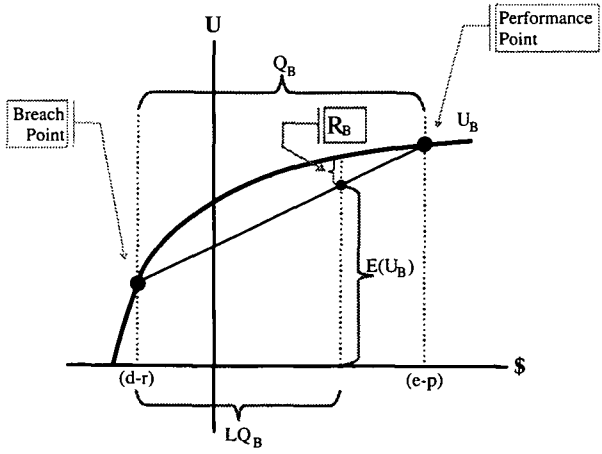

Figure 2. The buyer's utility from a contract.

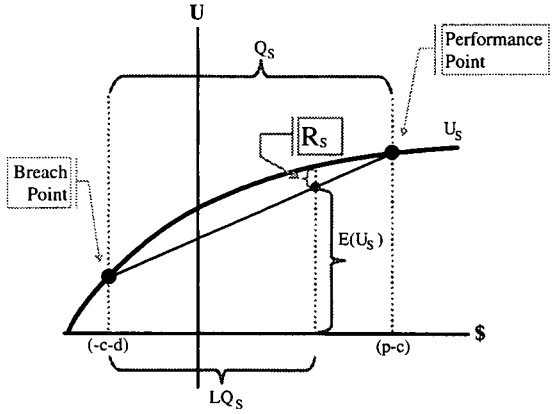

Figure 3. The seller's utility from a contract.

For a contract to allocate risk efficiently, it must be the case that p and d cannot be adjusted in such a way as to increase both $E(U_S)$ and $E(U_B)$. Otherwise, in a world of zero negotiation costs, the parties would bargain, changing d and p until no mutually beneficial alteration in the contract terms was possible. Often, one party will be able to bear risk at a lower cost (with less reduction in her utility) than the other can, and the parties will agree upon a price and damage remedy combination that reflects this fact.

Expressed in terms of Figures 2 and 3, as the damage remedy increases, the buyer's outcome in the case of breach moves to the right, and the seller's moves to the left. Similarly, an increase in price moves the buyer's performance point to the left and the seller's performance point to the right.

The parties' negotiations will aim to diminish joint risk. The party who can bear the risk more easily will tolerate her breach and performance points moving farther apart in order to allow the other party's points to move closer together. In the domain where $d < (e + r - p)$, an increase in d moves the buyer's points closer together and the seller's points farther apart. When $d = (e + r - p)$, the expectation measure of damages, the buyer's breach point and performance point overlap; the buyer experiences no risk. Any additional increase in d will cause the buyer's points to cross. The buyer will prefer breach over performance. But as soon as the buyer's points cross, the buyer again begins bearing risk. Any increase of d above $(e + r - p)$ causes both parties to bear additional risk. This means

that supercompensatory damages cannot be an efficient risk-spreading solution as long as the parties are risk adverse.[53]

At the other side of the spectrum, a decrease in d causes the seller's breach point to move to the right and the buyer's to move to the left. When $d = -p$, the seller's breach and performance points overlap. Any movement of d below $-p$ causes the seller's points to cross and both parties to bear more risk. Thus, the ideal risk-spreading damage remedy necessarily falls somewhere between $-p$ and $(e + r - p)$.

B. Where Damage Remedy Shapes Breach Decisions, Parties Will Strictly Prefer the Expectation Measure to Supercompensation

In the last Part, I considered only non-willful breaches. In practice, however, the decision whether to breach is often entirely under the control of the breaching party. In this Part, I will focus on the effect of supercompensatory remedies on breach decisions in cases where the promisor has the option whether to breach or to perform.

1. The Concept of Efficient Breach

From legal and economic perspectives, the mere fact that a contract has been entered into does not necessarily mean that it should be performed.[54] Contract law should aim to "encourage efficiency in individual affairs so as to maximize social wealth."[55] This can be accomplished only by establishing rules that facilitate the movement of resources to their highest-valued uses. When a promisor who has already entered a contract to provide certain resources to a promisee is approached by another potential buyer who values those resources more highly than the promisee and is willing to pay more than the contract price, performance of the contract becomes inefficient "in the straightforward sense that the cost of performance [including opportunity cost] is greater than the benefit."[56] The world will be better off if, at the end of the day, the resources are in the hands of the second buyer, and worse off if they are in the hands of the first. The "ultimate distribution of gains" resulting from the transaction is incidental;[57] all

53. For an analytical proof of this argument, see *infra* app. 1; *see also* Schwartz, *supra* note 46, at 396 (presenting a related analysis).

54. Standen, *supra* note 3, at 151 ("[T]he law's predilection for the 'expectation' measure of damages, and its general rejection of more protective remedies such as specific performance, suggests that breaches of contract are not only tolerated but are apparently encouraged under appropriate economic conditions.").

55. Sherwin, *supra* note 25, at 268.

56. Ayres & Madison, *supra* note 42, at 47.

57. Sherwin, *supra* note 25, at 280.

that matters is the post-breach level of total social welfare, which will, on average, be maximized if the resources go to the individual willing to pay the highest price for them.[58] "It is [therefore] not in the public interest to deter breaches that are efficient . . . because society benefits when the seller's economic gains from breach exceed the buyer's losses."[59] Thus, "the desired incidence of contractual . . . harms is not zero,"[60] and breach deterrence "is a term of some refinement, connoting a vision of the social good that favors wealth maximization."[61]

A great body of scholarship exists elaborating the advantages of the expectation measure for shaping breach decisions. Whenever the damage remedy is greater than $(e - p)$, there will be cases in which the promisor has an incentive to perform, even though performance is inefficient.[62] The expectation measure, however, does not have this disadvantage, in that it induces performance in all and only those cases where performance is efficient.[63] Rather than track this total social

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58. Law and economics scholars often simplify this statement and claim that welfare will be maximized per se—not merely on average—by adopting the view that the "only meaningful measure of value is what people are willing to pay." *Id.* at 268.

59. Diamond & Foss, *supra* note 2, at 680.

60. Standen, *supra* note 3, at 152.

61. *Id.*

62. *See* DiMatteo, *supra* note 4, at 676 (explaining the induction of inefficient performance); Schwartz, *supra* note 46, at 375 ("The greater are the damages that the promisor must pay on breach, the more often will the promisor choose to perform (at a loss) rather than pay."); John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1572 (1986).

> Overcompensation of plaintiff and punishment of defendant for breach of contract, it is asserted, may produce an economically inefficient allocation of resources. If the defendant, despite being under contract to the plaintiff, can shift his resources to a more valuable use, the defendant should not be prevented from doing so as long as he fully and effectively compensates the plaintiff for her losses.

Id.; Jeffrey V. Coopersmith, Comment, *Refocusing Liquidated Damages Law for Real Estate Contracts: Returning to the Historical Roots of the Penalty Doctrine*, 39 EMORY L.J. 267, 269 (1990) ("[A] punitive liquidated damages provision would create an inefficient resource allocation by, in effect, forcing the performing party to continue to engage in the less valuable alternative.").

63. *See* Eisenberg, *supra* note 45, at 573–74 ("The attraction of expectation damages is that they place on the breaching party the loss of the other party's share of the contract's value, and thereby sweep that loss into each party's self-interested calculus in a decision whether to perform or to breach."); Sebert, *supra* note 62, at 1572; Sherwin, *supra* note 25, at 278.

> One tenet of economic analysis in contract law is that breach is sometimes more efficient than performance, and efficient breach should be encouraged. Specifically, breach is efficient if the promisor can realize a net gain in the form of higher profits or saved costs by refusing to perform and applying the resources performance would command to another use. As long as the damage measure compensates the promisee for the lost value of her bargain, the choice to breach is efficient because it allows the resources to be applied to a higher-valued use.

Id. (footnotes omitted); Standen, *supra* note 3, at 151 ("Damages based on harm engender

welfare perspective, the analysis in this Part will focus, as in Part III.A, on determining what contract terms the parties would agree to if negotiation of the contract were costless.

2. Parties Engaged in Costless Negotiation Would Not Agree upon Supercompensatory Damages

The economic model here is similar to the preceding one. The players are the same: *B*, the buyer, and *S*, the seller. Here, however, the seller's decision to breach is shaped by the damage measure, which is set by the bargaining that occurs between the parties before entering the contract. This analysis will seek to demonstrate that, even when the damage measure has the potential to alter the seller's decision whether to breach, parties engaged in costless negotiation would never bargain for a supercompensatory remedy.

As in the last section, p denotes the contract price, e denotes the buyer's expectation, d denotes the damage measure, and c denotes the seller's cost of performance.[64] However, in this instance, a second form of "cost" is introduced, the opportunity cost, denoted c_o. In this analysis, the opportunity cost represents a second offer from a new potential buyer. I will assume that $c_o > e$ because otherwise the second offer would never lead the seller to breach, given that the remedy is set at or above expectation. Because it does not represent out-of-pocket expenditure, opportunity cost is not added to the analysis as an element of c.[65] Rather, c_o represents an additional benefit that can be reaped either by *S* if *S* breaches or by *B* if *B* resells *S*'s performance to the alternative buyer.

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theoretically sufficient deterrence by ensuring that no breach of contract or other risk-causing activity is undertaken where the defendant's expected damages exceeds the expected gains."); *see also* Coopersmith, *supra* note 62, at 269.

> Today, the theory characterized as "efficient breach" may be used to explain the prohibition on liquidated damages as penalties. Under this theory of contract law, a party to a contract has the choice of either performing or paying damages. The non-breaching party is presumably indifferent to whether he receives performance or the monetary equivalent of performance. However, because the breaching party has the opportunity to use his resources in pursuit of a better alternative, the world is generally better off.

Id. (citing Oliver Wendell Holmes, *The Path of Law*, 10 HARV. L. REV. 457, 462 (1897)).

64. For the sake of simplicity, this model will not consider the buyer's reliance. This omission has no substantive effect.

65. Although it would produce the same analytical result, the addition of opportunity cost as an element of c would not comport with the graphic utility representation introduced in Part III.A. This is true because, presumably, knowledge of a missed opportunity does not diminish utility as dramatically as corresponding out-of-pocket loss.

For the purposes of this model, when parties at the precontracting stage bargain for the damage measure, they are, in fact, bargaining over what happens in the event that the seller receives a second offer that may tempt her to breach. Assuming that (1) the seller will breach if and only if she receives a greater expected return from doing so, and (2) c is known to the seller from before the formation of the contract, the seller would never breach and the damage remedy would never be invoked unless a third party put forth a second offer.

Once the seller receives a second offer,[66] there are four possible outcomes for the contract: (1) the seller performs anyway, after which the buyer retains the performance; (2) the seller performs anyway, after which the buyer resells to the alternative buyer; (3) the seller first negotiates her way out of the contract by paying a price to the buyer for a release and then sells to the alternative buyer; or (4) the seller breaches and accepts the second offer. I will show that, if any one of these four cases were the certain outcome, the seller would ex ante prefer expectation damages more strongly than the buyer would prefer supercompensatory damages. It will then follow that, even though the outcome is actually uncertain, the seller will be willing to trade more in ex ante bargaining for the freedom to breach efficiently than the buyer will be willing to trade for the chance to extract additional gains from the occurrence of a second offer. Thus, in a world of zero negotiation costs, where the parties bargain until no additional change in the contract terms would increase their happiness, the parties would never negotiate to a supercompensatory remedy.

When damages equal expectation, only one of the four outcomes is possible. Once S receives a second offer such that $c_o > e$, S will always breach and pay damages to B.[67] B's outcome will be $(e - p)$, and S's will be $(c_o - c - e + p)$.[68] When the damage measure is greater than expectation, however, any of the four outcomes are possible. I will examine each in turn.

In the case of simple performance, S performs notwithstanding the second offer, and B does not resell to the second buyer. Performance will only take place in cases where, although $c_o > e$, the cost to S of extricating herself from the contract (either by negotiating a release or by breaching and paying damages) is high enough that there is no way

66. I will assume the probability of S receiving a second offer to be exogenous, beyond the control of either party.

67. This Part assumes that, at the time of S's decision whether to breach, S knows the value of e.

68. Naturally, S will choose this outcome over her performance outcome of $(p - c)$ because $c_o > e$.

for S to take advantage of the presence of the second offer. In this outcome, B receives a payoff of $(e-p)$, and S receives $(p-c)$. Thus, B receives the same outcome that she would have received under the expectation damages measure, while S receives a worse one. Therefore, if, given the supercompensatory remedy, performance were the certain consequence of a second offer greater than e, S would prefer the expectation measure more strongly than B would prefer supercompensation.

In the case of performance followed by resale, S performs and receives the payoff $(p-c)$. B then turns around and sells the performance—assuming that this is possible—to the alternative buyer at price c_o. B receives a payoff of (c_o-p-T), where T denotes the additional transaction cost of B getting in contact with the alternative buyer and executing the second exchange.[69] In this condition, B receives a surplus of (c_o-e-T) more than the $(e-p)$ that she would have received if the damage measure had been set at expectation. In comparison, S would have received $(c_o-c-e+p)$ under the expectation measure, but under the supercompensatory measure receives only $(p-c)$, which is less than her expectation return by (c_o-e). Thus, as long as $T > 0$, S prefers the expectation measure more strongly than B prefers the supercompensatory measure. Parties in a costless-negotiation world would, therefore, not select a supercompensatory remedy if resale by the buyer were the certain consequence of a second offer higher than the buyer's expectation.

In the case of negotiated exit, S engages in renegotiation with B and obtains a release from the contract by paying B a sum, Z. B receives an outcome of $(Z-N_B)$, where N_B denotes B's cost of negotiating S's release from the contract.[70] This amount is $(Z-N_B-e+p)$ more than B would have received under the expectation measure. S receives a payoff of $(c_o-c-Z-N_S)$, where N_S denotes the cost to the seller of negotiating the release.[71] This amount is $(Z+N_S-e+p)$ less than S

69. It seems rational to assume that, on average, the cost to the buyer of arranging a substitute transaction will be larger than the seller's cost of simply following an opportunity that has already presented itself. Thus, the insertion of the T term is justified.

70. *See* Sherwin, *supra* note 25, at 279–80 (noting a similar negotiation cost example); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365, 1381–82 (1982) (noting that negotiation to escape a claim for specific performance is costly).

71. Because each side will attempt to negotiate a release on advantageous terms, it is likely that these negotiation costs will be quite high. *See* William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 665 (1999) ("The potential transaction costs of the additional negotiation are quite high [in cases where] there is a 'bilateral monopoly' [meaning that] neither party has an alternative to dealing with the other and each may act strategically to obtain a larger share of the gain from the second transaction." (footnotes omitted)); Richard A.

would have received under the expectation measure. Because the variables involved are all positive, $Z + N_s - e + p > Z - N_B - e + p$. Thus, *S*'s losses as a result of the supercompensatory damage measure are greater than *B*'s gains. Therefore, if negotiated exit were the certain outcome of a second offer, *S* would prefer the expectation measure more strongly than *B* would prefer the supercompensatory measure.[72]

The last condition to consider is the condition where *S* is not deterred by the supercompensatory damage measure but breaches the contract and sells to the alternative buyer anyway. *S* has to pay the supercompensatory damage measure to *B*, but c_o is high enough that breach is still her best option. This is exactly the scenario evaluated in Part III.A. The damage measure is supercompensatory but has no effect on *S*'s behavior: breach is the sure consequence of *S* receiving a second offer; therefore, the probability of breach is independent of the damage measure. As shown above, in this case, *B* earns more from breach than from performance, but in order to contract for the supercompensatory remedy, *B* must have paid a price increase equal to more than the remedy was worth to *B*. When the damage measure does not shape breach decisions, risk-spreading concerns dominate, and supercompensatory measures have already been shown to intrinsically misallocate risk.

Posner, *The Strangest Attack Yet on Law and Economics*, 20 HOFSTRA L. REV. 933, 936 (1992) (noting that, although "in a frictionless world" (i.e., a world with, inter alia, zero negotiation costs) a default remedy of specific performance would never deter efficient breaches, "[i]n the real world" negotiation of a contractual release "runs into the problem of bilateral monopoly," which creates the risk of high negotiation costs).

72. It may seem strange to assume a world of zero negotiation costs at the contract-formation stage, but then consider the costs of the later negotiation to be nonzero. In fact, evaluating the later negotiation costs is appropriate in light of the underlying principles behind the negotiation-cost approach. A legitimate goal of contract law is to, as much as possible, make negotiation at the formation stage unnecessary by setting default rules that approximate the terms the parties would arrive at if they had unlimited time and energy to expend on negotiating and drafting the contract. Modeling a world where both the initial negotiation cost and the renegotiation cost are zero would do contracting parties in the real world only limited service in terms of decreasing their need to expend resources forming contracts. Real world contracting parties will insert contract terms to limit their negotiation costs in the future, and default rules intended to decrease overall negotiation costs must account for this. Thus, the free-negotiation principal applies only to the specific transaction for which default rules are evaluated. In the real world, of course, negotiation is costly—particularly renegotiation for release from a contract, a condition of bilateral monopoly. *See* Ayres & Madison, *supra* note 42, at 54–55, 57 (explaining that renegotiation of terms under conditions of bi-lateral monopoly is inefficient); Yorio, *supra* note 70, at 1381–82 (arguing that a negotiation to escape a claim for specific performance is costly); Timothy J. Muris, Comment, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053, 1059 (1982) (showing an example of how negotiations over a buyer's right to specific performance can become expensive).

Thus, if any one of the four outcomes analyzed in this Part were the certain outcome, then the parties would prefer the expectation measure over a supercompensatory remedy. It follows that, whatever the actual distribution of probabilities among the four outcomes, the parties in ex ante bargaining will choose expectation over supercompensation, though not necessarily over undercompensation, regardless of the effect of the damage remedy on breach decisions.

C. *Promisee's Information Cost*

In addition to distributing risk and shaping breach incentives, the damage measure also has potential benefits regarding the promisee's ability to cost-effectively gather information about the contract before entering into it. Particular damage measures have the advantage of making unnecessary some of the promisee's precontracting, information-gathering expenditures, while causing other of these expenditures to yield greater return.[73] In the following analysis, I shall first give a general approach for determining which damage measures have these benefits and, second, argue generally that no supercompensatory damage measure has informational benefits as great as those of the expectation measure.[74] Specifically, I will show that allowing supercompensation through election between specific performance and damages has particularly undesirable informational effects.

1. The Information-cost Principle as Applied to the Expectation and Reliance Measures

As in the model in Part II.A, the buyer's (B's) expected utility from a contract is

$$\begin{aligned} E(U_B) &= L(U_B(e-p)) + (1-L)(U_B(d-r)) \\ &= U_B(L(e-p) + (1-L)(d-r)) - R_B. \end{aligned}$$

In this model, however, B has imperfect information. From her perspective, her expectation (e), her reliance (r), and the seller's probability of performance (L) are all uncertain.[75] The damage remedy

73. Clearly, at the pre-contracting stage the promisee bears the majority of the cost of gathering information. The promisor is in a better position to know exactly what she intends to sell to the promisee, whereas the promisee usually has to expend resources to determine what she is getting. For this reason, the analysis will focus on the promisee's cost.

74. See *infra* appendix 2 for an example of this information-cost model applied.

75. In practice, uncertainty as to these variables is the rule, not the exception. Buyers are often unsure as to the quality of the items they contract to purchase, which impacts e. Their

(d) also may be uncertain depending on how it is defined doctrinally.[76] I will denote the uncertainty of a variable (n) as $u(n)$. B's risk loss becomes a function of, among other things, the uncertainties of all of the variables that factor into her utility function (i.e., $R_B = R_B(u(e), u(d), u(r), u(L), \ldots)$). As any of these uncertainties increase, so too does B's risk loss.

I will assume further that B may have opportunities to invest in reducing some of the relevant uncertainties, thereby reducing her risk. For most damage remedies, she must distribute her spending widely on seeking to diminish—for the purposes of the present model—as many as four uncertainties.[77] Certain damage measures, however, cause the number of variables affecting B's expected utility (the "degrees of freedom" of the function) to decline. This allows B to ignore certain variables in her precontracting information gathering. In addition, as the number of variables upon which R_B depends declines, R_B's average sensitivity to movement in the remaining degrees of freedom must increase. Therefore, decreasing the number of relevant uncertainties makes gathering information about the remaining uncertainties more cost-effective. This, in turn, increases B's valuation of the contract and makes B willing to pay a higher price to S.

The reliance measure of damages presents a clear-cut example of a damage measure that diminishes the number of relevant uncertainties. When $d = r$, the buyer's expected utility equation simplifies to the following:

$$\begin{aligned} E(U_B) &= U_B(L(e-p) + (1-L)(r-r)) - R_B \\ &= LU_B(e-p) - R_B(u(e), u(L), \ldots). \end{aligned}$$

By using r as the damage measure, both r and d drop out of B's expected utility equation, thereby eliminating the need for B to invest in

reliance often depends upon uncertain events taking place between the formation and execution of the contract. And, of course, the probability that the seller will breach is almost always uncertain.

76. A particularly relevant example of an uncertain damage measure is the ability to elect between expectation damages and specific performance, a remedy that depends on post-contracting and post-breach market fluctuations.

77. The model could easily be generalized to include more than four uncertainties. For example, the present model assumes litigation costs to be negligible. By eliminating this assumption, and recognizing that litigation costs are likely to be uncertain, it would be possible to generalize this model to take into account the impact that various legal rules would have on the level of uncertainty associated with litigation costs. Such an analysis may demonstrate the desirability of simple legal rules which minimize this particular uncertainty. Indeed, the model is ripe for expansion to include additional variables as elements of B's utility function and, therefore, as new possible sources of risk. However, for the present purposes, four uncertainties are enough. Expansion would merely complicate matters.

reducing $u(r)$ and $u(d)$. As will be shown, the information-cost advantages of the reliance measure are not as great as those of the expectation measure. However, as Part III.A implied, in some cases the reliance measure will possess risk-spreading advantages over expectation such that, in situations where the ideal risk-spreading solution is close to the reliance measure, the informational considerations may make reliance the optimal remedy.

Unlike the reliance measure, the expectation measure allows B to ignore S's probability of breach. When $d = (e + r - p)$,

$$\begin{aligned} E(U_B) &= U_B(L(e-p)+(1-L)(d-r))-R_B \\ &= U_B(L(e-p)+(1-L)(e+r-p-r))-R_B \\ &= U_B((e-p)(L+1-L))-R_B = U_B(e-p)-R_B(u(e),\ldots). \end{aligned}$$

Thus, the only variables that affect B's expected utility become e and p. Because p is assumed to be certain, the expectation measure allows B to devote all of her information-seeking resources to decreasing $u(e)$.

2. Implications for Various Supercompensatory Damage Measures

Unlike the expectation measure, no supercompensatory damage measure allows B to ignore S's probability of breach. By definition, a supercompensatory damage measure is one in which $(e - p) < (d - r)$. When this is the case, L will not drop out of B's expected utility function. Moreover, outside of the bizarre solution where L equals zero, e will never drop out of B's expected utility function. Thus, no supercompensatory damage measure will reduce the number of uncertainties upon which $E(U_B)$ depends as dramatically as will the expectation measure.

Nonetheless, if, for public policy reasons, a court or legislature were to impose a supercompensatory damage measure on a party in breach, the information-cost model suggests that some supercompensatory measures would be better than others. Treble damages, for example, have advantages over awards of expectation damages plus attorney's fees. Under treble damages,

$$d = 3(e-p+r),$$

$$E(U_B) = U_B(L(e-p)+(1-L)(3e-3p))-R_B(u(e),u(L),\ldots).$$

If A denotes the amount of attorney's fees, which are presumably uncertain, then under an expectation plus attorney's fees measure,

$$d = e - p + A + r,$$
$$E(U_B) = U(L(e-p) + (1-L)(e+A)) - R_B(u(e), u(L), u(A), \ldots).$$

While the treble damages measure uses only variables that already exist in B's expected utility, adding attorney's fees adds a new variable, and thus a new uncertainty. This same logic demonstrates that allowing supercompensation by opportunistic election between specific performance and damages is a particularly bad way to award supercompensation because it forces B to consider highly uncertain future movements in the land market.

IV. Expectation as a Ceiling in Scholarship and Doctrine

The preceding economic analysis argues that courts should seek to adopt a scheme of contract remedies such that some plaintiffs receive their full expectation, while other plaintiffs receive less than their expectation, but no plaintiffs receive more than their expectation. In this Part, I will show that courts and scholars follow this scheme almost exactly. In order to demonstrate that supercompensation through opportunistic election between specific performance and damages is truly the odd remedy out, I will first discuss those scholars who have advanced the theory that the default damage measure should be set below expectation.[78] Second, I will turn to contract doctrine and show that courts generally set expectation as the ceiling for recovery, but subtract from that amount whenever other policy considerations can be furthered by so doing.[79] Finally, I will discuss the contract doctrines of punitive and liquidated damages to show that courts go to great lengths to avoid awarding supercompensation.[80] It will be clear that, as the economic models predict, courts do not use other policy considerations to justify upward adjustments of recovery as freely as they do to justify downward adjustments.

A. *Fuller and Perdue*

In 1936, in a publication revered as "the most influential piece of contract scholarship [of the twentieth] century," Fuller and Perdue "revolutionized the way scholars thought about contract damages" by

78. *See infra* Part IV.A.
79. *See infra* Part IV.B.
80. *See infra* Part IV.C.

advocating a framework that used reliance as the basis for calculating contract damages.[81] In *The Reliance Interest in Contract Damages*,[82] they discussed three possible interests that contract remedies could be shaped to protect: the restitution interest, the reliance interest, and the expectation interest.[83] Remedially fulfilling the reliance interest, the central concept of their theory,[84] required "award[ing] damages to the plaintiff for the purpose of undoing the harm which his reliance on the defendant's promise has caused him."[85] In other words, under reliance damages, the monetary award should be sufficient to "place the plaintiff in as good a position as she would have occupied if no promise had been made"[86]—that is, the position she would have been in had the contract never been formed.[87] In the major exception to this rule, Fuller and Perdue argue to limit reliance at expectation: "[W]e will not in a suit for reimbursement for losses incurred in reliance on a contract knowingly put the plaintiff in a better position than he would have occupied had the contract been fully performed."[88] This means that a court should choose the lesser of reliance and expectation so that, regardless of breach, the plaintiff must "bear any losses that she would have suffered had the [contract been] performed."[89]

In many cases, the reliance interest will be the least of Fuller and Perdue's proposed possible interests (viz., their reliance measure is always less than or equal to expectation and frequently less than restitution). Fuller and Perdue saw expectation as overly generous, "'compensat[ing]' the plaintiff by giving him something he never had,"[90] and argued that courts should use the expectation remedy only as a shorthand, because reliance (which Fuller and Perdue argued

81. Kelly, *supra* note 10, at 1755, 1757.

82. L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52 (1936).

83. *Id.* at 53–54.

84. *Id.* at 53.

85. *Id.* at 54.

86. Kelly, *supra* note 10, at 1773 (examining Fuller and Perdue's *The Reliance Interest in Contract Damages*).

87. *Id.* at 1761 (discussing *The Reliance Interest in Contract Damages*).

88. Fuller & Perdue, *supra* note 82, at 79 (emphasis omitted).

89. Kelly, *supra* note 10, at 1763 ("Fuller and Perdue . . . rejected any application of the reliance interest that would produce a recovery larger than the expectation interest. The expectation interest imposed a cap on the amount of recovery, thus forcing the plaintiff to bear any losses she would have suffered had the defendant performed." (footnotes omitted)).

90. Fuller & Perdue, *supra* note 82, at 53.

should include the value of lost opportunities)[91] presents terrific difficulties of proof.[92] In this view, the reliance interest provides the "normative justification" for recovery,[93] and "damage awards [such as expectation] that permit[] the plaintiff to recover profit merely use[] profit as a proxy for the gains prevented because one party, in reliance on a promise, elected to forego other opportunities that would have produced similar profit."[94] The expectation measure simply provides the easiest way to make sure that reliance is protected, and reliance must be protected, it is argued, because without such a degree of protection, parties would be unwilling to engage in promissory exchange.[95] Thus, in order to protect reliance, "we must . . . dispense with its proof."[96]

The noteworthy praise that the reliance measure has drawn—for example from Professor DiMatteo espousing that "'[contractual] justice requires nothing more than compensation measured by the amount of harm suffered,'"[97] and from other scholars urging courts to award reliance damages more frequently[98]—reflects an intuitive understanding

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91. *Id.* at 55.

> [T]hough reliance ordinarily results in "losses" of an affirmative nature (expenditures of labor and money) it is also true that opportunities for gain may be foregone in reliance on a promise. Hence the reliance interest must be interpreted as at least potentially covering "gains prevented" as well as "losses caused."

Id.

92. Eisenberg, *supra* note 45, at 575 ("Reliance . . . is often difficult to prove."); Fuller & Perdue, *supra* note 82, at 62 ("The difficulties in proving reliance and subjecting it to pecuniary measurement are such that the business man knowing, or sensing, that these obstacles stood in the way of judicial relief would hesitate to rely on a promise in any case where the legal sanction was of significance to him.").

93. Kelly, *supra* note 10, at 1756 (discussing Fuller and Perdue's *The Reliance Interest in Contract Damages*).

94. *Id.*

95. *See* Eisenberg, *supra* note 45, at 575 ("There would be little incentive to make contracts if costs resulting from the other party's breach were not compensable. Therefore, the minimum damage measure to which contracting parties would normally agree is a reliance or cost measure, based on the parties' baseline reliance interests."); Sherwin, *supra* note 25, at 293–94 ("Legal protection against losses incurred in reliance on a contract serves commercial policies that are vital to our society . . . .").

96. Fuller & Perdue, *supra* note 82, at 62.

97. DiMatteo, *supra* note 4, at 643 (quoting Professor Corbin in his work, ARTHUR CORBIN, CONTRACTS § 1057 (rev. ed. 1993)).

98. *See, e.g.*, Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1291 n.61 (1980) ("Three critical insights can be extracted from Fuller's exploration of the remedial and formal structures of contract: first, reliance is the organizing principle that supports all contractual obligation . . . ."); Mark Pettit, Jr., *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HASTINGS L.J. 417, 418 (1987).

> This Article concludes that all the arguments that have been offered to justify the expectation principle independently of reliance protection are unpersuasive. . . . Unless

of the importance of risk spreading. Although, from an economic perspective, reliance produces less efficient incentives with respect to the breach decision than expectation does, reliance will tend to better spread risk in cases of parties with similar levels of risk aversion (see figure 4).[99]

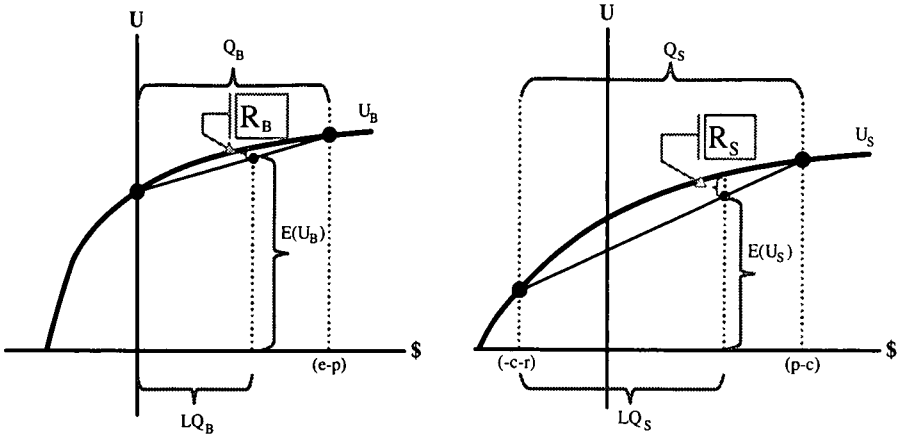

Figure 4. Under the reliance measure, the buyer's utility in the case of breach is equal to her precontracting utility. This means that, unlike under the expectation measure, the buyer bears some risk. The seller, on the other hand, bears less risk because $d = r$ and $r < (e + r)$.

B. Doctrinal Limitations on Recovering Full Expectation

In addition to the occasional use of the reliance measure of damages, the jurisprudence of contract remedies is rife with other limitations on plaintiffs' ability to recover full expectation. The apparent "fear of overcompensating contract plaintiffs"[100] has led to comments like the following from Professor Farnsworth, who stated, "All in all, our system of legal remedies for breach of contract, heavily influenced by the economic philosophy of free enterprise, has shown a marked

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> it can be shown that protecting the expectation interest will make us richer or more just or more free, we should stop after we have protected the reliance interest.

Id. But see Kelly, *supra* note 10, at 1787 ("Reliance limited by expectation imposes upon contract damages an asymmetry systematically skewed to favor the breaching party."). The reliance measure is, in fact, infrequently applied. *Id.* at 1758 ("Despite scholarly acclaim, the reliance interest plays virtually no role in the calculation of damages in contract cases.").

99. This risk-spreading advantage occurs because, due to the downward curvature of utility functions, as a party's breach and performance points move farther apart, the marginal risk loss for each additional increase in separation increases. As a result, when parties have similar levels of risk aversion, ideal risk spreading will often require that both parties bear some risk.

100. Sebert, *supra* note 62, at 1571.

solicitude for men who do not keep their promises."[101] Similarly, Professor Sebert argued: "The traditional rules establish full compensation as the maximum potential recovery for a contract plaintiff, and they impose the primary risk of error in calculating damages on the aggrieved plaintiff rather than upon the breacher; thus they often preclude realizing full compensation,"[102] and that, "[I]n the past few years, there seems to be an increasingly widespread recognition that traditional contract damage principles operate to create a much more substantial risk of undercompensation than of overcompensation."[103] The idea that expectation damages give more than optimal relief seems "tacitly to underlie the approach of classical contract law"[104] and is apparent from such doctrines as certainty, foreseeability, nonpecuniary loss, specific performance, punitive damages, and liquidated damages.[105] Using these doctrines, "courts often remove entire elements of claimed loss from the province of the jury,"[106] leaving "many victims of contract breach (probably a substantial majority)" not fully compensated.[107]

I will now briefly examine the manner in which each of these doctrines advances the "goal of limiting a promisee's recovery to [at most] lost expectation."[108]

1. Certainty

In order to be recoverable, damages must be proved with a "necessary degree of certainty,"[109] a rule that contributes to the law's "slant[] in favor of awarding less than full damages."[110] In practice, this

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101. E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1216 (1970).

102. Sebert, *supra* note 62, at 1567–68.

103. *Id.* at 1573; *see also* Sherwin, *supra* note 25, at 281 (arguing that "a variety of defects in the damage remedy . . . belie th[e] assumption" that contract damages "compensate the promisee for the value she placed on performance").

104. Eisenberg, *supra* note 45, at 572.

105. *See generally* Sebert, *supra* note 62, at 1566–67 (discussing the doctrines of certainty, foreseeability, non-pecuniary loss, specific performance, punitive damages, and liquidated damages); Orlando V. Da Silva, Comment, *The Supreme Court of Canada's Lost Opportunity:* Semelhago v. Paramadevan, 23 QUEEN'S L.J. 475, 485 (1998) (Can.) (discussing Canadian damages law).

106. Sebert, *supra* note 62, at 1567.

107. *Id.* at 1566.

108. Schwartz, *supra* note 46, at 369.

109. RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."); *see also* DiMatteo, *supra* note 4, at 648 (noting the difficulty in determining damages with the necessary degree of certainty).

110. DiMatteo, *supra* note 4, at 648.

doctrine amounts to a rule that courts will round down in calculating damages.

2. Foreseeability

As with certainty, the foreseeability doctrine, exemplified by *Hadley v. Baxendale,* is an example of the law's view of expectation as a ceiling for contract recovery.[111] *Hadley,* along with statutory enactments relating to consequential damages, establishes a presumption against awarding damages that follow only indirectly from breach.[112] As a result, the recovery of consequential damages differs sharply from that of full expectation damages.[113] Although some have criticized *Hadley's* tendency to provide less than complete compensation,[114] others recognize that "[a] properly fashioned rule for consequential damages . . . will not necessarily provide full compensation for all economic loss, even if failure to recover that loss will leave the buyer in a worse position than if the contract had been performed. Other policy considerations . . . [may justify] limiting such recovery."[115] The particular policy objective of *Hadley* is to induce the parties to share information in a manner that diminishes total risk.[116]

Hadley has been "[d]escribed as 'a fixed star in the jurisprudential firmament,' [and generally is recognized] as the definitive source for determining when consequential damages may be recovered for breach of contract."[117] *Hadley* established a two-prong test for recovery of consequential damages: the damages must either (1) reasonably be considered as "arising naturally" from breach—that is, arising "according to the usual course of things"—or (2) reasonably be assumed to have been considerations in the minds of both parties at the time of contract formation.[118]

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111. Hadley v. Baxendale, 156 Eng. Rep. 145, 145 (Ex. Ch. 1854).

112. *See* Paul S. Turner, *Consequential Damages:* Hadley v. Baxendale *Under the Uniform Commercial Code*, 54 SMU L. REV. 655, 661 (2001) (discussing such a presumption under *Hadley*, as well as under section 1-106 of the Uniform Commercial Code).

113. *See* Eisenberg, *supra* note 45, at 578 (illustrating that, under *Hadley*, recovery of consequential damages in contract law is narrower than in tort law).

114. *See id.* at 602 (arguing that, under *Hadley*, reasonably foreseeable costs are not considered in awarding damages).

115. Diamond & Foss, *supra* note 2, at 678–79 (footnotes omitted).

116. Lawrence A. Cunningham, *Cardozo and Posner: A Study in Contracts*, 36 WM. & MARY L. REV. 1379, 1427–28 (1995).

117. Diamond & Foss, *supra* note 2, at 665 (footnotes omitted) (citing GRANT GILMORE, THE DEATH OF CONTRACT 83 (1974)).

118. Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (Ex. Ch. 1854).

In some constructions, *Hadley's* second prong has been taken to mean that "consequential damages can be recovered only if, at the time the contract was made, the [seller] had reason to foresee that the consequential damages [were] the probable result of the breach."[119] Conceived this way, the two prongs are collapsed, with the first becoming merely a special case of the second.[120]

The *Hadley* test leads to a distinction between, on the one hand, "general or direct damages [that (1)] flow from a given type of breach without regard to the [promisee's] particular circumstances,"[121] (2) can be recovered even if unexpected, and (3) are usually "market-measured,"[122] and, on the other hand, "special or consequential damages," which (1) are circumstance-dependent and (2) "typically consist of the difference between the profits the [promisee] actually made in transactions with third persons and the profits [s]he would have made if the seller had performed."[123]

As applied, the *Hadley* doctrine imposes strict limits on recovery for unexpected consequential loss.[124] Indeed, although some commentators have framed *Hadley* as a "'foreseeability doctrine,' the principle as traditionally formulated and applied cuts off most foreseeable damages."[125] Some courts "preclude even consequential damages [that] the seller had reason to know the [plaintiff] would likely incur."[126] Other courts allow recovery only if the parties, as part of entering the contract, entered a "tacit agreement" that the party in breach would assume the loss if such loss should occur.[127] Thus, the *Hadley* doctrine often cuts off recovery of consequential damages to damages that at the time of making the contract (1) were reasonably foreseeable and/or (2) the party in breach actually understood to be possible.[128]

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119. Eisenberg, *supra* note 45, at 566; *see also* Diamond & Foss, *supra* note 2, at 669 (citing RESTATEMENT (SECOND) OF CONTRACTS § 451(1), (2)(b) (1979)).

120. Eisenberg, *supra* note 45, at 565–66.

121. *Id.* at 565.

122. Diamond & Foss, *supra* note 2, at 667–68.

123. Eisenberg, *supra* note 45, at 565; *see also* Diamond & Foss, *supra* note 2, at 668 (stating that consequential damages "result[] from the injured party's special circumstances").

124. Diamond & Foss, *supra* note 2, at 668; *see also* Eisenberg, *supra* note 45, at 567 (noting that *Hadley* represents "[a]n extremely strict standard of foreseeability, which requires that the damage not be merely foreseeable or reasonably foreseeable, but probable or even highly probable").

125. Eisenberg, *supra* note 45, at 566 (footnotes omitted) (citing DAN B. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 12.3 (1973)).

126. *Id.* at 570.

127. *Id.*

128. *Id.* at 567.

This rule differs sharply from the tort rule for consequential damages,[129] which dictates that once the defendant has breached a duty to the plaintiff, the plaintiff can recover all damages foreseeably and proximately caused by the tort; the tortfeasor is judged based on the information she had at the time of the tort and not, as in contract law, at the time of the creation of the duty.[130] Tort law applies a broad foreseeability doctrine, "allowing the victim compensation for all but extraordinary injuries."[131] The tortfeasor is considered to "take[] the plaintiff as he finds her,"[132] meaning that liability will ensue even for harms that the defendant, at the time of the tort, reasonably believed had a very low probability of occurrence.[133]

3. Nonpecuniary Loss

"Nonpecuniary losses, such as inconvenience, annoyance, and emotional distress, although likely [to be] real in many situations, are rarely recognized" in the law of contract remedies.[134] In an alternate phrasing, this has been described as a tendency to "treat non-market losses as 'nominal,'"[135] except "in narrowly restricted circumstances."[136]

As with the foreseeability requirement, this is in sharp contrast to the tort doctrine, which generally allows recovery for emotional damages.[137] In contract cases, courts traditionally have restricted damages resulting from emotional distress to unusual situations, such as (1) death and burial cases involving issues such as mishandling of a corpse or providing of a defective casket;[138] (2) cases relating to the

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129. *See id.* at 577–78 (noting that tort law determines damages under the principle of proximate cause).

130. *Id.* at 580 ("The defendant will be liable for any type of damage which is reasonably foreseeable as liable to happen even in the most unusual case . . . ." (quoting Koufos v. C. Czarnikow Ltd., [1969] 1 App. Cas. 350, 384–85 (1967) (appeal taken from Eng.))).

131. Diamond & Foss, *supra* note 2, at 674.

132. *Id.* at 674–75.

133. *See generally* Eisenberg, *supra* note 45, at 577–80 (discussing the contrast between tort law and contract law with regard to liability for consequential damages).

134. Sebert, *supra* note 62, at 1578 (footnote omitted).

135. Da Silva, *supra* note 105, at 502.

136. Sebert, *supra* note 62, at 1568.

137. Diamond & Foss, *supra* note 2, at 674–75 (noting that the broad tort foreseeability doctrine is designed to assure that "only in the most exceptional cases will a victim's full compensation be denied"); Sebert, *supra* note 62, at 1568 ("[C]ontract plaintiffs normally may recover for emotional distress only infrequently and in narrowly restricted circumstances. This limitation effectively denies the contract plaintiff access to the open-ended 'fund' of general damages, pain and suffering, that is regularly available to the tort plaintiff." (footnotes omitted)).

138. Sebert, *supra* note 62, at 1584–85.

breaching party's failure to promptly deliver a message that a close friend or relative has died;[139] (3) cases where the breach was necessarily accompanied by "public embarrassment or humiliation of the plaintiff, such as unjustified ejection of the plaintiff from a hotel, restaurant, or other public place";[140] and (4) cases where the breach directly impacts the injured party's health, such as cases of improperly performed medical procedures.[141]

Courts have sought to explain the doctrine of nonpecuniary loss alternatively in terms of the foreseeability doctrine[142] and the certainty requirement.[143] However, as neither of these explanations account fully for the case law, the doctrine barring recovery of nonpecuniary loss merits inclusion as a distinct example of the law's lack of commitment to the goal of awarding contract plaintiffs their full expectation.[144] I will examine the purported foreseeability and certainty explanations in turn.

The standard *Hadley* foreseeability doctrine cannot explain the fact that nonpecuniary losses generally are discounted even where such losses could be expected to occur in the great preponderance of cases. It would not be

> so unusual to expect emotional distress to arise from a botched home remodeling job, from a defective automobile that continually [breaks] down and [has] to be repaired, from the unjustified termination of disability insurance payments, from an attorney's failure to disclose a substantial lien on residential property that a plaintiff had contracted to purchase, or from the unjustified cancellation of a business opportunity on which a plaintiff had substantially relied[.] Yet in most cases courts have quickly, and without closely examining the specific facts, concluded that emotional distress could not be a foreseeable consequence of breach.[145]

To assert foreseeability as the basis of the nonpecuniary loss doctrine, one must at least conclude that courts apply a different, and far stricter, foreseeability standard to nonpecuniary losses than to those losses that are purely economic in nature.[146]

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139. *Id.* at 1585.
140. *Id.*
141. *Id.*
142. *Id.* at 1586.
143. *Id.* at 1587–88.
144. *Id.*
145. *Id.* at 1586–87.
146. *Id.* at 1587.

The standard certainty doctrine also fails to explain the case law on nonpecuniary loss.[147] Clearly, any valuation of noneconomic losses will be uncertain, but there is no reason to think that the estimation can be any more certain in the few cases in which contract law has traditionally provided compensation for nonpecuniary loss.[148] If courts are willing to open up the possibility of inaccurate assessment in cases that fall under the traditional exceptions to the prohibition against recovery of noneconomic damages, then something other than the certainty requirement must be invoked to explain why the courts are unwilling to be similarly generous in other cases.

4. Specific Performance

Specific performance is the quintessential full-expectation remedy. Other than the time delay involved in going to court and forcing performance, the plaintiff receives actual performance, exactly that for which she bargained. And yet courts strongly favor denying specific performance in favor of monetary damages, which I have shown tend toward compensation below expectation.[149] As Professor Schwartz has pointed out, the adoption of damages rather than specific performance as the default remedy reflects, among other factors, courts' "inarticulate reluctance to pursue the compensation goal fully."[150]

The law of contract remedies is characterized by a "remedial hierarchy" that prefers damages to specific performance.[151] Courts generally will award specific performance only when, in addition to other restrictions, damages are inadequate[152] as a "substitute for the promised performance."[153]

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147. *See id.* at 1587–88.

> The certainty ground, however, fails to provide a satisfactory explanation because uncertainties about the measurement and even the existence of emotional distress are likely to be similar in both situations in which case law has traditionally permitted recovery for emotional distress and those in which this recovery is normally denied.

Id.

148. *Id.*

149. *See, e.g.*, *supra* notes 100–08 and accompanying text (reviewing commentary that finds contract law damages result in plaintiffs receiving less than full compensation).

150. Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271, 274 (1979).

151. Jessica Freiheit, *The Breakdown of Hierarchy: Damages at Law Versus Damages in Equity*, 27 MANITOBA L.J. 185, 186 (2000).

152. RESTATEMENT (SECOND) OF CONTRACTS § 359(1) (1981).

153. 3 FARNSWORTH, *supra* note 2, § 12.6, at 174; *see also* Leahy, *supra* note 8, at 533 (stating that "the underlying rule is that specific performance will not be granted if legal damages are adequate").

Although "[t]here is no general formula for determining when" monetary damages are inadequate,[154] specific performance will not necessarily be available just because "expectation damages pose a significant risk of undercompensat[ing the plaintiff]."[155] Adequacy is judged based on the totality of the circumstances of the contract,[156] with courts looking to factors such as uncertainty in the appropriate damage amount,[157] and any obstacles to the plaintiff's use of a money award to obtaining adequate substitute performance.[158] Prototypical cases for specific performance include contracts involving "heirlooms, family treasures and works of art that induce a strong sentimental attachment."[159] In cases such as these, specific performance is justified because damages, calculated pursuant to the limiting doctrines of certainty, foreseeability, and the prohibition against recovering noneconomic loss, may be nominal and expose the plaintiff to risk of dramatic undercompensation.[160]

"In addition to the adequacy test, a number of other limitations restrict the availability of specific performance."[161] These include (1) a requirement of extra clarity in the contract terms; (2) a rule against awarding specific performance that would entail too much judicial supervision; (3) a requirement that the injured party be willing and able to make full and complete return performance;[162] (4) a doctrine of balancing the value of the injured party's loss against the breaching party's cost of compliance;[163] and (5) the court's equitable power (not extended to cases involving purely monetary damages) to second-guess the parties by looking into the price[164] and the fairness of the contract,[165] and to weigh other public-policy considerations.[166]

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154. Kennedy, *supra* note 6, at 648; *see* Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 687, 691 (1990) ("Courts have escaped the [adequacy] rule by defining adequacy in such a way that damages are never an adequate substitute for plaintiff's loss.").

155. 3 FARNSWORTH, *supra* note 2, § 12.20a, at 356.

156. *Id.* § 12.6, at 176 (citing U.C.C. § 2-716 cmt. 2).

157. RESTATEMENT (SECOND) OF CONTRACTS § 360(a).

158. *Id.* § 360(b); *see* Kennedy, *supra* note 6, at 630 (discussing the difficulty in finding a suitable substitute); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. c (discussing the doctrine relating to the "[d]ifficulty of obtaining [a] substitute").

159. RESTATEMENT (SECOND) OF CONTRACTS § 360 cmt. b.

160. 3 FARNSWORTH, *supra* note 2, § 12.6, at 174–77.

161. *Id.* § 12.7, at 179.

162. *Id.* § 12.7, at 180–83.

163. Standen, *supra* note 3, at 170.

164. *Id.*

165. 3 FARNSWORTH, *supra* note 2, § 12.7, at 185.

166. *Id.* § 12.7, at 187.

For the present purposes, the details of these limitations on specific performance are not important. What is important is that these limitations are further examples of the law's willingness to set recovery below expectation whenever other policy issues complicate the picture. In the next section, I demonstrate that the law shows far greater reticence to deviate upward from the expectation measure, refusing to tolerate supercompensation even when agreement of the parties and/or deterrence goals appear to favor it.

C. Doctrinal Barriers Against Supercompensation

1. Punitive Damages

Under prevailing law, punitive damages are not allowed in breach of contract cases.[167] This rule has been viewed as reflecting a "countervailing corollary to the principle of full compensation: Do not overcompensate the victim of contract breach."[168] "Damages are designed [only] to compensate for an established loss and not to provide a gratuitous benefit to the aggrieved party . . . ."[169] This rule on punitive damages is justified on the ground that "excessive liability . . . may discourage valuable commercial and economic activity and thus create an undesirable barrier to the efficient reallocation of resources."[170]

There exists only one well-established exception to the rule against awarding punitive damages: when the "conduct constituting the breach is also a tort for which punitive damages are recoverable."[171] In other words, the law of contract traditionally does not allow punitive damages. Tort law, on the other hand, does, and the mere fact that a tort happens to involve a breach of contract does not insulate the tortfeasor by locking the plaintiff into the limits of contract remedies.

Some have argued for supplementing the "independent tort" exception by expanding contract law's application of punitive damages, especially to cases involving malicious behavior by the breaching

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167. William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 630 (1999) (observing that "[t]raditionally, punitive damages have not been available for breach of contract."); Sebert, *supra* note 62, at 1569 (noting that "[t]raditionally, punitive damages were said never to be available in contract actions."); Amy A. Kirby, Note, *Punitive Damages in Contract Actions: The Tension Between the United Nations Convention on Contracts for the International Sale of Goods and U.S. Law*, 16 J.L. & COM. 215, 215 (1997) (stating that "punitive damages have been technically forbidden in breach of contract actions").

168. Sebert, *supra* note 62, at 1566.

169. Da Silva, *supra* note 105, at 496 (discussing Canadian law).

170. Sebert, *supra* note 62, at 1566.

171. *Id.* at 1569.

party.[172] These efforts have been largely unsuccessful, and although some jurisdictions now permit punitive contract damages in a narrowly defined set of cases involving promissory fraud,[173] bad-faith denials of insurance claims,[174] and cases in which "'elements of fraud, malice, gross negligence or oppression mingle in the controversy',"[175] the rule prohibiting punitive damages in breach-of-contract cases remains secure.

2. Liquidated Damages

Not only does the law of contract damages disallow judicially imposed supercompensatory remedies but also it refuses to enforce contract terms in which the parties appear to have bargained for and, by mutual consent, agreed upon such remedies. When the parties have entered a contract stipulating their own damage remedy, courts will enforce that remedy only if the specified sum does not exceed "the harm that the promisee could reasonably expect [ex ante] to suffer from breach or . . . the actual harm that breach turned out to cause."[176] Whenever the amount specified in the damages clause exceeds either of these amounts, it constitutes a windfall that "cannot be justified under the just compensation principle that underlies common law contract damages"[177] and "mandates that the non-breaching party . . . receive [only] expectation damages"[178]—although, as demonstrated in Part IV.B, expectation damages often provide substantially less than true expectation.

The Ohio Supreme Court has articulated this rule "prevent[ing parties] from contracting for a supercompensatory remedy"[179] as follows: "reasonable compensation for actual damages is the legitimate objective of . . . liquidated damages provisions and where the amount specified is manifestly inequitable and unrealistic, courts will ordinarily regard it as a penalty."[180]

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172. *See* Schwartz, *supra* note 46, at 396 (stating that "promisors sometimes behave maliciously [and] there is a plausible case for punitive damages when [this behavior] occurs").

173. *See* Sebert, *supra* note 62, at 1607–13.

174. Schwartz, *supra* note 46, at 371–72; Sebert, *supra* note 62, at 1613–19.

175. Hibschman Pontiac, Inc. v. Batchelor, 362 N.E.2d 845, 847 (Ind. 1977) (quoting Vernon Fire & Cas. Ins. Co. v. Sharp, 349 N.E.2d 173, 180 (Ind. 1976)).

176. Schwartz, *supra* note 46, at 369. *See generally* DiMatteo, *supra* note 4, at 656–63 (discussing the law of liquidated damages).

177. DiMatteo, *supra* note 4, at 642–43.

178. *Id.* at 647.

179. Schwartz, *supra* note 46, at 369.

180. Samson Sales, Inc. v. Honeywell, Inc., 465 N.E.2d 392, 393–94 (Ohio 1984).

The prohibition against bargained-for supercompensatory remedies is demonstrated further by the "no injury defense," which applies to breaches of contracts containing liquidated-damages clauses. The defense bars recovery under a liquidated-damages clause in cases where the plaintiff suffered no actual injury from the breach.[181]

V. POSSIBLE SOLUTIONS TO THE PROBLEM OF SUPERCOMPENSATION THROUGH OPPORTUNISTIC ELECTION BETWEEN SPECIFIC PERFORMANCE AND DAMAGES

A. *The Traditional Equitable Approach*

Consistent with the "equitable impulse to deter plaintiff overcompensation,"[182] some courts have applied the equitable doctrine of laches to disallow specific performance in cases characterized by opportunistic delay of election. Laches allows judges to deny claims for specific performance on the ground that the injured party has engaged in unreasonable delay that she knew or should have known would result in harm to the breaching party.[183] This reflects the view that "equity aids the vigilant not they who slumber on their rights."[184] Although this approach allows judicial intervention in some cases of opportunistic delay of election, the doctrine is only effective in egregious cases, where the facts cry out that opportunism was a factor.

In *Gaglione v. Cardi*,[185] for example, the Rhode Island Supreme Court invoked laches to justify the denial of specific relief where the plaintiff had waited approximately six years before initiating a suit for specific performance, during which time the subject property had increased in value at least five fold, from $20,000 to "in excess of $100,000."[186] It was not the six-year delay alone that caused the court to deny specific performance, as the court noted that "the mere lapse of time does not constitute laches."[187] Nonetheless, because the delay was "unexplained and inexcusable" and had the effect of "visiting prejudice" upon the defendant, it "operate[d] as an estoppel to the assertion of" the plaintiff's right to equitable relief.[188]

181. DiMatteo, *supra* note 4, at 643.
182. Ayres & Madison, *supra* note 42, at 84.
183. Kennedy, *supra* note 6, at 626.
184. *Id.* at 621–22.
185. Gaglione v. Cardi, 388 A.2d 361 (R.I. 1978).
186. *Id.* at 364–65.
187. *Id.* at 364.
188. *Id.* (internal quotation marks and citations omitted).

Crawford v. Workman[189] presents another example where a court applied laches to forestall the plaintiff from obtaining supercompensation through delayed election of a remedy. In this case, the plaintiff, Crawford, sued for specific performance of a contract granting him "coal, oil, gas, and other mineral" rights to an approximately 600-acre tract of land.[190] The plaintiff initiated suit in March 1906, after five years of delay. In the intervening time, the expansion of the railroads had vastly increased the practicality of transporting resources away from the land and caused the value of the land's mineral rights to increase "perhaps twentyfold."[191] The court noted that Crawford offered no excuse for his delay and conjectured that it was his "intent to await events, and if railroads should head in [the] direction [of the tract of land] insist upon the contract, [but] otherwise not."[192] The court then paraphrased *Pomeroy on Specific Performance* for the proposition that "where a vendee delays in order that he may speculate upon the chances . . . that through a rise in value his gain may be assured, and then, when he is thus certain that it will be a fortunate speculation, sues for a conveyance, equity may refuse to grant him relief."[193]

Finally, in *Hymel v. Old Homestead Inc.*,[194] the court found that the plaintiffs were not entitled to specific performance of an October 1927 contract where they had waited to initiate suit until August 1958[195] and had "exhibited no interest in the contract whatever and offered no excuse for their lack thereof" during the intervening twenty-five years.[196] The court noted that the "[p]laintiffs' unreasonable delay in filing . . . suit after the [property] in question [had] substantially increased in value . . . justif[ied] and require[d] a denial" of the plaintiffs' right to specific performance.[197]

As these cases reflect, laches gives courts some power to prevent plaintiff overcompensation in cases of opportunistic delay in electing a remedy. The laches approach, however, has two serious limitations. First, it requires that the element of opportunism be clearly apparent from the facts of the case. A plaintiff will only be estopped from

189. Crawford v. Workman, 61 S.E. 319 (W. Va. 1908).
190. *Id.* at 319.
191. *Id.* at 321.
192. *Id.*
193. *Id.* (citing section 407 of *Pomeroy on Specific Performance*).
194. Hymel v. Old Homestead Inc., 135 So. 2d 685 (La. Ct. App. 1961).
195. *Id.* at 686.
196. *Id.* at 687.
197. *Id.*

asserting an otherwise legitimate equitable claim in situations "where the facts calling for [estoppel] and the wrong to be prevented are both unquestionable."[198] As the case discussions above demonstrate, this means that laches will be invoked only in cases of extended delay, dramatic increase in value, or both. In *Gaglione,* the subject property increased in value more than five fold.[199] In *Crawford*, the court estimated the increase at twenty fold.[200] These facts make application of laches straightforward. But what about cases where the value has increased twenty percent or fifty percent? Such an increase would probably be enough to alter the plaintiff's election of remedy, but would a court find it sufficient to invoke laches?

Second, the laches approach requires that the court engage in a trial within a trial. Before denying specific relief, a court will have to hear evidence and make findings concerning the plaintiff's excuse for her delay and changes that have occurred in the land market. If the plaintiff can assert a rational, non-opportunistic justification for her late election of a remedy, she may succeed in muddying the issue enough that the court will be reluctant to deny her right to specific relief. In addition to the added cost that such a trial within a trial produces, it also must inevitably lead to judicial error and the denial of specific relief to certain individuals whose delay was not motivated by opportunism.

These obstacles can be overcome, however, by an alternative approach to the problem of supercompensation: alter the election of remedies rule so that plaintiffs must elect early.

B. Proposed Rule: Force Plaintiffs To Elect Early

Plaintiffs should be required to make the election between damages and specific performance early, in some cases even before initiating the litigation. The current rule, which allows election "even at an advanced stage of the action,"[201] allows plaintiffs to plead in the alternative and then to derive economic advantage from tactically abandoning one remedy or the other.[202] Providing plaintiffs the resultant systematic windfall cannot be justified in terms of any of the underlying policy reasons for creating an entitlement to specific relief. In identifying those policy considerations, I will once again start by asking the

198. Kennedy, *supra* note 6, at 624.

199. Gaglione v. Cardi, 388 A.2d 361, 364–65 (R.I. 1978).

200. Crawford v. Workman, 61 S.E. 319, 321 (W. Va. 1908).

201. RESTATEMENT (SECOND) OF CONTRACTS § 378 cmt. a (1981).

202. Clark, *supra* note 39, at 609 (arguing for a general rule against a plaintiff's gain through the tactical abandonment of a claim for specific relief).

question, what remedy would contracting parties likely agree upon if, first, the negotiations were costless, and second, courts did not second-guess their contracts?[203]

In a world of zero negotiation costs, parties would agree upon a remedy of specific performance only in those cases where the cost to the buyer of bearing the risk of being undercompensated by monetary damages is greater than the cost to the seller of bearing the risk that she will be forced to perform on the contract.[204] As shown in Part IV, the traditional rules for calculating expectation damages produce risk of undercompensation in a great many cases. This undercompensation will be most severe in cases where the object contracted for is unique,[205] such that no true substitute can be obtained easily,[206] and a significant fraction of the plaintiff's loss will be impossible to prove with adequate certainty.[207] In cases of land contracts, in particular, "awarding specific performance 'as a matter of course,' forestalls the systematic under-compensation of consumer purchasers" who otherwise would see their nonpecuniary loss based on their special connection to the bargained-for land go unrecognized.[208] From the seller's perspective, on the other hand, the seller will never be forced to take an out-of-pocket loss in order to perform a sale-of-land contract—as she may, for example, if the contract were for the erection of a building.

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203. In practice, courts often do second-guess the parties' agreement, especially when the parties agree upon specific performance as a remedy. This fact makes it all the more important to use the zero negotiation cost model to evaluate the legal rule because the parties' inability to contract out of an inefficient default term will mean that contracts are undertaken on less than the most mutually beneficial terms and will both (1) decrease the average per-transaction gains from trade and (2) lower the total level of promissory activity.

204. *See* Kennedy, *supra* note 6, at 630. Kennedy argues that parties engaged in free negotiation would likely agree upon the uniqueness test:

> From a functional perspective, the adequacy test essentially reaches the same result the parties probably would have bargained for if bargaining for a remedy was possible. For example, a person buying something unique would probably have bargained for specific performance, but a person buying widgets would probably have bargained for (and would probably prefer) damages.

Id.; *see also* Yorio, *supra* note 70, at 1377 (outlining an argument that the uniqueness test enhances efficiency).

205. *See* Yorio, *supra* note 70, at 1377.

206. Muris, *supra* note 72, at 1056–57 (arguing that in the absence of substitutes, courts will not devote sufficient resources to adequately determine damages); Yorio, *supra* note 70, at 1379.

207. *See* Yorio, *supra* note 70, at 1379 ("Promisees of unique goods usually care very much about obtaining a specific performance clause . . . because it may be difficult, or impossible, to buy a satisfactory substitute.").

208. Da Silva, *supra* note 105, at 497 (discussing Canadian law).

The court can simply transfer ownership of the land by its own decree,[209] thereby exposing the seller only to minimal risk.

With costless negotiation, the parties would never agree on a remedy that allowed the buyer the option to choose between damages and specific performance. This can be seen by recognizing that specific performance provides exactly expectation and, to the extent that any additional elective power given to the buyer makes the buyer better off, that elective power pushes the remedy over the threshold and into the supercompensatory domain. As demonstrated in Part III.B, parties engaged in costless negotiation would never choose supercompensation.

However, the parties would not agree upon specific performance as a remedy in all sale-of-land contracts. In some cases, the buyer's interest in the piece of land will be unrelated to the land's unique characteristics. As the Canadian Supreme Court noted in *Semelhago*, due to "the progress of modern real estate development . . . [r]esidential, business and industrial properties are all mass produced much in the same way as other consumer products. If a deal falls through for one property, another is frequently, though not always, readily available."[210] In such cases, the buyer bears little risk of dramatic undercompensation if forced to rely on monetary damages, thus making bargaining for a remedy of specific performance unlikely.

The current legal rule allows election between monetary damages and specific relief because each remedy best fits some subset of the cases, although the remedy of election itself fits no cases. This may balance interests appropriately by helping to ensure that a remedy somewhere nearby the efficient remedy is available in all cases. Allowing substantial delay before the election, however, does nothing to advance the relevant interests. In cases where specific performance is the ex ante efficient remedy, it is so because the buyer, at the time of contracting, values the land at above market price because of non-monetary factors that leave the buyer vulnerable to severe undercompensation by monetary damages. In these cases, the buyer is aware of her idiosyncratic valuation at the time of contracting and will certainly be aware of it at the time of breach. The buyer needs no additional information before deciding which remedy to pursue, and thus, no delay in making the election should be tolerated. Forcing the plaintiff to elect early eliminates the supercompensation that results

209. 3 FARNSWORTH, *supra* note 2, § 12.4, at 765.

210. Semelhago v. Paramadevan [1996] 2 S.C.R. 415, 428 (Can.), *available at* http://www.lexum.umontreal.ca/csc-scc/en/pub/1996/vol2/html/1996scr2_0415.html (last visited Jan. 23, 2004).

from opportunistically delayed election, thereby pushing the actual remedy closer to the efficient one.

Thus, in cases of breach of land-sale contracts, plaintiffs should be forced to elect between damages and specific performance before having a chance to gauge the market. At the latest, election should be required upon the filing of the litigation. Ideally, election should take place even earlier, perhaps through a simple declaratory filing that the plaintiff is required to make within a short time of the breach in order to retain her right to specific performance.

This argument does not naturally extend beyond land-sale contract cases to other cases in which the plaintiff has access to specific performance. In other cases, specific performance is not awarded as a matter of course, and plaintiffs can receive specific performance only by proving the inadequacy of monetary relief. Requiring early election would be meaningless in cases where the plaintiff simply could decline to submit evidence of uniqueness, which would lead the court to find specific relief inappropriate and award monetary damages.[211]

VI. CONCLUSION

This Article has been roughly syllogistic in structure: major premise—that under the current, lenient election of remedies rule, plaintiff buyers suing for breach of land-sale contracts are afforded, on average, a supercompensatory remedy;[212] minor premise—that the law should be arranged so as to never give a supercompensatory remedy to contract plaintiffs;[213] conclusion—that the current election of remedies rule should be altered. Part V argues that the election of remedies rule should be changed, at least as applied to land-sale contract breaches, and offers a suggestion for how to change it.

Phrased in ex post terms, it may sound implausible that plaintiffs would actually seek supercompensation by taking advantage of the extended deadline before electing between monetary damages and specific performance. Taking the ex ante perspective, however, it seems quite likely that the individual plaintiff, most likely a repeat player in the real estate market who has watched the market for land rise

211. A rule denying all relief in cases where the plaintiff asserts a right to specific performance and then fails to make the necessary proof should be avoided for the chilling effect it would have on individuals legitimately seeking specific relief in cases in which their entitlement is less than crystal clear.

212. *See supra* Part II.

213. *See supra* Parts III–IV.

or fall, would have the sense to elect a remedy that will maximize her return.

The undesirability of supercompensatory remedies is apparent from both the theoretical and the doctrinal perspectives. The economic principles of risk spreading, efficient breach, and information cost argue that supercompensatory remedies are inefficient in that parties engaged in costless negotiation would never agree on them. Remedies lower than expectation, however, may be efficient, depending on the parties' comparative costs of bearing risk. This view is reflected perfectly in the doctrine and commentary of contract damages. The law shows substantial willingness to award compensation equal to less than expectation, while it will not tolerate supercompensation, even where the parties explicitly agree to it in the contract.

Finally, it is relatively easy to correct the problem of supercompensation of land-contract plaintiffs. By shortening the window of time within which land-contract plaintiffs are required to elect between specific performance and damages, the supercompensation can be eliminated without compromising any of the policy goals advanced by allowing the election in the first place.

APPENDIX 1

In order to prove the conclusion reached intuitively in Part III.A, consider a supercompensatory damage remedy, d_1, such that $d_1 = (e + r - p_1 + \alpha_1)$ where $\alpha_1 > 0$. In this circumstance, phrased in terms of figure 2 *supra*, the buyer's (*B*'s) performance point, $(e - p)$, is to the left of her breach point, $(d_1 - r) = (e - p_1 + \alpha_1)$.

When the damage measure equals d_1, and the price equals p_1,

Equation 1:

$$E(U_B) = L(U_B(e - p_1)) + (1 - L)(U_B(e - p_1 + \alpha_1)).$$

Holding e as a constant, and assuming that both p and α are variable, small changes in p and α will affect $E(U_B)$ as follows:

Equation 2:

$$dE(U_B) = L\left(-dp\frac{\partial U_B(e - p_1)}{\partial(e - p)}\right) + (1 - L)\left(-dp\frac{\partial U_B(e - p_1 + \alpha_1)}{\partial(e - p + \alpha)} + d\alpha\frac{\partial U_B(e - p_1 + \alpha_1)}{\partial(e - p + \alpha)}\right).$$

Because of the positive slope and downward curvature of *B*'s utility function,

$0 < \frac{\partial U_B(e - p_1 + \alpha_1)}{\partial(e - p + \alpha)} < \frac{\partial U_B(e - p_1)}{\partial(e - p)}$. As a shorthand, let

$A = \frac{\partial U_B(e - p_1 + \alpha_1)}{\partial(e - p + \alpha)}$ and $vA = \frac{\partial U_B(e - p_1)}{\partial(e - p)}$, where $v > 1$.

Assume that *B* is considering an alteration to the contract in which both p and α decrease, according to the relationship, $xdp = d\alpha$, where $x > 0$. Substitution simplifies Equation 2 into

$$dE(U_B) = L(-dpvA) + (1 - L)(-dpA + dpxA).$$

B has an incentive to accept any alteration to the contract as long as $dE(U_B) > 0$. Thus, the values of x for which B has an incentive to accept a reduction in the price can be determined as follows:

$$0 < L(-dpvA) + (1-L)(-dpA + dpxA)$$
$$\therefore -(1-L)(-dpA + dpxA) < L(-vdpA)$$
$$dp < 0, 0 < A$$
$$\therefore -(1-L)(x-1) > -Lv$$
$$L < 1$$
$$\therefore 1 - L > 0$$
$$\therefore x < \frac{Lv}{1-L} + 1.$$

Thus, B has an incentive to accept any offered diminution in price as long as the changes in p and α are small, and $\frac{d\alpha}{dp} < \frac{Lv}{1-L} + 1$.

As the following analysis demonstrates, whenever the contract provides for supercompensatory damages, the seller, S, will be willing to accept a price diminution fitting this description. When the damage measure is d_1, the seller, S, has the following utility function:

Equation 3:

$$\begin{aligned} E(U_S) &= L(U_S(p_1 - c)) + (1-L)(U_S(-d_1 - c)) \\ &= L(U_S(p_1 - c)) + (1-L)(U_S(p_1 - e - r - \alpha_1 - c)). \end{aligned}$$

Thus, Equation 4:

$$\begin{aligned} dE(U_S) = {} & L\left(dp \frac{\partial U_S(p_1 - c)}{\partial(p-c)} \right) \\ & + (1-L)\left(dp \frac{\partial U_S(p_1 - e - r - \alpha_1 - c)}{\partial(p - e - r - \alpha - c)} - d\alpha \frac{\partial U_S(p_1 - e - r - \alpha_1 - c)}{\partial(p - e - r - \alpha - c)} \right). \end{aligned}$$

Stated in terms of figure 3 *supra*, while the damage remedy is d_1, S's performance point, $(p_1 - c)$, is to the right of her breach point, $(p_1 - e - r$

$-\alpha_1 - c$). Due to the upward slope and downward curvature of S's utility function, $0 < \frac{\partial U_S(p_1 - c)}{\partial(p-c)} < \frac{\partial U_S(p_1 - e - r - \alpha_1 - c)}{\partial(p - e - r - \alpha - c)}$.

As a shorthand, $D = \frac{\partial U_S(p_1 - c)}{\partial(p-c)}$ and

$$qD = \frac{\partial U_S(p_1 - e - r - \alpha_1 - c)}{\partial(p - e - r - \alpha - c)}, \text{ where } q > 1.$$

S considers an alteration to the contract where $dp < 0$, $d\alpha < 0$, $ydp = d\alpha$, and $y > 0$. Substitution causes Equation 4 to simplify into

$$dE(U_S) = L(dpD) + (1-L)(qdpD - qydpD).$$

S has an incentive to accept any alteration to the damage remedy for which $dE(U_S) > 0$. The situations under which $dE(U_S) > 0$ can be determined are as follows:

$$0 < L(dpD) + (1-L)(qdpD - qydpD)$$
$$\therefore -(1-L)(qdpD - qydpD) < L(dpD)$$
$$D > 0, dp < 0, (1-L) > 0$$
$$\therefore -(1-L)(q - qy) > L$$
$$\therefore (q - qy) < \frac{-L}{1-L}$$
$$q > 0$$
$$\therefore y > \frac{L}{q(1-L)} + 1.$$

Thus, S has an incentive to accept any alteration to the contract such that $\frac{d\alpha}{dp} > \frac{L}{q(1-L)} + 1$.

Although the interests of S and B are clearly adverse (i.e., B wants dp to be of as much greater magnitude than $d\alpha$ as possible, while S wants the opposite), supercompensatory remedies will always result in an overlapping area wherein both would profit from a reduction in both price and damage remedy. This is so because any alteration in the d and

α such that $\frac{L}{q(1-L)}+1<\frac{d\alpha}{dp}<\frac{Lv}{1-L}+1$ will benefit both S and B. Such a value must exist because $q > 1$ and $v > 1$.

Therefore, all contracts containing supercompensatory damage remedies are inefficient, at least from a risk-spreading perspective, because there will always exist mutually beneficial alterations that decrease the damage remedy.

APPENDIX 2

AN EXAMPLE OF THE DAMAGE MEASURE MAKING AN INFORMATION-GATHERING EXPENDITURE UNNECESSARY

Suppose that *B* is considering buying a home. *B* has two options: to buy from a large real-estate company that she knows never breaches a contract, or to buy from *S*, a local landlord, who may or may not breach. *S* is asking $130,000 for a house that is worth $150,000 to *B*. If *B* and *S* enter a contract, and that contract is performed, *B* will receive a surplus of $20,000. The real-estate company is selling another house that *B* values at $150,000, but the company is asking $143,000. If *B* enters that contract she will receive a surplus $7000. *B* knows that her reliance will be zero, and for initial consideration, the damage measure is zero. *L*, however, is uncertain. From her experience in real estate, *B* knows that there are only two kinds of local landlords: reliable ones, for whom $L = .9$, and unreliable ones, for whom $L = .4$. Before investing in research, *B* knows that *S* falls into one of these two groups, each with .5 probability. Assume that by expending $500 worth of her time to research *S*'s history, *B* can determine which kind of landlord *S* is.

Consistent with the general concave shape discussed in Part III.A, *B* has a utility function such that $U_B(x) = \ln(\frac{x}{500} + 10)$,

where x denotes the monetary value *B* places on what she receives. *B*'s expected utility from a purchase from the local landlord is calculated as follows:

$$E(U_B) = L(U_B(e-p)) + (1-L)(U_B(d-r))$$
$$e = 150000$$
$$p = 130000$$
$$d = 0$$
$$r = 0$$
$$\therefore E(U_B) = L(\ln(\frac{20000}{500} + 10)) + (1-L)(\ln(10)).$$

Before expending resources on researching *S*'s past history, *B* knows that *L* equals either .9 or .4, each with 50% chance. Under these circumstances of uncertainty, *B*'s valuation of the contract is:

$$E(U_B) = \frac{1}{2}\left[.9\ln\left(\frac{20000}{500}+10\right)+.1\ln(10)\right]+\frac{1}{2}\left[.4\ln\left(\frac{20000}{500}+10\right)+.6\ln(10)\right]$$
$$= \frac{1}{2}(3.75)+\frac{1}{2}(2.94) = 3.35.$$

That is, while B is uncertain whether S is reliable or unreliable, B's expected utility from the contract is 3.35 (the equivalent of \$9251 given with certainty).[214] If, on the other hand, B knew S's status, then B's expected utility from the contract would be 3.75 (the equivalent of \$16,261 given with certainty) if S were reliable and 2.94 (the equivalent of \$4458 given with certainty) if S were unreliable.

When the damage measure is set at zero, B's proper strategy is to invest the \$500 dollars worth of effort necessary to determine S's type and then enter the contract only if S is reliable. If S is unreliable, then B will buy from the real-estate company and receive a total surplus equivalent to (\$7000 – \$500). By adopting this strategy,

$$E(U_B) = \frac{1}{2}\left[.9\ln\left(\frac{20000-500}{500}+10\right)+.1\ln\left(\frac{-500}{500}+10\right)\right]+\frac{1}{2}\ln\left(\frac{7000-500}{500}+10\right)$$
$$= \frac{1}{2}(3.72)+\frac{1}{2}(3.14) = 3.43.$$

This is equal to the equivalent of \$10,438 given with certainty. Thus, even after the \$500 dollar expenditure is subtracted, B's research increases her valuation of the contract by \$1187.

This \$500 expenditure, however, would be unnecessary if the damage measure were set at expectation, rather than at zero. Under the expectation measure, B's expected utility from the contract would not depend on L, but would be

$$E(U_B) = L\ln\left(\frac{150000-130000}{500}+10\right)+(1-L)\ln\left(\frac{150000-130000}{500}+10\right)$$
$$= \ln\left(\frac{150000-130000}{500}+10\right) = 3.91.$$

214. The dollar equivalent of a utility value can be easily calculated using an equation derived from B's utility function: $U_B = \ln(\frac{x}{500}+10) \Rightarrow 500(e^{U_B}-10) = x$.

This translates into a cash-equivalent valuation of $20,000 given with certainty. Clearly this model does not take into account minor price adjustments that the seller would make to respond to a higher damage remedy. The point is simply that, because the expectation measure of damages makes *B* indifferent as to *L*, it eliminates the need for *B* to make expenditures to determine *L*'s true value.