# A Defense of Judicial Reconstructiou of Contracts

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The doctrines on impracticability, mistake, penalties, forfeiture, and good faith share a feature that is unusual in contract law. They give courts the power to excuse or modify terms in contracts between sophisticated parties who bargained over the terms of the contract with equal power and information. Such judicial modification of contracts seemingly violates the basic principle of freedom of contract in a context where the interference cannot be justified on the ground that it protects the weak or the ignorant from exploitation.[1] Judicial interference is also subject to strong criticism on economic grounds since sophistieated parties who bargain as equals might be expected to do a better job than courts in designing contracts to serve their interests.[2]

This Article argues that some aspects of these doctrines and related parts of contract law may be restated around two principles in a way that makes at least these aspects of the law defensible against the freedom of contraet and efficiency objections.[3] I call the

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1. The doctrine on penalties, which most plainly restricts freedom of contract, is the most strongly criticized. *See* Bigda v. Fischbach Corp., 849 F. Supp. 895, 902-03 (S.D.N.Y. 1994); Rattigan v. Commodore Int'l Ltd., 739 F. Supp. 167, 170-71 (S.D.N.Y. 1990); Barrera v. Ciolino, 636 So. 2d 218, 223 (La. 1994). The principle of freedom of contract also has been invoked as a reason to reject the doctrine of good faith, *see* English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983), or to adopt a conservative position on the use of doctrines like impracticability, mistake, good faith, and forfeiture to override the express terms of a contract. *See* Kama Rippa Music, Inc. v. Schekeryk, 510 F.2d 837, 842-44 (2d Cir. 1975); Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 74 (N.J. 1985).

2. For economic criticism of the doctrine on penalties, see Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369 (1990); Debora L. Threedy, *Liquidated and Limited Damages and the Revision of Article 2: An Opportunity to Rethink the U.C.C.'s Treatment of Agreed Remedies*, 27 IDAHO L. REV. 427 (1990). *Cf.* ANTHONY T. KRONMAN & RICHARD A. POSNER, THE ECONOMICS OF CONTRACT LAW 261 (1979) (describing the prohibition on penal liquidated damage clauses as "paternalistic" and "least defensible from an economic point of view"). For economic criticism of the doctrines on impracticability, mistake, and frustration, see Douglas G. Baird, *Self-Interest and Cooperation in Long-Term Contracts*, 19 J. LEGAL STUD. 583 (1990); Alan O. Sykes, *The Doctrine of Commercial Impracticability in a Second-Best World*, 19 J. LEGAL STUD. 43 (1990); Michelle J. White, *Contract Breach and Contract Discharge Due to Impossibility: A Unified Theory*, 17 J. LEGAL STUD. 353 (1988). For a general argument that courts should impose terms on contracts involving sophisticated parties only if the parties are asymmetrically informed at the time of contracting, see Benjamin E. Hermalin & Michael L. Katz, *Judicial Modification of Contracts Between Sophisticated Parties: A More Complete View of Incomplete Contracts and Their Breach*, 9 J. L. ECON. & ORGANIZATION 230 (1993).

3. Aspects of the law of restitution and tort also are consistent with these principles. Saul Levmore discusses a fascinating case that involves the use of restitution to compensate a party for expenses it undertook to save the other party to a contract from a significant loss. Saul Levmore, *Obligation or Restitution for Best Efforts*, 67 S. CAL. L. REV. 1411, 1414-16 (1994) (discussing Leebov v. United States Fidelity & Guar. Co., 165 A.2d 82 (Pa. 1960)). In *Leebov*, a builder sacrificed his trucks by using them as retaining barriers to prevent a landslide that would have inflicted a significant loss on a neighbor's property, a loss the builder's liability insurer would have borne. The builder was allowed to recover for the damage to the trucks in restitution from the insurer. From an ex ante perspective, the decision is consistent with the principle of unselfish performance, for the prospect of recovery might induce persons in the builder's situation to incur expenses that they are not obligated to incur under a contract that provides a much greater benefit to the other party to the contract. From an ex post perspective, the decision might seem consistent with the principle of loss alignment: had restitution not been allowed, the builder would have suffered a loss while the insurer benefited. The case is unusual in two respects: the loss shifted was a real economic loss and it was under an insurance contract. Typically, loss-shifting does not leave the party to whom the loss was shifted in a position worse than it would have been without the contract; and normally losses are not shifted under insurance contracts, for their function is to allocate losses. Perhaps the two points are related. Absent insurance, the law would require a builder to bear the loss on his trucks—the builder could not sue his neighbor for the loss he averted—for his excavation work ultimately caused the loss. Indeed, a builder would be liable for any harm it caused the neighbor. The insurance contract shifts the risk of loss of excavation to the insurer; and once we

two principles "unselfish performance" and "loss alignment." The principle of unselfish performance overrides contract terms that would permit a party to profit from acting or threatening to act in a way that would impose a significant joint net loss on the parties. The principle echoes a familiar justification for the doctrine on penalties, which is said to eliminate the incentive a promisor might have to perform inefficiently or that a promisee might have to induce or falsely claim breach if the promisor had to pay damages on breach that greatly exceeded the promisee's loss on breach.[4]

The principle of loss alignment relieves a party from a significant and unexpected loss under a contract when such relief would leave the other party in a position no worse than she would have been in had the contract not been made. While the principle of loss alignment is novel,[5] it is similar to other positions with deep roots in contract law. For example, it is consistent with the position that a promise should not be enforced absent detrimental reliance or unjust enriehment.[6] The principle of loss alignment excuses a promisor from an obligation only if excuse neither leaves him enriched, nor leaves the promisee at a reliance loss. Usually obligation in contract is grounded on consent[7] rather than on reliance or enrichment, but it is not surprising to find that when unexpected events alter the terms of performance in a way that makes consent a tenuous basis for enforcement of a contract, the absence of reliance and enrichment may justify nonenforcement of a contract. The principle of loss alignment also is akin to Charles Fried's principle of sharing.[8] And, part of my argument supporting the principle of loss alignment builds on the work of others who have argued that courts often invoke the impraeticability doctrine to save a promisor from an unexpected loss when doing so only deprives the promisee of a windfall.[9] However, as will become apparent, the principle of loss alignment accounts for the law better than either Fried's principle of sharing or the anti-windfall principle.

The principles help to explain and justify what courts do in cases that fall in a twilight zone of contract where terms malfunetion because of the unexpected. In this twilight zone, courts do not interpret contracts in the usual way because a contract can no longer be construed by reference to the parties' likely expectations. Perhaps it is this inability to ground construction on the parties' likely expectations that justifies the resort to principles of unselfish performance and loss alignment, which derive their force from

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accept that contractual allocation of risk and loss as a given, then the builder's action "enriches" the insurer. In this respect, the case is similar to Hall v. W.L. Brady Investments, Inc., 684 S.W.2d 379 (Mo. Ct. App. 1984), discussed *infra* notes 181-83 and accompanying text. That case also involved a court construing a contract to prevent a party from taking advantage of an unexpected event to shed a risk it bore under the contract. I might characterize these as cases of contract interpretation, rather than reconstruction, but the essential point is that a court ought to go outside the literal terms of a contract to impose liability for a real loss only when it is confident that the parties intended the party to whom the loss was allocated to bear that loss as a general matter, and that nothing in the specific language of the agreement arguably warrants a different allocation of the risk.

4. *See infra* notes 98-100 and accompanying text.

5. Elsewhere I show that an important reason for the use of open terms in contracts is to aligu losses when the cost or return on a contract is uncertain. Mark P. Gergen, *The Use of Open Terms in Contracts*, 92 COLUM. L. REV. 997, 1029-37, 1057-61 (1992).

6. Patrick Atiyah is a prominent and eloquent exponent of the position that either reliance or enrichment ought to be preconditions for the enforcement of a promise. *See* PATRICK S. ATIYAH, PROMISES, MORALS, AND LAW 143 (1981).

7. Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986).

8. CHARLES FRIED, CONTRACT AS PROMISE 71 (1981). The principle of loss alignment, like Fried's principle of sharing, would relieve a promisor from an unexpected loss if the effect is to deny the promisee a windfall gain. Loss alignment, unlike Friedian sharing, would not require sharing unexpected losses. And, unlike Friedian sharing, it would relieve the promisor from an unexpected loss under a contract so long as that leaves the promisee in as good a position as he would have been in had the contract not been made.

9. *See infra* note 64 and accompanying text.

beliefs about what is fair and efficient. Of course the line between interpretation and reconstruction of a contract is hazy, for interpretation is influeneed by norms of human behavior, including beliefs about what is fair and efficient.[10]

Unexpectedness is not an explicit element of the principle of unselfish performance because the fact that a contract makes it possible for a party to enrich himself by acting or threatening to act in a way that would result in a significant joint net loss to the parties is itself evidence that a contract is not functioning as expected. Rational people do not expose themselves to such behavior. Unexpectedness is an explicit element of the principle of loss alignment because people do enter into contracts that are zero-sum games, where one party's loss is the other's gain. That is the nature of gambling and insurance. The strongest case for reconstruction is when both principles apply, as they sometimes do in the penalty and forfeiture cases, for rational people try not to provide insurance for or gamble on events that the other party might practicably cause to happen in order to collect on the eontract.

I propose that we reorder the way we think about the doctrines on impracticability, mistake, penalties, forfeiture, and good faith not just by recasting them around the principles of unselfish performance and loss alignment, but also by fragmenting each doctrine into parts. Only some aspects of each doctrine ground on these two principles. Thus, the law of impracticability and mistake is best understood if cases that are governed by a few well-settled rules allocating risk[11] are separated from those involving unexpected events for which there is no such rule.[12] The principle of loss alignment applies in this second category of cases, and as we will see, cases in the second category pose fundamentally different problems from cases in the first.

The doctrine of good faith is best understood as serving two different goals. Usually courts invoke the doctrine to protect expectations based on the contract itself or on trade norms from over-literal interpretations of a contract.[13] This aspect of the good faith doctrine is essentially interpretive. But courts sometimes use the doctrine to prevent a party from selfishly injuring the other party in eircumstances the parties did not anticipate in contracting.[14] My most novel claim concerns the prohibition on penal damage clauses. I claim that often when courts invalidate stipulated damage elauses it is because an unexpected event causes a clause to overcompensate or because the promisee behaves opportunistically.[15] If I am right, then this use of the doctrine is more akin to the mistake and good faith doctrines than it is to the unconscionability doctrine (which polices terms that are unfair from the inception).[16]

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10. So Judge Cardozo observed in Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921) ("From the conclusion that promises may not be [so] treated . . . without a sacrifice of justice, the progress is a short one to the conclusion that they may not be so treated without a perversion of intention.").

11. *See infra* notes 43-49 and accompanying text.

12. *See infra* notes 63-89 and accompanying text.

13. Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1980), explains several of these doctrines, including good faith, as "low-cost methods of deterring opportunistic behavior," *id.* at 522, behavior which he defines as "behav[ing] contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer." *Id.* at 521.

14. *See infra* notes 191-202 and accompanying text.

15. *See infra* notes 112-23, 131-43 and accompanying text.

16. The point is not entirely original. *See, e.g.*, Samuel A. Rea, Jr., *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147 (1984). Rea justifies on economic grounds invalidating a stipulated damages clause that overcompensates because of a mistake by the parties. *See also* Muris, *supra* note 13, at 553. Muris makes the linkage with good faith.

My restatement of the law leads straightforwardly to its defense against the freedom of contract objection. The freedom of contract objection cannot stand if, as I claim, these doctrines serve as tools of contract construction that are employed when events occur that the parties did not anticipate in contracting. Such tools, if properly used, do not interfere with the freedom of contract since contract terms are respected so long as they serve their intended purpose. Any strength left to the freedom of contract objection depends on the contestable claim that judges and juries cannot determine whether the parties accounted for an event when they contracted.

A response to the economic objection to these doctrines is developed at length in Part II. I show that the possibility of judicial reconstruction of contracts under the two principles has no demonstrable harmful effect and may even have a beneficial effect on behavior in contract formation, performance, and modification or settlement. Overriding terms that permit a party to profit from an action that imposes a significant joint net loss on the parties has obvious positive economic value to the extent that it prevents a party from engaging in harmful behavior.[17] Of course, we might expect parties to negotiate to avoid such an outcome once its possibility arises even without judicial reconstruction of a contract. The real value of these doctrines often lies in the way they reduce incentives for strategic bargaining.[18] The possibility of judicial reconstruction of a contract to align losses should not have a harmful effect and may even have a beneficial effect on the precautions parties take in contract formation because it reduces the pressure on parties to account for risks that probably are not worth accounting for in a contract—that is, risks of low probability that even if they occur will not leave the parties in a worse position than they would have been in without the contract.[19]

By defending these doctrines from the economic objection I do not mean to claim an economic justification for them. The economic analysis is inconclusive, and it rests on problematic assumptions about human behavior. Probably the best justification for these doctrines is on fairness grounds. I think the principle of unselfish performance may ground on a belief that it is not right to profit by inflicting, or threatening to inflict, a much greater loss on another. Loss alignment may ground on a belief that (gambling aside) it is not right to profit from another person's accidental loss. The strength of such a justification depends significantly on the fit between the asserted norms and the law, for if the norms did not fit closely with the law we would question their validity or relevance. This approach to justification is open to the same criticism that Richard Craswell levies at Charles Fried's theory of contract.[20] Fried bases most of contract law on a principle of individual autonomy, but he invokes principles of fault and altruism to explain rules like impracticability that do not derive from the parties' agreement.[21] Craswell complains that Fried does not identify the source of these values or provide "any explicit theory explaining when each of these different values is an appropriate guide."[22] Without such a theory, Craswell concludes, Fried's argument "looks more like an *ex post* rationalization of the rules of contract law than a philosophical justification of those

17. *See infra* note 216 and accompanying text.

18. *See infra* notes 218-25 and accompanying text.

19. *See infra* notes 241-45 and accompanying text.

20. Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 521-23 (1989).

21. FRIED, *supra* note 8, at 89.

22. Craswell, *supra* note 20, at 523.

rules."[23] An answer to Craswell's objection is that a philosophical justification of contract may proceed from the bottom up by formulating principles that best fit the law and commercial practice, for these are good evidence of the principles to which we are committed. Those principles may then be tested against intuitions about fairness or the more rigorous calculus of efficiency. Some, including Fried presumably, might object to the principle of loss alignment on the very different ground that it is too parsimonious since it does not allow for sharing of unexpected losses.[24] An answer to this objection is that a principle of loss sharing fits neither the law nor commercial practice, whatever its intuitive appeal. Courts rarely override contracts that provide for sharing of unexpected losses, and people often contract to bear losses asymmetrically.[25]

My defense of these doctrines extends only to those aspects that are consistent with the principles of unselfish performance and loss alignment. This is not to say that the other aspects of these doctrines are indefensible from the freedom of contract or efficiency objections. Rather, for many of the doctrines the other aspects are uncontroversial. The other aspects of the impracticability doctrine—the traditional rules of excuse—may be justified either by the parties' actual expectations, precedent, or even efficiency. The other aspects of the doctrine of good faith consist of interpretive rules that allow courts to protect expectations grounded on contract terms or practice from overly formal interpretations of a contract. The other aspect of the rule on penalties—the actual prohibition of clauses that parties intend to serve as penalties—is the most difficult to justify. Perhaps this aspect of the rule on penalties should be abolished. Its abolition may have less effect than one might suppose, for, as I will demonstrate, only a few cases that void liquidated damage clauses seem to involve genuine penalties.

## I. THE ROLE OF THE PRINCIPLES OF LOSS ALIGNMENT AND UNSELFISH PERFORMANCE IN CONTRACT LAW

The doctrines on impracticability, penalties, forfeiture, and good faith differ in many respects. First, they offer essentially different forms of relief. The impracticability and mistake doctrines usually excuse all or part of an obligation under a contract, leaving the parties to principles of restitution to determine their remaining rights and obligations.[26] Doctrines on forfeiture and penalties excuse a party from an offensive condition or stipulated damage term but otherwise enforce a contract.[27] The doctrine of good faith imposes an affirmative duty to so act, the breach of which may result in a court imposing damages.

Second, the doctrines differ in the degree to which they command courts to respect private bargains. The doctrine on penalties regulates what parties may bargain for—it

23. *Id.*

24. Arguments for loss sharing are collected in Jeffrey L. Harrison, *A Case for Loss Sharing*, 56 S. CAL. L. REV. 573, 574 n.6 (1982).

25. The principle of sharing sometimes is justified by analogizing parties to a contract to a partnership. *See* FRIED, *supra* note 8, at 72 ("[Parties to a contract] are joined in a common enterprise, and therefore they have some obligation to share unexpected benefits and losses in the case of an accident in the course of that enterprise."). The analogy exposes the flaw in the argument. The only common enterprise with open-ended loss sharing is a general partnership, and that feature is making it an increasingly rare form of enterprise as partnerships convert to limited liability companies. Few impracticability cases involve true loss sharing. *See infra* note 63.

26. RESTATEMENT (SECOND) OF CONTRACTS § 272 (1979).

27. *Id.* § 356 cmt. a.

prohibits penal damage terms and requires that parties take care in forecasting damages.[28] The impracticability, mistake, and frustration doctrines permit courts to ignore contractual terms, but it commands them to respect bargained-for allocations of risk.[29] The doctrines on good faith and forfeiture lie somewhere between interpretation and the impracticability and kindred doctrines in the degree to which they command courts to respect bargains. Much of good faith case law borders on interpretation, as courts imply limits on the exercise of discretion under a contract from other contract terms or from the practices of the parties or their trade.[30] The good faith doctrine gives courts more leeway than interpretation—courts sometimes impose duties as a matter of good faith without reference to the parties' likely intent—but few courts will use the doctrine to override an express contract term.[31]

Third, while some of the elements of the principles of loss alignment and unselfish performance appear in each doctrine, none of the doctrines exhibits all of the elements of the two principles. A desire to avert selfish performance is a common justification for the doctrines on penalties and forfeiture.[32] And, as I will demonstrate, these doctrines align losses because excusing a party from a duty to pay excessive damages or from forfeiture usually saves him from a loss while leaving the other party in the same position as performance: that is, in as good or better position than he would have been had the contract not been made.[33] However, the doctrine on penalties does not require that an outcome be unexpected.[34] In contrast, unexpectedness appears prominently in the impracticability doctrine in the form of a rule that limits relief to unforeseen circumstances,[35] while loss alignment is not a stated goal of the doctrine. Standard formulations of the good faith doctrine address one sort of opportunistic behavior—the use of discretionary powers under a contract to defeat contract-based expectations[36]—but do not consider the possibility that good faith may constrain selfishness in unexpected circumstances about which the parties could have no preexisting expectations. This Part shows that these apparent differences in the doctrines cloak essential similarities. Loss alignment turns out to explain impracticability cases that are not covered by traditional rules of excuse.[37] Many decisions that void liquidated damages terms do not frustrate the parties' intent in liquidating damages because the courts set aside terms that unexpectedly overcompensate or that are abused by an opportunistic promisee.[38] And sometimes courts

28. *Id.* ("[T]he parties to a contract are not free to provide a penalty for its breach.").

29. U.C.C. § 2-615 cmt. 8 (1990) ("The provisions of this section are made subject to assumption of greater liability by agreement . . . .").

30. Mark P. Gergen, *A Cautionary Tale About Contractual Good Faith in Texas*, 72 TEX. L. REV. 1235, 1265-71 (1994).

31. The U.C.C. waffles on the question of how much control parties have over the duty of good faith. It provides "that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable." U.C.C. § 1-102(3) (1990).

32. *See infra* notes 98-99 and accompanying text.

33. *See infra* note 100 and accompanying text.

34. *See infra* notes 101-03 and accompanying text.

35. *See infra* notes 51-52 and accompanying text.

36. *See infra* notes 185-88 and accompanying text.

37. *See infra* notes 63-89 and accompanying text. Performance is infeasible in the usual impracticability or mistake case so that neither party is in a position to obtain a more favorable outcome for himself at the expense of the other party by performing or interfering in the other's performance.

38. *See infra* notes 112-23, 131-43 and accompanying text.

use the doctrine of good faith to temper selfish behavior in circumstances that the parties to a contract could not have anticipated in making the contract.[39]

### *A. Impracticability, Frustration of Purpose, and Mistake*

The impracticability doctrine and the related doctrines of impossibility, frustration of purpose, and mistake[40] are said to pose some of the most difficult problems in contract law.[41] Actually most such claims are quite easy to resolve. When a party seeks to be excused from a contract because an event significantly increases his cost of performance or reduces his return on the contract, the basic question always is whether he bears the risk of that event. Whether a party bears the risk is determined first by examining the parties' agreement (which ought to be defined expansively to include trade practice and course of dealing or performance)[42] and second by examining established background rules of excuse.

Well-established rules of excuse apply when the death or disability of a person,[43] or the destruction of an asset,[44] or a government order prevents performance of a contract.[45] Other rules apply when the frustration of means for delivery or payment unduly delays performance of a contract.[46] These rules of excuse date back at least to 19th-century English law (it is striking that most of these rules were announced in dicta prior to their application),[47] and most cases in which contracts are excused in England and the United

39. *See infra* notes 191-202 and accompanying text.

40. The doctrine of impracticability generally protects sellers or providers of goods or services when the anticipated means of production fail or become much more costly than expected. U.C.C. § 2-615 (1991). The doctrine of impossibility is the old form of the impracticability doctrine. Taylor v. Caldwell, 122 Eng. Rep. 309 (Q.B. 1863). The doctrine of frustration of purpose generally protects buyers or users of goods or services when circumstances reduce the anticipated value of the goods or services. Krell v. Henry, [1903] 2 K.B. 740 (Eng. C.A.). The doctrine of mutual mistake applies when the error goes to a fact existing at the time the contract was made. Lenawee County Bd. of Health v. Messerly, 331 N.W.2d 203 (Mich. 1982). The boundaries between these doctrines are vague and they are very similar in form. For a case applying all three doctrines, coming to the same conclusion on each, and noting the considerable overlap between them, see Aluminum Co. of Am. v. Essex Group, Inc., 499 F. Supp. 53, 70-71 (W.D. Pa. 1980). There is also some overlap between these doctrines and the rule in Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854), and other rules defining the scope of a seller's obligation, such as the rules on warranties, since these also may be used to allocate risks of unexpected events.

41. Sheldon W. Halpern, *Application of the Doctrine of Commercial Impracticability: Searching for "The Wisdom of Solomon,"* 135 U. PA. L. REV. 1123 (1987).

42. U.C.C. § 1-201(3) (1991) adopts an expansive definition of agreement. Colley v. Bi-State, Inc., 586 P.2d 908 (Wash. Ct. App. 1978), relies on trade practice to hold a seller of wheat to its contract on destruction of crop notwithstanding the background rule of excuse. In Waldinger Corp. v. CRS Group Engineers, Inc., 775 F.2d 781 (7th Cir. 1985), the court erred in relying upon the impracticability doctrine rather than principles of interpretation to excuse breach. A contractor sought to be excused from a contract to construct equipment because it could meet the performance specifications but not the design specifications. The contractor was aware that it could never satisfy the design specifications when it entered into the contract (there was evidence that the specifications had been manipulated to ensure a competitor got the job), but it assumed based on prior practice that the design specifications would be waived by the engineer if the performance specifications were met. The case misapplies the impracticability doctrine because the problem that occurred was foreseen by the parties. The court argued that the engineer's insistence on rigid compliance with the design specifications was unforeseen. *Id.* at 787-88. The case would be better grounded on a theory of good faith or waiver. The court may not have invoked these theories out of unwillingness to allow evidence of prior dealings to subvert the express terms of the contract.

43. RESTATEMENT (SECOND) OF CONTRACTS § 262 (1979).

44. U.C.C. § 2-613 (1991); RESTATEMENT (SECOND) OF CONTRACTS § 263 (1979).

45. U.C.C. § 2-615(a) (1991); RESTATEMENT (SECOND) OF CONTRACTS § 264 (1979).

46. U.C.C. § 2-614 (1991).

47. Williams v. Lloyd, 82 Eng. Rep. 95 (K.B. 1629) (stating that bailee is discharged from duty to return horse if it dies); Hyde v. Dean of Windsor, 78 Eng. Rep. 798 (Q.B. 1597) (stating that promisor would be excused upon death); Abbot of Westminster v. Clerke, 73 Eng. Rep. 59, 63 (K.B. 1536) (stating that seller would be excused from a contract to sell wheat if government forbade performance).

States fall under these rules.[48] Other well-established rules assign certain risks to parties. An example is the rule that a contractor who contracts to build a free-standing structure bears the risk of fire or other circumstances making construction more costly than expected or even impossible.[49]

If an agreement is silent on whether a party bears a risk and no well-established rule governs the case, the next question is whether the parties accounted for the risk when they made the contract.[50] Sometimes this question is put in terms of the foreseeability of the risk at the time the parties made the contract, though a better formulation is whether the parties could reasonably be expected to have accounted for the risk in the contract.[51] A failure to make a special provision for a risk when that could be done without undue burden is interpreted as an implicit decision to allocate that risk through the general terms of the contract. Notably, it is only at this point of the analysis, after the application of the background rules, that unexpectedness clearly becomes relevant under the impracticability doctrine. The rules of excuse for the incapacity of persons or destruction

48. E. ALLAN FARNSWORTH, CONTRACTS 714 (2d ed. 1990) ("Nearly all of the cases of impracticability that have arisen can be placed in one of these three traditional categories."); John D. Wladis, *Impracticability As Risk Allocation: The Effect of Changed Circumstances upon Contract Obligations for the Sale of Goods*, 22 GA. L. REV. 503, 585-87 (1988) (concluding that 26 of 30 excuse cases arising under the U.C.C. fall under traditional rules of excuse). My own survey of impossibility, impracticability, and frustration cases in a Westlaw search conducted on July 18, 1995, bears this out. Thirty-seven cases decided after January 1, 1992, appear under the most pertinent West key number (Contracts key number 309). Eight do not raise true impracticability issues. Nineteen reject the defense. One grants relief on an alternative ground. Conam Alaska v. Bell Lavalin, Inc., 842 P.2d 148 (Alaska 1992). Eight accept the defense or remand so that a jury may decide the issue. Six of these cases fall under the traditional rules, one involves death, Ames v. Sayler, 642 N.E.2d 1340 (Ill. App. Ct. 1994); four involve legal impossibility, Peach State Meat Co. v. Excel Corp., 860 F. Supp. 849 (M.D. Ga. 1994); Far West Fed. Bank v. Office of Thrift Supervision, 787 F. Supp. 952 (D. Or. 1992); UNCC Properties v. Greene, 432 S.E.2d 699 (N.C. Ct. App. 1993); Centex Corp. v. Dalton, 840 S.W.2d 952 (Tex. 1992); and one involves destruction of goods, Spalding & Son v. United States, 28 Cl. Ct. 242 (1993). The two remaining cases are consistent with the principle of loss alignment. Haessly v. Safeco Title Ins. Co. of Idaho, 825 P.2d 1119 (Idaho 1992), held that the defendant might be excused from an agreement to purchase an easement for highway access on the plaintiff's property. The agreement was made at a hearing in a legal proceeding brought by a third party demanding an easement when the highway department denied access on the plaintiff's land. Ellwood City Forge Corp. v. Fort Worth Heat Treating Co., 636 A.2d 219 (Pa. Super. Ct. 1994), held that a lessee of a furnace was entitled to a jury instruction on the issue of impracticability where it alleged that the parties made the lease on the mutual misunderstanding that the furnace had a capacity of 450 kilowatts when its capacity was only 350 kilowatts. The cases are similar to those that excuse contracts for the sale of land or a good where the land turns out to be much less valuable than the parties expected. *See infra* note 88.

49. RESTATEMENT (SECOND) OF CONTRACTS § 263 illus. 4 (1979).

50. This test synthesizes two elements of the impracticability rule in the U.C.C. and the Second Restatement of Contracts: that the nonoccurrence of the event rendering performance impracticable "was a basic assumption on which the contract was made" and that the party has assumed no greater obligation. RESTATEMENT (SECOND) OF CONTRACTS § 261 (1979); *see also* U.C.C. § 2-615 (1991). Comment 8 to U.C.C. § 2-615 formulates the test as whether "the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which are fairly to be regarded as part of the dickered terms, either consciously or as a matter of reasonable, commercial interpretation from the circumstances." *Id.* cmt. 8.

51. Eastern Air Lines v. Gulf Oil Corp., 415 F. Supp. 429, 441 (S.D. Fla. 1975) ("If a contingency is foreseeable, it and its consequences are taken outside the scope of U.C.C. § 2-615, because the party disadvantaged by fruition of the contingency might have protected himself in his contract."). People may not account for a foreseen risk in contracting if its probability is low and it is difficult to address in the contract. *See, e.g.*, Transatlantic Fin. Corp. v. United States, 363 F.2d 312 (D.C. Cir. 1966) (stating foreseeability is relevant but not dispositive because parties may be too busy to provide for foreseen risks); L.N. Jackson & Co. v. Royal Norwegian Gov't, 177 F.2d 694 (2d Cir. 1949) (stating that informality and incompleteness of agreement were relevant to whether risk was accounted for in contract); RESTATEMENT (SECOND) OF CONTRACTS § 261 cmt. c (1979) (stating the fact that an event was foreseeable or foreseen does not preclude relief since "[f]actors such as the practical difficulty of reaching agreement on the myriad of conceivable terms of a complex agreement may excuse a failure to deal with improbable contingencies").

of goods that are essential to performance of a contract will apply even if the risk was foreseeable.[52]

It is when the answers to all three questions—did the parties allocate the risk in the agreement, does the law allocate the particular risk, and was the risk foreseeable—are negative that impracticability issues become hard to resolve. This difficulty is manifest in the fact that respectable authority exists for the conflicting positions that excuse is automatic[53] or, contrastingly, rare[54] if the answer to these questions is "no." Excuse also is more difficult to justify in such a casc. Excuse in a case covered by the established rules can be justified by the parties' expectations, either by reference to the rule itself (which is well established and fairly elear) or to expectations that exist independent of the rule. So, a farmer is excused from a contract to sell a crop from designated land upon loss of the crop even though the risk of loss is foreseeable[55] because it is assumed that parties contract with reference to the rule of excuse.[56] The rule of excuse on the death or disability of the service provider has been grounded on peoples' likely expectations.[57] And Karl Llewellyn claimed that the UCC's rule of excuse for events such as nondelivery due to strike or damage to factory codified a common contract term that parties assumed implicitly when they did not make it explicit.[58] Excuse under some of the established rules might also be justified on economic grounds. Even those who criticize the impracticability doctrine on economic grounds concede that the economic argument for the doctrine is strongest with regard to rules like that excusing a farmer on destruction of a crop.[59] Such rules are sufficiently well known to positively influence the parties'

52. U.C.C. § 2-613, which excuses a seller on a casualty to identified goods, has no requirement that the loss of the goods be unforeseeable. Dunavant Enters., Inc. v. Ford, 294 So. 2d 788 (Miss. 1974), recognizes that the rule of excuse on destruction of goods applies even to a foreseeable loss of crops. It seems that the rule of excuse on death or incapacity also applies to a foreseeable risk. The comments to the rule in the Restatement state that the rule might be overcome "if the language or the circumstances indicate to the contrary" but "that an intention to do so must be clearly manifested." RESTATEMENT (SECOND) OF CONTRACTS § 262 cmt. a (1979). There is conflicting authority on whether a contract may be excused because of government interference if the interference was foreseeable when the contract was made. *Compare* A & S Transp. Co. v. County of Nassau, 546 N.Y.S.2d 109 (N.Y. App. Div. 1989) (holding that a contract will not be excused if interference was foreseeable); *UNCC Properties*, 432 S.E.2d 699 (same) *with* Contex Corp. v. Dalton, 840 S.W.2d 952 (Tex. 1992) (holding that a contract is excused even if interference was foreseeable); Washington State Hop Producers Inc. v. Goschie Farms, Inc., 773 P.2d 70 (Wash. 1989).

53. Opera Co. of Boston v. Wolf Trap Found. for the Performing Arts, 817 F.2d 1094 (4th Cir. 1987) (stating that "defense is made out" when a party shows the "unexpected occurrence of an intervening act" of which "nonoccurrence was a basic assumption of the agreement" and which makes performance impractieable).

54. *See supra* note 48 and accompanying text.

55. U.C.C. § 2-615 emt. 9 (1991). U.C.C. § 2-613 comes into play only if the crops exist when the contract is made so that they can be identified in the contract.

56. Dunavant Enters., 294 So. 2d at 788. Litigation over crop loss usually involves questions about whether evidence of trade practice or course of dealing can show that the parties intended for a crop to be grown on certain land when the contract contains no such limitation.

57. RESTATEMENT (SECOND) OF CONTRACTS § 262 cmt. a (1979) ("[I]t is sufficiently rare for a party to undertake a duty to render personal service in spite of his death or incapacity that an intention to do so must be clearly manifested.").

58. Karl N. Llewellyn, *Comment on Section 54, Report and Second Draft: The Revised Uniform Sales Act, reprinted in* 1 AM. L. INST. & NAT'L CONFERENCE OF COMM'RS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE DRAFTS 504-07 (1972).

> The type of exemption concerned is so wide-spread and familiar in the contracts of *well-organized* and *well-advised sellers*, it is so reasonable and fair, it is (until lawyers are consulted) so thoroughly taken for granted by buyers, as to evidence the sound basc-line for *general* law. . . . The principle stated seeks simply to read the exemption into contracts in which they are not express.

*Id.* at 506-07 (emphasis in original).

59. Sykes, *supra* note 2, at 88-91 (concluding that excuse in the crop failure cases "may on average be efficient" because farmers may tend to be more averse than buyers or less able to hedge against risk). A case discussed by Sykes, Asphalt International, Inc. v. Enterprise Shipping Corp., 667 F.2d 261 (2d Cir. 1981), raises the interesting question of whether excuse is proper if a background rule so dictates, but the unusual circumstances of the case mean a party would be unjustly enriched. The defendants were excused from a charter contract after their tanker was damaged in a collision

behavior in taking precautions against risk. And some such rules allocate risk to the party who probably best bears it. Even if the rule does not allocate a risk to the superior risk bearer in some cases that fall under the rule, the fact that the rule allocates risk in a clear and dependable fashion so that people may plan around it may itself be worthwhile.

None of these reasons justifies excuse in a hard case. By definition the parties have no expectations about their rights and obligations in the event at issue *before* it occurs, so excuse cannot be justified by the parties' expectations. The law is muddled, thcreby leaving doctrinal argumcnt indecisive. The usual economic argument for the impracticability doctrine, which is to allocate the risk of a loss to the best loss avoider or best insurer,[60] is unpersuasive because excuse is too uncertain in such cases for the doctrine to positively influence the parties' bchavior in taking precautions against risk.[61] Usually uncertainty about who bears a risk worsens precaution by dividing incentives to take precaution. Nor are parties likely consciously to rely on the impracticability doctrine as a background rule or gap filler to save them the cost of spelling out a term to cover a risk when the law is unclear. In cases that fall outside the background rules, excuse under the doctrine is too uncertain—and it is too easy to write broad terms like gross inequity

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because the cost of repairing the tanker greatly exceeded its value. The decision was grounded on the rule excusing a contract upon destruction of the means of performance. As Sykes observes, the decision seems offensive once one takes account of the fact that the tanker was overinsured, for the defendants reaped a windfall. Sykes, *supra* note 2, at 87-88. However, Sykes weakens the point by trying to explain the relevance of the concern with the defendant's windfall on economic grounds.

60. Christopher J. Bruce, *An Economic Analysis of the Impossibility Doctrine*, 11 J. LEGAL STUD. 311 (1982); Jeffrey M. Perloff, *The Effect of Breaches of Forward Contracts Due to Unanticipated Price Changes*, 10 J. LEGAL STUD. 221 (1981); Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977); *cf.* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 15-16 (1985) (suggesting impracticability rule may temper reliance).

61. Nor does current economic analysis explain the element of unforseeability in the impracticability doctrine. Foreseeability is not relevant under an analysis that justifies the impracticability doctrine as means for allocating risk, because the better risk bearer should be allocated a risk whethcr or not it is foreseeable. Posner & Rosenfield, *supra* note 60, at 99-100.

The critiques by Sykes, *supra* note 2, and Richard S. Markovits, The Appropriate Judicial Response to Partial Agreements—To Contracts That Are Formally Incomplete: An Economic and Overall Analysis (1987) (copy of unpublished manuscript on file with the *Indiana Law Journal*) of the economic justifications for the doctrine are especially trenchant. Neither critique considers the argument I advance in Part II in defense of the doctrine that some low probability risks that do not make an investment in a contract worse than alternative investments may best be dealt with when they occur because the cost of such resolution, when discounted by the probability of the risk's occurrence, is less than the cost of accounting for the risk in the contract.

Markovits asks us to assume parties who spend the optimal amount investigating and planning for risks. They may not identify or plan for all contingencies, but they will identify and plan for those of sufficient likelihood and impact to warrant attention. The price each party demands will be a function of the weighted average of his costs under all planned-for contingencies plus the risk costs for uncertainty he bears (this might include, for example, the cost of arranging hedges). The critical point is that the level of search and precaution, and so the price charged, are optimal ex ante. Both parties do the best they can facing an uncertain future. If, in such a case, it turns out that a party's cost exceeds contract price, excuse is not warranted. The party loses a gamble consciously taken, which he was paid to take. Excusing the party from liability under the contract raises obvious fairness concerns. And it may discourage people from taking such optimal precautions in the future. Markovits concludes that relief is warranted only when one or both parties make a mistake ex ante. For example, they do not consider a risk that they could cheaply discover and protect against and which others in their position would protect against. But, Markovits goes on to reason, courts are unlikely to be able to identify such cases. That there is an ex post loss proves nothing since it may merely reflect a losing bet. That a loss was unanticipated also proves nothing since the ex ante risk of that event may have been slight enough that the parties were right to disregard it. Thus, courts should be extremely wary of setting aside formally complete contracts. Markovits, *supra*, at 13.

Sykes shows that if we assume parties have equal information, Sykes, *supra* note 2, at 68-70, and that they cannot insure against a risk, *id.* at 66-67, then a case can be made for the doctrine only if the protected party is more risk averse than the other party. Even then the awkward nature of the remedial options under the doctrine (excuse or enforce the contract) makes that case problematic. This is because the protected party will receive a lower price, which will increase his damages for nonperformance should the conditions for excuse not be met, *id.* at 55, and because it perversely distributes the risk the protected party faces, *id.* at 56-58.

clauses[62] to cover low probability high-impact risks—for parties to rely consciously on the impracticability doctrine for protection from such risks.

Courts often decide these hard cases in a way that is consistent with the principle of loss alignment.[63] Courts are most likely to excuse a contract in a case not covered by the established rules when doing so saves one party from an unexpected loss while leaving the other party in a position no worse than he would have been without the contract. Several scholars have observed that courts often excuse contracts when unexpected events inflict a loss on one party and provide a windfall gain to the other.[64] This is the

62. Such provisions are common in long-term coal supply contracts with indexed prices. Gross inequity provisions enable the parties to reopen the contract if the indexing provision results in unanticipated losses or (sometimes) profits. Paul L. Joskow, *Vertical Integration and Long-Term Contracts: The Case of Coal-Burning Electric Generating Plants*, 1 J.L. ECON. & ORGANIZATION 33, 73 (1985).

63. Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271, 292-95 (1992), takes the contrary position that courts excuse contracts only in cases where performance is impossible or of absolutely no value. The evidence cited by Schwartz does not bear out his claim. First, he observes correctly that many cases of excuse involve impossible or no-value performance. *Id.* at 292. Of course this does not establish the negative. Indeed, one of the cases he cites as excusing a buyer when performance was of absolutely no value, Opera Company of Boston, Inc. v. Wolf Trap Found. for the Performing Arts, 817 F.2d 1094 (1987), is inconsistent with his position because performance was concededly of some value to the promisee. Second, he cites secondary authorities who bemoan the absence of a coherent theory that explains when courts will excuse contracts in a case not covered by the traditional rules. Schwartz, *supra*, at 293 n.49. This undercuts Schwartz's claim because the problem of prediction exists only if courts sometimes do excuse contracts in cases not covered by the traditional rules. Third, he cites three cases that reject impracticability claims because the seller failed to show that its costs rose unexpectedly or that the increase was sufficient to justify relief. *Id.* at 293 nn.50-51 (citing Louisiana Power & Light v. Allegheny Ludlum Indus., 517 F. Supp. 1319 (E.D. La. 1981); Iowa Elec. Light & Power Co. v. Atlas Corp., 467 F. Supp. 129, 133 (N.D. Iowa 1978), *rev'd on other grounds*, 603 F.2d 1301 (8th Cir. 1979); Eastern Airlines v. Gulf Oil Corp., 415 F. Supp. 429, 440 (S.D. Fla. 1975)). These cases do not require that performance be impossible to warrant excuse. Rather they demand only proof of a substantial and unexpected cost increase that results in a loss to the promisor.

While Schwartz presumably would argue that the principle of loss alignment is broader than the cases warrant, others might argue that it is too narrow since it does not cover cases that override contract terms to share unexpected losses between parties. Many advocate sharing unexpected losses. *See* Harrison, *supra* note 24. As Harrison observes, there is little case support for a principle of sharing. *Id.* at 581. In projects to repair or add on to an existing structure, courts split the loss when a structure is destroyed in mid-project by allowing recovery in restitution for work that has been incorporated in the structure but not other work. *See, e.g.*, Carroll v. Bowerstock, 164 P. 143 (Kan. 1917). This rule has not been extended to other situations. As noted earlier, the impracticability doctrine has many such specific rules allocating losses that in form and function are quite different from the principles courts apply in cases for which there is no settled rule. Harrison collects a few other cases that split losses, but notes that in these cases the party on whom the court imposed the loss was in some ways at fault. Harrison, *supra* note 24, at 582-84 (discussing Northern Corp. v. Chugach Elec. Ass'n, 518 P.2d 76, 82 (Alaska), *modified on reh'g*, 523 P.2d 1243, 1246-47 (Alaska 1974), *aff'd*, 562 P.2d 1053 (Alaska 1977) (defendant insisted that plaintiff haul rock across frozen lake, leading to the loss of plaintiff's equipment); Albre Marble & Tile Co. v. John Bowen Co., 155 N.E.2d 437, 440-41 (Mass. 1959), *aff'd on reh'g*, 179 N.E.2d 321 (Mass. 1962) (defendant was partly responsible for making performance of general contract impossible and insisted that work be performed when risk of cancellation became apparent)).

Subha Narashimhan, *Of Expectations, Incomplete Contracting, and the Bargain Principle*, 74 CAL. L. REV. 1123 (1986), develops a model of impracticability and modification that assumes parties do not plan for all possible contingencies. Generally, she advocates dividing surpluses (or losses) that fall outside the contemplated range of outcomes between the parties in some fashion (usually evenly). She justifies this by the bargain principle on the ground that it fulfills the expectations of the parties. *Id.* at 1137-42.

64. *See* Robert L. Birmingham, *Why is There* Taylor v. Caldwell? *Three Propositions About Impracticability*, 23 U.S.F. L. REV. 379, 393-97 (1989). Andrew Kull, *Mistake, Frustration and the Windfall Principle of Contract Remedies*, 43 HASTINGS L.J. 1 (1991), also argues that a "windfall paradigm" explains the law of impracticability and related doctrines. However, he muddles the point by grouping cases covered by the traditional rules of excuse, which sometimes leave the promisee saddled with a real loss, with odd cases that involve true windfalls. *Id.* at 32-33. Also, he adds a questionable remedial gloss: the response of courts to windfalls is to do nothing. They leave the parties where they find them. This is an accurate description of English law prior to the enactment of the Law Reform (Frustrated Contracts) Act, 1943, 6 & 7 Geo. 6, ch. 40 (Eng.). *See* Fibrosa S.A. v. Fairbairn Lawson Combe Barbour, Ltd., [1942] 1 K.B. 12, 28 (Eng. C.A. 1941). Whether it is an accurate description of U. S. law is less clear. United States law permits a court to order restitution of benefits conferred under an excused contract. Kull, *supra*, at 33 (citing RESTATEMENT (SECOND) OF CONTRACTS § 377 (1979)). What U.S. law does not allow, according to Kull, is an award to compensate a reliance loss on an excused contract. *Id.* at 33-34. Respectable authority suggests that a court has more flexible remedial powers than Kull supposes.

most obvious sort of misalignment of losses. Robert Birmingham has argued that this is the crucial fact in *Krell v. Henry*,[65] the first English case of excuse that did not fall under one of the traditional rules. *Krell* relieved the defendant from a contract to let the plaintiff's room to view a coronation procession when the procession was canceled due to the King's illness. For Birmingham, the crucial fact in *Krell* is that the coronation was rescheduled, allowing the plaintiff to relet the room. If this were true, enforcing the original contract would have given the plaintiff twice the profit he expected on the coronation.[66] A difficulty with this interpretation of *Krell* is that the opinion never mentions this fact. But this fact, if true, so influences our feelings about the equities in the case that it is plausible that it influenced the court. And John Wladis has argued in an article that explores the nooks and crannies of the English law on impossibility that this fact best explains *Krell*, which Wladis claims otherwise sits oddly in English law.[67]

Other classic mistake and impracticability cases involve unexpected losses and windfall gains. Birmingham cites *Aluminum Co. of America ("Alcoa") v. Essex Group, Inc.*[68] and *Albert D. Gaon & Co. v. Societe Interprofessionelle des Oleagineaux Fluides Alimentaires*.[69] *Alcoa*—the most interesting[70] and criticized impracticability decision in recent years[71]—reformed a twenty-one year contract to process molten aluminum because of a defect in a price adjustment term.[72] The case is an easy one under the principle of loss alignment because it is clear that the parties did not intend for Alcoa, the processor, to bear the risk of fluctuations in processing costs.[73] It also is clear that the defect in the

65. [1903] 2 K.B. 740 (Eng. C.A.).

66. *See* Birmingham, *supra* note 64, at 393.

67. John D. Wladis, *Common Law and Uncommon Events: The Development of the Doctrine of Impossibility of Performance in English Contract Law*, 75 GEO. L.J. 1575, 1614-20 (1987). Wladis' immediate point is that this fact best distinguishes *Krell* and a number of contemporary cases excusing contracts to let rooms to watch the procession from a number of other cases that enforced contracts to charter boats to view the fleet in another event that was scheduled for the coronation and then canceled. While the viewing of the fleet was rescheduled, like the procession, an owner of a vessel was less certain to profit from the rescheduled event than was an owner of a room because rooms with views of the procession route were more limited in number than were vessels that could carry passengers to view the fleet. Wladis' larger point is that when one looks at roughly 130 years of English impossibility cases, all but *Krell*, its companion cases, and a few other odd cases can be explained by well-settled rules of excuse for the death of persons or destruction of things essential to the performance of a contract, events that delay performance and so frustrate a contract, and contract terms providing for excuse.

68. 499 F. Supp. 53 (W.D. Pa. 1980).

69. [1960] 2 Q.B. 334 (1959), *aff'd*, [1960] 2 Q.B. 348 (Eng. C.A.).

70. What makes the case of particular interest, apart from its magnitude (Alcoa was seeking relief from what it claimed was a potential $75 million loss, 499 F. Supp. at 59), is the court's recognition of the overlap between the various excuse doctrines, *id.* at 70-71, the fact that the parties had tried to control for the risk of price fluctuations with an index which failed, and the court's reformation remedy, *id.* at 78-80. The case is also unusual among impracticability cases in that its result is also consistent with the principle of unselfish performance. There was evidence that Essex took advantage of the below-market price term to increase the quantity of aluminum processed in a way that resulted in a significant joint net loss under the contract.

71. *See* John P. Dawson, *Judicial Revision of Frustrated Contracts: The United States*, 64 B.U. L. REV. 1, 26, 28 (1984) (describing the decision as "grotesque" and "bizarre"); Halpern, *supra* note 41, at 1127 (stating that "*Alcoa* has virtually faded into obscurity"). The outcome of the case cannot be justified on grounds of superior risk allocation, the usual substantive function thought to be served by impracticability rules, since Alcoa, a large diversified firm, could bear the risk of changes in its production costs or the price of aluminum at least as well as or better than Essex.

72. The price term resulted in a price significantly below Alcoa's cost of production because it did not adequately reflect a huge increase in energy costs. The parties had anticipated that Alcoa's net income per pound of aluminum under the contract would fluctuate between one cent and seven cents. *Alcoa*, 499 F. Supp. at 58.

73. Essex's goal was to obtain molten aluminum at a cost no higher than its competitors, with which it expected to earn an adequate return on its investment in its manufacturing plant. *Id.* The parties took pains to limit the risk that the contract price would diverge from Alcoa's actual production costs. They employed a prominent economist, Alan Greenspan, to design the index. Additionally, they tested the index to ensure its stability and accuracy in measuring Alcoa's costs in prior years. *Id.* at 69. The contract also included a ceiling price pegged to the market to protect Essex against the risk that the price adjustment term would dictate a price above the market price of aluminum. *Id.*

price adjustment term imposed large losses on Alcoa while providing even larger gains to Essex. The *Albert D. Gaon* case excused a carrier from a contract to transport nuts from Sudan to England via the Suez Canal when the canal closed. Birmingham asserts (sadly without proof) that the carrier's losses on the canal closure were the shipper's gains because the cost of nuts in England rose with shipping costs. We could add to Birmingham's list *Sherwood v. Walker*,[74] a mistake case that excused a contract to sell a cow that was greatly underpriced because the parties mistakenly thought her to be barren.[75]

Unexpected losses and windfall gains involve straightforwardly uneven outcomes to the parties. Other cases involve a more subtle form of unevenness: the promisor bears an unexpected loss and the promisee is deprived of an expected gain that proves to be unrealizable. In such a case, excuse relieves the promisor from a loss while leaving the promisee in a position no worse than he would have been in had the contract not been made. In legal parlance, the promisee is deprived of his expected gain on the contract but suffers no reliance loss.

*Krell* may actually be such a case. The rescheduled coronation was a less grand affair than that which was originally planned,[76] so the flat owner may never have made the profit he originally expeeted on the coronation. Still the flat owner probably lost nothing which he otherwise could have made on the flat. The first contract probably did not dispossess the original tenant since it was for daylight hours only,[77] so there was no reliance loss. The profits that were lost if the room was let for less on the rescheduled procession were economic rents[78]—excess rents the flat commanded because of its unique location—the realization of which depended on the procession taking place.[79]

Several excuse cases that fall outside the established rules save a promisor from an unexpected loss while denying a promisee an expeeted gain that proved to be

74. 33 N.W. 919 (Mich. 1887).

75. *Sherwood* is unlike the other cases in that the loss complained of was a lost opportunity—the foregone profit on the cow—rather than an out-of-pocket loss. Courts generally treat lost opportunities differently than out-of-pocket losses, rarely granting relief for lost opportunities. Lenawee County Bd. of Health v. Messerly, 331 N.W.2d 203, 210 n.13 (Mich. 1982) (suggesting the result in *Sherwood v. Walker* would be different today); Wood v. Boynton, 25 N.W. 42 (Wis. 1885); *cf. Alcoa*, 499 F. Supp. at 92 (arguing that relief ought never be granted when a party claims a lost opportunity because of a mistake). A mistakenly lost opportunity was recaptured in West Coast Airlines v. Miner's Aircraft & Engine Service, 403 P.2d 833 (Wash. 1965). For an English case along similar lines, see Grist v. Bailey, 1967 Ch. 532 (setting aside a contract to sell a house in equity where parties undervalued house because of mistaken belief that tenant had statutory right to remain).

76. ROBERT W. HAMILTON ET AL., CONTRACTS CASES AND MATERIALS 543 (1984) (suggesting that the rescheduled coronation was a smaller affair).

77. *Krell*, [1903] 2 K.B. at 749-50.

78. Economic rent is defined as "[T]he payment for a resource where the availability of the resource is insensitive to the size of the payment received for its use . . . ." Armen A. Alchian, *Rent*, *in* 4 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 141 (John Eatwell et al. eds., 1987).

79. The principal opinion in *Krell*, by Lord Justiee Williams, stumbles around this fact. Williams distinguishes *Krell* from a case where someone engages a cab to go to Epsom Downs to see the Derby before it is caneeled. Williams noted that a cab driver might charge an "enhanced price for such a journey," but he argued that this was unlike the lease of the flat because "the cab had no special qualifications for the purpose" while "the rooms were offered and taken, by reason of their peculiar suitability from the position of the rooms for a view of the coronation procession." *Krell*, [1903] 2 K.B. at 750-51. Lord Justice Williams makes this point in the context of an argument that the foundation of the contract in *Krell* was the procession. If foundation means the parties' goal in making the contract, then the cab hypothetical is not distinguishable because the passenger and driver both understand that the cab is hired (and a premium paid) to go to the Derby. The difference in the two cases is in the amount of the premium, which would be much higher in *Krell* because of the "peculiar suitability" of the rooms for viewing the procession. The example of the cab also appears in another opinion by Williams holding that a party could not get out of a contract to charter a vessel to view the fleet and see a navy review planned for the coronation even though the review was canceled. Herne Bay Steam Boat Co. v. Hutton [1903] 2 K.B. 683, 689 (Eng. C.A.).

unrealizable. The case cited as the first in the United States to excuse a contract on grounds of impracticability[80]—*Mineral Park Land Co. v. Howard*[81]—fits this pattern. The court excused the defendants from a contract to take all the earth and gravel they required for a bridge construction project from the plaintiff's land at five cents per cubic yard when a high water table greatly increased extraction costs.[82] The foregone rents probably included significant economic rent, for the case is a classic example of bilateral monopoly: the defendants' bridge ran over the ravine in which the plaintiff's land lay. The poor quality of the plaintiff's land also suggests that the extraction of gravel did not diminish its value for other purposes; that is, there was no reliance loss. *Florida Power & Light Co. v. Westinghouse Electric Corp.*[83] excused Westinghouse from a promise to remove and dispose of spent nuclear fuel from two reactors it built for Florida Power when Westinghouse's plans for commercial reprocessing were frustrated. Westinghouse had hoped to earn a profit of $16 million to $19 million from reprocessing the spent fuel,[84] but instead faced an unexpected disposal cost of over $67.3 million.[85] The court emphasized the fact that Florida ratepayers profited from the contract notwithstanding the change, saving almost $8 billion dollars over the lives of the plants when the cost of alternative power sources was compared.[86] *Kansas City v. Kansas City*[87] is similar to *Florida Power*. The court relieved Kansas City, Missouri from a promise to dispose of sewage for Kansas City, Kansas for a fixed fee after pollution control laws greatly increased disposal costs. Kansas City probably was not made worse off by the contract even after this result, for the output of sewage probably was not price sensitive and other opportunities for disposal were not permanently foregone.

Mistake cases which excuse a contract to buy an object that turns out to be nearly worthless because of a hidden defect save the buyer from an unexpected loss while leaving the seller in the same position he was in before contracting (*i.e.*, with a worthless object). There are many such cases,[88] though there are also many cases where courts deny

80. CHARLES L. KNAPP & NATHAN M. CRYSTAL, PROBLEMS IN CONTRACT LAW 754 (3d ed. 1993).

81. 156 P. 458 (Cal. 1916). Relief was granted on similar facts on grounds of mistake in Edwards v. Trinity & Brazos Valley Railway. Co., 118 S.W. 572 (Tex. Ct. App. 1909). *Mineral Park* is historically important because it is one of the first cases to explicitly use impracticability instead of impossibility as a standard.

82. The actual price was five cents per cubic yard for the first 80,000 cubic yards. The next 10,000 cubic yards were free, and the balance was five cents per cubic yard.

83. There are three published decisions in the case at 826 F.2d 239 (4th Cir. 1987), 597 F. Supp. 1456 (E.D. Va. 1984), and 517 F. Supp. 440 (E.D. Va. 1981). I think the result in *Florida Power* is questionable because there was evidence that the risk of costly disposal may have been accounted for by the parties in contracting. Baird, *supra* note 2, at 589-90, makes this point. Westinghouse undertook to construct the plant for a fixed price and to provide fuel for the first ten years of the plant's operations at a fixed charge per kilowatt hour of electricity produced. 517 F. Supp. at 444-45. Florida Power demanded these promises as well as a promise by Westinghouse to dispose of spent fuel because it was uncertain about nuclear power. *Id.* at 443-45, 446-47. And Westinghouse was aware of the uncertainty regarding reprocessing of spent fuel. *Id.* at 454. Indeed, Florida Power was given the option of keeping the spent fuel, 826 F.2d at 241, which suggests that it was to reap any benefit if commercial reprocessing appeared to be profitable while Westinghouse was to incur the cost if it appeared to be unprofitable.

84. *Florida Power*, 597 F. Supp. at 1468.

85. This includes a disposal fee of $70 million, less a $2.7 million credit for performing certain services on the spent fuel. *Id.* at 1479.

86. *Florida Power*, 826 F.2d at 258, 279. Apparently, $8 billion is the amount saved by not producing the same amount of electricity at a fossil fuel plant. *Florida Power*, 597 F. Supp. at 1473.

87. 393 F. Supp. 1 (W.D. Mo. 1975); *cf.* Vernon v. Los Angeles, 290 P.2d 841 (Cal. 1955).

88. Bentley v. Slavik, 663 F. Supp. 736 (S.D. Ill. 1987) (excusing contract for sale of violin because of mistake about its maker and value); Renner v. Kehl, 722 P.2d 262 (Ariz. 1986) (excusing land sale contract because land was too dry to accommodate crop); Schultz v. Contra Costa, 203 Cal. Rptr. 760 (Ct. App. 1984) (excusing land sale contract because of mistake about suitability for building); Murr v. Selag Corp., 747 P.2d 1302 (Idaho Ct. App. 1987) (excusing land sale contract because of mistake about adequacy of acreage); Vermette v. Anderson, 558 P.2d 258 (Wash. Ct. App. 1976) (excusing land sale contract because of mistake about instability of slope).

buyers relief because they find that the terms of the contract or the foreseeability of the occurrence requires the buyer to bear the risk of the hidden flaw.[89] The cases relieving buyers from contracts to buy unexpectedly worthless objects are in accord with the principle of loss alignment, though they may instead be grounded on a different principle, which we might call a warranty principle. This principle holds sellers responsible for the quality of what they sell. The two principles dictate a different result when the unexpected defect in the object causes a loss to the buyer independent of the price paid for an object. The loss alignment principle would deny the buyer relief in this circumstance; a warranty principle would make the seller liable for the buyer's loss.

### *B. Excessive Stipulated Damage Clauses*

The prohibition of excessive stipulated damage clauses is one of the most perplexing rules in contract law. It is odd that parties may freely bargain over performance terms in a contract but that they may not freely bargain over remedies on breach of those terms. The application of the rule is uncertain even in the most basic cases. At its core, the rule prohibits parties from writing damage clauses in contracts that they expect will overcompensate the promisee on breach.[90] But even such a clause may be enforced by casting the excessive payment as an alternative performance term.[91] A damage clause and

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The law regarding the right of a tenant to be excused from a lease when unforeseeable events render his contemplated use of the premises impracticable is roughly consistent with the principle of loss alignment, though it may be better explained by the principle of unselfish performance. A tenant may be excused from a lease if the contract restricts his use of the premises to the use that was rendered impracticable. *See, e.g.*, Garner v. Ellington, 501 P.2d 22 (Ariz. Ct. App. 1972) (excusing lease which limited use of premises as theatre and bookstore when remodeling permit denied); Industrial Dev. & Land Co. v. Goldschmidt, 206 P. 134 (Cal. Ct. App. 1922) (excusing lease which limited use of premises as saloon upon prohibition). A tenant may not be excused from a lease if his use of the premises is unrestricted. *See, e.g.*, Lloyd v. Murphy, 153 P.2d 47 (Cal. 1944) (holding commercial frustration does not excuse lease when its purpose has not been totally destroyed). In the first situation, where the property is rendered valueless to the tenant because of the contract restriction—though it may retain significant value for other uses—excuse frees the property for more profitable use. It also more closely aligns individual loss and joint loss, though the landlord will suffer an economic loss on the transaction if any changes made in the property because of the lease reduced its value in the rental market. In the second situation, the tenant is likely to be able to use the property as profitably as could the landlord (often by subleasing or assigning the lease). The loss to the tenant is unlikely to be severe enough to justify relief, or, if the loss is severe, it will be due to an event that is foreseeable, such as a fire.

89. Maloney v. Sargisson, 465 N.E.2d 296 (Mass. App. Ct. 1984) (enforcing contract to sell land despite purchaser's mistake about soil condition that made land unsuitable for building because purchaser had tested soil and so bore the risk); Lenawee County Bd. of Health v. Messerley, 331 N.W.2d 203 (Mich. 1982) (enforcing contract to sell apartment house despite mistake about sewage system that affected habitability because "as is" clause assigned risk to buyer); Deans v. Layton, 366 S.E.2d 560 (N.C. Ct. App. 1988) (enforcing contract to sell land despite mutual mistake about drainage that made much of land unsuitable for development because purchaser was experienced real estate developer who bore the risk of poor drainage conditions on the property).

90. Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc., 361 N.E.2d 1015 (N.Y. 1977). Most cases that involve clauses that seem intended to serve as penalties require a promisor to forfeit a deposit, down payment, or other rights on breach. Albins v. Elovitz, 791 P.2d 366 (Ariz. Ct. App. 1990) (holding void as a penalty clause that allowed wife to withdraw waiver of child support and collect attorney's fees if husband tried to reinstate visitation rights); Pacheco v. Scoblionko, 532 A.2d 1036 (Me. 1987) (holding void as a penalty a clause that required forfeiture of fees paid to a summer camp); Muhlhauser v. Muhlhauser, 754 S.W.2d 2 (Mo. Ct. App. 1988) (holding void as a penalty a clause which forfeited husband's interest in marital home if he failed to pay maintenance or child support); Snarr v. Picker Corp., 504 N.E.2d 1168 (Ohio Ct. App. 1985) (holding void as a penalty a clause that required forfeiture of rights under profit-sharing plan on breach of covenant not to compete). In a recent Illinois case, a court had little difficulty in invalidating a clause that required a cable company to forfeit a $100,000 letter of credit if it did not fully install cable in the Village of Schaumburg by the contract deadline. Village officials admitted that they negotiated the clause as a penalty because of the cable company's "lousy" performance record. Telenois, Inc. v. Village of Schaumburg, 628 N.E.2d 581 (Ill. App. Ct. 1993).

91. It is through such reasoning that courts have sustained take-or-pay clauses that require a buyer to pay for goods it promised to buy even if it does not take the goods. Prenalta Corp. v. Colorado Interstate Gas Co., 944 F.2d 677 (10th Cir. 1991); Universal Resources v. Panhandle E. Pipe Line Co., 813 F.2d 77 (5th Cir. 1987); Sabine Corp. v. Ong W. Inc., 725 F. Supp. 1157 (W.D. Okla. 1989); Resources Inv. Corp. v. Enron Corp., 669 F. Supp. 1038, 1041 (D. Colo. 1987);

an alternative performance term may be functionally similar. The rule also requires parties to take care when they specify damages to avoid overcompensation. However, courts take wildly different positions on the standard of care required in forecasting damages.[92] Judges[93] and academics[94] have harshly criticized the doctrine, often on the ground that it violates freedom of contract.[95] The criticism of the doctrine seems to be having an impact, for it is being weakened by statutes[96] and by courts.[97]

The prohibition of excessive stipulated damage clauses has all the elements of the principles of unselfish performance and loss alignment save the most important—excuse is not limited to cases where a damage clause overcompensates for unexpected reasons. A concern with preventing selfish performance is a common justification for the rule. The rule eliminates the promisor's incentive to perform inefficiently when stipulated damages exceed the actual loss on breach[98] and the promisee's incentive to induce (or falsely claim) breach when stipulated damages exceed his return on performance.[99] And excusing

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Koch Indus., Inc. v. Columbia Gas Transmission Corp., No. 83-990-A (M.D. La. March 14, 1985); Colorado Interstate Gas Co. v. Chemco, 833 P.2d 786 (Colo. Ct. App. 1991); *see* A.F. Brook, II, Comment, *Great Expectations: Assessing the Contract Damages of the Take-Or-Pay Producer*, 70 TEX. L. REV. 1469, 1478-79 (1992); *see also* Carlyle Apartments Joint Venture v. AIG Life Ins. Co., 635 A.2d 366 (Md. 1994) (upholding prepayment fee on a loan on ground that it was an alternative performance term). Cases that invalidate clauses that require a promisor to pay the contract price should it not perform include Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985); Syncsort, Inc. v. Indata Services, 541 A.2d 543 (Conn. App. Ct. 1988); Mid-Atlantic Autec v. Keeler Motor Co., 605 N.Y.S.2d 447 (N.Y. App. Div. 1993). Superfos Inv. Ltd. v. Firstmiss Fertilizer, 821 F. Supp. 432 (S.D. Miss. 1993), attempts to distinguish, on specious grounds, a take-or-pay term from a term that required the buyer to pay the price of a minimum quantity of liquid fertilizer.

92. For example, courts disagree on whether accelerated payments must be discounted for time. Rattigan v. Commodore Int'l Ltd., 739 F. Supp. 167, 171 (S.D.N.Y. 1990) (holding that accelerated payment is not a penalty though it is not discounted to present value); United Am. Fin. Corp. v. Knoxville Properties (*In re* United American Financial Corp.), 55 B.R. 117 (Bankr. E.D. Tenn. 1985) (holding that accelerated payment is a penalty because it is not discounted to present value). Courts have also disagreed about whether liquidated damages may be set by a rule of thumb and not particularized. *Cf.* Chien v. Tova Realty, 573 N.Y.S.2d 855 (N.Y. Civ. Ct. 1991) (holding that forfeiture of 10% down payment on co-op contract is void as a penalty absent proof of comparable actual or expected damages); Illingworth v. Bushong, 688 P.2d 379 (Or. 1984) (upholding use as "rule of thumb" 10% of purchase price as earnest money on real estate contract).

93. *Lake River Corp.*, 769 F.2d 1284; Bigda v. Fischbach Corp., 849 F. Supp. 895 (S.D.N.Y. 1994); *Rattigan*, 739 F. Supp. at 170 n.1.

94. Goetz & Scott, *supra* note 2; Schwartz, *supra* note 2; Threedy, *supra* note 2.

95. *Rattigan*, 739 F. Supp. at 170-71; Barrera v. Ciolino, 636 So. 2d 218 (La. 1994); FARNSWORTH, *supra* note 48, at 935. Farnsworth states that:

> compared with the extensive power that contracting parties have to bargain over their substantive contract rights and duties, their power to bargain over their remedial rights is surprisingly limited. The most important restriction is the one denying them the power to stipulate in their contract a sum of money payable as damages that is so large as to be characterized a 'penalty.'

*Id.*

96. The sales provisions of the U.C.C. validate ineptly drawn clauses that might often overcompensate but that turn out to approximate actual damages. This is the plain import of the requirement in U.C.C. § 2-718(1) that liquidated damages be "reasonable in the light of the anticipated *or* actual harm caused by the breach." U.C.C. § 2-718(1) (1987) (emphasis added). The lease provisions of the U.C.C. dispense with the requirements that liquidated damages clauses be justified by the difficulties of proof of loss or the inadequacies of other remedies. *Id.* § 2A-504 (1987). The lease provisions also eliminate the statement in the sales provision that a term fixing unreasonably large damages is void as a penalty. This change was to make it clear that liquidated damages might well exceed the contract price when breach of the lease deprives the other party of tax benefits.

97. Some recent cases suggest that a liquidated damages clause should be enforced unless there is evidence of oppression or unconscionability. *Bigda*, 849 F. Supp. 895; Hartford Fire Ins. Co. v. Architectural Management, Inc., 550 N.E.2d 1110, 1115 (Ill. App. Ct. 1990).

98. Lake River Corp. v. Carborundum Co., 769 F.2d 1284, 1289 (7th Cir. 1985) ("[A] penalty clause may discourage efficient as well as inefficient breaches of contract."); John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277, 291 (1972).

99. *See* Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (arguing that penalty terms ought not be enforced when they give a party the means or incentive to induce breach); Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 242-45 (1981) (arguing that overcompensatory damage clause gives promisee incentive to falsely claim breach).

an excessive damage clause almost always saves the promisor from a significant loss while leaving the promisee in as good or better position than he would have been without the contract.[100] But the law seems quite clear about the irrelevance of unexpectedness.[101] There is old authority for the proposition that a court may never set aside a clause that seemed a reasonable projection of damages when a contract was made because the clause unexpectedly overcompensates,[102] and Alan Farnsworth, the leading scholar of U.S. contract law, says that courts only rarely invalidate clauses for this reason.[103]

In the next part of the discussion, I will show that courts often set aside damage clauses that may have seemed reasonable when a contract was made because they unexpectedly overcompensate or because the promisee behaved opportunistically. First, however, I want to show that good reasons exist to assume that when a clause does significantly overcompensate it may be because the clause did not function as the parties expected. The argument grounds on Alan Schwartz's claim that it generally is not in people's interests to contract for overcompensatory damages.[104] The most general explanation for why people use a clause providing for excessive damages is as a device to signal the

100. In most contracts, a promisee's expectation interest will exceed its reliance interest or restitution interest (*i.e.*, the promisor's gain on the contract), so to award excessive liquidated damages would overcompensate the promisee's reliance and impose a loss on the promisor. In the two situations where liquidated damages might be deemed excessive under the law, though the promisor does not suffer a loss in excess of the parties' joint loss, strong arguments exist for awarding the amount of liquidated damages.

One such situation is where a clause protects a promisee against a loss on what turns out to be a losing contract for reasons independent of the promisor's breach—that is, the promisee would have lost its investment even had the promisor performed. A clause is vulnerable to challenge in this situation. The Restatement reqnires that damages be liquidated "at an amount that is reasonable in the light of the anticipated or actual loss *caused by the breach*." RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979) (emphasis added). When reliance exceeds expectation, the loss is caused not by the breach but by external events that make performance less valuable to the promisee. Under the general law of contracts, a promisee's reliance loss is used as a surrogate for expectation damages where expectation is uncertain. Expectation damages are given if they are probably less than reliance. L. Albert & Son v. Armstrong Rubber Co., 178 F.2d 182 (2d Cir. 1949). It follows that a court might refuse to enforce liquidated damages in excess of expectation but approximating reliance.

A liquidated damages clause should be enforced if the clause compensates reliance though the reliance loss exceeds expectation damages. It is commonplace for one party to agree to protect the other against loss on its investment in a contract even when the loss is not due to the first party's failure to perform. Take-or-pay and minimum-take contracts often serve this function. J. Harold Mulherin, *Complexity in Long-Term Contracts and Analysis of Natural Gas Contract Provisions*, 2 J.L. ECON. & ORGANIZATION 105, 111 (1986); *see* Gergen, *supra* note 5, at 1050 n.159.

The other situation where liquidated damages might be excessive under current law, though enforcement of the clause would not violate the principle of loss alignment, is where a clause requires a promisor to disgorge its profit on a contract upon breach though that profit exceeds the promisee's loss upon breach. This case should not arise in practice because a promisee need not resort to a liquidated damages clause to recover the promisor's profit, because in such a case it may elect to rescind the contract and recover the profit in restitution.

101. Use of the rule against penalties to protect parties from the unexpected can be traced back to some of the earliest English antecedents of the rule, which voided penal bonds when accidents or unexpected events such as theft or a flood prevented performance of a contract. William H. Lloyd, *Penalties and Forfeitures*, 29 HARV. L. REV. 117, 123 n.28 (1915).

102. Banta v. Stamford Motor Co., 92 A. 665 (1914). The U.C.C. requires that a liquidated damages clause be "reasonable in light of the anticipated *or* actual harm caused by the breach," U.C.C. § 2-718(1) (1966) (emphasis added), which suggests that a well-drawn clause is always valid and that a poorly drawn clause is valid if it approximates actual damages.

103. FARNSWORTH, *supra* note 48, at 941 (stating that a clause that represents a reasonable forecast of damages is invalid only "in the rare and extreme situation in which . . . the injured party actually suffered no loss at all").

104. Schwartz concludes that it might be in a promisee's interest to contract for overcompensatory damages only in three unusual instances: a promisee might think breach more likely than the promisor; a promisee might think he can influence a promisor's decision to breach; and a promisee might prefer risk. Schwartz, *supra* note 2, at 392-95. Telenois, Inc. v. Village of Schaumburg, 628 N.E.2d 581 (Ill. App. Ct. 1993) suggests that another exception might be made to Schwartz's analysis to cover what might broadly be described as agency problems. Schaumburg officials may have been willing to give up whatever the cable company demanded in return for submitting to the penal clause because that cost was berne generally by all subscribers, and so went unnoticed, while the cost of incomplete installation would be berne by only a few households, which would be greatly aggrieved. *See supra* uote 90.

promisor's credibility or as security for performance.[105] Schwartz shows that this is a foolish thing to do. A right to collect excessive damages is poor security for performance because the promisee still has nothing better than a claim against the promisor for damages that must be enforced through the legal system. In this respect, excessive damage clauses provide less security than forfeiture provisions, which allow the promisee to seize or retain assets unilaterally.[106] Further, there are other less problematic ways to signal credibility, such as posting a bond.[107] And, of course, excessive damage clauses create a risk of opportunistic behavior in the form of inefficient performance by the promisor or interference or a false accusation of breach by the promisee.

What conclusion should we draw if we assume that people generally do not contract for overcompensatory damages? Schwartz's conclusion is that damage clauses should be enforced absent proof of unconscionability. This conclusion hinges on Schwartz's assumptions that people rarely make mistakes in forecasting damages and drafting damage clauses[108] and that courts will poorly measure actual damages and may misunderstand parties' objectives in liquidating damages.[109] If these assumptions are correct, then a rule empowering courts to ferret out excessive damage clauses would do little good since they should be few in number. In fact the rule will do much harm: it will

105. *See* KRONMAN & POSNER, *supra* note 2, at 224 (arguing that penal liquidated damages clause may serve a signaling function); RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 93-94 (2d ed. 1977) (same).

Overcompensatory damage clauses might be used to restrain competition from third parties in a monopoly situation. For example, a high-cost seller with temporary monopoly power might anticipate the appearance of a lower cost competitor at some point in the future. To perpetuate its monopoly power, the seller would offer its customers a lower priced contract with a clause providing for liquidated damages in excess of the seller's lost profits should the customer switch to a competitor. Such a clause enables the seller to capture part of the profit of a lower cost competitor who does enter the market. Philippe Aghion & Patrick Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388, 392-98 (1987); Joseph F. Brodley & Ching-to Albert Ma, *Contract Penalties, Monopolizing Strategies, and Antitrust Policy*, 45 STAN. L. REV. 1161 (1993). Most of the cases discussed in this part do not fit this theory, for there is no reason to think that the party who benefited from the excessive damage term enjoyed monopoly or feared the entrance of a lower-cost competitor. The theory requires specialized conditions. The monopolist and its customers must be uncertain about the appearance of a lowercost competitor and that competitor's profit margin, Brodley & Ma, *supra*, at 1167-68, and they must anticipate the appearance of only one competitor. *Id.* at 1173-74. Though Brodley and Ma do cite to a number of antitrust cases that arguably involve such uses of penal damage clauses, *id.* at 1182-94, this problem surely is best dealt with through antitrust law.

106. It is striking that all the cases cited *supra* note 90, with the exception of *Telenois*, 628 N.E.2d 581, involve forfeiture of a deposit or a right. Forfeiture clauses may respond to enforcement problems in a way that damage clauses requiring collection cannot. *Cf.* Robert E. Scott, *Rethinking the Regulation of Coercive Creditor Remedies*, 89 COLUM. L. REV. 730, 741-48 (1989) (explaining why creditors might demand collateral of little value to themselves and great value to the borrower). Schwartz argues that measures to improve monitoring of performance and to reduce the cost of suit are the preferred solution to enforcement problems in most contracts and not punitive damages. Schwartz, *supra* note 2, at 395-403. Forfeiture clauses also may respond to the desire of parties to keep whatever payments they receive under a contract.

107. *See* Rea, *supra* note 16, at 156-57.

108. While Schwartz concedes the possibility that people may make a mistake in liquidating damages, he does not think that possibility warrants the rule. Schwartz, *supra* note 2, at 383-86. He addresses the problem of mistake in contract law at greater length in a later article. Schwartz, *supra* note 63, at 279-82. There he concludes that courts will intervene when a contract malfunctions because parties have inadvertently overlooked a problem or when the cost of solving a problem exceeds the private gain. However, courts will not intervene when the malfunction is due to a contingency that the parties would not have tried to cover in a contract because its occurrence is difficult for a third party to verify. *Id.* at 279-82. Presumably this reasoning requires enforcing an overcompensatory liquidated damages clause when the parties use the clause because damages are difficult to measure. Schwartz's argument fails, thus, on its own terms. *Id.* at 274. His theory is not an accurate depiction of what courts do under the law on liquidated damages. And, as I show above, it does not accurately depict what courts do under the impracticability doctrine. *See supra* note 63.

109. Schwartz, *supra* note 2, at 370 ("[E]ven with the benefit of hindsight, courts seldom could do better for the parties than the parties can do for themselves."); *id.* at 384 ("The liquidated damages rule . . . directs courts to evaluate the parties' predictions. Courts should be expected to do this job badly."); *id.* at 386 ("[T]here may be more to fear from judicial oversight than from poor party predictions."); *id.* at 387 ("Courts, however, cannot easily know when a clause is supracompensatory.").

increase litigation costs because of the uncertain validity of many damage clauses that should be enforced,[110] and it will have harmful effects on contracting, reliance, and performance that result from the possibility that courts will err in assessing damages and strike down a clause in a way that leaves a promisee undercompensated on breach or otherwise frustrates the legitimate objectives of parties in liquidating damages.[111] If these assumptions are incorrect—and I think they are—then a rule that empowers courts to set aside overcompensatory damage clauses may do more good than harm. If people are prone to err in forecasting damages or drafting damage clauses, then there will be a fair number of cases where clauses unexpectedly overcompensate. If courts do a reasonably good job in identifying cases where stipulated damages greatly exceed actual damages, and in identifying the parties' objectives in stipulating damages, then damage clauses are likely to be set aside only in cases where clauses malfunction. And, as I will show later, the possibility of setting aside damage clauses in such cases may improve behavior in performance, settlement, and contracting.

The cases provide some evidence of the difficulty people have in writing foolproof damage clauses and of the capacity of courts to identify overcompensatory clauses. In a substantial number of cases where courts set aside clauses, it seems fairly clear that the clause overcompensates and that this result was due to unanticipated contingencies. In a few cases, courts refuse to enforce a possibly overcompensatory clause where the promisee acted opportunistically.

Unexpected overcompensation is most clearly the basis for invalidating a stipulated damage clause when a court voids a clause that it finds was a reasonable estimate of damages ex ante because the clause overcompensates ex post. Part of the law of liquidated damages is concerned with the ex post rather than the ex ante reasonableness of a liquidated damages clause—the rule that voids a liquidated damages clause when actual damages are zero.[112] But the modern form of this rule does not help my case much. Relief under the rule is not restricted to unexpected outcomes.[113] And it is not clear whether the rule restricts relief to cases where actual damages are zero: the principle of

110. Goetz & Scott, *supra* note 2, at 566-68.

111. *Id.* at 568-83; Schwartz, *supra* note 2, at 384-87.

112. *See* Colonial at Lynnfield, Inc. v. Sloan, 870 F.2d 761 (1st Cir. 1989); Massman Constr. Co. v. City Council, 147 F.2d 925 (5th Cir. 1945); Hubbard Business Plaza v. Lincoln Liberty Life Ins., 649 F. Supp. 1310 (D. Nev. 1986), *aff'd*, 844 F.2d 792 (9th Cir. 1988); Norwalk Door Closer Co. v. Eagle Lock & Screw Co., 220 A.2d 263 (Conn. 1966). RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. b, illus. 4 (1981), adopts this position. For a contrary decision, see Southwest Eng'g Co. v. United States, 341 F.2d 998 (8th Cir.), *cert. denied*, 382 U.S. 819 (1965).

113. Courts have erred by mechanically applying a rule that voids liquidated damage clauses when actual damages are zero without considering the parties' expectations in writing the term. *Hubbard Business Plaza*, 649 F. Supp. 1310, is one such case. Hubbard entered into a loan commitment agreement with Lincoln Liberty, promising to pay two percent of the loan principal if it did not close the loan. Hubbard failed to close. The court held the two percent fee void because Lincoln Liberty had suffered no actual damage due to a rise in interest rates. *Id.* at 1316. The court held the term void even though it recognized that the two percent fee had fairly compensated Lincoln Liberty for the risk that interest rates would drop over the term of the commitment. Given the term (a year extended for another 18 months), *id.* at 1312, the risk borne by Lincoln Liberty was substantial. The outcome is difficult to defend since the liquidated damage clause could easily be rewritten as the price term for an option on a loan. *Cf.* Valdina Farms, Inc. v. Brown, Beasley & Assocs., 733 S.W.2d 688 (Tex. Ct. App. 1987) (upholding a similar fee by characterizing it as the price for an option). There is obvious harm and no apparent good in making the enforceability of a common business term in everyday circumstances turn on its formal character. Nor is the outcome in *Hubbard Business Plaza* compelled by *Norwalk Door*, 220 A.2d 263. It would be so only if the parties expected Hubbard to close the loan if interest rates rose so that the rate was below market, for only then would the payment of the fee on the "zero damage" outcome be unexpected. This seems unlikely since many factors might compel a person not to exercise an option on a loan that would be secured by real property though the option is "in the money."

loss alignment is not so ungenerous.[114] More helpful to my argument are the cases commonly cited as the sources for the "zero-damage rule." In these seminal cases, courts refused to enforce liquidated damages clauses not because of the odd fact that actual damages were zero, but rather because the events making the damages excessive were unexpected. The leading case is *Norwalk Door Closer Co. v. Eagle Lock & Screw Co.*[115] Eagle Lock promised to supply Norwalk with door closers for seven years. Eagle could not assign the contract, and a change in control of Eagle was deemed a breach for which liquidated damages of $100,000 would be paid. At the time of the contract, Norwalk apparently thought who controlled Eagle was crucial, for Norwalk was given the right to terminate the contract and to collect damages if Eagle's president and general manager left.[116] After four years Eagle terminated the contract because of a change in ownership and Norwalk sought liquidated damages, although it continued to do business with Eagle's successor on the same or better terms than it did business with Eagle.[117] The court refused to enforce the liquidated damages clause, stating that "if the damage envisioned by the parties never occurs, the whole premise for their agreed estimate vanishes, and, even if the contract was to be construed as one for liquidated damages rather than one for a penalty, neither justice nor the intent of the parties is served by enforcement."[118]

A fair number of cases wholly or partially set aside damage clauses when actual damages are positive but much less than liquidated damages in circumstances where the best justification for setting aside the clause is that the parties did not anticipate the outcome in liquidating damages. *Mattingly Bridge Co. v. Holloway & Son Construction*[119] is emblematic of these cases. A general contract and a subcontract contained virtually identical per diem liquidated damage clauses for delay in completing a construction job for a state. The state collected damages for a seventeen and two-thirds day delay from the general contractor, though the actual delay in completion was 193 days. The court refused to enforce the liquidated damages clause against the subcontraetor for the full period of delay on the ground that it would be a penalty.[120] A dissent argued that the clause was a

114. *See* Loomis v. Lange Fin. Corp., 865 P.2d 1161 (Nev. 1993). Some cases suggest that damages must be zero. *See* Realco Equities, Inc. v. John Hancock Mut. Life Ins. Co., 540 A.2d 1220, 1224 (1988) (denying relief because "the evidence did not clearly demonstrate that the plaintiff suffered no damage"). Other cases suggest a more open rule. *See* Schrenko v. Regnante, 537 N.E.2d 1261, 1263 (Mass. App. Ct. 1989) ("[S]uch a clause may not be enforced, however, if the amount involved is so disproportionate to the actual expense cause by the breach as to shock the conscience of the court.").

115. 220 A.2d 263. Another case often cited as a source for the zero-damage rule, *Massman Construction*, 147 F.2d 925, is more complex. The case voids a per diem delay charge in a contract for the construction of bridge piers where a delay in completing the piers caused no harm because of a delay in completing the connecting road. One reason the court gave for setting aside the clause was that the presupposition upon which the parties had liquidated damages, requiring actual losses, never occurred. Therefore, without the contingency upon which it is based, the presupposition was nullified. *Id.* at 927. The court also justified relief on the ground that the contractor had been misled about soil conditions and on the ground that the engineer and the city council had both sought to waive liquidated damages bnt could not get approval of the Reconstruction Finance Corporation and Works Progress Administration. *Id.* at 927-28.

116. Another provision of the centract suggests that Norwalk thought it important who ran Eagle Lock. *Norwalk Door*, 220 A.2d at 265.

117. The court does not explain the impact on Norwalk of the eventual change in Eagle's ownership other than to say that "Norwalk continued uninterruptedly doing the same business with the same persons at the same location" under a new contract with more favorable terms to Norwalk. *Id.* at 267.

118. *Id.* at 268.

119. 694 S.W.2d 702 (Ky. 1985). United States *ex rel.* Lichter v. Henke Construction Co., 157 F.2d 13 (8th Cir. 1946) and Bedford v. Miller, Inc., 212 F. 368 (4th Cir. 1914), reach the same result on similar facts.

120. The court actually enforced liquidated damages for a 32 2/3-day delay. This was comprised of the 17 2/3-day delay charged by the state against the general contractor plus a 15-day delay because the subcontract was to be completed 15 days before the completion date of the general contract. *Mattingly Bridge*, 694 S.W.2d at 706. The subcontractor was charged the damages though a prior decision found that its delay was not responsible for the general contractor's delay in completion of the general contract. *Id.* at 704. Nevertheless, the terms of the subcontract made the subcontractor

reasonable forecast of damages when the contract was made and so should be enforced.[121] The majority did not challenge this point, but instead argued that the parties intended the clause to compensate the general contractor for damages charged by the state, and no more.

Similar to *Mattingly Bridge* are many cases that refuse to enforce per diem damage clauses for extended delays in performance of months or years on contracts where the usual delay is days or weeks.[122] Damages under per diem clauses for overlong delays are likely to be excessive because the rate at which damages accrue tends to diminish with time as promisees adjust to nonperformance. In addition, parties may not consider the possibility of such long delays in performance when setting per diem damages. Cases that refuse to enforce clauses when a breach is partial also have been explained on the ground that the parties intended the clause to apply only on a total breach.[123]

Courts sometimes use the prohibition of penal damage clauses to invalidate a clause to protect a party who may have misunderstood that it breached the contract or the amount of liquidated damages for which it would be liable.[124] For example, in *Syncsort,*

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chargeable with damages because the contract provided that the damages would run, if the subcontractor delayed completion of its work, until the state certified completion of the work on the general contract. *Id.* at 703. The case is muddled by the fact that the parties worked under two contracts—one fictitious, the other real—to disguise from the state the fact that the subcontractor was doing more than 50% of the work on the general contract, which was illegal under state law. A prior decision held that the subcontrator's rights and liabilities were governed by the contract under which the parties really operated. Holloway & Son Constr. v. Mattingly Bridge Co., 581 S.W.2d 568 (Ky. 1979).

121. *Mattingly Bridge*, 694 S.W.2d at 706 (Stephenson, J., dissenting).

122. Northwestern Terra Cotta Co. v. Caldwell, 234 F. 491 (8th Cir. 1916) (invalidating $50 per diem clause that resulted in $5,750 damages on a contract with a price of $13,000 where work was substantially complete); Germain Lumber Co. v. United States, 56 F. Supp. 1001 (W.D. Pa. 1944) (invalidating per diem damages of $5,471 on contract worth $5,887); Muldoon v. Lynch, 6 P. 417 (Cal. 1885) (invalidating per diem charge when unexpected inability to obtain transport resulted in two-year delay in shipping a monument from Italy to San Francisco); Loggins Constr. Co. v. Stephen F. Austin State Univ. Bd. of Regents, 543 S.W.2d 682 (Tex. Ct. App. 1976); First State Bank v. Smith, 160 S.W.2d 311 (Tex. Ct. App. 1913) (invalidating $20 per diem clause on 173-day delay); S.L. Rowland Constr. Co. v. Beall Pipe & Tank Corp., 540 P.2d 912 (Wash. Ct. App. 1975) (invalidating $150 per diem damages where 4 ½-month delay in pipe construction was for cleanup and landscaping).

123. *See* Jordache Enter., Inc. v. Global Union Bank, 688 F. Supp. 939 (S.D.N.Y. 1988) (interpreting stipulated damage clause to require apportionment of fixed sum to be paid if jeans were imported in violation of plaintiff's exclusive right); Brecher v. Laikan, 430 F. Supp. 103, 107 (S.D.N.Y. 1977) (refusing to enforce promissory note given as security for promise to ensure performance of four loans because "the parties never envisioned the situation that came to pass after Brecher's death: partial performance, then a total breach of a lesser divisible obligation, followed by complete performance on the other three loans"). This is a more plausible basis for cases that void overbroad clauses when actual damages are low. The rule once was that an overbroad clause had to be evaluated by the court from the perspective of the parties at the time it was written, and that if it imposed excessive damages on trivial breaches it was void. Seidlitz v. Auerbach, 129 N.E. 461 (N.Y. 1920). In theory, such a clause would be void even upon a substantial breach. This position could not be maintained for it might leave a promisee with no remedy when a substantial breach inflicted difficult-to-measure damages. When the New York Court of Appeals faced such a case, it upheld the clause by reasoning that though it was overbroad, if read literally the parties had intended it to apply only on substantial breaches. Hackenheimer v. Kurtzman, 138 N.E. 735 (N.Y. 1923).

A related issue is whether stipulated damages may be apportioned when the parties share fault for the breach. The traditional rule was that a party who bore any fault for a breach could not seek to enforce a stipulated damage provision. However, the trend seems to be towards apportionment. Good discussions of the issue can be found in Aetna Casualty & Surety Co. v. Butte-Meade Sanitary Water Dist., 500 F. Supp. 193 (D.S.D. 1980); Baldwin v. National Safe Depository Corp., 697 P.2d 587, 590 (Wash. Ct. App. 1985).

124. A troublesome Washington case—Lind Bldg. Corp. v. Pacific Bellevue Devs., 776 P.2d 977 (Wash. Ct. App. 1989)—may also best be explained under this reasoning. Lind contracted to purchase land from Pacific Bellevue for $4,144,085, paying a $20,000 deposit that was to be forfeited as liquidated damages on breach. Lind paid another $50,000 when certain contingencies were resolved, and the contract gave Lind the right to delay closing for 30 days by paying another $20,000. Lind had difficulty arranging financing so it sought and obtained several further extensions in the closing, for which it agreed to pay an additional $160,000. Lind eventually breached and Pacific Bellevue sold the property several months later for $5,150,000. The court held the liquidated damages term void because actual damages were zero. Later Washington cases and a statute repudiate *Lind Building*. WASH. REV. CODE ANN. § 64.04.005 (West 1992) (providing a safe harbor for liquidated damage clauses up to five percent of purchase price); Wallace Real Estate Inv., Inc. v. Groves, 868 P.2d 149 (Wash. Ct. App.), *aff'd*, 881 P.2d 1010 (Wash. 1994); Watson v. Ingram, 851 P.2d 761, 767 (Wash. Ct. App.

*Inc. v. Indata Services*,[125] the court invalidated a clause in a software licensing agreement that required the licensee to pay the three-year licensing fee if it canceled the agreement after a sixty-day trial period. The decision is difficult to defend (among other legitimate functions the damage clause protects the licensor from the risk that a licensee will cancel the agreement but continue to use software) until one adds the fact that the licensee failed to test the equipment within the trial period because it thought the sixty days ran from the date of its acceptance of the software rather than the date of installation.[126] In effect, the court used the rule against penalties to save the licensee from an interpretive mistake.

The licensee's mistake regarding the trial period in *Syncsort* was unilateral. In this respect, the case differs from *Mattingly Bridge*, which involved a mutual mistake since neither party probably anticipated the event that made the stipulated damages excessive. The law of excuse for unilateral mistake is less generous than that for mutual mistake. However, a party can still make a credible case for relief even under the law of unilateral mistake because of the excessiveness of liquidated damages.[127] Under the Second Restatement of Contracts, relief is given for unilateral mistake if the mistake makes enforcement of a contract unconscionable.[128] The Restatement mentions two factors as relevant to unconscionability in this context: absence of reliance by the promisee[129] and gross disparity in values exchanged.[130] Both factors are present in *Syncsort*. The licensor has no reliance loss if it is paid the cost of installing the software, assuming the licensee would not have agreed to purchase the software without an opportunity to test it. Moreover, requiring the licensee to pay the full three-year fee for unused software results in grossly disparate returns under the contract.

Another group of cases refuses to enforce overcompensatory stipulated damage clauses when the promisee acts opportunistically. *Bigda v. Fischbach Corp.*[131] illustrates one form of opportunism: a nit-picking claim of breach. When Victor Posner took over Fischbach Corporation, its general counsel, Bigda, obtained a five-year employment contract under which Fischbach promised to pay Bigda an amount equal to three years' salary plus benefits if it breached the contract at any time during the five years. The contract promised Bigda he would remain general counsel and retain his office and other perquisites.[132] Bigda worked for Fischbach without complaint until near the end of the five-year period, when he left the company and claimed breach on the ground that Posner and his successor had undercut Bigda's authority as general counsel in various ways.[133]

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1993). But *Lind Building* is different from the normal case involving forfeiture of a deposit because the buyer plausibly argued that it did not realize that the extension payments were subject to forfeiture. The original contract required forfeiture of "the Deposit," which it defined as the initial payments totaling $90,000.

125. 541 A.2d 543 (Conn. App. Ct.), *cert. denied*, 548 A.2d 443 (Conn. 1988).

126. *Id.* at 544.

127. While it is unusual, the mistake doctrines will extend to cover interpretive mistakes as well as mistakes about facts that affect the return on a contract. *See* RESTATEMENT (SECOND) OF CONTRACTS § 20 cmt. d, illus. 4 (1981) (observing that where neither party knows of the other's mistake in the meaning of a term but one party had reason to know, the mistake doctrine determines whether the contract is voidable). *But see* Creative Communications Consultants v. Gaylord, 403 N.W.2d 654, 657 (Minn. Ct. App. 1987) (holding that mistake doctrine does not provide relief from interpretive mistake regarding meaning of commission term).

128. RESTATEMENT (SECOND) OF CONTRACTS § 153 (1979).

129. *Id.* § 153 cmt. d.

130. *Id.* § 153 cmt. c (referring to § 208 comment c to define unconscionability). Section 153 concerns imbalance of consideration.

131. 849 F. Supp. 895 (S.D.N.Y. 1994).

132. *Id.* at 899. It was possible that Bigda had taken advantage of his position to foist the employment contract on the company in anticipation of Posner's takeover. *Id.* at 903.

133. *Id.* at 900.

In remanding the case to the trial court, the court reopened the issue of whether Bigda had acted in bad faith by claiming breach so late in the contract's life.[134]

Other cases involve inducement of breach by the promisee. In one particularly blatant case, a jury found that a builder unreasonably delayed completion of a house in order to induce the buyer to breach: the buyer's failure to close on time would allow the builder to sell the house at a greater profit and pocket the buyer's earnest money.[135]

A sense of how significantly mistake and opportunism figure in the entire pool of cases involving challenges to stipulated damage clauses can be obtained by examining a sample of cases. I found twenty-three cases decided after 1992 under the most pertinent West key number.[136] The damage clause was upheld in twelve of these cases despite a claim that it grossly overcompensated.[137] Two of these twelve cases drew what I think to be the appropriate distinction to earlier cases that invalidated similar clauses when application of the clause would have unexpected consequences.[138] Three cases that refused to enforce

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134. *Id.* at 907.

135. Roswell Properties, Inc. v. Salle, 430 S.E.2d 404 (Ga. Ct. App. 1993); *see also* Orange Cove Irrigation Dist. v. United States, 28 Cl. Ct. 790 (1993) (suggesting that the United States set impossible performance conditions for completion of forms in order to impose penal charge on water users); Story v. City of Bozeman, 856 P.2d 202 (Mont. 1993) (holding that contractor's failure to complete project on time was due to city's breach of its duty of good faith and interference by agent of city).

136. Damages key number 80 (December 10, 1994). The pattern is the same if the net is cast wider. Adding the most inclusive key numbers—Damages 74 to Damages 76—increases the pool by 47 cases. Sixteen of these do not involve claims of excessive liquidated damages. Twenty enforce the clause despite a claim of excessiveness. Six of the remaining 11 cases that deny liquidated damages do so in circumstances where that does not violate the parties' probable expectations in making the contract. One of these cases invokes the rule as an interpretive guide to hold that a note could be prepaid without paying unaccrued interest. Acord v. Jones, 440 S.E.2d 679 (Ga. Ct. App. 1994). One invokes the rule to deny a claim to recover liquidated damages on top of actual damages. Outrigger Resort Corp. v. L & E Corp., 611 So.2d 1358 (Fla. Dist. Ct. App. 1993). Three invoke the rule to deny liquidated damages where the party trying to collect such damages had contributed to the breach by acting in apparent bad faith. *Orange Cove Irrigation*, 28 Cl. Ct. 790; *Roswell Properties*, 430 S.E.2d 404; *Story*, 856 P.2d 202. One refuses to enforce a clause providing for cancellation of a note on a trivial default in payment of rent where the obligor had refused to pay the note for reasons other than the breach. Beasley v. Horrell, 864 S.W.2d 45 (Tenn. Ct. App. 1993). Only five cases involve straightforward rejection of a clause, and three of these ground on other concerns. AFLAC, Inc. v. Williams, 444 S.E.2d 314 (Ga. 1994) (invalidating clause requiring payment of 50% of future retainer fees on cancellation of retainer agreement with attorney because it was inconsistent with client's freedom to cancel contract with lawyer); Borek, Stockel & Co. v. Slevira, 609 N.Y.S.2d 679 (N.Y. App. Div. 1994) (invalidating liquidated damages clause that reinforced restrictive covenant in employment contract); North Am. Inv. Co. v. Lawson, 854 P.2d 384 (Okla. Ct. App. 1993) (holding a clause requiring payment of two dollar late fee per day on rent unconscionable in low-income lease where landlord ran up fee by applying rents to past-due amounts). Only two cases fit the classic mold. Garcia v. Canan, 851 F. Supp. 327 (N.D. Ill. 1994) (invalidating 10% late charge on late payments on note); Telenois, Inc. v. Village of Schaumburg, 628 N.E.2d 581 (Ill. App. Ct. 1993); *see supra* note 90 for discussion of *Telenois*.

137. Chicago Dist. Council of Carpenters Pension Fund v. Industrial Erectors, Inc., 840 F. Supp. 1248 (N.D. Ill. 1993); Margaret H. Wayne Trust v. Lipsky, 846 P.2d 904 (Idaho 1993); United Air Lines, Inc. v. Hewins Travel Consultants, Inc., 622 A.2d 1163 (Me. 1993); Luna v. Smith, 861 S.W.2d 775 (Mo. Ct. App. 1993); Mason v. Fakhimi, 865 P.2d 333 (Nev. 1993); Loomis v. Lange Fin. Corp., 865 P.2d 1161 (Nev. 1993); J.L. Davis & Assocs. v. Heidler, 622 A.2d 923 (N.J. Super. Ct. App. Div. 1993); Fisher v. Schmeling, 520 N.W.2d 820 (N.D. 1994); Reliance Ins. Co. v. Utah Dep't of Transp., 858 P.2d 1363 (Utah 1993); Wallace Real Estate Inv., Inc. v. Groves, 868 P.2d 149 (Wash. Ct. App.), *aff'd*, 881 P.2d 1010 (Wash. 1994); Watson v. Ingram, 851 P.2d 761 (Wash. Ct. App. 1993).

138. *Reliance Ins.*, 858 P.2d 1363, involved a challenge to a clause providing for $600 liquidated damages per day for delay in completing a highway construction project where the contractor completed the highway so that it was open to traffic in a timely fashion, but delayed almost half a year in landscaping. The court upheld the clause because it was meant to compensate the Department of Transportation for its overhead costs in maintaining personnel to inspect the construction site, a cost it continued to incur during the landscaping. It distinguished S.L. Rowland Construction Co. v. Beall Pipe & Tank Corp., 540 P.2d 912 (Wash. Ct. App. 1975), which refused to enforce a per diem damages clause when a contractor completed a pipeline but failed to complete landscaping on time, on the ground that the damage clause in the *S.L. Rowland* case was meant to compensate for loss of use of the pipe. *Reliance Ins.*, 858 P.2d at 1371.

*Watson*, 851 P.2d 761, is one of several Washington cases that have struggled with Lind Building Corp. v. Pacific Bellevue Developments, 776 P.2d 977 (Wash. Ct. App. 1989). See *supra* note 124 for a discussion of *Lind Building*. Watson upholds a term requiring the forfeiture of $15,000 on breach of a contract to buy a home for $355,000, even though the owner resold the home for $380,000. It distinguishes *Lind Building* on what I think is the proper ground–the buyers had made additional deposits to extend the contract that they may not have realized were subject to forfeiture. *Watson*, a damage clause or remanded so that a lower court could decide the issue of invalidity involved unexpected circumstanees.[139] A fourth case that remanded a clause involved opportunistic behavior by the promisee.[140] Four cases struck down clauses that probably should have been enforced sinee the outcome seems like one that could have been anticipated by the parties and the clauses arguably served a purpose other than penalizing nonperformance.[141] Two cases remanded so that a lower court could pass on clauses of arguable merit.[142] One case involves unique concerus since it invalidates a penal interest clause in a separation agreement.[143]

To summarize, most overcompensatory damage clauses survive challenge.[144] The cases that invalidate clauses are a mixed bag. More than half involve changed circumstances or opportunistic behavior by the promisee.[145] A small percentage of cases involve genuine unconseionability; that is, an excessive damage clause that seems to be the product of ignorance or imbalance of bargaining power.[146] The rest of the cases split into two groups. Some involve clauses that the parties should have known would overcompensate and that serve no discernible risk allocation function.[147] Other cases involve clauses that plainly serve what should be a legitimate function, usually allocation of risk, which the court either fails to recognize or to respect.[148] Cases in the last category clearly seem wrongly

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851 P.2d at 765.

139. Two cases plainly fit this description. Carney v. Boles, 643 So. 2d 339 (La. Ct. App. 1994), refused to enforce a clause requiring that an executive's salary be paid for a year if his employment was terminated by operation of law when the FDIC took over the bank, though he remained in his position at the same salary. Southpace Properties, Inc. v. Acquisition Group, 5 F.3d 500 (11th Cir. 1993), refused to enforce a clause requiring that the broker's fee be paid if property under an exclusive listing contract was withdrawn from the market during the 180-day listiug period when the seller did not remove the property from the market but did contribute it to a limited partnership with an interested buyer after no offers near the listing price were forthcoming. The third case is more difficult to place. The damage clause in Pace Communications, Inc. v. Moonlight Design, Inc., 31 F.3d 587 (7th Cir. 1994), required an advertiser who received a volume discount to pay the undiscounted price should it cancel some of the pages. The discount was stepped so the cost per additional page decreased but was always positive. However, the advertiser was also given a block discount, which it lost on the cancellation of any page. The effect of the loss of the block discount was dramatic. The advertiser would have paid $94,000 under the contract for 24 pages. The bill, for 19 pages after it canceled five and lost the block and step discounts, was $113,000. The contract was a form contract. My gness is that the damage clause was designed without considering the effect of a block discount, which was unusual.

140. Bigda v. Fischbach Corp., 849 F. Supp. 895 (S.D.N.Y. 1994); *see supra* notes 131-34 and accompanying text. There were other reasons to deny Bigda's claim. Bigda arguably acted in bad faith since he did not complain of mistreatment until after he left the company. *Bigda*, 849 F. Supp. at 903-04. And it was possible that Bigda had taken advantage of his position to foist the employment contract on the company in anticipation of Posner's takeover. *Id.* at 903. The contract was poorly designed because it invited an opportunistic claim of breach by Bigda in its later years regarding performance conditions that were difficult to monitor.

141. Balcor Pension Invs. v. Wiston XXIV Ltd. Partnership (*In re* Wiston XXIV Ltd. Partnership), 170 B.R. 453 (D. Kan. 1994) (invalidating a clause in a note with a rising interest rate that required the payment of an amount on forfeiture that would ensure the average yield on the note regardless of the time of forfeiture); Superfos Inv. Ltd. v. FirstMiss Fertilizer, Inc., 821 F. Supp. 432 (S.D. Miss. 1993) (invalidating a term functionally equivalent to a "take-or-pay" clause); Manning & Assocs. Personnel, Inc. v. Trizec Properties, Inc., 442 S.E.2d 783 (Ga. Ct. App. 1994) (invalidating a clause that allowed a landlord to recover its investment in building on tenant's breach on theory that contract protects expectation and not reliance); Mid-Atlantic Autec v. Keeler Motor Car Co., 605 N.Y.S.2d 447 (N.Y. App. Div. 1993) (invalidating a clause requiring automobile dealer to pay the contract price for solvents used to clean automobiles for any automobiles in its inventory at the time it canceled the contract).

142. U.B. Vehicle Leasing, Inc. v. Bender, 1993 Mass. App. Div. 193 (1993) (remanding so lower court could pass on clause that required automobile lessee to pay balance of rents on cancellation); Wasserman's Inc. v. Township of Middletown, 645 A.2d 100 (N.J. 1994) (remanding so lower court could pass on a clause that required township to pay liquidated damages equal to 25% of lessee's gross proceeds on cancellation of lease).

143. Weiss v. Weiss, 615 N.Y.S.2d 468 (N.Y. App. Div. 1994).

144. *See supra* notes 137-38.

145. For changed circumstances cases, see *supra* notes 119-26, 138-39. For opportunism cases see *supra* notes 131-35, 140.

146. *See supra* notes 136 and 143.

147. *See supra* notes 90, 136, and 140.

148. *See supra* note 141.

decided. Whether cascs in the penultimate category are wrongly decided depends on whether one accepts the principles that parties cannot intentionally write penalty clauses and that they ought to take some care in measuring damages.

Perhaps we might minimize the risk of judicial error by doing away with the doctrine on penalties entirely and relying on doctrines like mistake[149] and good faith to deal with the cases where damage clauses malfunction. I think the better course is to retain the doctrine in something like its present form but to make it clear that an overcompensatory clause should be enforced if the beneficiary of the clause can show that it was serving its intended, legitimate function—to set difficult to measure damages or to allocate risk when the loss from breach is indeterminate.[150] I fear the more radical change may be underprotective because it is difficult to override the express terms of a contract with the doctrines of mistake and good faith. This is troubling if, as I believe, mistakes occur fairly often and if the fact that a clause is overcompensatory is itself strong evidence of mistake. The less radical charge may be inadequate. It may be that courts will demand that undue care be taken in estimating difficult to measure damages, or that they will be deaf to arguments about the legitimate risk-allocation functions served by some clauses. Other than my brief survey, there is no data on why parties stipulate damages, how often they err, or how often clauses that serve legitimate functions are invalidated. This lack of knowledge is a reason to choose the less radical course. Moreover, by reformulating the law to require an inquiry into the function served by a clause, that change may provide the information needed to measure the harm inflicted by the rule.

### *C. Forfeiture and the Measure of Damages When Repair Cost Exceeds Loss in Value*

On the face of it, there is a close fit between the principles of loss alignment and unselfish performance and the several doctrines in the law of conditions that can be used to avoid forfeiture by the obligee, as well as the damages rule that measures damages by the loss in value from defective performance rather than the cost of repairing the defect when the latter amount is much greater than the former. The reality is more complex. Most cases decided under these doctrines can be explained by interpretive arguments that garner little force from the two principles.

The classic case of *Jacob & Youngs, Inc. v. Kent*[151] illustrates these doctrines at work and their complementary nature. A builder inadvertently installed Cohoes pipe in a home, though the construction contract specified the use of Reading pipe. The owner suffered

149. The mistake doctrine might not apply if a court conclndes that a liquidated damages clause overcompensated not because of a mistake about an existing fact, but rather the failure to anticipate a future event. RESTATEMENT (SECOND) OF CONTRACTS § 151 cmt. a (1981) ("[T]he erroneous belief must relate to the facts as they exist at the time of the making of the contract."); *id.* illus. 1 (mistake doctrine does not apply when parties fail to anticipate storm that makes performance impracticable); *accord* Baker v. Penn Mut. Life Ins. Co., 788 F.2d 650, 661 (10th Cir. 1986) (holding that a commission scale agreement will not be voided for mutual mistake where mistake went to future earnings under agreement). Sometimes courts evade this limit on the mistake doctrine by deeming that the future event about which the parties were mistaken was latent at the time they contracted. *See, e.g.*, LaFleur v. C.C. Pierce Co., 496 N.E.2d 827, 833 (Mass. 1986) (holding that later arising injury was sufficient to void workers' compensation settlement on grounds of mistake because it was latent at the time of settlement).

150. The rule on stipulated damages could be restated as follows: (1) stipulated damage clauses may be used to liquidate difficult to measure or otherwise uncompensable damages or to allocate risk of loss on breach by setting damages within the range of possible damages; (2) notwithstanding (1), a stipulated damage clause is void if stipulated damages clearly and significantly exceed actual damages because of a contingency probably not considered by the parties in liquidating damages; and (3) stipulated damage clauses may not be used as penalties.

151. 129 N.E. 889 (N.Y. 1921).

no loss because the two pipes were of equal quality. While Judge Cardozo's opinion is silent on this point, the contract in fact was ambiguous about whether the contract specification was merely a standard that pipe similar in quality to Reading pipe be used or was a strict condition that Reading pipe be used.[152] That ambiguity could have been resolved in favor of the builder on the ground that not construing the clause as a strict condition avoided forfeiture. A distaste for forfeiture informs the interpretation of ambiguous conditions.[153] If the condition was read as strict, it might still be overcome by applying the doctrine opposing disproportionate forfeiture.[154] Disproportionate forfeiture occurs when enforcement of a condition would leave the obligee with a reliance loss while significantly overcompensating the obligor for his loss from nonfulfillment of the condition.[155] Either doctrine would establish the builder's right to payment of the balance under the contract. The rule awarding loss in value when repair cost is grossly disproportionate would protect the builder from a claim by the homeowner for the cost of replacing the pipe.[156] This rule relieves the promisor from the normal rule of damages for unfinished or defective performance, which gives the promisee the cost of remedying the defect, if the remedial cost greatly exceeds the promisee's loss from the breach.[157]

### I. The Measure of Damages if Repair Cost Clearly Exceeds Loss in Value

The rule awarding loss in value when repair cost is grossly disproportionate has been justified on grounds that echo both the principle of unselfish performance and the principle of loss alignment. The *First Restatement of Contracts* justified the rule on economic grounds—it was said to avoid the waste that would result if the threat of paying repair costs induced promisors to repair defects that were better left unrepaired;[158] that is, the rule was said to discourage selfish performance. The *Second Restatement* justifies

152. The contract contained a clause stating that "work . . . which is not fully in accordance with the drawings and specifications . . . will be rejected and is to be immediately . . . replaced." JOHN P. DAWSON ET AL., CASES AND COMMENTS ON CONTRACTS 816-17 (4th ed. 1982). This is not quite language of condition, and another provision stated that any particularly specified brand was "to be considered as a standard" that could be changed with prior approval. RICHARD DANZIG, THE CAPABILITY PROBLEM IN CONTRACT LAW: FURTHER READINGS ON WELL-KNOWN CASES 122 (1978).

153. Charles Ilfeld Co. v. Taylor, 397 P.2d 748, 750 (Colo. 1964); RESTATEMENT (SECOND) OF CONTRACTS § 227(1) (1981).

154. RESTATEMENT (SECOND) OF CONTRACTS § 229 (1981); *see also* Delaware Steel Co. v. Calmar Steamship Corp., 378 F.2d 386 (3d Cir. 1967) (excusing failure to give timely notice of claim); Holiday Inns of Am., Inc. v. Knight, 450 P.2d 42 (Cal. 1969) (excusing failure to give timely notice of exercise of an option to renew lease); RESTATEMENT (SECOND) OF CONTRACTS § 229 illus. 1 (1981) (describing facts of *Jacob & Youngs*).

155. Forfeiture is defined as the denial of compensation to an obligee who made an expenditure on a contract. RESTATEMENT (SECOND) OF CONTRACTS § 227 cmt. b (1981). It is defined as disproportionate when the obligee's loss on forfeiture exceeds the obligor's loss from nonfulfillment of the condition. *Id.* In theory, these doctrines protect only an obligee who has relied. *See* Hoosier Energy Rural Elec. Co-op. v. Amoco Tax Leasing IV Corp., 34 F.3d 1310 (7th Cir. 1994) (holding that doctrine does not permit recovery of expected gain). This limitation is consistent with the principle of loss alignment.

156. RESTATEMENT (SECOND) OF CONTRACTS § 348 illus. 4 (1981). Judge Cardozo found that the contract did not condition payment on perfect performance. Had it, Cardozo said, he would enforce the condition:

> This is not to say that the parties are not free by apt and certain words to effectuate a purpose that performance of every term shall be a condition of recovery. That question is not here. This is merely to say that the law will be slow to impute the purpose, in the silence of the parties, where the significance of the default is grievously out of proportion to the penalty of his transgression.

*Jacob & Youngs*, 129 N.E. at 891. Apparently the contract was ambiguous on the condition.

157. RESTATEMENT (SECOND) OF CONTRACTS § 348(2)(b) (1981).

158. RESTATEMENT (FIRST) OF CONTRACTS § 346(1)(a) (1932).

the rule on fairness grounds—it is said to deny the promisee a windfall recovery.[159] This justification echoes the principle of loss alignment since a windfall is an unexpected gain and will usually be matched by a loss to the promisor. The shift in justification stems from a recognition that parties often will renegotiate rather than make wasteful repairs. However, as I will demonstrate, the doctrine still may have economic value in discouraging strategic bargaining in renegotiation.

It is also fairly clear that the rule awards loss in value rather than repair costs only when loss in value is consistent with the promisee's expectations in contracting; that is, the rule respects freedom of contract. Some argue otherwise, namely that the rule frustrates people who want to contract for costly tasks of little market value but great personal value to themselves.[160] But it is clear under either Restatement's version of the rule that it is the promisee's own valuation of performance that counts in deciding whether to award repair cost.[161] There is a risk that a contract for a task of mostly personal value will be underenforced. If repair has significant personal value, but that value does not suffice to justify an award of repair cost, damages are likely to be limited to loss in market value.[162] But this risk of underenforcement is due to the general reluctance in contract law to award monetary damages for emotional losses, not the limitation on repair costs.[163]

Cases that deny repair cost under the rule are of two types. In some, the promisor does the work but makes a mistake, often inadvertently. The mistake is costly to repair and it does not significantly diminish the value of the work to the promisee.[164] *Jacob & Youngs* is emblematic of such cases. These cases are quite different from impracticability, mistake, and frustration cases. In those cases, problems arise because an exogenous event affects the cost or return on performance of a contract. In *Jacob & Youngs* and cases like it, problems arise because a party makes a mistake in performing. While the difference is subtle, these cases might be grounded on interpretive principles. People who contract for the performance of complex tasks are likely to realize that mistakes will be made, and

159. RESTATEMENT (SECOND) OF CONTRACTS § 348 cmt. c (1981); *see also* Hancock v. Northcutt, 808 P.2d 251, 254 (Alaska 1991) (arguing that the true concern of the doctrine is avoiding giving plaintiff a windfall).

160. *See* Timothy J. Muris, *Cost of Completion or Diminution in Market Value: The Relevance of Subjective Value*, 12 J. LEGAL STUD. 379, 385-86 (1983).

161. The Second Restatement makes this clear when it states that the preferred remedy is repair cost "if that cost is not clearly disproportionate to the probable loss in value *to him*." RESTATEMENT (SECOND) OF CONTRACTS § 348(2)(b) (1979) (emphasis added). The First Restatement allows for an award of repair costs though repair is not warranted by the market value. For example, the promisee is entitled to the cost of completing an ugly fountain though it would reduce the value of his property. RESTATEMENT (FIRST) OF CONTRACTS § 346 illus. 3 (1932).

162. The Second Restatement requires an award of loss in market value, RESTATEMENT (SECOND) OF CONTRACTS § 348(2)(a) (1981), unless repair cost is not grossly disproportionate to loss in value (including personal value), *id.* § 348(2)(b), or other loss in value to the promisee can be proved with sufficient certainty, *id.* § 348(2). The last proviso provides a door for an award of emotional damages. But that door is difficult to pass through because of the general rule denying emotional damages except for breaches involving bodily harm or likely to cause a "serious emotional disturbance." *Id.* § 353.

163. There are various proposals to cure this problem. One proposal is that courts should take greater account of subjective value and award remedial cost if repair has significant nonpecuniary value to avoid undercompensation. Muris, *supra* note 160, at 395-96. A slightly more extreme proposal is that courts should almost always award remedial cost, except in limited circumstances where such an award substantially overcompensates, and then courts should compensate lost subjective value. Carol Chomsky, *Of Spoil Pits and Swimming Pools: Reconsidering the Measure of Damages for Breach of Contract*, 75 MINN. L. REV. 1445, 1496 (1991). The most extreme proposal would grant specific performance as a matter of course as a remedy for breach of contract, Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1989). This proposal has an effect similar to always awarding remedial cost. These more extreme proposals create an increasingly greater risk of overcompensation.

164. A more recent case along these lines involved a significant error, misplacement of a home on a lot. Levesque v. D & M Builders, Inc., 365 A.2d 1216 (Conn. 1976).

expect that they cannot insist upon the repair of a mistake that is harmless. Of course, we cannot know people's real expectations, but a term excusing the contractor from the duty to repair in circumstances like those in *Jacob & Youngs* is so natural that it could be implied even under the conservative—and delightfully expressed—English standard for implying terms in a contract. This standard asks if "while the parties were making their bargain an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common, 'Oh, of course!'"[165]

More difficult to justify are cases where a promisor is allowed to escape with paying loss in value rather than cost of completion when he simply fails to perform. There can be no pretense in these cases that the promisee received essentially what he expected. It is these cases that invite recourse to the principle of loss alignment, and indeed, they often involve a significant and unexpected increase in the cost or decrease in the return of performance. This proposition follows logically. One can deduce from the fact that performance is at an enormous loss that circumstances changed since the time the contract was made because people usually seek to profit in a contract. It has been argued that people may anticipate a change in cost or return and use the contract to bet on that change,[166] but contracting for the performance of a task is a poor way to bet on changes in the price of the task's inputs or outputs, because the promisee's payoff if the price of inputs rise or the price of output declines is threatened by the promisor's right to perform. This proposition also is borne out by the cases.[167]

The famous case *Peevyhouse v. Garland Coal & Mining Co.*[168] may also illustrate the point. The case held that a coal company that failed to do promised remedial work on

165. Shirlaw v. Southern Foundaries, Ltd., 2 K.B. 206, 227 (1939) (following The Moorcock, 14 P.D. 64 (1889)).

166. Richard Posner raises this possibility in discussing Groves v. John Wunder Co., 286 N.W. 235 (Minn. 1939). *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF THE LAW 120-21 (4th ed. 1992). John Wunder promised to level Grove's land after removing sand and gravel. It cost $60,000 to level the land though it was worth only $12,160 leveled. This discrepancy may have resulted from a drop in the land's value during the Great Depression. Posner suggests that the court's award of remedial cost may have been appropriate if the contract provision requiring the defendant to restore the land was meant to allocate the risk of a drop in the market value of the land to defendant. For instance, in *Groves*, John Wunder could cause Groves to bear part or all of the decline in value of the land by threatening to perform or by performance.

167. In this footnote, I collect several cases that award loss in value, though the breach is significant and intentional, and that seem also to involve unexpected increases in the return on performance. *See generally* Bowes v. Saks & Co., 397 F.2d 113 (7th Cir. 1968) (awarding no damages rather than substantial cost of restoring leased premises to original condition citing "peculiar" facts; lease terminated simultaneously with sale of building by landlord and tenant renewed lease with new owner remaining as occupant); Missouri Baptist Hosp. v. United States, 555 F.2d 290, 295 (Cl. Ct. 1977) (awarding loss in value rather than cost of restoring leased premises to original condition citing "peculiar" facts: property values in area in which building was located had substantially declined since lease was made); Pennsylvania Cement Co. v. Bradley Contracting Co., 11 F.2d 687, 688 (2d Cir. 1926) (awarding loss in value rather than cost of constructing bulkhead and reasoning that an award of cost of completion would give a windfall to city because property reverted to it earlier than anticipated due to breach of lease); City of Anderson v. Salling Concrete Corp., 411 N.E.2d 728 (Ind. Ct. App. 1980) (awarding decrease in value with cost of $600,000 to level land that would be worth only $200,000 leveled because leveling land was more costly than expected); *cf. Groves*, 286 N.W. 235 (awarding $60,000 remedial cost though loss in value was only $12,160 because land value had dropped in Great Depression); Arizonne v. Archer, 178 P. 263 (Okla. 1919) (awarding cost of drilling oil well though drilling in nearby areas had proven the field to be unproductive and valueless). *But see* Dodge St. Bldg. Corp. v. United States, 341 F.2d 641, 645 (Cl. Ct. 1965) (Laramore, J., dissenting) (distinguishing cases that majority relied upon because these cases involved unusual facts).

168. 382 P.2d 109 (Okla. 1962), *cert. denied*, 375 U.S. 906 (1963). A recent case from Oklahoma, Schneberger v. Apache Corp., 890 P.2d 847 (Okla. 1994), errs by misreading *Peevyhouse*. The case involved a suit for breach of a promise made in a settlement agreement to reduce levels of water pollutants from mining operations to certain target levels. The court read *Peevyhouse* as imposing a special rule limiting damages to loss in value in any suit for breach of a promise to repair or restore land when remedial cost was much greater. *Id.* at 849. This misreads *Peevyhouse*, for that case plainly limited the rule to the breach of an incidental term. *Id.* at 851 n.4. The promise to reduce water pollution levels can hardly be characterized as incidental to the settlement agreement, for the agreement was the result of a suit brought by the plaintiffs to seek redress for the pollution. Other cited Oklahoma cases do not support the result because they involve the measure of damages in trespass, nuisance, or statutory actions for damages from drilling. *Id.* at 852 n.8.

strip-mined land was liable only for the $300 loss in market value, rather than the $29,000 remedial cost. Evidence exists to show that the gap between the two sums may have resulted from the underestimation by Garland of the area that wonld be mined on the Peevyhouse land.[169] A recent article by Judith Maute that digs deeply into the background of *Peevyhouse* suggests a richer story.[170]

## 2. The Doctrines That Oppose Forfeiture

On the surface, there is an almost perfect fit between the principle of loss alignment and the doctrines that oppose forfeiture, and in particular, the doctrine that permits a court to excuse a condition to avoid disproportionate forfeiture. The definition of forfeiture requires that the obligee have made an investment in reliance on a contract that would be lost were he denied payment because of his nonfulfillment of a condition, and a condition will be excused only if its nonfulfillment has not harmed the obligor. When fulfillment of a condition is still possible (though inefficient), the prospect of relief from forfeiture tempers the incentive an obligor would have to inefficiently perform and tempers the incentive an obligee would have to interfere with his performance. In these respects, the doctrines are similar to the rule that voids excessive damage clauses, but they differ in another respect—they respect freedom of contract. People have the right to contract for conditions that would result in forfeiture;[171] they may not contract for

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169. Chomsky, *supra* note 163, at 1500 n.179.

170. Judith L. Maute, Peevyhouse v. Garland Coal & Mining Co. *Revisited: The Ballad of Willie and Lucille*, 89 NW. U. L. REV. 1341 (1995).

Some evidence presented by Garland at trial did suggest that some of the more costly than expected work was valueless because of the location of the pits. *Id.* at 1380-82. But none of the theories pressed by Garland Coal Company at trial really turned on the facts: Garland challenged the Peevyhouse's cost estimate. It challenged the need for certain fills that would be valueless if the Peevyhouse's property line lay where it did; and it invoked the rule limiting damages to loss in value when repair cost was grossly disproportionate. *Id.* at 1378. In addition, the trial judge punted the case to the jury by giving it instructions to award repair costs but not to award oppressively overcompensatory damages. *Id.* at 1384-85. This evidence (along with a dispute about the measure of remedial cost) disappeared in the arguments on appeal, and the case was presented on the bare (and probably incorrect) facts that the remedial work would cost over $29,000 and add only $300 to the market value of the land. *Id.* at 1386-90 (the argument that costs increased unexpectedly was made in a brief in respouse to a petition for rehearing, *id.* at 1402-03). The facts I think crucial were strained out of the case, but perhaps their shadow remained. The facts presented to the Oklahoma Supreme Court simply did not make sense, as the majority opinion observed. *Peevyhouse*, 382 P.2d at 112 ("[W]e are called upon to apply principles of law theoretically based upon reason and reality to a situation which is basically unreasonable and unrealistic."). Maute faults the court for not questioning the measure of remedial cost or loss in value (which it took from the Garland Coal Company's brief), *see* Maute, *supra*, at 1396-98, but the Peevyhouses did not challenge these claims in their brief. *Id.* at 1387-90. Neither does it seem that the plaintiff's reply brief addressed these claims, for Maute reports that the argument in the brief focused on the defendant's profit on the lease. *Id.* at 1392-94. It is plausible that the majority, faced with these "unrealistic" numbers, intuited that something was amiss with the remedial work. Maute adds an important fact—in negotiating the lease, the Peevyhouses agreed to forego a $3,000 bonus payment in exchange for Garland's promise to perform remedial work. *Id.* at 1363. I think Maute is correct in arguing that the Peevyhouses were entitled to at least that much on breach, but perhaps this argument derives its force from the fact that this amount fairly measures their reliance loss (they could not have realized more for their coal since it was the standard bonus payment).

171. Kama Rippa Music, Inc. v. Schekeryk, 510 F.2d 837, 844 (2d Cir. 1975) (disfavoring forfeiture rule "does not license judicial eradication of rights . . . clearly vested by the contracting parties as part of their bargain"); Dunkin' Donuts of Am., Inc. v. Middletown Donut Corp., 495 A.2d 66, 74 (N.J. 1985) ("[I]f parties choose to contract for a forfeiture, a court of equity will not interfere with that contract term in the absence of fraud, accident, surprise, or improper practice."). The interpretive presumption against finding a condition when such condition would result in forfeiture gives way if the obligee clearly assumed the risk of forfeiture. The Second Restatement of Contracts contains the interpretive presumption against forfeiture, and states that a contract should be so interpreted, though that increases the risk of forfeiture, "if circumstances indicate that [the promisee] has assumed the risk." RESTATEMENT (SECOND) OF CONTRACTS § 227(1) (1981). Robert Childres, *Conditions in the Law of Contracts*, 45 N.Y.U. L. REV. 33, 37 (1970), argues that courts seldom enforce conditions when the amount forfeited greatly exceeds the promisor's loss from nonfulfillment of the condition.

excessive stipulated damages. The power of courts to set aside conditions that result in forfeiture is best explained by a factual premise that people do not usually intend that conditions have such an obnoxious effect. Combining the right and the countervailing factual premise, we end up with the presumption that an obnoxious term should not be enforced. This presumption can be overcome if the party who seeks to benefit from the term can show how not enforcing the term would frustrate his objectives. The Second Restatement of Contracts seems to contemplate this sort of inquiry when it states that a court in ruling on a condition should consider "the importance to the obligor of the risk from which he sought to be protected and the degree to which that protection will be lost if the nonoccurrence of the condition is excused."[172]

Notwithstanding these superficial similarities, principles other than unselfish performance and loss alignment explain most of what courts do with the doctrines on forfeiture. The cases cited by the *Second Restatement of Contracts* as authority for the doctrine that permits a court to excuse a condition to avoid disproportionate forfeiture turn on facts that suggest waiver (the obligor treats the condition as unimportant and later surprises the obligee by demanding compliance[173]) or facts like those in *Jacob & Youngs* (inadvertent and trivial flaws in performance[174]) rather than facts that suggest that enforcing a condition has unexpectedly harsh consequences because of a change in circumstances. This is equally true of cases cited by the Second Restatement as authority for the interpretive presumption against forfeiture.[175] The principles of unselfish performance and loss alignment are not needed to explain cases in either the waiver or

He bases this proposition on a survey of cases citing the Restatement of Contracts over a 10-year period.

172. RESTATEMENT (SECOND) OF CONTRACTS § 229 cmt. b (1981).

173. RESTATEMENT (SECOND) OF CONTRACTS § 229 cmt. a (1981) cites Burger King Corp. v. Family Dining, Inc., 426 F. Supp. 485 (E.D. Pa.), *aff'd mem.*, 566 F.2d 1168 (3d Cir. 1977), as "an excellent discussion of the principle on which this Section is based." The case is best grounded on a theory of waiver. Family Dining was promised an exclusive franchise in a suburban Philadelphia county if it opened 10 restaurants on schedule. Burger King tried to cancel the exclusivity clause because this condition was not met, but the court excused the condition since Burger King had not complained of delays in opening earlier stores. There is no discussion in the case of the cost to Burger King of the delay.

174. In the Second Restatement, all four illustrations of conditions that would be set aside under § 229 fit this pattern. RESTATEMENT (SECOND) OF CONTRACTS § 229 illus. 1 is *Jacob & Youngs*. Illustration 2 is a failure to give written notice of a claim for damage of goods where oral notice was given and the other inspected the goods. *Id.* illus. 2. Illustration 3 is a one-day delay in completing construction. *Id.* illus. 3. Illustration 4 is a one-day delay in making a payment to secure an option on which substantial payments had already been made. *Id.* illus. 4. Many cases overriding conditions to avoid forfeiture when the obligee cannot demonstrate prejudice involve the failure to promptly notify an insurer of a claim or to cooperate. *See, e.g.*, Estes v. Alaska Ins. Guar. Ass'n, 774 P.2d 1315 (Alaska 1989); Foundation Reserve Ins. Co. v. Esquibel, 607 P.2d 1150 (N.M. 1980); Oregon Auto. Ins. Co. v. Salzberg, 535 P.2d 816, 819 (Wash. 1975). For a recent noninsurance case in this mold, see Varel v. Banc One Capital Partners, Inc., 55 F.3d 1016 (5th Cir. 1995) (excusing condition that would have resulted in forfeiture of right of first refusal to purchase stock in family corporation where breach was dissolving shell corporation that was of no significance without obtaining bank's consent).

175. All of the examples of the interpretive presumption against forfeiture in the Second Restatement of Contracts involve the issue of whether payment to a service provider is conditioned on success of a venture. RESTATEMENT (SECOND) OF CONTRACTS § 227 illus. 1-4; *see, e.g.*, Architectural Sys., Inc. v. Gilbane Bldg. Co., 760 F. Supp. 79 (D. Md. 1991); A.A. Conte, Inc. v. Campbell-Lowrie-Lautermilch Corp., 477 N.E.2d 30 (Ill. App. Ct. 1985). Such cases require the allocation of a real loss, an issue on which the principle of loss alignment is silent. The Restatement's analysis of these cases seems to turn on assumptions about how parties expect the risk of loss to be allocated in each case. If a strict rule or strong interpretive presumption against forfeiture is justified when conditions allocate real losses, it is likely to be either on the substantive ground that the promisor is better placed than the promisee to evaluate the risk of loss, or on the procedural ground that the promisee will be unaware of the contractual allocation of risk. Both have been given as reasons for interpreting a provision that a real estate broker will be paid upon passage of title as a condition to payment, for it is thought that the broker ought to be sensitive to the risks attendant to completing a sale and the seller may be unaware of the risk he bears absent such a condition. *See, e.g.*, Ellsworth Dobbs, Inc. v. Johnson, 236 A.2d 843, 852 (N.J. 1967).

the *Jacob & Youngs* mold, since they comfortably ground on interpretive principles.[176] Indeed, only such principles can explain some of these cases. Waiver, unlike the principle of loss alignment, may shift liability for real losses. Moreover, the concern of the principle of unselfish performance—that an obligee will act or threaten to act to fulfill a condition that is undesirable from the parties' joint perspective because the forfeiture provision yields a positive private return to him—will not apply if fulfillment of a condition is impossible when the risk of forfeiture becomes apparent. Obviously this concern is not present when a condition is a mere formality cheaply performed, as is often true.

*Hoosier Energy Rural Electric Cooperative v. Amoco Tax Leasing IV Corp.*[177] illustrates the different scope of these principles. The case involved a sale-leaseback of generating and transmission equipment by Hoosier Energy to Amoco. The purpose of the contract was to transfer the tax benefits of the equipment's depreciation to Amoco. The magnitude of those benefits depended on whether the property was depreciable over five or fifteen years, and the contract included a term requiring Amoco to pay Hoosier Energy a bonus if the IRS ruled by June 30, 1983, that the property was five-year property. The IRS so ruled on February 16, 1984, but it made the ruling retroactive. Hoosier Energy sued to recover the bonus and Amoco invoked the condition. The court ruled for Amoco. The principles of unselfish performance and loss alignment do not help Hoosier Energy. Performance of the condition was outside Hoosier Energy's control, so there is no danger that forfeiture would cause it to perform unwisely.[178] Hoosier Energy also sought to recover an additional benefit under the contract and not to avoid a loss.[179] The opinion cites both facts as reasons for denying the claims under the doctrines opposing forfeiture. The opinion is less persuasive in rejecting Hoosier Energy's interpretative argument. The court's literal interpretation of the condition contradicts what was surely the parties' goal in drafting the condition—ensuring Hoosier Energy reaped part of the profit from a favorable depreciation classification. Unfortunately, the United States Court of Appeals for the Seventh Circuit often takes too literal an approach to contract interpretation,[180] a fact Hoosier Energy may have realized and sought to avoid.

One or both of the principles of unselfish performance and loss alignment can help to explain the occasional cases that set aside conditions despite a substantial shortfall in performance by the obligee and in the absence of facts that suggest waiver. *Hall v. W.L.*

176. *See supra* text accompanying notes 164-65. It is even easier to explain cases that hold it bad faith for a promisor to feign dissatisfaction to avoid paying for a service for which he inevitably reaps a benefit under a contract that conditions payment on his satisfaction. Morin Bldg. Prods. Co. v. Baystone Constr., Inc., 717 F.2d 413 (7th Cir. 1983); *cf.* RESTATEMENT (SECOND) OF CONTRACTS § 228 cmt. b (1989) (stating that the argument for an objective standard of satisfaction "is particularly strong where the obligor will be left with a benefit which he cannot return"). These cases are consistent with the principle of loss alignment—they prevent a windfall to the buyer and a loss to the unpaid seller—but one hardly needs to resort to that principle to explain them. The obligor's conduct violates the most basic requirement of good faith: honesty. U.C.C. § 1-201 (1989).

177. 34 F.3d 1310 (7th Cir. 1994).

178. *Id.* at 1318-19.

179. *Id.* at 1320.

180. *See* Dennis M. Patterson, *A Fable from the Seventh Circuit: Frank Easterbrook on Good Faith*, 76 IOWA L. REV. 503, 514-20 (1991).

*Brady Investments, Inc.*[181] is one such case.[182] Brady Investments agreed to provide permanent financing for a construction project upon "satisfactory completion." The real estate market fell and Hall, the builder, delayed completing unleased space until tenants could be found. The court held that Hall was entitled to permanent financing by implying an objective test of satisfaction and concluding that the delay in completion was reasonable given the lack of tenants. The case is not comfortably grounded on principles of interpretation, for it is farfetched that the parties meant "satisfactory completion" as "completion or not depending on tenant demand." It is more likely that the parties did not anticipate the possibility of a downturn in the rental market. We can be fairly sure that they did not intend the condition to protect Brady from the leasing risk, for that risk is routinely covered by a "lease-up" clause. Indeed, it would be unwise to use a completion clause to cover the leasing risk, for that gives the builder an unnatural incentive to complete. The principle of unselfish performance justifies this decision because relieving the builder from the condition eliminated the incentive he otherwise would have to complete the building when market conditions did not warrant completion.[183] The decision probably cannot be justified under the principle of loss alignment, for the lender may well have been left with a loss on the contract because of the decline in value of the property. The better argument here is that the lender was meant to bear the risk of that loss under the contract (had it not wanted to bear the risk it would have bargained for a lease-up clause), and cannot complain when a court interprets the contract in a way that prevents it from taking advantage of an unexpected event to shed the risk.

181. 684 S.W.2d 379 (Mo. Ct. App. 1984). The opinion in the case does not directly grapple with the real issue. The opinion only discusses the issue whether the standard of satisfaction was objective or subjective, and concludes, quite rightly, that the standard of satisfaction in a commercial case is objective. *Id.* at 387. The real issue was not the standard of satisfaction, but rather what was meant by the term "completion." The court left the interpretation of the clause to the jury, but the natural interpretation—until one takes account of the trade practice and the circumstances—is that completion means finishing the work, not leaving it unfinished until market conditions warrant finishing the job.

182. United Equities Co. v. First Nat'l City Bank, 52 A.D.2d 154 (N.Y. App. Div. 1976), *aff'd*, 363 N.E.2d 1385 (N.Y. 1977), may be consistent with the principle of loss alignment. First National made a forward contract to deliver yen to United Equities with a settlement date of October 14, 1971. Paragraph IV of the contract provided that if the yen could not be delivered on that date First National would deliver it on January 14, 1972, and if it could not deliver the yen on that date First National would pay the spot price of yen. *Id.* at 155. After the 1971 devaluation of the dollar, Japan forbade non-residents from opening new bank accounts in Japan and limited existing nonresident accounts to pre-devaluation yen balances. *Id.* at 155-56. These actions made it impossible for First National to deliver the yen on October 14, 1971. United Equities could not open a Japanese account to receive the transfer of yen (apparently yen could be transferred only in Japan), and it would have significantly harmed First National's operations to dedicate yen in its accounts to United Equities because of its needs for working capital in yen. *Id.* at 156. Instead, First National credited to United Equities' account the difference between the spot price of yen on October 14 and the contract price. *Id.* at 157. United Equities, however, demanded a new forward contract with a settlement date of January 14, 1972, at the original contract price of yen per Paragraph IV, even though that would have provided a substantial windfall to it since the cost of such a contract on October 14 would have been $59,000. *Id.* at 156-57. The case is perceived as rightly decided once one concedes the majority's premise that the forward contract was a bet on the price of yen on October 14 and that United Equities did not care about actual delivery. *Id.* at 158. This conclusion flies in the face of Paragraph IV, which pushed the contract forward until First National could deliver, but the court likened Paragraph IV to a *force majeure* clause, which it said was there to protect from unforeseen losses rather than to make it possible to reap a greater profit. *Id.* at 157.

183. Roberts Oil Co. v. Transamerica Ins. Co., 833 P.2d 222 (N.M. 1992), makes a prudential argument for relieving an insured from a condition requiring that it notify prior insurers of claims made and not make voluntary payments without their consent when the insured and its current insurer acted quickly to clean up a leak from gas storage tanks without first determining what their rights were with respect to prior insurers. Prudence dictated that the insured act quickly to minimize the environmental harm.

### D. Good Faith

The doctrine of good faith usually serves an interpretive function.[184] In most good faith cases, courts invoke the duty to prevent parties from seizing on gaps or technicalities to defeat the clear intent of the express terms of a contract.[185] Often this involves preventing a party from using a discretionary power or interfering with the fulfillment of a condition in a way the parties clearly did not intend. For example, an employer cannot fire an at-will employee to avoid paying a promised bonus[186] and a homebuyer cannot take advantage of a condition that financing be approved to get out of a contract by failing to apply for a loan.[187] A few good faith cases protect expectations that courts derive from practice (either of the parties or of their trade).[188] Whether a court may require adherence to practices that are not required by the express terms of a contract is hotly contested, but the question remains essentially one of interpretation—that is, is the written contract or the practice a better indicator of the parties' likely expectations? Practice is relevant to contract interpretation as well as the definition of good faith.[189] Interpretation ostensibly requires more respect for express terms than does the doctrine of good faith, but this difference is slight.[190]

184. In some good faith cases courts give content to open-ended performance terms, as in cases construing output and requirements clauses. U.C.C. § 2-306(1) (1989). While courts assume a creative role in defining obligations in these cases, the parties invite the intervention when they use an open term.

185. One court has said that the doctrine "prevent[s] de facto breach of explicit terms where there is de jure performance." Alan's of Atlanta v. Minolta Corp., 903 F.2d 1414, 1429 (11th Cir. 1990). This is in accord with the view that good faith requires a party to perform consistently with the other party's contract-based expectations. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980).

186. Jordan v. Duff & Phelps, Inc., 815 F.2d 429, 438 (7th Cir. 1987), *cert. denied*, 485 U.S. 901 (1988); Fortune v. National Cash Register Co., 364 N.E.2d 1251 (Mass. 1977); K Mart Corp. v. Ponsock, 732 P.2d 1364 (Nev. 1987); *cf.* Morris v. Macione, 546 So.2d 969 (Miss. 1989) (holding it bad faith to dissolve corporation solely to avoid obligation to pay shareholders discount on purchases).

187. Sorenson v. Connelly, 536 P.2d 328 (Colo. Ct. App. 1975).

188. *See* K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 760-63 (6th Cir. 1985) (holding that lender must give notice before terminating line of credit because such notice was customary); Conoco, Inc. v. Inman Oil Co., 774 F.2d 895, 908 (8th Cir. 1985) (holding that manufacturer cannot compete against jobber in bidding on construction job for current customer of jobber and basing decision partly on trade practice); Nanakuli Paving & Rock Co. v. Shell Oil Co., 664 F.2d 772, 805-06 (9th Cir. 1981) (holding that it is bad faith for seller to refuse to "price protect" buyer on event of price increase where that was trade practice); Oloffson v. Coomer, 296 N.E.2d 871, 875 (Ill. App. Ct. 1973) (holding that buyer must cover on anticipatory repudiation because that was customary); *see also* Banque Keyser Ullman v. Skandia Ins. Co., 2 All E.R. 923 (1987) (holding that insured has duty to warn its insurer of the fraud of an intermediary partly on the basis of testimony of participants in trade that they thought it proper to give such a warning); *cf.* Misco, Inc. v. United States Steel Corp., 784 F.2d 198, 203 (6th Cir. 1986) (remanding with instruction that trial court should consider trade practice in determining what notice was reasonable on a franchise termination); Don King Prods., Inc. v. Douglas, 742 F. Supp. 741, 767-68 (S.D.N.Y. 1990) (stating that promoter who represents both boxers in a match ought not intervene to favor one, but suggesting that a lower industry standard of practice may be shown on remand). Occasionally the absence of evidence of a custom is cited as a reason for rejecting a claim of bad faith. *See* Personal Touch, Inc. v. Lenox, 708 F. Supp. 108 (E.D. Pa. 1989).

189. U.C.C. § 1-205(5)(1989) (providing that trade usage—defined elsewhere in the Code as any practice regularly observed in a trade so as to create an expectation of its observance, *id.* § 1-205(2)—is relevant to interpreting parties' agreement). For an incisive examination of the interconnectedness of trade norms, interpretation, and good faith under the U.C.C., see Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169, 186-211 (1989).

190. For a case arguing that both interpretation and good faith justify enforcing a trade norm where there was a contradictory express term, see *Nanakuli*, 664 F.2d at 772. U.C.C. § 1-102(3) (1989) provides that the duty of good faith may not be disclaimed, but "parties may by agreement determine the standards by which the performance of [the duty] is to be measured if such standards are not manifestly unreasonable." U.C.C. § 1-205(4) (1989) requires that express terms control when they conflict with trade usage. However, any "reasonable" construction of express terms may be used to comply with trade usage. This gives a court considerable leeway since it may consider trade usage in deciding whether a contract is ambiguous, and then rely on an ambiguity apparent from trade usage to adopt a construction consistent with trade usage. Consider the district court opinion in U.S. Naval Inst. v. Charter Comm., 687 F. Supp. 115 (S.D.N.Y. 1988),

But the doctrine of good faith sometimes is more than a powerful interpretive principle. In a fair number of cases, courts use the doctrine of good faith to redefine contractual obligations in circumstances about which the parties probably had no expectations when the contract was made. What courts do in these cases is consistent with the principle of unselfish performance. They prevent a party from enriching himself by acting or threatening to act in a way that would impose a significantly greater loss on the other party.

Something like the principle of unselfish performance can be found at work in cases that hold it bad faith for a party to act or threaten to act in a way that would not benefit himself but would harm the other party with the purpose of evading a commitment. Thus many cases hold it to be bad faith for a lessor or licensor to deny consent to an assignment of a lease or license where the assignment would not harm him as a way to exact a concession from the lessee or licensee.[191] This principle applies to issues other than consent to assignments. For example, in *Carter v. Adler*,[192] it was held in bad faith for a landlord to open a competing grocery store in an expansion of a mall for the express purpose of driving out of business a tenant in the original mall who had a long-term lease with favorable terms and a no-compete clause. Though perhaps this case may be comfortably grounded on the core principle of good faith that a party may not use a power or discretion under a contract with the purpose of defeating a right expressly granted the other party.

*Ellis v. Chevron U.S.A., Inc.*[193] offers a fuller statement of the same principle in a context where the court utilizes the principle to reconstruct a contract to deal with changing circumstances. Ellis gave Chevron a ten-year lease on land for a gas station with a right to renew for two five-year periods and thereafter a right of first refusal for any purchase or lease of the property. At the end of the second five-year renewal term, Ellis received an offer from an auto parts chain (the Pep Boys) to lease Chevron's parcel and an adjoining parcel owned by Ellis on favorable terms to build a large store.[194] Chevron tried to exercise its right of first refusal, offering to match the price and other terms of the Pep Boys' offer but only with respect to its parcel. The court held that Ellis could demand that Chevron match all the terms of the Pep Boys' offer, reasoning that Ellis was required only to act in a commercially reasonable manner and that it was reasonable to seek the larger lease because of its much higher expected return.[195] It added:

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*rev'd*, 875 F.2d 1044 (2d Cir. 1989). The issue was whether the publisher of a paperback edition of a best seller breached a term providing an October "publication date" when it shipped the book to stores to begin selling in September. The court relied heavily on the trade practice of shipping books well in advance of the publication date in holding the term ambiguous and adopting a construction of "publication date" as the beginning of a nationwide sales campaign. This contradicted the usual meaning of "publication" as printing or distributing.

191. *See, e.g.*, First Nationwide Bank v. Florida Software Servs., Inc., 770 F. Supp. 1537, 1542-43 (M.D. Fla. 1991).

192. 291 P.2d 111, 117 (Cal. Ct. App. 1955). A later case, Edmond's of Fresno v. MacDonald Group, Ltd., 217 Cal. Rptr. 375 (1985), held that it was bad faith to open a competing store in a mall extension where a lease for the original mall had a no-compete clause on the ground that the terms of the lease indicated that the no-compete clause was to cover mall expansions.

193. 246 Cal. Rptr. 863 (Dist. Ct. App. 1988).

194. The lease was for a 10-year term with four options to renew for 10 years. The parts store was to be built on the two parcels and an adjoining block of land, with Ellis to have the improvements and an option to purchase the adjoining land at the end of the lease. *Id.* at 864.

195. *Id.* at 867-68. The court also tried to justify its decision by claiming that it was consistent with the parties' expectations. This part of the opinion is unpersuasive. The court reasoned that Ellis expected to be able to seek more lucrative offers to develop his property after 20 years, and that nothing in the contract required him to subordinate his profit to Chevron's after that point. *Id.* at 866. But Chevron equally expected to be able to protect its substantial investment in the property after 20 years with the right of first refusal. The right of first refusal protected both interests since Chevron could maintain its investment by offering Ellis a return as good as his next-best return on the parcel after 20 years.

> We ... would prohibit a contract condition by which a lessor could select an alternate use for his property which is inconsistent with the lessees' existing use yet holds no economic advantage for the lessor. Arguably the exercise of such a provision which serves only to oust a lessee could constitute a breach of the covenant of good faith and fair dealing.[196]

The principle in *Ellis* is not quite unselfish performance.[197] It would permit actions that benefit that actor but impose a significantly greater cost on the victim so long as the action was not done for the purpose of getting out of an unfavorable term in a contract or harming the victim. So it was said in another case that "the implied covenant does not extend so far as to undermine a party's 'general right to act on its own interests in a way that may incidentally lessen' the other party's anticipated fruits from the contract."[198] What is condemned is genuine malice.

But this principle does not easily limit itself to genuinely malicious acts, for selfishness in its grosser forms is difficult to distinguish from malice and is almost as contemptible. Thus it is not surprising that sometimes courts invoke the duty of good faith to provide a remedy for nonmalicious actions that impose costs on the other party that significantly exceed the benefit to the actor.[199] So a licensor was held to have acted in bad faith when, while strip-mining, it negligently cut the licensee's subsurface mine.[200] Similarly, a landlord was held to have acted in bad faith when it failed to complete structural repairs on the residential part of a building when that resulted in the tenant being denied a certificate of occupancy required to legally operate a restaurant.[201] Likewise, a bank that held the first mortgage on a property was held to have acted in bad faith to a second mortgage holder when it made an unsecured loan to the mortgagee and then applied all of the mortgagee's payments to the unsecured loan.[202] None of these actions were malicious; they were only extraordinarily selfish.

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Probably neither party realized in drafting the right of first refusal the possibility that Ellis would seek to develop the Chevron parcel with other land in 20 years.

196. *Id.* at 868.

197. In *Ellis*, the court also suggested that Chevron might have prevailed had it offered Ellis a lease "economically equivalent" to the Pep Boys' lease. *Id.* This course of action induces the parties to maximize their joint return since Chevron would retain the lease only if it could offer Ellis a return as good as the Pep Boys and still profit. An earlier California case, Mitchell v. Exhibition Foods, Inc., 229 Cal. Rptr. 535 (Dist. Ct. App. 1986), held that a lessee exercising a right of first refusal did not have to match every term of an offer, but instead could disregard terms that were economically disadvantageous to it and commercially unreasonable.

198. M/A-Com Sec. Corp. v. Galesi, 904 F.2d 134, 136 (2d Cir. 1990) (quoting Van Valkenburgh, Nooger & Neville, Inc. v. Hayden Publishing Co., 281 N.E.2d 142, 145 (N.Y.), *cert. denied*, 409 U.S. 875 (1972)).

199. Inferential authority for the principle exists in cases that reject good faith claims after weighing the costs and benefits of a challenged action to determine whether it was commercially reasonable. *See* Carter v. Safeway Stores, Inc., 744 P.2d 458 (Ariz. Ct. App. 1987). In that case, a lessor argued that a lessee's decision to convert a clothing store into a grocery store violated the duty of good faith. The lessor objected to change because rents under the lease were partly based on gross sales and clothing stores have much smaller gross sales per square foot than grocery stores. The court rejected the good faith claim, reasoning that the change imposed little cost on the lessor, which was likely to receive little or no rent on sales in any event because sales had historically been too low to trigger the percentage-rent term, and that the change provided a significant benefit to the lessee, which could not compete against new supermarkets because of the small size of the store. *Id.* at 461.

200. Williams v. Jader Fuel Co., 944 F.2d 1388, 1395 (7th Cir. 1991). The court rejected a claim of willful interference because there was no evidence of willfulness. *Id.* at 1397. The licensee had no claim for trespass because the license did not give right to possession of the subsurface. *Id.* at 1398.

201. Roli-Blue, Inc. v. 69/70th St. Assoc., 506 N.Y.S.2d 159 (N.Y. App. Div. 1986). *Galesi*, 904 F.2d 134 at 160, distinguished *Roli-Blue* by arguing that the harm was more direct in that case. Directness presumably goes to the expected severity of the harm. *Roli-Blue* had to ground on the duty of good faith because the lease plainly disclaimed all warranties. *Id.* The court reasoned that it was doubtful the parties intended the disclaimer to cover this contingency because the landlord began the structural repairs after the lease was made, and that the tenant was powerless to cure the problem. *Id.* at 161.

202. Ranier v. Mount Sterling Nat'l Bank, 812 S.W.2d 154 (Ky. 1991).

The reason why the principle does not easily limit itself to truly malicious acts, but extends to cover any act done with insufficient regard for the other party's interests, may lie deeper in the law. A similar issue has arisen under the torts of interference with contract and interference with business relations, which were once (very long ago) said to lie only for truly malicious acts. As Oliver Wendell Holmes, Jr., observed, the justification for why malice serves as a basis for liability under civil law need not be morality (the argument the law punishes people who act with evil intent), but rather the effect of malice on the balancing of social and private interests that lies at the heart of many rules of liability. Holmes' point was that when an act is motivated by malice the harm it inflicts surely outweighs the good it does, for "gratification of ill-will" does not count as a positive in balancing interests.[203] A corollary to this point is that malice is not essential to liability, it is only a factor (albeit a strong one) to be taken into account in interest balancing.

The analogy to the law of tortious interference also casts light on what is wrong with the position that good faith requires more than unselfish performance. Some cases assert a broader principle that a party to a contract may not interfere with the other party's receipt of benefits under the contract. This principle would be unobjectionable if it meant only that a party may not exercise a right or discretion under a contract to defeat a right of the other party that is grounded on a specific term of the contract. This is a restatement of one of the core requirements of good faith.[204] But sometimes this principle is invoked to prohibit one party to a contract from entering into competition against the other in the absence of a covenant not compete.[205] The law of tortious interference reminds us that competition is privileged, or to put it differently, that the law does not easily impose rules of liability that would restrain competition.[206] Similarly, there is a rule in contract that anticompetitive terms are not easily implied.[207] The point can be expressed more generally: the suggested principle of noninterference sweeps too broadly for the issue in implying terms to regulate performance in circumstances the parties did not anticipate is finally one of interest-balancing, and many acts that diminish the other party's return under a contract should not be deemed a violation of the duty of good faith because the good they do outweighs that harm.[208]

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203. Oliver W. Holmes, Jr., *Privilege, Malice, and Intent*, 8 HARV. L. REV. 1, 5 (1894).

204. *See supra* notes 184-88 and accompanying text.

205. Scheck v. Burger King Corp., 756 F. Supp. 543, 548-49 (S.D. Fla. 1991), relies on this principle in finding a colorable claim of bad faith stated when a franchisor granted a competing franchise near the plaintiff. St. Benedict's Dev. Co. v. St. Bendict's Hosp., 811 P.2d 194 (Utah 1991), relied on the principle in finding a colorable claim of bad faith stated where a hospital that leased land to the plaintiff to develop a professional office building later developed a competing office building. Neither contract had a no-compete or exclusivity clause, and in *Scheck*, 756 F. Supp. at 549, any such promise was expressly disclaimed.

206. *See* RESTATEMENT (SECOND) OF TORTS § 768 (1979).

207. *See, e.g.*, *Scheck*, 756 F. Supp. at 549.

208. For example, Meier's Trucking Co. v. United Construction Co., 704 P.2d 2, 6-7 (Kan. 1985), held that it was not bad faith for a general contractor on a highway construction project to advise the state of a cost-saving change in the project that greatly reduced the return of the subcontractor because the change was commercially reasonable. The Kansas Department of Transportation ("KDOT") contracted with United to excavate earth and rock for a highway project. United subcontracted with Meier's to haul the material to a distant site. Later United proposed to KDOT that the waste material be used on a nearby construction job for KDOT, eliminating the need for costly long-distance haulage and the need to obtain costly fill for that second site.

## II. A RESPONSE TO THE ECONOMIC CRITIQUE

The prevailing view in economics is that judicial modification of contracts between sophisticated parties can be justified on grounds of efficiency only if monopoly or other conditions create externalities so that the optimal private contract is not socially optimal. One defense of this proposition takes the form of an abstract proof that courts cannot improve contracts.[209] The proof proceeds along the following lines. It is shown that a first-best solution to a difficult contractual problem exists if information about cost and return is publie at the time of production. Logically, a court can at best mimic this solution if it imposes a contract. Then, it is shown that no first-best contract exists if information is not public at the times of production—that is, if information about actual cost or return is private to one party. Logically, neither can a court improve on the second-best contract that is the best attainable in this situation because, like the uninformed party, it will not have access to relevant information.[210] As a practical matter, inexperienced courts are likely to make contracts worse since they will lack the ingenuity to mimic the design of the best attainable contract, and they will evaluate information about cost or return less accurately than would the parties, however verifiable that information may be.

Even in a world where people lack the ingenuity to design first- or second-best contracts, judicial modification of contracts is thought harmful. If a poorly designed contract misregulates performance, the possibility of judicial modification may worsen matters because the parties' resulting uncertainty about their obligations will make private modification or settlement more difficult to attain.[211] The consequences are greater settlement and litigation costs and perhaps less efficient performance. Courts may err in evaluating cost or return on performance and modify a contract in a way that worsens performance. Courts may upset risk-allocating terms that serve to regulate reliance or to shift losses. Such an outcome may deny welfare gains from loss shifting and the prospect of such an outcome may adversely affect reliance. The prospect that courts may upset terms that regulate performance or allocate risk may increase the cost of writing contracts because people will be induced to take additional measures to make contracts ironclad. And this prospect may decrease the expected return on contracts, making marginal contracts unattractive.

The current economic justifications for default rules do not provide an answer to these objections insofar as the cases examined in Part I are concerned. Default rules are thought to serve two economic functions. One view is that default rules supply terms that most parties want and so save them the cost of having to spell out a term.[212] The other view is

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209. Hermalin & Katz, *supra* note 2; Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISCIPLINARY L.J. 389, 404-06 (1993). Schwartz's example is a contract where production may produce an economic gain and both parties must make a reliance investment before the cost and return on production is revealed. The first-best solution requires that the seller get the actual surplus from the trade and the buyer get the expected surplus.

210. Hermalin & Katz, *supra* note 2, at 243-45.

211. *See* Baird, *supra* note 2, at 595-96; Chomsky, *supra* note 163, at 1474-75, 1479-80; Goetz & Scott, *supra* note 2, at 567-68. Some scholars recognize that strict enforcement may impose significant bargaining costs when the parties must settle to avoid inefficient performance and agree how to split a resulting large gain. POSNER, *supra* note 166, at 45; Clarkson et al., *supra* note 99, at 362 n.34; Muris, *supra* note 160, at 388-89; Schwartz, *supra* note 163, at 284-86. This analysis is not well-developed.

212. Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983); *see also* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

that default rules compel action (such as the disclosure of private information) because parties must contract around rules they do not want. Such counter preferential default rules have been called penalty defaults.[213] Obviously, the doctrine on penalties is not easily explained as a default rule, since it overrides a contract term rather than fills in a gap. The impracticability doctrine has been explained as a default rule. Such an explanation may work for the traditional impracticability rules that apply in fairly specific instances,[214] but it will not work in the cases I include under the principle of loss alignment for two basic reasons. First, excuse is most likely if the outcome was of low probability when a contract was made. Second, people cannot be sure of excuse even after the events triggering application of the principles occur, because of the indeterminacy of the law and doubt about relevant facts. The first feature means that the dominant effect of the principles is likely to be on the parties' behavior in performance, settlement, or litigation after the event triggering their application occurs—any gains from lessening the cost of writing contracts or prompting disclosure of private information are likely to be small. The second feature means that the principles serve poorly as a device to allocate risks to improve precautions taken before contracting or reliance, because doubt about the allocation of risk usually worsens precaution and reliance.[215]

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213. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). The rule that a promisor is not liable for a promisee's loss on breach when that loss was not foreseeable or communicated to the promisor may be explained in either way. The rule may be preferred by most people, perhaps because it regulates a promisee's reliance. Or the rule may be desirable, though it is usually better for a promisor to bear a promisee's loss, because it forces a promisee to disclose his potential loss to a promisor, and so enables a promisor to take proper precautions. It also enables a promisor to charge a promisee according to the level of its reliance, which regulates a promisee's reliance. *Id.* at 101-04.

214. The determination of the optimal default rules, particularly penalty defaults, is quite difficult. Slight changes in assumptions about such factors as the competitive position of the parties and the cost of transacting around a rule can alter the optimal default rule in a radical way. Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992); Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990).

215. If the parties assess the probability of a court shifting the loss differently, then they may jointly take too much or too little precaution. If they are risk-averse, they will jointly take too much precaution because they will both overweight the risk of bearing the loss. If they separately test, they may reproduce test measures and lose informational advantages in cumulative testing. For example, if testing involves a lump-sum expenditure, neither party may have sufficient incentive to test when the expected liability for the loss is divided between them, where one would have sufficient incentive to test if it was not. If they separately insure against the risk, they duplicate the cost of obtaining insurance.

Shared risk of liability for reliance losses does not necessarily result in suboptimal testing. Consider a contract with zero expected gain—that is, the expected return precisely equals the expected cost. *B* invests $r_b$ and *S* invests $r_s$ in period one so that say *S* may produce a good in period two at cost $c_r$ with a value of $v_r$ to *B*. An event *q* with a probability of *PR(q)* will make it impractical for *S* to produce the good. Either (or both) parties may expend *t* to predict the probability of *q* with an accuracy of *PR(a)*. Price *p* equals $v_r$-$r_b$, reflecting the fact that the expected return on the contract equals 0 (*i.e.*, $(v_r-c_r)(1-PR(q))=r_b+r_s$). Assume *S* may bo excused on the occurrence of *q* with a probability of *PR(ex)*. Thus, *q* is the only outcome where $c>v_r$. If *S* is excused, *B* bears $r_b$. If the contract is enforced, *S* is liable for $v_r$-*p*, or $r_b$. The chart shows each party's returns on every possible outcome, discounting for the chance of relief in rows 3 and 4.

| | (a) Not Test Not q | (b) Not Test q | (c) Test Negative | (d) Test Positive Not q | (e) Test Positive q |
|---|---|---|---|---|---|
| 1. Joint return | $v_r-(c_r+r_b+r_s)$ | $-(r_b+r_s)$ | $-(t_s+t_b)$ | $v_r-(c_r+r_b+r_s+t_s+t_b)$ | $-(r_b+r_s+t_s+t_b)$ |
| 2. *S*'s return-no chance of excuse | $v_r-(c_r+r_b+r_s)$ | $-(r_b+r_s)$ | $-t_s$ | $v_r-(c_r+r_b+r_s+t_s)$ | $-(r_b+r_s+t_s)$ |
| 3. *S*'s return-chance of excuse | $v_r-(c_r+r_b+r_s)$ | $-(r_b(1-PR(ex))+r_s)$ | $-t_s$ | $p-(c_r+r_b+t_s)$ | $-(r_b(1-PR(ex)+S+t_s)$ |
| 4. B's return—chance of excuse | 0 | $-r_bPR(ex)$ | $-t_b$ | $-t_b$ | $-(r_bPR(ex)+t_b)$ |
| 5. Probability | 1-PR(q) | PR(q) | PR(q) | (1-PR(q)) PR(a) | (1-PR(q)) (1-PR(a)) |

This Part defends the principles of loss alignment and unselfish performance from the economic critique. I aceept the assumptions of that critique that people are relentless profit-maximizers who are sensitive to low probability risks. Yet, if we relax those assumptions, I think the case for the principles of loss alignment and unselfish performance is even stronger. The intuitions behind my argument can be simply stated. I start with the case where contract terms regulating performance malfunction, so that a party may profit by acting or threatening to act in a way that would impose a significant joint net loss on the parties. In this situation, the most signifieant effect of the choice between a rule of strict enforcement and a rule allowing a court to modify a contract is on settlement. While the prospect of judicial modification hampers settlement by increasing legal uncertainty, it also furthers settlement by narrowing the settlement zone and reducing incentives to misrepresent private information affecting the value of settlement. I then consider when the possibility of judicial modification of a contract might reduce the cost of making a contract. I show that the possibility of modifieation of a contract to align losses might increase the joint expected return on a contract, because it allows parties not to investigate or take precautions regarding risks that they best ignore: risks that do not make the contract less attractive than alternative opportunities.

I do not claim that the ability of courts to modify contracts to align losses and temper selfish performance necessarily improves the joint expected return under a contract, much less social welfare. I only show that the benefits of such a judicial power may well exceed the costs if our criterion is maximizing the parties' joint expected return under a contract. The balance of costs and benefits turns on behavioral factors such as people's inclination to bargain strategically, their sensitivity to low probability risks and to legal rules, and the ability of courts to ascertain relevant variables. The claim that the expeeted benefits to the parties of judicial reconstruction of contracts may exceed the costs under realistic assumptions about human behavior and judicial capacity is not trivial. It shows that assertions that rational calculators would want courts *always* to enforce contracts as written cannot stand. Rational calculators might choose a world where they were not always held to their contracts.

### *A. Performance, Settlement, and Litigation Under the Principle of Unselfish Performance*

My hypothetical example starts at the end of the life of a contract. It is period two of a two-period contract between *S* and *B* to produce a good for pre-paid price *p*. *S* has learned the cost (*c*) of producing the good and *B* has learned the value (*v*) of the good to her. The contraet contains a stipulated damage term that requires *S* to pay *B* damages in the amount of *d* if he does not deliver the good. The good is only of value to *B*. This contract malfunctions if $d>c>v$, for *S* has an incentive to produce the good at a net loss (this is cheaper than paying the higher damages amount). There are two possible rules. Under a rule of strict enforcement, *S* will pay *d* if he does not perform. I assume that *S* has no other grounds to avoid liability for *d*, so if *S* does not perform, the contraet is

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Without a ehance of excuse *S* has the optimal incentive to test—his return on every outcome equals the parties' joint return. Introducing a chance of excuse diminishes *S*'s incentive to test, but it increases *B*'s incentive by an equal amount. Later we will see that a possibility of excuse may induce more optimal testing if a contract has a significant positive expected return or involves risks of significant but offsetting impact. *See infra* notes 239-40 and accompanying text.

settled by a payment of *d* at zero transaction costs. The assumption of zero-enforcement costs under a rule of strict enforcement loads the deek in favor of the rule. Under a rule of excuse, a court may excuse *S* from liability for *d* if *d* greatly exceeds *v*. Excuse is not certain and *B* and *S* incur litigation costs should *S* seek to be excused.

If we assume the parties cannot bargain—that is, *S* must produce the good, pay *d*, or litigate to determine his liability for *d* if the law permits excuse—a rule of excuse plainly is superior to a rule of strict enforcement. This would not necessarily be so if excuse under the rule were certain but costly to obtain whenever *d* exceeded *v*. In such an environment, *S* might litigate when that was not in the parties' joint interest, because he would not consider *B*'s share of litigation costs. But this will not occur if excuse is of increasing probability, as the gap between *d* and *v* grows but is never certain. Such uncertainty about excuse gives *S* an undue incentive to perform under a rule of excuse[216]—that is, *S* will perform when the parties would jointly do better if he breached—but it gives *S* less incentive to perform than strict enforcement.

More interesting is the effect of the two rules on bargaining. *S* ought to pay *B* an amount smaller than *d* but greater than *v* to settle the contract. This discount of *d* is, in effect, a payment from *B* to *S* to improve performance by not producing the good. In bargaining, *B* and *S* face a situation similar to bilateral monopoly, because a settlement that avoids production or litigation produces a gain in savings of *v-c* or litigation costs that they may share. How quickly and whether they settle depends on their ability to agree how to divide such gain. A rule of excuse may expedite settlemcnt in two ways. If both parties know *c* and *v*, a rule of excuse may expedite settlement by narrowing the bargaining zone. If *S* does not know *v* and/or *B* does not know *c*, a rule of excuse tempers their incentive to misrepresent the value of *v* or *c*.

Before I explain these effccts, a caveat and some explanation is in order. The economie and game theoretic models of bargaining I draw on have not been very successful in predicting or explaining people's behavior when agreement produces a gain they must divide. Subjects do not behave precisely as the models predict in even the simplest experiments.[217] Nor do the models adequately explain such real-world phenomena as lengthy labor strikes or failures to settle legal disputes. Still, the models and experimental tests provide some potentially useful insights into how the two rules may affect bargaining. Further, the effects are so dramatie that they might appear useful even though the game theoretic models are only a partial explanation of human behavior.

Theories of why rational calculators might fail to agree when it is in their joint interest to do so fall into two general categories. One category of thcories explains failures to agree by differences in opinion about the value of the good over which the parties bargain that result in one party demanding more than the other is willing to pay. For example, parties to a legal dispute may not settle, though settlement saves them litigation costs, because the plaintiff's estimate of recovery less the cost of collection exeeeds the

216. The possibility of enforcing *d* though *d*>*v* means that *S* will undervalue excuse by *(d-v)(1-ex(d,v))*, where *ex(d,v)* defines the probability of excuse at *d* and *v*. This amount should usually exceed *B*'s litigation costs, since the probability of excuse *ex(d,v)* is very low unless the gap between *d* and *v* is very large.

217. For instance, the models predict in games with a single take-it-or-leave-it offer that the offeror will capture almost the entire joint gain from agreement because he will expect the offeree to accept an offer that gives him a small positive sum, since the offeree is better off with that than nothing. In fact, parties tend to split the gain in this situation. Gary E. Bolton, *A Comparative Model of Bargaining: Theory and Evidence*, 81 AM. ECON. REV. 1096 (1991); Jack Ochs & Alvin E. Roth, *An Experimental Study of Sequential Bargaining*, 79 AM. ECON. REV. 355 (1989); Alvin E. Roth et al., *Bargaining and Market Behavior in Jerusalem, Ljubljana, Pittsburgh, and Tokyo: An Experimental Study*, 81 AM. ECON. REV. 1068 (1991).

defendant's estimate of liability plus the cost of defense.[218] In this situation, the plaintiff's lowest settlement price exceeds the defendant's highest price.

The other category of theories explains failures to agree by strategic bargaining. These theories assume the parties know or suspect that there may be a range of mutually profitable payoffs. Parties adopt potential loss-causing strategies to capture a larger share of the known or suspected gain. Much of the work on strikes focuses on strategic bargaining when one or both parties does not know the value of settlement to the other.[219] Labor does not know the firm's profits, so it makes a demand based on a high profit and strikes if the firm rejects the demand. The result is a strike if the firm's actual profits are low. Similar to this is the view that ascribes failures to settle legal claims to strategic bargaining in the face of uncertainty about the other party's valuation of a case.[220] In the labor context, such theories are thought to explain only short strikes, since once a firm rejects a high demand signaling its low profitability, labor should lower its offer. Longer strikes may result if parties unalterably commit themselves to a bargaining strategy,[221] or from forced delays between offers,[222] or from labor's expectation that the firm's position will deteriorate abruptly at some point, which leads labor to hold out to push the firm to the "crunch" point where holding out becomes much more costly to the firm.[223] Presumably similar glosses could be added to the theory that explains failures to settle legal disputes by strategic bargaining in the face of uncertainty about the other party's valuation of a case. The most prominent theory of how strategic bargaining may impair settlement of legal claims focuses more on the parties' uncertainty of each other's bargaining strategy than their ignorance about each other's valuation of settlement. For instance, a defendant may make a low offer resulting in no settlement because he underestimates how hard the other party will bargain.[224]

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218. George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984); George L. Priest, *Reexamining the Selection Hypothesis: Learning from Wittman's Mistakes*, 14 J. LEGAL STUD. 215 (1985). Results in contract litigation are inconsistent with the Priest-Klein hypothesis, which suggests that plaintiffs should win half of the cases. One study reports plaintiff success rates in contract litigation, other than insurance and product liability suits, at rates over 64% and often around 80%. Theodore Eisenberg, *Testing the Selection Effect: A New Theoretical Framework with Empirical Tests*, 19 J. LEGAL STUD. 337, 357 (1990) (Table A1). Another study reports plaintiff success rates in commercial, employment, and real estate litigation of 75% to 87%, defining success as an award greater than the defendant's highest settlement offer. Samuel R. Gross & Kent D. Syverud, *Getting To No: A Study of Settlement Negotiations and the Selection of Cases for Trial*, 90 MICH. L. REV. 319, 339, 367 (1991). The authors find a consistent pattern in commercial litigation: low settlement offers by plaintiffs (*i.e.*, below the median award), many zero settlement offers by defendants, and litigation by plaintiffs ending in success. *Id.* at 369. They attribute this to strategic behavior by defendants, who they posit refuse to settle in the hope that the relatively high cost of litigation, as compared to the award, will dissuade plaintiffs from proceeding.

219. John Kennan & Robert Wilson, *Can Strategic Bargaining Models Explain Collective Bargaining Data?*, 80 AM. ECON. REV. 405 (1990).

220. Keith N. Hylton, *Asymmetric Information and the Selection of Disputes for Litigation*, 22 J. LEGAL STUD. 187 (1993), argues that a combination of asymmetric information about liability and strategic bargaining explains reported patterns of success and failure in contract and tort disputes. His theory is that defendants will win more often than they lose when they better know their liability, because mostly innocent defendants will reject settlement offers. Some guilty defendants will reject settlement offers for strategic reasons in the hope that plaintiffs will think them innocent and so settle on a favorable basis. Hylton argues that reported patterns of success in various categories of litigation are consistent with this hypothesis because defendants have a much higher success rate in malpractice, motor vehicle, antitrust, products liability, and employment discrimination litigation, where he thinks defendants have systematic informational advantages in evaluating liability. Hylton does not explain how such informational advantages persist through discovery.

221. Beth Hayes, *Unions and Strikes with Asymmetric Information*, 2 J. LAB. ECON. 57 (1984).

222. Oliver Hart, *Bargaining and Strikes*, 104 Q.J. ECON. 25, 27 (1989).

223. *Id.* at 27.

224. Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982). Gross & Syverud, *supra* note 218, find a significant percentage of cases where defendants make zero offers but plaintiffs recover at trial. They attribute this to strategic bargaining because a zero offer exceeds the defendant's expected cost of going to trial. *Id.* at 343. Strikingly, it was rational for plaintiffs to respond to zero offers with trials,

To summarize, almost all theories of why rational parties fail to agree, though it is in their apparent interest, explain bargaining failures by one of two sorts of informational problems.[225] The analysis that follows first examines the case where the parties are ignorant of the value of the contract to each other. A rule of excuse is most clearly superior in this case. The analysis then examines the case where the parties have approximate knowledge of the value of the contract to each other and their uncertainty stems from the outcome in the event of litigation under the rule of excuse (*i.e.*, legal uncertainty) or from uncertainty about the other party's bargaining strategy. The two rules—excuse and strict enforcement—perform differently in this general case depending on the relationship between *c*, *d*, and *S*'s likely cost on litigation and depending on the inclination of the parties to bargain strategically. Neither rule is plainly superior.

### 1. *S* is ignorant of *v* and *B* is ignorant of *c*

A rule of excuse may promote settlement by tempering the parties' incentive to hide or misrepresent the value of settlement when there is private knowledge about that value.[226] Assume that *B* and *S* contract in period one for the production and delivery of a good in period two, with the price *p* prepaid by *B*. They know in period one that *c* and *v* may vary in a range from 0 to *x*. In period two, *B* learns *v* and *S* learns *c*. Ideally, *S* would produce the good if $v>c$, otherwise *S* would pay *B* an amount equal to *v* to settle the contract. However, if *v* is low, *B* may recover more than *v* by misrepresenting the value of *v* on the chance that *c* will be even greater and that *S* will agree to pay the

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because the expected return (roughly 33% of such cases ended in victory) exceeded the expected cost of going to trial. Thus, a zero-offer strategy seems to impose a certain joint-net loss on the parties. One way (not Gross and Syverud's) to explain such a strategy is as a response to uncertainty about the plaintiff's valuation of a case. By uncertainty I mean that completely informed parties might significantly differ in their valuation. A defendant might make a zero offer in such a situation because plaintiffs who value claims low will not press the case. Any positive offer unnecessarily compensates such claimants. Consistent with this hypothesis is the fact that zero offers were much less prevalent in vehicular negligence cases, *id.* at 356, where claim valuation is more certain.

225. Raquel Fernandez & Jacob Glazer, *Striking for a Bargain Between Two Completely Informed Agents*, 81 AM. ECON. REV. 240, 247 (1991), argue that failure to agree may not require uncertainty about the valuation of settlement or the other party's strategy. They show, for instance, that a long strike may result in labor contract negotiations where both parties know the stakes and each other's strategy, yet those strategies require the party who first makes a conciliatory offer to capitulate most of the joint gain. Such theories seem to assume "rules" of the bargaining game that are suicidal.

226. *See generally* Eric L. Talley, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195 (1994).

The standard model explaining why unions strike because of asymmetric information is consistent with a basic intuition underlying this theory—that is, that a person who does not know another person's valuation of an object will make a demand by factoring the probable value to the other party and the loss to himself if he makes too low an offer. In the strike literature, the simple model of a one-round game or a game with firm commitment assumes a union knows a firm has high or low profits, and that it makes a demand based on high profits if the amount of high profits times the probability the profits are high exceeds the amount of low profits. *See, e.g.*, Hart, *supra* note 222, at 28. The greater the excess of high over low profits, the more likely this condition will be met. Hart's refinement of the model that suggests that a union may exploit the threat of a rapid decay in the firm's position echoes another basic intuition underlying Talley's model—people will shade their demands upwards or downwards depending upon who bears the brunt of the loss if they cannot agree. *Id.* at 39.

Robert Forsythe et al., *An Experimental Analysis of Strikes in Bargaining Games with One-Sided Private Information*, 81 AM. ECON. REV. 253 (1991), tests bargaining under these basic conditions—that is, where one party does not know the value of settlement to the other and so makes a strategic offer on the calculated probability that the value is high. They found that people were more likely to make strategic offers when the stakes were high. They ran several games where two people bargained over how to split a large or small pie where only one knew the size of the pie. The pie "shrank" the longer they bargained. In settings *Ia* and *Ib*, a good pie and a bad pie were worth $6.00 and $1.00 respectively. In setting *II*, their worths were $3.90 and $2.30. In both settings, it was rational for the offeror to make a demand on the assumption that the pie was large (which would result in a rejection of the offer if the pie turned out to be small), since the probability of a large pie times the large pie exceeded the small pie. But rejections occurred less often in setting *II* because the offeror often made a demand based on the small pie. *Id.* at 268. The authors attribute this to mild risk aversion.

misrepresented value of $v$ to avoid incurring the greater cost $c$ in performing. $B$'s misrepresentation of $v$ may result in a joint loss to the parties if $B$ demands more than $c$ and $S$ responds by performing when in truth $c$ is greater than $v$. A misrepresentation of $v$ might also impel $S$ to litigate, causing both parties to incur unnecessary litigation costs. In deciding what she should demand of $S$, the sly $B$ will consider the probable value of $c$ and her likely return if she makes too high a demand, and so causes $S$ to perform or to breach and litigate.

For example, if $B$ was in the powerful position of being able to make a thoroughly credible take-it-or-leave-it offer, and $S$ could only perform or pay $B$'s demand (*i.e.*, $S$ could not breach and litigate), then a relentless, profit-maximizing $B$ would demand the average value of $c$ if $v=0$. Under such a strategy, $B$ has an even chance of getting her demand and an even chance of getting zero since there is an even chance that $c$ will exceed its average value, causing $S$ to accept $B$'s demand. $B$'s strategy is somewhat different if she will entertain a counteroffer from $S$. Then $B$'s strategy depends on the cost to her and $S$ of prolonging bargaining. This occurs, for example, if $B$ expects $S$ to begin performance while preparing a counteroffer that would diminish the potential joint gain to be divided between the parties if $c>v$. A plausible strategy for $B$ to pursue in this situation is to demand more than the average value of $c$. $S$ would accept an offer below $c$ if the cost to him of prolonging the negotiations exceeded his expected return given his estimation of the likely value of $v$. $B$ would then reduce her demands as $S$ rejected her offers because that would signal a low value of $c$.

A moment's reflection should suffice to realize that the outcome of bargaining—who wins, the delay and cost, and the likelihood of complete impasse—depends on a host of variables, including the risk preferences of the parties, their reputations for honesty or hard bargaining, their concern with future reputation, the cost of delay, and the structure of bargaining (who makes offers, how often, and how quickly). Thus, we should be wary of generalizations about the effects of different legal rules on bargaining. Still, one relevant generalization seems plausible: a party is more likely to misrepresent the value of agreement in a way that may cause a joint loss if the other party's retaliatory options are less costly to the first party. Strict enforcement of an excessive damage clause has precisely this troubling effect, for it denies $S$ the option to respond to a high demand by breaching and litigating, which is the least attractive outcome to $B$.

Consider $B$'s bargaining position in the example above under three possible regimes: no stipulated damage clause, a stipulated damage clause with strict enforcement, and a stipulated damage clause with possible excuse. In the latter two cases $d$ (the amount of stipulated damages) greatly exceeds $v$, as $B$ knows but $S$ does not. Absent a stipulated damage clause when $B$ makes an offer to $S$, she will consider two possible negotiation-ending responses by $S$: performance, or breach and litigation. $B$'s option to breach and litigate presents $S$ with the risk that a high demand will result in his receiving less than $v$, for he will recover $v$ on litigation less his costs of litigation. This option for $S$ and the concomitant risk to $B$ will presumably cause $B$ to shade her offer downwards, indeed it might be rational for $B$ to demand only $v$ plus $S$'s expected litigation costs, for it is only this demand if truthfully conveyed that $S$ must rationally accept. A stipulated damage clause with strict enforcement makes a high demand less risky to $B$. Now she no longer need fear breach and litigation by $S$ if $d>v$. $B$ loses only if $S$ performs, and so $B$ will shade her offer upwards from $v$ based on the expected value of $c$. $B$ would expect $S$ to accept her offer once $S$'s expectation of the value of $v$ exceeds $c$. A loss from partial or full performance might result if $c$ is below its expected value. A stipulated damage clause with a rule of excuse gives the option to breach and litigate value back to *S*. *B*'s demand is likely to be higher than it would be were there no stipulated damage clause, since the possibility of enforcemeut of the clause means that *S* will expect to pay more on average than *v* plus litigation cost should *S* exercise the option to litigate, leaving that option less valuable to *S*. In the same outcome, the average rcturn to *B* may or may not be less than *v*, depending on whether *B*'s litigation costs exceed the difference between *d* and *v* discounted by the probability of enforcement of the clause. But the value to *S* of the option to litigate grows, and with it the concomitant threat to *B*, as the gap between *v* and *c* grows. For a very low value of *v*, it is likely to be this option that will constrain *B* in bargaining and not the expected value of *c*.

### 2. Both parties have approximate knowledge of *c* and *v*

The effect of a rule of excuse on settlement when both parties have approximate knowledge of *c* and *v* depends on *B*'s perception of whether *S* will pay *d*, perform, or litigate (should there be a rule of excuse) if they do not settle. Which action *S* will take depends on the relation of *c* to both *d* and *S*'s likely cost of litigation under a rule of excuse. There are four possible situations: (1) *c* exceeds *d* by a sufficient amount that *B* knows *S* will pay *d* rather than perform; (2) *c* is close enough to *d* so that *S* will perform rather than pay *d* under a rule of strict enforcement, and *c* is greater than *S*'s likely cost of litigation under a rule of excuse so *S* will litigate under that rule; (3) *c* is less than *d* and less than *S*'s likely cost of litigation under a rule of excuse so *S* will perform under both rules; and (4) *c* is less than *d* but *B* does not know whether *S* will perform or litigate under the rule of excuse. Only in the first situation does a rule of excuse unambiguously impair settlement. In the second situation a rule of excuse may detcr or facilitate settlement; in the third situation it has no effect; and in the fourth situation it would facilitate settlement if people are more likely to take aggrcssive stances in bargaining if the size of the pie they are squabbling over is larger.

#### a. *c* exceeds *d*

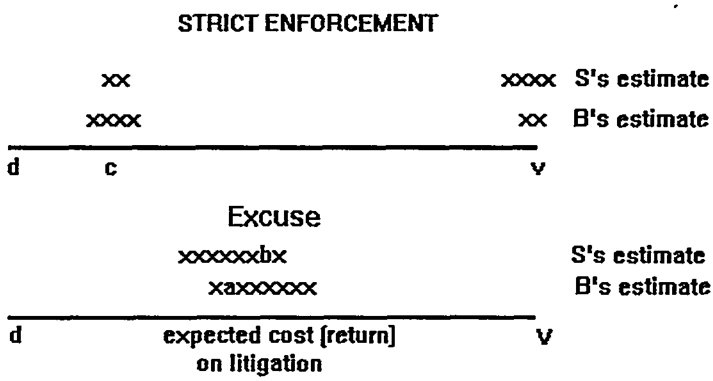
Presumably there is some value of *c* greater than *d* where *S* cannot credibly threaten to perform if the parties do not settle, since he clearly is better off paying *d* rather than performing. It is only in this situation that a rule of strict enforcement clearly is more conducive to settlement than is a rule of excuse. Under strict enforcement, *S* will pay *d* since that is his only viable option. Under excuse, the parties will negotiate across a range with a maximum settlement price of *S*'s expected cost of litigation—the expected damages (which is a function of the amount of *d*, *v*, and the probability that the clause will be enforced) plus *S*'s litigation costs—and a minimum settlement price of *B*'s expected return on litigation which are the expected damages less *B*'s litigation costs. Obviously, settlement will be delayed or impossible if *B*'s estimate of the expected return on litigation exceeds *S*'s estimate of the expected cost. This is possible, even though litigation costs represent a deadweight loss, if there is sufficient uncertainty about the outcome of litigation.[227]

227. Any self-serving biases in valuing a case would increase the likelihood of impasse. George Loewenstein et al., *Self-Serving Assessments of Fairness and Pretrial Bargaining*, 22 J. LEGAL STUD. 135 (1993), argue that self-serving biases in case evaluation are a major impediment to settlement of legal claims.

### b. *c* is close to *d* or is less than *d* and is greater than *S*'s likely cost of litigation

A rule of excuse may either facilitate or impair settlement if *c* is less than *d* but greater than *S*'s expected cost of litigation under this rule. In this situation, *S* will perform under a rule of strict enforcement so the parties will bargain over a large settlement zone, with *B*'s minimum price equal to *v* and *S*'s maximum price equal to *d*. On the other hand, *S* will litigate under a rule of excuse if the parties cannot settle. The parties will bargain over a smaller settlement zone, with *B*'s minimum price equal to her expected return on litigation and *S*'s maximum price equal to his expected cost of litigation. Diagram I shows the different settlement zones under the two rules. The "x" areas indicate the range within which each party may estimate the outcome of performance and litigation. I assume that *c* and *v* are somewhat uncertain, and that while each party has a sense of the outcome facing the other party, each knows his own outcome better. I also assume that the outcome of litigation is more uncertain than the outcome of performance. *S*'s expected cost of litigation is to the left of *B*'s expected return because litigation costs represent a deadweight loss.

Diagram I




As Diagram I illustrates, a rule of excuse may either facilitate or impair settlement. In some cases, the possibility of excuse may prevent settlements that would occur under strict enforcement because *B*'s minimum price may exceed *S*'s maximum price. This would be true, for instance, if *B*'s and *S*'s expected return and cost of litigation were at points a and b in the diagram. Such disagreements in predieting the outcome of litigation are a significant risk. The uncertainty of excuse and the enormous difference in payments from *S* and *B*, depending on whether damages are liquidated or actual, means parties may vary greatly in their valuation of the case. As Diagram I shows, strict enforcement always creates a large settlement zone.

Conversely, the possibility of excuse may facilitate settlement in some cases by greatly narrowing the settlement zone when *S*'s and *B*'s valuations of the case converge but do not cross.[228] Strategic bargaining may positively correlate with the size of the settlement zone because parties have more to gain by threats, posturing, or other actions that may enable them to capture a larger share of the settlement gain when the zone is large. Some models of strategic bargaining do suggest that such a correlation exists,[229] though the little empirical data is inconclusive.[230] Conceivably, widening the settlement zone might lengthen the time it takes to reach settlement but not diminish the likelihood of eventual settlement. The literature on strikes, which suggests the strongest correlation, is concerned more with delay in settlement than with no-settlement outcomes. If this is the effect of widening the settlement zone, then delay would be most costly in our example if *S* had to begin performance pending settlement or concede breach and liability for liquidated damages under the rule of strict enforcement.

c. *c* is less than *d* and less than *S*'s likely cost of litigation

A rule of excuse has no effect on settlement if *c* is less than *S*'s expected cost of litigation under the rule. In this situation, a rule of excuse will not affect settlement because *S* will perform if the parties cannot settle under either rule. Thus, under either rule the parties will bargain over a settlement zone with *B*'s minimum price equal to *v* and *S*'s maximum price equal to *c*.

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228. HOWARD RAIFFA, THE ART AND SCIENCE OF NEGOTIATION 56-58 (1982), reports that in experiments where parties' valuations may vary in this fashion, they tend eventually to come to agreement even with a very small settlement zone.

229. The Fernandez-Glazer model, which shows how perfectly informed parties might strike to their mutual disadvantage, suggests a correlation, because it is the large gap in returns depending on whether a party signals strength or weakness that prolongs strikes. Fernandez & Glazer, *supra* note 225, at 247-48. Contrariwise, Cooter et al., predict that the probability of settlement will increase as the transaction costs of prolonged bargaining and the costs of trial increase. Cooter et al., *supra* note 224, at 238, 240-41.

230. Linda R. Stanley & Donald L. Coursey, *Empirical Evidence on the Selection Hypothesis and the Decision to Litigate or Settle*, 19 J. LEGAL STUD. 145 (1990), seem to have found that widening the settlement zone makes impasse more likely when both parties are unduly optimistic about their chances for victory if they do not settle. Subjects bargained over the division of 100 tokens and were told that if they failed to agree to divide the tokens then all the tokens would be given to one party, depending on whether there were more red or white tokens in an urn, less a penalty for their failure to settle. *A* won if there were more than 50 red tokens. The authors manipulated several variables: the number of red tokens in the urn, the number of tokens the subjects could sample before bargaining (five or 25), and the penalty in tokens for failing to settle (15 or 33). An increase in the penalty increased the potential gains from settling. However, when *A* drew a higher proportion of red tokens than *B*, an increase in the penalty was strongly correlated with failure to settle. Indeed, when the sample size was large (25), both sides were unduly optimistic, and *A* drew a higher proportion of red tokens than *B*, the act of increasing the penalty from 15 to 33 tokens increased failures to settle from 50% to 91%. That is, widening the settlement zone when both parties were unduly optimistic about their chances of success significantly increased the likelihood of impasse. The effect was reversed when both parties were unduly pessimistic. When *A* drew fewer red tokens than *B*, an increase in the penalty was positively correlated with settlement. *Id.* at 160. The authors do not try to explain this phenomenon. *Id.* at 163-64. When *A* drew a higher proportion of red tokens than *B*, each party would be over-optimistic about his own chance for success if they failed to settle. The increase in the failure rate is consistent with the view that litigation results when two optimists collide, but there is no logical reason why an increase in the penalty for a failure to settle would suppress settlement, even between optimists since even an optimist who predicted victory would know that the penalty would shrink his take. It would also be interesting to know whether increasing the penalty increased the time it took (*i.e.*, the number of offers) to successfully settle cases. The authors do not report whether widening the settlement zone increased the number of rounds it took to settle. The authors may miss the major effect of such widening.

No clear correlation between the size of the settlement zone—that is the magnitude of the joint cost to the parties should they go to litigation—and impasse is found in Loewenstein et al., *supra* note 227, at 149. The authors reach this conclusion after testing settlement in four scenarios—high shared costs, high costs that were borne entirely by the plaintiff, high costs that were borne entirely by the defendant, and low shared costs. The authors found that the settlement rate in the fourth scenario was between that in the first and those in the second and third. *Id.* at 150 (Table 1). The authors allowed only 30 minutes for negotiations, and did not test the effect of widening the settlement zone on the time it took to reach settlement. *Id.* at 147.

### d. *c* is less than *d* and *B* does not know whether *S* will litigate or perform

A rule of excuse may outperform a rule of strict enforcement when *B* does not know whether *S* will litigate under a rule of excuse or perform if they do not settle.[231] Such uncertainty has two possible causes: *B* may not know the precise value of *c*,[232] or she may not know how *S* will evaluate his expected cost of litigation. In this situation, *B* may well make less aggressive demands under a rule of excuse than she would make under strict enforcement. Under strict enforcement, *B* has an incentive to demand an amount near *c* because she will know that *S* is better off paying that demand rather than performing. Of course, *S* has an incentive to retaliate by threatening to perform to drive *B* down to a price nearer to *v*, which is *B*'s minimum price. Under a rule of excuse, *B* has an incentive to shade her demand downward from *c* because of the risk that *S* will respond to too high a demand by litigating. It would be rational for *S* to litigate in response to a high demand if his expected cost of litigation is less than the amount for which he expects *B* would eventually settle.

In effect, under either rule the parties are playing a game of chicken, and the more stalwart will capture a larger share of the gain from settlement. The game is likely to be less nasty under a rule of excuse because the stakes are lower. This point is clear if we assume that the parties can only make simultaneous offers with a settlement if their asking prices cross and impasse with performance or litigation if their prices do not cross. Each party would formulate their offer to try to capture as large a share of the gains from settlement as possible while minimizing the risk of impasse. In this situation, widening the settlement zone could conceivably increase the probability of impasse because each party has more to gain by taking an aggressive position, and there is greater room to misjudge the other party's offer. A rule of strict enforcement results in a larger settlement zone, as Diagram II illustrates,[233] because *B*'s minimum price under a rule of excuse is the average of her expected return on litigation and her expected return on performance, while her minimum price under a rule of strict enforcement is *v*. Unlike the case depicted in Diagram I, there is no risk that a rule of excuse will eliminate room for settlement that would otherwise exist under strict enforcement.

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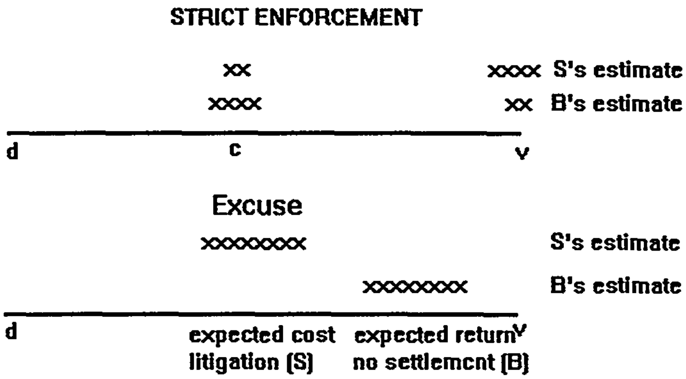
231. If *S*'s expected cost of litigation under a rule of excuse exceeds *c*, and *B* knows that, then a rule of excuse will not affect settlement since under either strict enforcement or excuse *c* and *v(r)* set the settlement range.

232. This effect requires much less uncertainty about the value of *c* than did the effect analyzed above. So long as the possible values of *c* range around *S*'s expected cost of litigation, *B* will be uncertain about whether *S* will litigate under a rule of excuse or perform.

233. The two rules also involve different sorts of uncertainty. The rule of excuse primarily involves shared legal uncertainty. The rule of strict enforcement primarily involves *B*'s uncertainty about *c*.

Diagram II




The case in Diagram II assumes that *B* cannot test *S*'s response on impasse and then formulate her bargaining position. If *B* could costlessly determine *S*'s response, then this case dissolves into either the case where *B* knows *S* will litigate (in which a rule of excuse has mixed effects) or the case where *B* knows *S* will perform (in which a rule of excuse has no effect). But it is unlikely that *B* could costlessly determine *S*'s response. If it is costly for *B* to determine *S*'s response, it may well be in *B*'s interest to proceed without resolving that fact, for the expected cost of determining *S*'s response might exceed the expected benefit. To test *S*'s response, *B* could demand performance. If *S* performs, he signals that his expected cost of litigation exceeds *c*. *B* would then offer settlement knowing that the cost *S* will bear on impasse is *c*, which is a better bargaining position for *B* than not knowing *S*'s response. However, *S*'s partial performance diminishes *c* by the cost *S* incurs (to *c'*), and it may diminish *v* if partial performance benefits *B* (to *v'*). Thus, the settlement zone moves downwards from *cv* to *c'v'*, and, presumably, so too does the amount *B* could reasonably expect to capture on settlement. The sly *B* will test *S*'s response by demanding performance only if the extra amount she expects to capture by moving the range to *c'v'* discounted by the probability that *S*'s response on impasse will be to perform exceeds the amount *B* expects to capture when the bargaining range is that depicted in the second line of Diagram II. The dilemma confronting *B* is that she can be confident that *S* has begun to perform (or that the performance is not a ruse by the equally sly *S*) only if the cost incurred is significant. But any significant cost might significantly diminish *B*'s expected outcome on settlement, and so it is likely to be profitable for *B* to test *S* only if initially it is probable that *S*'s response will be to perform.

### *B. Precaution, Contract Costs, and Reliance Under the Principle of Loss Alignment*

That the prospect of judicial reconstruction of a contract under enlightened principles may improve performance or facilitate settlement under a contract is not surprising if we assume a sufficiently imperfect contract. This Part demonstrates the more questionable proposition that sometimes the prospect of judicial reconstruction of a contract may lessen the cost of writing contracts or other precautions taken before contracting.[234] Now we find $S$ and $B$ in the first period contemplating a two-period contract. If they contract, $S$ may invest $r_s$ to reduce his production eost in period two to $c_r$, and $B$ sometimes may invest $r_b$ to increase the value of the good to her in period two to $v_r$. An exogenously determined event $q$ of probability $PR(q)$ may make it impossible to produce the good, in which event $r_b$ and $r_s$ will be valueless. Either $S$ or $B$ may expend $t$ prior to contracting or expending $r_b$ or $r_s$ to better determine the probability of $q$. If they test, the probability the test is accurate is $PR(a)$.

If $S$ and $B$ were divisions in a single firm, that firm would have two deeisions to make. First, it would test to better determine the probability of $q$ if the expected return on testing were positive; this decision requires weighing the losses avoided by true negatives,[235] the gain foregone from false negatives,[236] and the cost of the test.[237] Second, the firm would invest $r_b$ and/or $r_s$ in period one if the expected return were positive; this decision requires weighing the deerease in $c$ and increase in $v$ from the investment, the probability of $q$, and the reliance loss on $q$.[238] If $S$ and $B$ are independent, they must negotiate a contract at the start of period one. Neither $S$ nor $B$ would want to proceed without a contract because their investments in period one can be exploited by the other since the value of each investment depends on the other's performance in period two. In designing the contract, $S$ and $B$ should try to allocate the gains from trade to ensure that each makes the optimal expenditure in period one in preeaution and reliance and that $S$ produces the good in period two if that is profitable.

The reason why a rule of excuse might increase the parties' joint expected return on the contract is similar to the reason why the parties might want to use an open-term contract. An open-term contract leaves the parties' obligations open to be defined by a court or by a mechanism the parties create. For instance, if $c$ and $v$ may vary in a way that changes the optimal quantity of production, the contract may require $S$ to use "best efforts" to produce the good and require that $v$ be divided between $S$ and $B$. Or the contract may be a requirements contract with the price set by monitorable criteria that are expected to track $c$, inducing $B$ to demand and requiring $S$ to produce the optimal level of the good for every outcome. Such open-term contracts have lower precaution and contract costs than do fixed-price contracts, sinee the parties have less incentive to test or haggle over uncertain risks or risks that are costly to test and prove that may alter individual cost and

234. Paul L. Joskow, *Commercial Impossibility, the Uranium Market and the Westinghouse Case*, 6 J. LEGAL STUD. 119, 154-55 (1977), Perloff, *supra* note 60, and Oliver Williamson, *Assessing Contract*, 1 J. L. ECON. & ORGANIZATION 177, 294-302 (1985); all analyze the impracticability problem, at least in part, from a perspective like mine, that tries to balance the transaction costs of ex ante provision for risk with ex post adjustment. Williamson is the most complete analysis along these lines.

The analysis in Janet K. Smith & Richard L. Smith, *Contract Law, Mutual Mistake, and Incentives to Produce and Disclose Information*, 19 J. LEGAL STUD. 467, 482-87 (1990), is similar to the analysis here in that they consider the effect of a rule providing for excuse on ex ante transaction costs and the social desirability of not encouraging investment in information that provides no allocative benefit. They argue that the mutual mistake rule efficiently encourages people not to invest in producing information where early production of such information has no allocative benefit. However, they focus solely on the time value of deferring expenditures on the production of information.

235. That is, the test predicts failure when the actual result would be failure.

236. That is, the test predicts failure when the actual result would be success.

237. If the firm does not test, its expected return is $(v_r-(c_r+r_b+r_s)(1-PR(q))) - (r_b+r_s)PR(q)$. If it tests, its expected return is $((v_r-(c_r+r_b+r_s)PR(a) - (r_b+r_s)(1-PR(a)) - t)(1-PR(q)) - tPR(q)$. This assumes, for the sake of simplicity, that the test predicts success or failure with the same probability as their occurrence without testing. The firm ought to test if $((v_r-(c_r+r_b+r_s)PR(a) - (r_b+r_s)(1-PR(a)))(1-PR(q)) - t > (v_r-(c_r+r_b+r_s)(1-PR(q)) - (r_b+r_s)PR(q)$. Solving for t, the firm ought to test if $(r_b+r_s)PR(q) - ((v_r-c_s) - (v_r-c_s)PR(ta))(1-PR(q)) > t$.

238. Without testing, the firm would invest $r_b$ in period one if $(v_r-v)(1-PR(q)) > r_b$.

return, but still leave them with a positive joint return.[239] This will be so when a contract has a significant positive expected return or when it involves significant risks with offsetting impacts on the parties and that return or those risks arc uncertain or are difficult to test or price. In these situations, the savings in contract and precaution costs from the use of open terms may exceed the costly aspects of such terms.[240]

A rule that would excuse $S$ from a formally complete contract on the occurrence of $q$ can also improve joint expected return when a contract has a positive expected returu or involves risks with offsetting impacts on the parties. I will illustrate with the former case. Assume that $B$ initially offers $S$ a contract at a price $p$ to be paid on delivery that does not account for the risk of $q$. The expected return on the contract is $v$ and the expected cost is $c$. Neither $B$ nor $S$ makes an investment in reliance on the contract. The contract has a positive expected return, that is, $v>c$. $S$ may test $q$ and/or add a condition that excuses him from liability for $v$ if $q$ occurs, but testing or negotiating such a condition is costly. The cost of negotiating the condition is denoted as $t_s$ and $t_b$. To simplify matters further, I assume that such a condition would be enforced without cost or risk of error. I compare two rules: (1) strict enforcement, under which $B$ must produce the good or pay damages, and (2) excuse, under which a court may relieve $S$ from the contract if $q$ occurs. $S$ and $B$ both incur litigation costs if $S$ seeks to be excused ($l_s$ and $l_b$), and the probability that excuse will be granted if $q$ occurs is $PR(ex)$. Finally, there is no chance that the rule of excuse will be invoked if the condition is added to the contract, and there is no chance the rule will be invoked if the condition is not added to the contract and $q$ does not occur.

Unless a test is cheap and accurate or adding a condition is expensive, $S$ will prefer to add the condition rather than test. Without the condition $S$ has too great an incentive to test because he undervalues false negatives (the joint loss if the contract is foregone is $v-c$, and his private loss is $p-c$) unless $S$ captures all the gain on the contract (*i.e.*, $v=p$).[241] The more interesting question is which rule—excuse or strict enforcement—gives $S$ the optimal incentive to add the condition. Under a rule of strict enforcement, $S$ will add the condition if to do so costs him less than the loss he expects to occur on $q$ discounted by its probability, that is, if $(v-p)PR(q) > t_s$. Under a rule of excuse, it is in the parties' joint interest to add the condition if the cost to do so is less than the expected litigation costs if the rule is invoked discounted by the probability of $q$, that is, if $(l_s + l_b)PR(q) > t_s + t_b$. $S$'s incentives to account for $q$ in the contract differ from the parties' joint interest. $S$ will not consider $B$'s litigation cost if the condition is not added, $q$ occurs, and excuse is sought; but he will consider his potential damages if $q$ occurs and he pays damages. $S$ will add the condition if $((v-p)(1-PR(ex)) + l_s)PR(q) > t_s$. $S$ tends to undervalue adding the condition because of the first factor, and he tends to overvalue adding the condition because of the second.

239. Gergen, *supra* note 5, at 1032-37, 1059-60.

240. Under an open-term contract, the division of cost and return has a negative impact on performance, reliance, and precaution. *Id.* at 1011 (agent's performance and reliance), 1031-32 (agent's precaution), 1038-44 (principal's reliance and precaution), 1049-53 (precaution, reliance, and performance in bilateral open contracts). Enforcement cost and error are likely to be greater than under a formally complete contract, especially with the "best efforts" contract, Since the standard of "best efforts" is uncertain, it requires monitoring cost and return. Enforcement error may induce performance error. Enforcement error may also induce over or underperformance, depending on the circumstances and perceived bias (if any) in the error. *Id.* at 1019-25. Communieation is also likely to be imperfect under these contracts, since a party has no incentive to disclose risks that may result in a reliance loss to the other. *Id.* at 1038-39. For example, if the cost of producing the good exceeds the return, $S$ may not be required to produce the good under a "best efforts" contract, and $B$ will bear the loss of his period one investment. $S$ may not disclose the risk of this outcome to $B$.

241. *Id.* at 1029-32.

The combination of these effects virtually always gives $S$ suffieient incentive to account for $q$ in the contract but always gives him an equal or less ineentive to account for $q$ in the contract than he would have under a rule of strict enforcement. For a rule of excuse to give $S$ insufficient incentive to account for $q$ in the contract it must be true both that $(l_s+l_b)PR(q) > t_s+t_b$ and that $t_s > ((v-p)(1-PR(ex)) + l_s)PR(q)$. These expressions define cases where it is in the parties' joint interest to account for $q$ but not in $S$'s individual interest. But both expressions will be true only if $l_bPR(q)-t_b > (v-p)(1-PR(ex))PR(q)$. $S$ will invoke the rule of excuse on the occurrence of $q$ only if he expects that $(v-p)PR(ex) > l_s$, or only so long as he expects that the potential savings from invoking the rule exceed the litigation cost. Assuming any significant uncertainty of excuse (*e.g.*, $PR(ex) < .50$) and parity between $l_s$ and $l_b$, it is impossible for $l_bPR(q)-t_b$ to excced $(v-p)(1-PR(ex))PR(q)$ since $(v-p)(1-PR(ex)) > l_b$. For $S$ to have too little incentive to account for $q$ in the contract, excuse must be fairly certain, $B$'s litigation or settlement costs must be high, and $PR(q)$ must be high. But, if $PR(q)$ is high, excuse will always be unlikely. Thus, the possibility of excuse will induce $S$ to take less care in contracting than would a rule of strict enforcement but virtually never induce him to take too little care. $S$ may incur a lower cost in contracting under the rule of excuse than he would without it if it may ever be true that $S$ can profit by invoking the rule. $S$ has a greater incentive to incur $t_s$ under a rule of strict enforcement than he has under a rule of excuse so long as $(c-p)PR(q)-t_s > ((c-p)(1-PR(ex))+l_s)PR(q)-t_s$, or if $(c-p)PR(ex) > l_s$. This also defines the eases where $S$ would find it in his interest to seck excuse under the rule of excuse, where the damages to be avoided times the probability of suceess exceed his litigation costs.

A rule of excuse has a more problematic effcct if $B$ relies on the contract.[242] A rule of exeuse diminishes $S$'s incentive to take precaution against $B$'s potential loss, but if the contract has a significant positive expected return to $B$ and $S$ does not assign a high probability to the chance of excuse, $S$ probably will have more than sufficient incentive to take precaution. This is because while $S$ may undervalue $B$'s investment in taking precaution, he still will overprotect against the risk of nonperformanee because sometimes he will be held liable for $B$'s foregone gain on breach. If the contract does not have a significant positive expected return to $B$, $S$ has too little incentive to take precaution under a rule of excuse. A rule of excuse gives $B$ an incentive to take precaution, but such division of incentives to take precaution poses problems discussed earlier.

These countervailing effects can be seen by comparing individual and joint return under each rule for each possible outcome if the parties do or do not test. The following table provides this information. Rows 3 and 4 factor in the probability of excuse as $PR(ex)$.

242. I assume the existence of rules that require that damages be foreseeable and certain. The requirements of foresecability and certainty of proof encourage $B$ to communicate $r_s$ to $S$, which induces $S$ to take precautions against $q$ and to adjust price or to take other measures in the contract to temper excessive reliance by $B$.

| | (a) Not Test Success | (b) Not Test q | (c) Test Negative (q predicted) | (d) Test Positive Success | (e) Test Positive q |
|---|---|---|---|---|---|
| 1. Joint return | $v_r$-($c_s$+$r_b$+$r_s$) | -($r_b$+$r_s$) | -($t_s$+$t_b$) | $v_r$-($c_s$+$r_b$+$r_s$+$t_b$+$t_s$) | -($r_b$+$r_s$+$t_b$+$t_s$) |
| 2. S return-strict enforcement | p-($c_s$+$r_s$) | -(($v_r$-p)+$r_s$) | -$t_s$ | p-($c_s$+$r_s$+$t_s$) | -(($v_r$-p)+$r_s$+$t_s$) |
| 3. S return-rule of excuse | p-($c_s$+$r_s$) | -(($v_r$-p)(1-PR(ex)) +$l_s$+$r_s$) | -$t_s$ | p-($c_s$+$r_s$+$t_s$) | -(($v_r$-p)(1-PR(ex)) +$l_s$+$r_s$+$t_s$) |
| 4. B return-discounting for excuse | $v_r$-(p+$r_b$) | (($v_r$-p)(1-PR(ex)) -($l_b$+$r_b$)) | -$t_b$ | $v_r$-(p+$r_b$+$t_b$) | (($v_r$-p)(1-PR(ex)) - ($l_b$+$r_b$+$t_b$)) |
| 5. Probability | 1-PR(q) | PR(q) | PR(q) | (1-PR(q)) PR(a) | (1- PR(q)) (1-PR(a)) |

Testing is jointly profitable if the sum of columns c, d, and e exceeds the sum of columns a and b, each discounted by its probability. Essentially, testing is jointly profitable if the loss avoided by successfully predicting $q$ (column b minus column e) minus the gain foregone when the test falsely predicts $q$ (column a minus column d) exceeds the cost of the test. In other words, testing is jointly profitable if the gain in saved reliance losses from true negatives minus the loss in lost profits from false negatives exceeds the cost of the test. To the extent $v_r$-$r_b$ > $p$ (*i.e.*, to the extent of *B*'s expected gain on the contract) *S* undervalues success (compare cells 1a and 2a and cells 1d and 2d) and overvalues failure (compare cells 1b and 2b and cells 1e and 2e). In other words, *S* undervalues false negatives and overvalues true negatives. Introducing a rule of excuse does not affect *S*'s undervaluation of the loss from false negatives (column a minus column d), but it reduces the value he places on true negatives (column b minus column e). *S* may or may not value true negatives excessively depending on the relationship of *(($v_r$-p)(1-PR(ex)))* and $r_b$. If the contract involves a significant gain to *B*—that is, $v_r$-$p$ is significantly greater than $r_b$—and *PR(ex)* is not high, then *S* will have too great an incentive to take precaution. Note also that the chance of excuse gives *B* an incentive to test (row 4) because he ascribes a positive value to true negatives (cell 4e minus cell 4b). But *B* and *S*'s aggregate incentive to test under a rule of excuse is always less than *S*'s incentive under strict enforcement to the extent $v_r$-$p$ > $r_b$ because *B* puts less value than *S* on true negatives. And *B* is unlikely to test the larger $v_r$-$p$ > $r_b$ because of the resulting high value he places on the loss from false negatives (cell 4d minus cell 4a).

The case where a risk has an offsetting effect on the parties and *B* makes an investment in period one that is valuable only if *S* performs in period two poses a slightly different problem. A risk with offsetting effects might increase *S*'s cost and *B*'s return in period two by the same amount. The parties are jointly better off if they ignore such risks since they do not affect their net joint return. A rule of strict enforcement gives *S* undue incentive to take precaution against such risks. However, a rule excusing *S* from the contract if the event occurs may give *B* an undue incentive to take precaution. This is because excusing *S* exposes *B* to a loss on its investment in period one since *S* may take advantage of its freedom not to perform to appropriate much of the value of *B*'s investment, which is valueless if *S* does not perform. How *B* will evaluate this risk is difficult to predict, for *B*'s expected loss depends on the bargain he expects to strike with *S* should the risk occur and *S* threaten to invoke the rule excusing him from the contract.

If the odds of excuse are fairly low, *B* may expect a favorable settlement and so no loss arises.

If, as I have argued, courts excuse contracts only when the party harmed by excuse is not left in a position worse than she would have been in without the contract[243]—if courts follow the principle of loss alignment—then the problems resulting from reliance by *B* are mitigated.[244] When risks involve offsetting effects on the parties, this approach reduces the threat to *B* that *S* will use the possibility of adjustment to appropriate *B*'s investment in the contract to leave *B* worse off for making the investment. When risks involve joint net losses, this approach concentrates liability for those losses on *S*, and so reduces the problems that arise from dividing incentives to take precaution. When risks involve joint net losses but a contract has a significant positive expected return to *B*, this approach induces more nearly optimal precaution by *S* than does a rule of strict enforcement, though it still probably induces excessive precaution by *S*.[245]

I have yet to discuss the most significant negative effect of a rule of excuse. The analysis above assumes that people expect that the rule will never upset a contractual allocation of risk. Thus, the analysis assumes that if *B* and *S* account in the contract for some risks but ignore *q*, they would think that excuse or some other judicial modification of their contract was possible on *q* but not on the outcomes for which they accounted. In reality, one might fear that courts may use the power to modify contract terms to upset contractual allocations of risk. This means that an increase in contract costs, arising when people take greater care to write contracts to ensure that the rule does not upset

243. Again this statement excludes cases covered by established rules of excuse; examples may include the rules excusing sellers of identified goods and personal service providers from liability on destruction of the goods or death. The certainty of these rules avoids the problems of divided incentives to take precaution. It also excludes "waiver-type" cases, in which a party is held liable for the other party's reliance loss because he did not communicate facts that would affect reliance that he had learned of after the contract was made. For instance, under a contract excusing a builder from the obligation to pay an architect if a construction loan is not approved, it may be appropriate to use the rule of good faith to require the builder to inform the architect of events changing the risk of loan denial when such information would alter the architect's continuing investment in the project. *See* Parsons v. Bristol Dev. Co., 402 P.2d 839, 845 (Cal. 1965). This is a counterpart to the *Hadley* rule. *See* Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854). Just as we want the promisee to disclose his potential loss if the promisor bears the risk of liability for that loss on nonperformance, we want the promisor to disclose the risk of nonperformance if the promisee bears that risk. Another illustration may be the use of the impracticability rule to encourage postoccurrence mitigation of losses, though the mitigation rule ought to serve as well in this situation.

244. In theory, this minimum payment should comprise not just the promisee's investment in the contract plus his next-best rate of return on the investment, but also some compensation for risk borne under the contract. Failure to include in reliance a risk-adjusted return on investment undercuts the benefits of excusing parties from losses in excess of reliance. To illustrate, assume a contract between a mineral lessee and a lessor to extract minerals from land. The parties expect to extract 101,000 units of mineral worth $10 per unit net of expenses, but they face two known risks: a five percent risk of extracting only 50,000 units and a 50 percent risk that the lessor's cost (perhaps the decrease in the value of its land) would be either $2,500 or $5,000. The parties do not account for the five percent risk in the contract, but they do account for the 50 percent risk by negotiating a price of 6.856¢ per unit to split the expected profit on 101,000 units evenly. The lessor promises to take 101,000 units. It may be in the parties' joint interest to disregard the five percent risk in contracting, but they will not do so under either a rule requiring the lessee to pay expectation damages or a rule excusing the lessee from damages in excess of the lessor's ex post reliance loss. Under the first rule, the lessee would expend up to $254.12 to resolve the five percent risk. Under the second rule, if excuse is certain on the low-quantity outcome, the lessor would expend up to $15.96 to resolve the risk of that outcome. The latter incentive exists because the parties do not share risk and reward equally under the low-quantity outcome. The lessor is protected from loss if its reliance cost is high, but it is not allowed to share in the profit if its reliance cost is low.

245. In an earlier article, I show that in contracts with positive reliance and uncertain expected gains, parties are likely to optimize precaution and reliance under a hybrid contract which makes the promisor strictly liable for the promisee's reliance loss, but only contingently liable for any excess gain if such gain proves to be realizable. *See* Gergen, *supra* note 5, at 1039.

allocations of risk, must be set against the reduction in precaution and contract costs that parties relying on the rule use to save them from some remote risks.[246]

We cannot know whether these costs outweigh the benefits of a rule of excuse. The comparison of the effects turns on such immeasurable factors as people's expectations that courts may upset contractual allocations of risk, their expectations that courts may save them from unallocated risks, and the effect of both of these expectations on the care taken in contracting. If people account poorly for low-probability risks[247] and they are insensitive to legal rules, as some evidence suggests,[248] then neither expectation nor effect may be very significant in reality.

Reasons exist to think that these and other costs of rules upsetting contract terms are not insufferable. People often expressly invite adjustment of contracts with vague terms like gross inequity and *force majeure* clauses.[249] They seem to think the benefits of these terms outweigh their costs. Given the prevalence of rules like the impracticability doctrine, it cannot be assumed that parties who did not signal their desire for adjustment by the use of such terms necessarily want a contract enforced as written.[250] Further, current law induces courts to err on the side of enforcing contracts as written, reducing the chance that parties will factor a risk into a contract but not have the contract enforced. For instance, the impracticability doctrine saves parties only from unforeseeable risks: the test is not whether a risk was considered, but whether it could have been.[251]

## CONCLUSION

The validity of the economic objections to the doctrines of impracticability, mistake, penalties, forfeiture, and good faith finally turns on two issues of capability: (1) the capability of parties to design contracts that deal well with low probability contingencies, and (2) the capability of judges to determine when a contract malfunctions because the parties failed to account for a contingency. The doctrinal analysis in Part I bolsters the economic analysis in Part II because, if reported decisions are a fair guide, they show that people often make mistakes in writing contracts and that judges do a decent job in identifying and rectifying those mistakes. Judges make mistakes too, of course. Yet, the

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246. These losses cannot be justified by savings in precaution from excusing a party from a risk, even if it is not in the parties' joint interest to take precaution against that risk, for paying a party to bear a risk may optimize precaution.

247. For example, people tend to overweight risks that are close to mind, perhaps because of recent occurrence. Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974), *reprinted in* DANIEL KAHNEMAN ET AL., JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 11 (1982). They also tend to overestimate the probability of outcomes that require the occurrence of several high-probability events (conjunctive risks) while they tend to underestimate the probability of events that require only one of several low-probability events to occur (disjunctive risks). *Id.* at 15-16. Such biases will warp the effects of rules in ways that are difficult to predict. For example, the tendency to underestimate disjunctive risks may mean that people will tend to underestimate the risk that a contract will be excused under a doctrine like that of impracticability, for that requires the conjunction of low-probability events—the risk triggering application of the rule and a party invoking the rule successfully. In contrast, the attention paid to unusual cases excusing contracts may cause lawyers who advise parties in drafting contracts to overweight the risk. The point is that if these and other biases are sufficiently pronounced, they may swamp the effects that we would predict in a world populated by rational calculators.

248. A striking illustration is the Texaco-Pennzoil case, where apparently not one of many highly paid counselors realized that it was uncertain whether an agreement in principle was legally binding. *See* Mark P. Gergen, *The Texaco-Pennzoil Affair and the Economic Analysis of Remedies for Mistakes in Contract Formation*, 9 REV. LITIG. 441, 467-69 (1990).

249. Marvin O. Young, *Construction and Enforcement of Long-Term Coal Supply Agreements—Coping With Conditions Arising from Foreseeable and Unforeseeable Events—Force Majeure and Gross Inequities Clauses*, 27 ROCKY MTN. MIN. L. INST. 127, 142-44 (1982).

250. *Cf.* Williamson, *supra* note 234, at 200-01.

251. *See supra* notes 50-51.

performance of judges under these doctrincs is not so bad as to justify abolishing the doctrines, as some have proposed. The better course is to try to improve judges' performance by refining the doctrines.

The doctrines can be improved by breaking them into parts and reassembling those parts around more coherent principles. Some applications of these doctrines involve genuine default rules (*i.e.*, established rules that parties can and do rely on in contracting) or genuine interpretation (*i.e.*, a determination of the parties' likely expectations in making a contract). I have not addressed these areas of the doctrines, other than to argue that the problems they pose are quite different from the problems posed in cases that try to reconstruct contracts to deal with truly unanticipated events. In such cases, two general principles seem to guide courts—they try to deter selfish performance and to align losses—and I think properly so.

Clearer account can be taken of these principles by restating the law. In the areas of impracticability, mistake, and frustration, if an established rule allocating risk does not govern a case, relief should be predicated on a showing that an unforeseen contingency resulted in the promisor suffering a loss that can be rectified without leaving the promisee in a worse position than she would have been in without the contract. The law on penalties should be restated to make it clear that one ground for setting aside an excessive damage clause is that it unexpectedly overcompensates. Moreovcr, when a clause is shown to overcompensate, the promisee should be asked to show some legitimate function served by the clause that justifies its enforcement. Few changes need to be made in the areas of forfeiture and disproportionate remedial costs—although it would not hurt to clarify that these rules should protect a party whose breach is substantial and purposeful only if events not anticipated by the parties significantly increase the cost or decrease the return on performance. In the law of good faith, it needs to be recognized that the doctrine does more than protect expectations from overliteral interpretations of a contract (its major function); it also empowers courts to require reasonable behavior when circumstances arise that the parties did not anticipate in contracting.