The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures

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Courts will not enforce liquidated damage clauses when a stipulated sum exceeds (i) the harm that the promisee could reasonably expect to suffer from breach or (ii) the actual harm that breach turned out to cause.¹ Courts traditionally have not awarded punitive damages “for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.”² Courts also will not grant specific performance “if damages would be adequate to protect the expectation interest of the injured party,” nor will courts enforce contracts that accord promisees a right to specific relief.³

These three rules share the goal of limiting a promisee’s recovery to his lost expectation. The liquidated damage rule prevents the promisee from contracting for a supracompensatory remedy, and the punitive damage rule prevents courts from awarding such a remedy. The specific performance rule achieves the law’s goal indirectly. A promisee who has a right to specific performance can compel the promisor to perform even when the promisor’s loss from performance would exceed the promisee’s gain. A promisor can purchase her freedom, but sophisticated promisees sometimes will demand more than their expectation as the price. Permitting specific performance only when damages could not protect the expectation interest limits the ability of promisees to obtain supracompensatory payments by threatening to seek specific relief. The ban on “specific performance clauses” prevents a promisee from obtaining by contract the power that the general specific performance rule aims to abolish.

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1. RESTATEMENT (SECOND) OF CONTRACTS § 356 (1981); U.C.C. § 2-718(1) (1989).

2. RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981); U.C.C. § 1-106(1) (1989) (by inference).

3. RESTATEMENT (SECOND) OF CONTRACTS § 359(1) (1981); U.C.C. § 2-716(1) (1989).

These three rules rest on a normative premise and on a positive premise. The normative premise holds that supracompensatory remedies are undesirable. The positive premise holds that promisees prefer supracompensatory remedies, and so must be prevented from getting them. The normative premise is true but the positive premise is false. It is shown below that promisees do not want contractual damage measures that would grant more than their lost expectation. Several legal implications follow from this showing.

First, the initial, or “ex ante,” branch of the liquidated damage rule is unnecessary. Courts do not have to prevent promisees from obtaining penalty clauses if promisees do not want penalty clauses. The ex ante rule is not merely unnecessary: judicial review produces mischief. Courts sometimes mistake compensatory damage measures for penalties, and so have found that particular liquidated damage clauses would inevitably overcompensate promisees when those clauses only protected the expectation. Thus, the ex ante branch of the liquidated damage rule should be abandoned.

The “ex post” branch of the liquidated damage rule, which bans clauses that overcompensate in fact, seems justifiable at first glance. An ex ante reasonable estimate of the damages that the promisee will later incur may exceed the promisee’s actual loss. The normative premise that supracompensatory remedies are undesirable then apparently justifies the ex post branch of the rule, because it implies that courts should not enforce liquidated damage clauses that exceed actual damages. This view is unpersuasive: party estimates may err, but courts generally do not review contracts to ensure that performance under a contract’s terms yields the consequences that the parties expected it to have. The general absence of judicial review follows from two premises: even with the benefit of hindsight, courts seldom could do better for the parties than the parties can do for themselves; and the willingness of courts to attempt to rescue parties from bad deals reduces the parties’ incentive to write good contracts originally. These premises support foregoing judicial review of the liquidated damage term just as they support foregoing review of other contract terms. Thus the ex post branch of the liquidated damage rule should be repealed as well.

Some courts have relaxed the traditional prohibition against awarding punitive damages in ordinary contract actions. The traditional rule should be restored. A state-supplied right to sue for punitive damages is similar to a contract-supplied right to sue for a penalty; in both cases, a disappointed promisee would sue on the right *if* it existed. Showing that promisees prefer the right not to exist implies both that a promisee would reject a contract that contained a penalty clause and would vote against a punitive damages regime if he could. This promisee preference should control.⁴

4. Punitive damage awards are sometimes justified on retributive and deterrence grounds. Retributive concerns are outside this Article’s scope; they also seem irrelevant to the commercial breaches that are its subject. Punitive damages will increase deterrence when the law is underenforced. For example, if some tort victims will not sue, injurers face a suboptimal incentive to behave properly. Letting plaintiff victims

Finally, parties should be permitted to contract for specific relief. The current ban on such contracts can be justified on grounds similar to those that underlie the liquidated damage rule. The *ex ante* aspect of this justification holds that a right to specific performance functions similarly to a right to sue on a penalty clause: both rights permit promisees to compel inefficient performances. If promisees want this power, then they should be prevented from contracting for specific relief, just as they are prevented from contracting for penalties. But promisees do not want this power. Rather, promisees prefer specific performance primarily when their expectation cannot be monetized; in this circumstance, a promisee neither could prove damages nor create a liquidated damage clause. Because specific relief is efficient relative to no relief, courts should enforce specific performance contracts. If courts were to do this, then arguably they should police these contracts specially, just as they police liquidated damage clauses specially. Again, the *ex post* justification for judicial review holds that the parties' initial belief that specific performance was necessary may turn out to be mistaken, but the promisee might then use his contract right to specific relief to extort a supracompensatory payment from the promisor. As is shown below, promisees do not use the specific performance remedy to exploit today, and would be unlikely to use the remedy for exploitation were they able to contract freely for it. Hence, courts should not police specific performance contracts specially.⁵ If specific relief clauses become enforceable, the current specific performance rule would not be the best default (what would be is a difficult question).

Part I shows that promisees prefer compensatory remedies. Part II explores the normative implications of this preference. Part III defends the use of certain assumptions that underlie the argument. Part IV considers one important and sometimes unrealistic assumption in detail. This assumption holds that promisees always sue to protect their expectation interest; in particular, promisees always detect breaches and never are deterred from suing by high legal costs. The former aspect of the assumption often is plausible because breach usually is easy to detect; the latter aspect is more questionable because legal costs do seem to deter some suits. Part IV makes two claims. First, promisees prefer not to solve the "collection cost problem" with penalty clauses. Second, the state should not respond to the inefficiencies that sometimes follow from underenforcement of the law with punitive damage awards. Rather, the state should encourage promisees to sue by reducing collection costs. Part V considers the recent trend to award punitive damages for contract

recover punitive damages responds to this underenforcement concern. Part IV below considers whether underenforcement justifies punitive damages in contract contexts. The claim made in the text above is that punitive damages should not be awarded to vindicate the promisee's interest in realizing gains from trade.

5. Courts do and should police all contracts to ensure that parties do not violate the duty of good faith in performance. An early and perceptive argument that the parties should be allowed to contract for specific performance is in Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978).

breaches which disadvantage individuals. This trend is particularly manifest in two contexts, the wrongful denial of insurance benefits to individual insureds⁶ and dismissals from employment.⁷ Awarding punitive damages in the former case is undesirable; awarding them in the latter case may be wise only when an unregulated right to dismiss would create an externality, such as reducing a firm's incentive to obey the law.

I. CONTRACTING FOR REMEDIES

Part I shows that promisees would reject supracompensatory remedies in three contexts that cover much of the contracting ground: (i) when parties function in competitive markets; (ii) when parties bargain (in competitive markets, there is no bargaining) and are well informed about the relevant economic parameters; (iii) when parties bargain but are imperfectly informed. In the first two cases, the promisee's preference for compensatory relief follows from the familiar result that the expectation interest remedy is efficient respecting the breach decision. The expectation remedy is efficient respecting breach because it induces the parties to perform when performance would maximize their joint gains, and to breach otherwise.⁸ In cases (i) and (ii), the promisee's preference for expectation damages follows from the remedy's efficiency because the promisee's share of the gains from trade is exogenously determined; hence, the promisee cannot maneuver to obtain a larger share of a smaller pie. The promisee thus wants the pie to be as large as possible. Since a penalty clause would shrink the pie—that is, reduce the parties' joint gains from contracting—the promisee would reject it.

In the third case, strategic behavior is possible. A standard result in bargaining theory is that uninformed parties sometimes rationally sacrifice efficiency gains in the course of attempting to maximize their own shares. Thus, it is a separate question whether promisees would seek inefficient damage measures

6. Courts that award punitive damages for the breach of an insurance contract usually describe the breach as a tort—the violation of the implied covenant of good faith and fair dealing. *See, e.g., Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 169 Cal. Rptr. 691, 620 P.2d 141 (1979); *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 271 N.W.2d 368 (1978). These are best regarded as contract actions because the companies' conduct was a breach of contract and because similarly situated parties could respond in their contracts to the legal rule. Some courts do let promisees sue in contract itself. *See, e.g., Linscott v. Rainier Nat'l Life Ins. Co.*, 100 Idaho 854, 606 P.2d 958 (1980); *Kirk v. Safeco Ins. Co.*, 28 Ohio Misc. 44, 273 N.E.2d 919 (1970).

7. These courts also say that the action is in tort. *See Carter v. Catamore Co.*, 571 F. Supp. 94 (N.D. Ill. 1983); *Dare v. Montana Petroleum Mktg. Co.*, 212 Mont. 274, 687 P.2d 1015 (1984); *K Mart Corp. v. Ponsock*, 103 Nev. 39, 732 P.2d 1364 (1987).

8. That the expectation measure is efficient respecting breach was first proved formally by Shavell. *See Shavell, Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980). Sam Rea inferred from this result that "the parties to a contract are unlikely to agree ex ante to damages that exceed the expected loss." Rea, *Efficiency Implications of Penalties and Liquidated Damages*, 13 J. LEGAL STUD. 147, 159 (1984). This Article confirms and extends Rea's inference by showing that promisees would not seek penalty clauses in a variety of contracting contexts. The Article also draws different normative implications than Rea does from the promisee's preference. *See infra* notes 24-32 and accompanying text.

when bargaining under conditions of imperfect information. Part I.C. shows that promisees never would seek penalty clauses in this context but may seek damage measures that inefficiently undercompensate. The normative implications of this latter preference are not pursued here.

A. *The Competitive Case*

The conclusion that a promisee functioning in a competitive market would not purchase a contractual remedy in excess of his best estimate of the harm that breach would impose rests on the following assumptions: (1) the promisee is not risk preferring; (2) the promisor and promisee share the same estimate of the breach probability; (3) the promisor's costs are determined exogenously⁹ (this assumption implies that the promisee cannot affect the probability of performance except through his choice of a contract damage measure); (4) the promisee does not engage in post-contractual reliance;¹⁰ (5) the promisee always detects breach¹¹ and will sue if breach occurs; (6) renegotiation after the contract is made is costly;¹² (7) if the promisor breaches, a court cannot accurately determine what the promisee's gain from performance would have been.¹³

It is helpful to begin by recreating the result that a contract requiring the promisor to pay the expectation interest remedy on breach would maximize the

9. In the analysis below, the promisor estimates performance cost when the contract is made; her actual costs are determined by the state of the world ex post. The promisor's costs will be higher than her estimate if input prices unexpectedly rise. The promisor is assumed to have no control over input prices. Breach in all the cases considered here is preferable to the promisor when her costs come to exceed the price by a sufficient amount.

10. This assumption is made for convenience and does not affect the analysis. If the contract specifies a particular sum as the promisee's damages—the situation considered here—then the promisee's legal expectation would not be a function of his postcontract reliance expenditures. Consequently, the promisee will engage in optimal reliance. The question is whether the sum that the contract specifies will be penal or not. This is taken up next. The effect of the legal damage rules on the parties' reliance incentives is thoughtfully reviewed by Craswell and Rogerson. See Craswell, *Performance, Reliance and One-Sided Information*, 18 J. LEGAL STUD. 365 (1989); Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39 (1984).

11. The assumption that breach always is detected is plausible in the cases considered here, in which breach entails the failure to supply promised goods or services, or to pay money when it is due, or to retain someone in employment. Undetected breaches seem primarily to occur in certain principal-agent contexts, as where an employee covertly shirks. An optimal principal-agent contract could have a penal element when one possible output correlates perfectly with the shirking input. Such "shifting support schemes" are not discussed here. See E. RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* 148-50 (1989). Undetected breaches are briefly considered *infra* at note 67.

12. If renegotiation is costly, the parties have an incentive to write an efficient initial contract. Since an efficient damage measure exists—the expectation interest—renegotiation will not be discussed.

13. Goetz and Scott were the first to show that promisees seek liquidated damage clauses when the expectation interest would be difficult to prove. See Goetz & 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). The seven assumptions listed above apply to all the cases considered here unless it is otherwise stated.

parties' joint gains from contracting.¹⁴ If the contract is performed, the promisor, who is assumed to be a seller, would earn the price less her costs; the promisee would earn the value he places on performance less the price. The sum of these gains is the surplus from contracting. To calculate this surplus, a little notation is helpful. Let p be the product's price, c be the promisor's cost of producing or purchasing the product and v be the promisee's gross gain from performance. Then the contracting surplus is $p - c$ (promisor gain) + $v - p$ (promisee gain) = $v - c$ (promisee gain less promisor cost). When the gain from performance would exceed the cost, the parties should perform; when the gain would be below the cost, the parties should not perform. In this latter case, breach would generate a positive gain; the promisor would save her cost c , which exceeds the promisee's lost value v . Hence, the applicable damage rule should induce performance when $v > c$ but not otherwise.

The expectation interest remedy awards the promisee his expected gross gain less the price ($v - p$). Any damage rule bites only when the promisor's costs exceed the price (otherwise the promisor will perform). Under the expectation remedy, the promisor will perform when her loss from doing so ($c - p$) is less than her loss from paying damages ($v - p$), or when $v > c$; the promisor will breach when her performance cost would exceed the damage payment, or when $v < c$. The expectation measure thus induces performance when performance would generate positive gains, and breach otherwise.

Next define a contract damage measure as a term that requires the promisor to pay k times the expectation interest to the promisee upon breach, where $0 \leq k \leq \infty$. If $k = 1$, the damage measure would award the promisee his expectation; if $k > 1$, the damage measure would award a penal sum (k is then referred to as the "penal multiplier"). When the contract contains a damage measure, the promisor will perform when her cost of performance is less than k times the expectation remedy. If k exceeds one, the promisor thus may be induced to perform although performance cost would exceed the value of performance to the promisee. Similarly, if k is less than one, the promisor may breach too often. Thus, only the expectation measure maximizes the parties' joint gains from contracting.

Promisees functioning in competitive markets would not purchase supracompensatory remedies (contract damage measures with k exceeding one). A competitive market is defined by the "free entry" condition. There is free entry if a new firm could enter a market at no cost disadvantage relative to incumbent firms. When free entry obtains, price in equilibrium equals average cost (including a competitive return on the sellers' investment). If firms in the market were earning profits, new firms would enter until the profits were

14. When the parties' comparative advantages at reducing or insuring against breach are considered, some parties functioning in competitive markets will prefer damage rules that award less than the expectation interest. This idea is interestingly discussed by Epstein. See Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989).

competed away. That firms earn zero profits implies that buyers—the promisees—receive the entire surplus from contracting. Consequently, the promisees want the surplus to be as large as possible. The expectation interest measure maximizes the contracting surplus. Thus, promisees would contract for a damage measure that just equals their expectation.

It may be helpful to say a little more concerning why a promisee would prefer the expectation measure to a chance at a large penalty if the promisor breaches. Let p^c be the price associated with a compensatory damage measure d^c , where $d^c = v - p^c$, and let p^p be the price associated with a penal damage measure $d^p = k(v - p^p)$, where $k > 1$. As said above, the promisor wants to perform when price exceeds cost. Hence, a contractually induced performance always is at a loss to the promisor. The greater are the damages that the promisor must pay on breach, the more often will the promisor choose to perform (at a loss) rather than pay. Thus, the cost of the contract to the promisor is increasing in the damage measure. Since price equals cost in the competitive case, the price associated with the damage rule d^p exceeds the price associated with the damage rule d^c ; that is, $p^p > p^c$.

Next ask whether the promisee would prefer a penalty clause. There are two cases to consider. In the first, the promisor performs. The promisee's net gain under the compensatory damage measure d^c is his gross gain minus the price $(v - p^c)$ while his net gain under the penal measure d^p would be the same gross gain minus the "penal price" $(v - p^p)$. Since the penal price p^p exceeds the compensatory price p^c , the promisee's net gain would be lower under d^p . The promisee always does worse under the penal measure when the promisor performs because the contract price is increasing in k , the penal multiplier, while the promisee's gross gain from performance, v , is fixed. In the second case, the promisor breaches. The promisee then does better with a penalty clause because his recovery is greater. The loss to the promisee in the former case necessarily exceeds his gain in the latter. Recall that the parties'—here the promisee's—surplus is maximized under the expectation damage measure. This implies that the surplus must be smaller under any other damage measure; and the surplus could be smaller with the penal measure only if the promisee's loss from promisor performance would exceed his gain from promisor breach.

This conclusion is illustrated with a simple picture that plots the promisee's expected gain from the contract as a function of the penal multiplier k :¹⁵

Figure 1

In Figure 1, the promisee's expected gain, which is plotted on the vertical axis, is maximized at $k = 1$ (damages are compensatory) and becomes constant at the value for k that is high enough always to induce the promisor to perform. Hence, in the competitive case a promisee would not knowingly contract for damage measures that would overcompensate him relative to the expectation measure.

B. *The Perfect Information Bargaining Case*

When there is heterogeneity in the market for goods or services, a promisor-seller has bargaining power; she is supplying something that is (at least slightly) unique. The promisee also has bargaining power because the demand for unique items is relatively limited. The bargaining problem has been extensively studied for cases when each bargainer knows the other's payoffs from agreement and disagreement. This study shows that the parties divide the gains from trade according to their respective discount rates and disagreement payoffs. Respecting the former factor, suppose that the promisor's discount rate exceeds the promisee's discount rate. Then the failure to agree promptly imposes higher opportunity costs on the promisor than on the promisee; the promisor's higher discount rate implies that she attaches relatively less weight to future gains than to present gains. Consequently, the promisor is less willing than the promisee to reject a low offer now in the hope of getting a higher one later. The more patient player—the party with the lower discount rate—thus has more bargaining power; he can afford to wait longer to get his price.

Respecting the disagreement factor, suppose that there is an exogenous probability that the parties' bargaining process will cease—a selling season will

15. Figure I is a copy of a computer graph of the promisee's expected gain as a function of the penal multiplier k . The graph was obtained by solving the promisee's maximization problem mathematically and putting sample values of the variables into the solution. The math is not set out here because the intuition seems clear enough. The graph identifies the "global max"; the promisee's gain declines below the gain under compensatory damages when the multiplier drops below one because then the promisor breaches too frequently.

end, for example. Were bargaining to terminate, each party would receive its "disagreement payoff," the value of the party's next best option. These disagreement payoffs often differ. Then the party with the higher disagreement payoff has more bargaining power. Because she is relatively less prejudiced by the failure to agree, she can hold out for a better deal in the relationship.¹⁶

Now consider the promisee's preferences respecting the contract's damage measure. The promisee's share of the gains from trade is exogenously determined; it is a function of the parties' discount rates and disagreement payoffs—their respective bargaining power. A promisee who cannot affect the size of his share will want to maximize the size of the pie. This he can partly do because the gains from trade are a function, *inter alia*, of the contract's damage measure, which the parties choose. As shown above, the damage measure influences the gains through its effect on the promisor's decision whether to perform. Consequently, the promisee would bargain for the expectation measure. Only it maximizes the contracting surplus—the pie's size. Experimental evidence is consistent with the conclusion that promisees would seek the expectation measure. This evidence shows that parties bargain to the efficient outcome when they know what that outcome is.¹⁷

C. *The Imperfect Information Bargaining Case*

Parties that bargain often do not know their adversaries' payoffs or other relevant information about them. This leads parties to engage in strategic behavior.¹⁸ For example, a buyer will attempt to persuade the seller that the buyer has a low valuation for the object of sale because a seller who believes this will accept a lower price. When bargaining itself is costless to the parties but they have positive discount rates, strategic behavior will delay agreement unduly; when continuing to bargain is costly, the parties sometimes may not agree although positive gains from trade exist.¹⁹ It is shown here that another inefficiency would not arise: promisees in imperfect information bargaining environments would reject supracompensatory remedies.

16. This intuitive story respecting the sources of bargaining power is formalized by Sutton. See Sutton, *Non-Cooperative Bargaining Theory: An Introduction*, 53 REV. ECON. STUD. 709 (1986).

17. See Harrison & McKee, *Experimental Evaluation of the Coase Theorem*, 28 J.L. & ECON. 653 (1985); Hoffman & Spitzer, *Experimental Effects of the Coase Theorem with Large Bargaining Groups*, 15 J. LEGAL STUD. 149 (1986).

18. For a recent, illuminating discussion of strategic bargaining, see Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. (forthcoming 1990).

19. By now, there is a large literature respecting bargaining. For recent discussions, see Cramton, *Dynamic Bargaining with Transaction Costs*, 37 MGMT. SCI. (forthcoming 1991); J. Keenan & F. Wilson, *Bargaining with Private Information* (forthcoming 1991).

1. *An Intuitive Story*

A seller/promisor wants to trade an object to a buyer/promisee. There is a distribution of buyer "types," which means that potential buyers differ in the valuation they attach to the object. A buyer's type is just his valuation. The seller knows the distribution of buyer types but does not know the type—the particular valuation—of the person with whom she is bargaining. The seller will offer a contract with two terms, a price and a liquidated damage clause. The clause specifies a gross buyer valuation— v in the analysis above—for the object. If the seller breaches, she must pay the specified sum to the buyer as damages. The seller prefers to sell to the buyer with the highest valuation because this buyer is willing to pay the highest price. Accordingly, the seller will initially propose a contract with a liquidated damage clause that specifies the highest buyer valuation (recall that the seller knows the distribution of buyer valuations) and a correspondingly high price. The price is increasing in the damage measure; that is, a contract with a high liquidated damage clause has a higher price than a contract with a low liquidated damage clause (because, as Part I.A. showed, higher damage measures impose higher costs on sellers, and a seller will not propose a price that is below cost).

The buyer can accept the initial high price, high damage measure contract or reject it (buyers have positive discount rates and so are motivated to agree rather than reject because rejection delays and thus partly dissipates the gains from trade). If the buyer does reject, the seller will propose a new contract with a lower price and a liquidated damage clause that corresponds to the second highest buyer valuation. This process continues until the buyer finally accepts a contract. Because the seller does not know the buyer's actual type, a buyer can accept a contract with a liquidated damage clause that is above his true valuation for the object of sale, equal to his true valuation or below his true valuation. The damage measure is penal if it is above the buyer's true valuation; then the buyer will be overcompensated in the event of breach. The question is what kind of contract the buyer will accept.

A buyer will not accept a contract with a damage measure that is above his true valuation, but may accept a contract with a damage measure that is below it. Respecting the former conclusion, a buyer cannot fool the seller to the buyer's advantage by accepting a contract with a damage measure that exceeds his true valuation. The buyer is disadvantaged by this strategy when the seller performs, because the buyer pays the price of a person with a higher valuation than his own. The buyer is overcompensated in the event of breach—he receives damages that exceed his true valuation—but he has paid the (appropriately high) price for this opportunity. Thus, the buyer gains nothing by misrepresenting his type—by accepting a contract with a penal damage measure.

In contrast, a buyer may fool the seller to his advantage by pretending to have a lower valuation than he actually has. Such a buyer gains when the seller

performs, because he pays the price of a person with a lower valuation than his own; the buyer loses when the seller breaches, because he then is undercompensated. The gain will exceed the loss when the seller has considerable bargaining power. To see why, realize that the buyer can make positive profits in two ways: (i) by realizing the difference between his true valuation and the appropriate price or (ii) by fooling the seller into charging a price that is below the price that the buyer's true valuation would warrant. When the seller has considerable bargaining power, she is able to appropriate much of the gain from trade by charging a price that is close to the buyer's "revealed valuation"—the valuation that the contract's damage measure specifies. In this event, the buyer's strategy of earning profits by realizing the difference between his true valuation and the price is relatively unattractive; that difference is small. The high valuing buyer does better by "revealing" a falsely low valuation and paying the correspondingly low price. Hence, buyers sometimes may accept contracts with undercompensatory liquidated damage clauses.

In sum, when the parties are uninformed bargainers, promisees still will not accept contracts with penal damage measures, but may agree to contracts with undercompensatory damage measures. The analysis that generates this conclusion is somewhat artificial; in it, the seller does all the proposing while in real life the parties often make proposals to each other. The logic that generates the conclusion seems general, however. It is difficult to see how a promisee in an imperfect information environment could maximize utility by pretending to a valuation for the object of sale that is higher than his own. Finally, a contract with an undercompensatory damage measure is inefficient because the seller will breach too often. This inefficiency is another cost that imperfect information imposes.²⁰

2. *An Analytical Story*²¹

20. The analysis above assumes that both parties know the breach probability. When promisees/buyers do not know it, there is a dispute in the literature as to whether reliable promisors would offer penal damage measures to signal that they are unlikely to breach. Less reliable promisors could not mimic these signals because they would have to pay off too frequently. For arguments that promisors would offer penalties in some asymmetric information environments, see R. COOTER & T. ULEN, *LAW AND ECONOMICS* 295 (1988); Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 720-21 (1986). For an argument against, see Rea, *supra* note 8. This dispute is irrelevant here. The liquidated damage rule attempts to protect promisors from promisees. If a sophisticated promisor wants to send a penalty signal, only paternalistic considerations would justify a court in preventing her from doing so.

21. This section puts the analysis above in formal terms. Persons familiar with bargaining theory will recognize that the text sets out a screening model, in which the uninformed party—the seller—"screens" buyer types by proposing contracts. The novelty here is that the screening is done by proposing contract clauses—the contract's damage measure—along with prices. Readers who find the intuitive story clear enough and who are uninterested in the details can skip to the summary section and Part II. An interesting screening model that uses contract terms but is set in a market rather than a bargaining context is Matthews & Moore, *Monopoly Provision of Quality and Warranties: An Exploration in the Theory of Multidimensional Screening*, 55 *ECONOMETRICA* 441 (1987).

Two parties want to trade an object. The seller does not know the valuation of the buyer with whom she deals but knows the distribution of buyer types. For simplicity, this distribution is assumed to have two members: $v \in \{v_l, v_h\}$, where $0 < v_l < v_h$. The buyer knows the distribution of seller costs but ex post will not know the seller's cost realization. The seller can propose a contract that is the pair $\{p, d\}$, where p is the price and d is the damage measure. There are two damage measures (reflecting the two valuations): $d_h = v_h$ and $d_l = v_l$. There also is a high and a low price: $p_h > p_l$. Four contracts are possible but two would not exist in equilibrium. The seller will not propose the contract $\{p_l, d_h\}$ because if the buyer actually has a high valuation, the seller believes that she can do better than the low price p_l ; thus the seller would not begin with the contract $\{p_l, d_h\}$. The buyer will not accept the contract $\{p_h, d_l\}$ because he would lose money; knowing this, the seller will not propose that contract. Hence, attention can be restricted to the contracts $\{p_l, d_l\}$ and $\{p_h, d_h\}$. To keep the problem interesting, assume that the seller earns greater profits under the contract $\{p_l, d_l\}$ than under the seller's next best alternative.

There are two relevant questions. First, would penalty contracts exist in equilibrium? In this story, a penalty contract is the pair $\{p_h, d_h\}$ when accepted by the low valuing buyer. Second, would undercompensatory damage measures exist in equilibrium? The contract $\{p_l, d_l\}$ is undercompensatory when accepted by the high valuing buyer. The seller begins by proposing the contract $\{p_h, d_h\}$; under it, she earns the maximum profit in performance states because she is paid the highest price, and she is appropriately compensated for risking the high penalty. If this contract is rejected, she proposes the contract $\{p_l, d_l\}$. The two questions can be approached by determining when (if ever) a buyer would do better by pretending to be a type different than his own.

To pursue this issue, the contract prices must first be determined. The seller's price is the sum of three elements: (i) the expected cost of performance when she does perform; (ii) the expected cost of the damage payment when she breaches; and (iii) the share of the expected surplus from contracting that the seller's bargaining power permits her to command. The bargaining power parameter is x where $0 \leq x \leq 1$. When $x = 1$, the seller gets all the gains from trade. For convenience, the seller's costs are assumed to be uniformly distributed on the unit interval.²² First consider the contract $\{p_h, d_h\}$. The seller takes the damage measure to equal the buyer's valuation. Then the price is:

$$1) \quad p_h = \int_0^{v_h} c dc + (1 - v_h)v_h + x \int_0^{v_h} (v_h - c) dc$$

22. This means that all seller cost realizations are equally probable and that these (and the buyer's valuations) are normalized to lie between zero and one. The argument below holds for the normal distribution and any other standard distribution. The uniform distribution is the easiest to work with.

The solutions to this and for the similarly derived price p_l are

$$2) \quad p_h = v_h - \frac{v_h^2}{2} + x\left(\frac{v_h^2}{2}\right)$$

$$3) \quad p_l = v_l - \frac{v_l^2}{2} + x\left(\frac{v_l^2}{2}\right)$$

The first question is whether a buyer with a low valuation will accept the contract $\{p_h, d_h\}$. His expected gain from doing this is

$$4) \quad E(B_l^h) = v_h(v_l - p_h) + (1 - v_h)(v_h - p_h)$$

His expected gain from rejecting the contract $\{p_h, d_h\}$ and accepting the appropriate contract $\{p_l, d_l\}$ is

$$5) \quad E(B_l^l) = v_l - p_l$$

Therefore, the low valuing buyer will accept the appropriate contract²³ when

$$6) \quad E(B_l^l) > E(B_l^h)$$

Substituting the values for the prices into the inequality and letting $x = 0$ (the seller has no bargaining power), the inequality simplifies to

$$7) \quad \frac{1}{2}(v_l^2 + v_h^2) > v_l v_h$$

This is satisfied for all values of v_l and v_h . As x increases, the two prices increase but the buyer's valuation is unchanged. Consequently, expression (4) and expression (5) become smaller in the same proportion. Therefore, the inequality in (6) is satisfied for all values of x that exceed zero as well; low valuing buyers would not accept the contract $\{p_h, d_h\}$. No buyer, that is, will pretend to have a valuation higher than his own.

There will be a separating equilibrium if the high valuing buyer would accept the contract $\{p_h, d_h\}$ that the low valuing buyer will reject. An example shows that a high valuing buyer would reject this contract and accept the

23. The first three terms in equation (1) are the three elements of the seller's price that are described in text. In these equations, the probabilities of performance and breach can be expressed as v_h and $(1 - v_h)$ respectively. This is because the seller's possible costs and the buyer's valuations are assumed to lie on the unit interval. The seller in this case believes that she is dealing with the high valuing buyer. Hence, the probability that the seller will perform is the probability that her costs will equal or be below the sum v_h (for she must pay the damage measure v_h on breach). No probabilities appear in equation (5) because when the low valuing buyer chooses the appropriate contract, his gain is the same in every state; he receives his valuation less the price either through performance or through receiving expectation damages of $v_l - p_l$.

contract $\{p_l, d_l\}$ when the seller has enough bargaining power. Using the solutions above, let $v_h = .8$, $v_l = .5$ and $x = .4$. Then the high valuing buyer has an expected gain of .19 under the contract $\{p_h, d_h\}$ and an expected gain of .20 under the contract $\{p_l, d_l\}$. When the seller has enough bargaining power, the equilibrium will be pooling: all buyer types reject the contract $\{p_h, d_h\}$ and accept the contract $\{p_l, d_l\}$.

The intuition underlying these results is as given above: the low valuing buyer never can fool the seller to his advantage by pretending to a valuation higher than his own while the high valuing buyer can fool the seller in performance states. When the seller has enough bargaining power, the latter buyer type does better by fooling the seller than by accepting the contract that is appropriate to his type. Thus buyers will reject contracts with penal damage measures but sometimes will accept contracts with undercompensatory damage measures. The latter contracts are inefficient; when the damage measure is too low, the seller breaches too often. Nevertheless, the low "pooling contract" $\{p_l, d_l\}$ would exist in equilibrium: the seller earns greater profits under the pooling contract than she would earn without a deal; and accepting this contract is a best response for every buyer type when the seller has sufficient bargaining power.²⁴ Contracts sometimes are inefficient in imperfect information environments. Under present understanding, contracts will not contain penal damage measures.

D. *Summary*

Promisees would not contract for supracompensatory remedies when they act in competitive markets or bargain under conditions of full or asymmetric information. In the former two cases, promisees cannot engage in strategic behavior, but rather earn an exogenously determined share of the gains from trade. Hence, promisees prefer the contractual damage measure that maximizes these gains. The optimal measure restricts the promisee to his expectation

24. This result should be viewed as tentative. The analysis does not specify the seller's beliefs respecting the probability that the buyer who rejects the contract $\{p_h, d_h\}$ has a high or a low valuation, but these beliefs may matter. To see why, suppose the seller believes that such a buyer has a high valuation with probability .9. Then, when the buyer rejects, the seller's best response may be to offer $\{p_h, d_h\}$ again. Since the buyer's discount rate is positive, if the seller pursues the strategy of offering $\{p_h, d_h\}$ again, the high valuing buyer may do better accepting it initially rather than waiting. The low valuing buyer never would accept $\{p_h, d_h\}$. Hence, particular seller beliefs respecting the probability that each type exists in the relevant population together with positive discount rates could cause the pooling equilibrium to disappear. This possibility is not pursued formally because it is enough to show here that the low valuing buyer never would accept the contract $\{p_h, d_h\}$.

The message space is very restricted in bargaining models, the convention being to permit the parties to communicate their types only by their willingness to delay agreement. See, e.g., J. Kennan & R. Wilson, *Theories of Bargaining Delays* (Stanford Center on Conflict and Negotiation Working Paper No. 12, 1990). Whether parties also can communicate with the contract clauses they are willing to propose or accept has received relatively little attention. This Article argues that the parties can communicate with the damage measure, and such communication would not produce penalties. More sophisticated treatments of the subject obviously would be helpful.

interest. In the last case, promisees can engage in strategic behavior but nevertheless do not prefer supracompensatory remedies. This is because a promisee would have to pay for this preference, and so would gain nothing by pursuing it. The three situations analyzed here cover much of the contracting ground.²⁵ Thus the law regulating liquidated damage clauses, punitive damages and specific performance should be evaluated in light of the recognition that promisees prefer compensatory remedies.

II. LEGAL IMPLICATIONS

A. *Liquidated Damage Clauses*

The ex ante branch of the liquidated damage rule directs a court to put itself in the position of the parties when the contract is made, and to ask whether the contract's stipulated sum exceeds a reasonable estimate of the loss that the promisee could suffer from breach. This judicial review is justified on the ground that promisees prefer penalty clauses and so must be prevented from obtaining them. The ex post branch of the liquidated damage rule directs a court to strike a liquidated damage clause that would overcompensate the promisee. This judicial review is justified on the ground that some ex ante reasonable estimates of the promisee's harm will turn out to be too high. Part II.A begins with the ex ante rule.

Part I implies that a penal sum would be stipulated only if the contracting process was unfair—for example, the promisor was uninformed—or if the parties made an erroneous prediction respecting the harm that breach would

25. This note briefly discusses unincluded cases. A seller may be uninformed about buyer valuations but function in a market rather than a bargaining environment. It can be shown that penalty contracts would not emerge in such markets; again, a penalty contract would specify a liquidated damage sum that exceeds the promisee's valuation. The seller would offer buyers a menu of contracts; different buyer types sometimes will choose the pooling contract but no buyer will select a penalty contract. The reason for this preference is identical to that set out above. This line of argument was suggested to me by Richard Craswell. A recent analysis shows that a monopolist seller may extract a penalty from buyers in order to deter entry by other sellers; since the new entrant must compensate a buyer for breaching his contract with the monopolist, entry costs are increasing in the size of the contract penalty for breach. Aghion & Bolton, *Contracts as a Barrier to Entry*, 77 AM. ECON. REV. 388 (1987). There is no evidence that such contracts are used. Also, the promisor/buyer in this analysis is made no worse off by the penalty; he will breach only when a new entrant's price is low enough to permit the buyer to pay the monopoly seller the penalty and still be at least as well off as if the buyer had purchased under the original contract. Since the liquidated damage rule seeks to protect promisors from having to pay large penalties on breach, and in this model it is actually the entrant rather than the buyer/promisor who would pay the penalty, the model is not relevant here. Rather, the antitrust laws should be used to ban entry deterring contractual practices. Finally, Avery Katz suggests that promisees with market power may use penalty clauses to price discriminate; promisors whose demand is high may be segregated by their willingness to accept penalty sanctions. The empirical significance of this insight is unclear. Also, if the price discrimination is inefficient, again it probably is better dealt with under the antitrust laws. There do not seem to be other important situations in which promisees would prefer supracompensatory remedies.

cause. The unconscionability doctrine applies in the former case.²⁶ The genus of which the latter case is a species is generally unregulated: except for the liquidated damage clause itself, courts do not ask whether the parties' agreement rested on predictions that were objectively reasonable given the evidence that the parties had before them when they signed the contract. This restraint follows from the courts' correct belief that they are not as good at drafting contracts as business people are. The liquidated damage rule, however, permits enforcement only of damage predictions that are reasonable *ex ante* and so directs courts to evaluate the parties' predictions. Courts should be expected to do this job badly.

There is evidence that this pessimistic expectation is plausible. Consider two federal appeals court cases that invalidated widely used liquidated damage clauses that did not overcompensate. In *Chandler Leasing Division v. Florida-Vanderbilt Development Corp.*,²⁷ an equipment lease required the lessee to pay on default (a) fifteen percent of the equipment's cost to the lessor plus (b) the unpaid rent minus (c) the net proceeds of resale of the leased equipment. The court held that requiring the lessee to pay fifteen percent of the equipment's cost was "an unenforceable attempt to contract for a penalty in excess of actual damages." In the court's view, the lessor was entitled only to the unpaid rent plus any damage to the leased property and retaking expenses; these damages "were certainly capable of accurate estimation." The court added that if the lessee breached "in the latter months of the lease," there would be little unpaid rent yet the lessee would have to pay the full fifteen percent of the equipment's original cost. That would be "unconscionable."²⁸ Since enforcement of the fifteen percent clause would necessarily overcompensate the lessor, the clause was unreasonable in expectation.

This decision is incorrect because fifteen percent of the equipment's cost almost certainly reflected the expected value of the lessor's reversionary interest in the leased property—the probable value the property would have on the expiration of the lease. To prohibit the lessor from collecting the value of the reversion from the defaulting lessee would produce undercompensation. To see why, consider a simple example. A lease requires the promisor to make ten monthly payments of \$10 each (\$100 in total), after which the promisor must

26. See, e.g., U.C.C. § 2-302 (1989). As is well known, a contract clause will be found unconscionable if it is both procedurally and substantively defective. A supracompensatory damage measure may be substantively unconscionable. Part I implies that a promisee might contract for such a measure if the contracting process was procedurally unconscionable. For example, a promisor who could not read the contract would not exact the full price for a penalty clause; in that event, the clause could produce positive profits for the promisee. The unconscionability doctrine is sufficient to deal with such cases. Hence, the liquidated damage rule should be analyzed on the assumption that the parties' contracting process was procedurally fair.

27. 464 F.2d 267 (5th Cir. 1972). This and the next case apparently involved markets rather than bargaining environments.

28. *Id.* at 270-71. The court did not mean that the contract was unconscionable under the unconscionability doctrine, which it made no effort to apply. Rather, the court used the word "unconscionable" to mean supracompensatory.

return the leased property, which then is expected to be worth \$15 (the reversion). The promisee/lessor's expectation interest thus sums to \$115 (rent plus reversion). Let the promisor make five payments and breach. The promisee resells the property and sues. The lease, suppose, authorizes the promisee to recover \$50 (the unpaid rent) plus \$15 (the reversion or fifteen percent clause), less the resale proceeds. Thus, the promisee receives a total sum of \$115: \$50 in voluntary payments plus \$65 by resale and by action. The \$115 sum, recall, is the promisee's expectation interest so the contract ensures him full compensation, not overcompensation.

The court in *Chandler Leasing* struck the fifteen percent clause. In the illustration here, to do that would permit the promisee to recover only \$100, the promised rental payments. This undercompensates.²⁹ The fifteen percent clause thus was not a penalty but rather a necessary part of the lessor's compensatory damages. Also, because the type of liquidated damage clause involved in the case is widely used in equipment leases, the court created a precedent that, if followed, would seriously affect the leasing industry.³⁰

The second example is equally troubling.³¹ There the promisee, *A*, was to process materials that the promisor, *B*, was to ship to it. The contract required *B* to ship a minimum quantity or to pay *A* the full processing price for material that *B* did not ship, up to the specified quantity. *B* shipped less than the minimum quantity and claimed, in the lawsuit, that the minimum quantity term created a penalty. Judge Posner agreed, holding that the clause overcompensated the promisee *A* on an expected basis. Because *A* would incur no variable processing costs for unshipped material, yet would be paid as if it had done the work, the contract would permit *A* to do better on breach than it would do on performance (when it would get the full price less its processing cost).

This analysis was erroneous. The minimum quantity clause was functionally equivalent to a take-or-pay clause. These clauses require buyers/promisors to pay sellers/promisees the full price on a specified minimum quantity. If the promisor breaches by taking less than the stated minimum quantity, the promis-

29. The court was concerned that the promisor might breach toward the end of the lease and that enforcement of the 15% clause would then create a penalty. This is incorrect because the timing of breach is irrelevant. In the example in text, suppose that the promisor made \$99 in payments and then breached. The contract would permit the promisee to recover \$16 (unpaid rent plus reversion) while the court would permit him to recover \$1. This is too little because the promisee's expectation interest sums to \$115.

30. The Comment to § 2A-504 of the proposed new U.C.C. Article 2A dealing with lease contracts describes clauses such as the one used in this case as "common in leasing practice." A similar case to *Chandler Leasing* is *Lee Oldsmobile, Inc. v. Kaiden*, 32 Md. App. 556, 363 A.2d 270 (Md. Ct. Spec. App. 1976) in which a retail automobile dealer's contract authorized it to retain the downpayment as liquidated damages. Such clauses are common in retail contexts. The court struck the clause "because at the time the contract was made, . . . any damages which would result from a possible future breach . . . would be easily ascertainable." These damages would be the difference between the contract and market or resale prices. The dealer, however, apparently was a lost volume seller, whose typical suit would be for profits. These are hard to prove. The liquidated damage clause probably represented a reasonable estimate of those profits and thus should have been sustained.

31. The case is *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284 (7th Cir. 1985).

ee can recover the price although it saved variable cost by not having to produce the goods. Take-or-pay clauses authorize promisees to recover the full price on a minimum quantity rather than the contract market differential on the larger amount that the parties expect will be shipped because the contract market differential can be difficult to prove in court. The formula for creating the minimum quantity is chosen so that the specific performance damages under the contract equal the contract market differential for the larger amount the parties expected to trade. Thus damages under take-or-pay clauses are not penal.³² Hence, a judge as expert in economics and as friendly to freedom of contract as Judge Posner created a precedent that, if generalized, would outlaw an efficient practice in several industries (take-or-pay clauses are used in natural gas, coal, and electricity contracts).³³

These examples suggest that there may be more to fear from judicial oversight than from poor party predictions. Thus the branch of the liquidated damage rule that authorizes *ex ante* judicial review should be repealed.³⁴

The *ex post* branch of the liquidated damage rule authorizes a court to strike a stipulated sum that turns out to be above the promisee's loss. This aspect of the rule may seem justifiable because a remedy that is supracompensatory in

32. For discussion of take-or-pay clauses, see Crocker & Masten, *Efficient Adaptation in Long-Term Contracts: Take or Pay Provisions for Natural Gas*, 75 AM. ECON. REV. 1083 (1985); Masten, *Minimum Bill Contracts: Theory and Policy*, 37 J. INDUS. ECON. 85 (1988).

33. Judge Posner recognized that the contract in this case resembled a take-or-pay clause but believed that the take-or-pay clause in such industries as natural gas could be compensatory only because suppliers there had a very large ratio of fixed to variable cost; the clause must overcompensate, he held, where the promisee incurred "only a fraction of its costs before performance began." This is incorrect: the clause never overcompensates on an expected basis. A take-or-pay clause may be *ex post* inefficient when demand collapses; then the efficient trading quantity may be less than the contract minimum. To find the efficient trading quantity, a court would have to know the relevant demand and cost curves. The discussion of the *ex post* branch of the liquidated damage rule shows that courts should not attempt to reconstruct such economic variables. See text this page. Judge Posner's difficulty probably stemmed from the fact that he had made no study of liquidated damage clauses generally and neither party mentioned take-or-pay clauses during the case. That courts and lawyers seldom are industry experts is the reason why courts generally do not review contract clauses.

Courts often strike liquidated damage clauses if the promisor can breach in several ways but is required to pay the same stipulated sum for any breach. Such clauses are considered penal because they necessarily overcompensate when the default is small. This reasoning erroneously assumes that it is costless to specify the expected loss for every type of breach that could occur. Creating stipulated sums actually is costly, so parties sometimes specify sums that reflect mean or minimum expected losses. Contracts that do this will not overcompensate promisees on average. An example of judicial misunderstanding here is *Stock Shop, Inc. v. Bozell & Jacobs, Inc.*, 481 N.Y.S.2d 269 (N.Y. Sup. Ct. 1984). The plaintiff shipped a large number of original color transparencies to defendant for possible use by one of defendant's clients in an advertising campaign. Specifying the value of each photograph in a large batch would be expensive so the contract recited that defendant "agrees . . . that the reasonable minimum value of . . . [each individual lost] . . . transparency shall be no less than fifteen hundred (\$1,500) dollars." Defendant lost several photographs. The court did not dispute plaintiff's claim, in the suit for stipulated damages, that its liquidated damage clause was standard in the industry. Nevertheless, the clause was held to be invalid in expectation because the "\$1,500 per photograph figures may bear no relationship to the actual value of a photograph."

34. Rea argues that a liquidated damage clause that is penal in expectation probably reflects either unconscionability or some form of mistake and so should be stricken. See Rea, *supra* note 8. This argument is unpersuasive for the reasons given in text; that is, courts should apply the unconscionability doctrine if there is reason to believe that a procedural defect existed, and, absent such a defect, should not review contracts to correct mistakes.

the event could induce an inefficient performance. Courts, however, cannot easily know when a clause is supracompensatory. Promisees contract for stipulated sums when it would be expensive or impossible for them to prove their actual loss. In addition, the existence of ex post judicial review sometimes forces a promisee to attempt to prove that loss in order to defeat the promisor's claim that the stipulated sum is penal in application. Because this is hard to do, a promisor's ability to force substantive review encourages promisors to breach when performance would be efficient. Since promisees stipulate sums just in order to avoid this danger, substantive ex post review reduces the efficacy of liquidated damage clauses. And since these clauses are no more likely than other contract terms to malfunction, ex post judicial review is no more justifiable here than elsewhere. Therefore, the branch of the liquidated damage rule that authorizes this review should be repealed also.³⁵

B. *Specific Performance*

Contracts for specific performance are unenforceable, but courts award specific relief when damages are inadequate. The ban on specific performance contracts is best justified in the same (unpersuasive) way as the ban on penalty clauses. There is an ex ante aspect. The specific performance remedy can function in the same way as a penal damage measure; a promisor who fails to perform specifically is subject to severe sanctions. Hence, promisees could *seek* specific performance contracts in order later to induce promisors to perform

35. Section 2A-504(1) of the proposed new U.C.C. Article dealing with leases eliminates ex post judicial review of liquidated damage clauses in lease contracts. The Comment does not explain why, but good reasons for the reform exist.

Commentators occasionally claim that liquidated damage clauses create externalities while expectation damages do not. See Chung, On the Social Optimality of Liquidated Damage Clauses (unpublished manuscript on file with author); Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237 (1981). It apparently follows that courts should award the expectation in preference to enforcing a liquidated damage clause. This conclusion assumes that courts know what the expectation is. In contrast, promisees commonly use liquidated damage clauses when the rules that damages must be foreseeable and provable with reasonable certainty would otherwise preclude recovery of the expectation. Since compensatory damages are efficient relative to no damages, courts should enforce liquidated damage clauses though they may create externalities. Also, the scope of the externality argument is unclear. The interesting Chung paper, *supra*, for example, argues that the promisor and promisee will agree to a penalty clause in order to improve the bargaining power of the promisor in an ex post negotiation with a later buyer, who is expected to appear in the interval between the time the contract is made and the time when it is to be performed. Such penalty clauses sometimes could prevent higher valuing buyers from purchasing, but the circumstances under which the argument holds seem limited.

Professor Daniel Friedmann recently criticized efficient breach theory. See Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1 (1989). According to Professor Friedmann, giving the promisee a property right in a promised performance is more consistent with our society's general normative views than, and would not increase transaction costs relative to, a rule that permitted promisors to breach on the payment of compensation. Professor Friedmann does not claim that supracompensatory damages are efficient nor does his argument support general judicial review of liquidated damage clauses. He concludes that "parties in a contractual setting should be left free to define the ambit of their rights, and it is open to them to stipulate that the promisor will be allowed to terminate the contract subject to payment of damages." *Id.* at 23.

more frequently than their costs and the promisees' valuations would justify, or to require promisors to purchase their freedom by making supracompensatory payments. It was shown above that promisees prefer contracts that deny them these powers. Consequently, the "ex ante" justification for banning contracts for specific relief is incorrect.

If courts were to enforce these contracts, there remains the question what should be done when the contract is silent respecting remedies. Promisees generally prefer damages when the market offers good substitutes for the promisor's performance. An order for specific relief may take years to get; in the meanwhile, the promisee could not carry on his affairs. A promisee would rather purchase a substitute promptly and sue later for monetary relief.³⁶ In contrast to this general promisee preference, specific performance is optimal relative to damages in two important cases. In the first, the expectation measure is not monetizable. Hence, the parties could neither rely on courts to award it nor create liquidated damage clauses. Specific performance is efficient relative to no remedy. In the second case, renegotiation is cheap. Then specific performance can be efficient relative to damages.³⁷ Promisees also may prefer specific performance when they anticipate difficulty in collecting money. The parties' preferences respecting specific relief thus may be too context-dependent to support the creation of any general default. On the other hand, some rule is necessary. Perhaps the best solution is to make damages the default, in consequence of the general promisee preference for substitutional relief, but to enforce specific relief clauses.³⁸

There also is an "ex post" aspect to the ban on specific performance contracts. A promisee with a contract right to specific performance may later learn that the market provides good substitutes but forego these in favor of threatening specific performance to exploit the promisor. Restricting specific performance to cases when the legal remedy is inadequate deters this behavior. The concern to prevent exploitation cannot justify the ban on specific performance contracts for two reasons. First, promisees would not seek these contracts in order to exploit. Promisors know when substitutes are conveniently obtainable ex post. Hence, a request for a specific performance clause when it likely would be unnecessary may excite suspicion (and a high price). Thus exploitation could occur only when a promisee who contracted for the right to specific relief later discovered that such relief was unnecessary but chose to demand it to extort

36. This argument was first made in Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979).

37. See Rogerson, *supra* note 10 (when renegotiation is costless, buyer engages in ex post reliance and buyer has bargaining power, specific performance remedy induces more optimal reliance than damage remedy).

38. An implication of this solution is repeal of the rule that a promisee/buyer always can get specific performance of a promise to sell realty. There seems no evidence that such promisees commonly prefer specific relief to damages. To the contrary, agreements to sell real property frequently contain liquidated damage clauses.

a large payment. This apparently would seldom happen. Second, bad faith promisees seldom could make credible extortion threats. As said above, when substitutes exist, promisees commonly do better to buy them. Also, the promisor could purchase a substitute and supply it to satisfy her contractual duty. Hence, a promisee who threatens a specific performance suit when a thick market exists *ex post* is unlikely to be believed.

The argument that promisees would not use the right to obtain specific performance to exploit promisors generates two predictions. First, requests for specific performance will be as uncommon in jurisdictions where specific performance is freely available as they are here. If promisees seek specific performance only when substitutes are unavailable, and do not seek to exploit, then the incidence of specific performance requests should be invariant to the legal regime, so long as market conditions are roughly the same across these regimes. This prediction is consistent with impressionistic evidence that specific performance is seldom sought in European jurisdictions where the remedy is easy to get.³⁹ The second prediction is that promisees who litigate specific performance cases to judgment almost always win. American doctrine holds that the promisee is entitled to specific performance when the remedy at law is inadequate. If promisees seek specific performance when market substitutes clearly do not exist, rather than to extort promisors, then promisee plaintiffs obviously would lack an adequate legal remedy and so should always prevail. This prediction was confirmed by a recent survey of many cases, which found that specific relief almost never is denied on the ground that plaintiff had an adequate legal remedy.⁴⁰ Promisees have no greater incentive to exploit when the remedy is made available by contract than when it is made available by law.

In sum, specific relief clauses as well as liquidated damage clauses should be freely enforceable. Promisees would not seek either type of clause to exploit promisors, nor is the danger of *ex post* exploitation serious. Just as courts apply the standard damage rules when the contract does not contain a liquidated damage clause, they should apply these rules if the contract is silent respecting specific performance. The damage remedy usually is best, but the parties should have discretion to substitute other remedies. If courts enforced clauses for specific relief while letting damages be the default, the current rules regulating the granting of specific relief are unnecessary. Regulation is superfluous when contract will do.

39. Schwartz, *supra* note 36, at 277 & n.24.

40. Laycock, *The Death of the Irreparable Injury Rule*, 103 HARV. L. REV. 688 (1990). Making specific performance clauses enforceable probably would expand use of the remedy; parties could define damage adequacy for themselves rather than rely on the courts' relatively restricted definition.

C. Punitive Damages

Promisees prefer there not be a punitive damages remedy for the same reason that they reject penal contract measures. The likelihood that the promisee would sue on either remedy, if it existed, would induce the promisor to perform too frequently. Promisors charge extra if they have to perform in loss states. These higher prices reduce the promisees' expected gains from trade below the gains they would make under the expectation measure. Because both punitive damages and penal contract measures have this effect, promisees want neither remedy. Thus the traditional rule against awarding punitive damages for contract breach should be retained.⁴¹

Punitive damages also should not be awarded for the tort of inducing breach of contract because imposing a penalty on the third party has the same effect as imposing the penalty on the promisor. To see how, suppose that a third party is considering whether to bid for the promisor's performance. The third party would reduce the size of her bid by the value of the sanction that the promisee could impose on her. If the promisee could only sue the third party for the promisee's expectation, the third party would induce breach whenever she valued the promisor's performance more highly than the promisee did. If the promisee could sue for punitive damages, the third party would reduce her bid by the amount of the penalty. When the penalty is high enough, the third party would not attempt to induce breach although her valuation is highest. In these cases, the promisor would perform although the (opportunity) cost of performance—the third party's best offer—exceeded the value of performance to the promisee. Promisees *ex ante* prefer not to have damage rules that generate this result.⁴² Hence, only compensatory damages should be awarded for the tort of

41. An example of the cases that are disapproved here is *Hibschman Pontiac, Inc. v. Batchelor*, 266 Ind. 310, 362 N.E.2d 845 (1977). In *Hibschman*, compensatory damages for breach of a repair and replacement warranty on a new car were \$1,500. The Indiana Supreme Court held that while the evidence would support a verdict that "appellant merely attempted to fulfill its contract and to do no more than that contract required," the facts also would support an inference "that Hibschman Pontiac acted tortiously and in willful disregard of the rights of Batchelor" by not making repairs and by trying "to convince Batchelor that the problems were not with the car, but rather with Batchelor." The jury awarded punitive damages of \$15,000, ten times actual losses. The supreme court reduced the penal multiplier to five and affirmed. In a more recent example, according to the *Wall Street Journal*, plaintiff sued E.F. Hutton & Co. because his broker pursued a more risky trading strategy than plaintiff believed he had authorized. Plaintiff lost \$27,000 which the jury awarded him; the jury also awarded \$800,000 in punitive damages, a penal multiplier of almost thirty. See *Wall St. J.*, Sept. 26, 1990, § B, at 7, col. 1.

42. This analysis rests on the assumption that promisees prefer to profit from performance, not speculate on the later appearance of parties with valuations higher than their own. If promisees plan to search *ex post* for other parties who have valuations higher than their own and propose these parties to the promisor, then they must be compensated for this activity. Such promisees could contract for "penal" damage measures (or prefer a punitive damage award); the increment of damages above the expectation actually would be compensation for incurring search costs. See Haddock, McChesney & Spiegel, *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CALIF. L. REV. 1, 34-36 (1990). This possibility is ruled out by the assumption here that promisees want only performance. The possibility also is consistent with this Article's argument: Haddock, et al. show that the promisee would contract to get his expectation plus a competitive return for the service of finding a higher valuing promisee, not that the promisee would prefer a supracompensatory remedy when he provided no search services. As an empirical matter, promisees seem

inducing breach. The *Pennzoil* case shows that this reform would have important consequences.⁴³

This analysis of the punitive damages remedy rests on the assumptions that the expectation interest is fully compensatory and that promisees always will sue to obtain it. Given these assumptions, punitive damages are inappropriate to vindicate the promisee's interest in realizing gains from trade. Both assumptions are questionable, however. Respecting the former, punitive damages sometimes are awarded to compensate the promisee for dignitary losses that the expectation remedy traditionally excluded.⁴⁴ This is a weak rationale for punitive damages. The law generally refuses to compensate for emotional harm because the damages are difficult to foresee and to prove with reasonable certainty. If the unforeseeability and uncertainty objections are too weak to bar the award of damages for dignitary losses, then these losses should be included in the promisee's expectation. If the objections are telling, then compensation for dignitary losses cannot be justified by calling the compensation "penal." Thus the argument against awarding punitive damages for breach of contract is unaffected by the recognition that some losses are intangible. The assumption that promisees always sue is more troublesome. Part IV considers this assumption in detail.⁴⁵

III. ASSUMPTIONS OF THE ARGUMENT

The analysis in Part I rested on several assumptions. Some of these, such as that the parties do not engage in postcontractual reliance, have been discussed above. Four assumptions have not been considered. Part III discusses three of them. The fourth, that promisees always sue, is analyzed in Part IV.

to provide these services infrequently.

43. The *Pennzoil* case involved a suit for inducing the breach of a merger agreement. The Texas appeals court affirmed a judgment against the inducer of \$10 billion, of which \$3 billion were punitive. See *Texaco, Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. Ct. App. 1987). A general criticism of the tort of inducing breach of contract is in Perlman, *Interference with Contract and Other Economic Expectancies: A Clash of Tort and Contract Doctrine*, 49 U. CHI. L. REV. 61, 78-89 (1982). For recent defenses of the tort see BeVier, *Reconsidering Inducement*, 76 VA. L. REV. 877 (1990); Epstein, *Inducement of Breach of Contract as a Problem of Ostensible Ownership*, 16 J. LEGAL STUD. 1 (1987). The argument in text holds only that punitive damages should not be awarded against the tortfeasor.

44. See Chapman & Trebilcock, *Punitive Damages: Divergence in Search of a Rationale*, 40 ALA. L. REV. 741 (1989). The Restatement (Second) now provides that damages "for emotional disturbance" should be granted when "the breach is of such a kind that serious emotional disturbance was a particularly likely result." RESTATEMENT (SECOND) OF CONTRACTS § 353 (1981).

45. The analysis here of the normative implications of a promisee preference for compensatory relief can be extended to any remedy that may be thought to overcompensate, such as restitution or the cost of completion rule. For example, a breaching promisor is permitted to receive restitution damages. RESTATEMENT (SECOND) OF CONTRACTS § 374(1) (1981). This rule is justifiable because the contrary rule would put the promisee in a better position than performance would have done; that is, a legal rule which denied restitution would function as a penal damage measure. Since the parties prefer there not to be penalties, they would contract for the rule awarding restitution if the law did not supply it. Other extensions of the analysis here are omitted for brevity. A general discussion of possibly supracompensatory remedies is in Craswell, *Contract Remedies and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988).

A. *Promisees Do Not Prefer Risk*

The analysis assumes that promisees do not prefer risk. A promisee that likes risk may want to treat his contract as a lottery ticket that pays his valuation minus the price upon performance and a multiple of this sum upon breach. The price increase that this preference induces is the cost of the lottery ticket. There seems not to be evidence that parties treat commercial contracts as lottery tickets. Rather, these parties make contracts to obtain the gains from engaging in contracting behavior. Hence, the assumption that the parties do not prefer risk seems innocuous.⁴⁶

B. *Promisees Cannot Affect the Odds of Breach*

Part I also assumed that the promisee cannot affect the likelihood that the promisor will breach (except through the promisee's choice of a damage measure). In the analysis above, the promisor's breach decision is a function of her costs, which are assumed to be exogenously determined. Hence, the assumption that the promisee cannot affect the breach probability is implied by the assumption that costs are exogenous. Suppose instead that a promisee, after the contract is made, could increase the promisor's costs such that the promisor would prefer breach. Such a promisee may seek a penal damage measure if his expected gain from inducing breach exceeded the reduction in his gain from the contract's higher price.⁴⁷ The *ex ante* branch of the liquidated damage rule permits a court to strike a clause that is so motivated. Also, a liquidated sum that is compensatory in the expectation may turn out to be supracompensatory in the event. A promisee then may attempt to induce breach to collect the penalty.⁴⁸ The *ex post* branch of the liquidated damage rule eliminates the incentive to induce breach because it holds that supracompensatory clauses are unenforceable. Thus the conclusions reached above would have to be modified if promisees commonly could, and also would, substantially increase a promisor's costs after the contract were made.

The assumption that promisees cannot affect the odds of breach is often true. For example, a buyer seldom can affect the failure rate on the seller's

46. When the parties are risk averse, their preference for contract remedies is influenced by their concern for risk sharing. See, e.g., Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427 (1983). Liquidated damage clauses are commonly sought by commercial promisees. These promisees are not risk averse if they are maximizing profits, because then their utility functions are linear in income. The analysis above goes through if promisees are risk neutral or risk averse.

47. A promisee could profit from this strategy only if the promisor did not anticipate it and raise the price to reflect the possibility that breach could be caused by the promisor as well as by exogenous events.

48. Clarkson, Miller, and Muris argue that this is a serious danger. See Clarkson, Miller & Muris, *Liquidated Damages v. Penalties: Sense or Nonsense*, 1978 WIS. L. REV. 351. The text next argues that the danger ordinarily is remote. In unusual cases when such strategic behavior is feasible, the parties seemingly avoid it by using third-party bonding mechanisms. See Kroeber, *An Alternative Mechanism to Assure Contractual Reliability*, 12 J. LEGAL STUD. 333 (1983).

assembly line. When the promisee could affect the odds of performance, the question is whether he would bargain for a penalty rule in anticipation of doing so; if not, the assumption of promisee powerlessness does not affect the conclusions reached above. Promisees would not bargain for penalty clauses in the hope of later causing contract breaches, nor would promisees often exploit promisors when stipulated sums turn out to be penal, because in both situations the costs of inducing breach seem higher than the gains. A promisee would incur three categories of cost. First, the contract price is higher when the damage rule is penal. Second, inducing breach can create reputational losses. Third, the promisee could himself be liable for damages. Respecting the third cost, inducing breach to collect liquidated damages is a violation of the legally implied covenant of good faith. A promisee who is found to have violated this covenant cannot collect liquidated damages and also is liable for the promisor's lost expectation.

The gains from successfully inducing breach are unlikely to exceed these three categories of cost. The first cost is incurred for sure (because the price is higher when the contract's damage measure is higher); the last two costs are increasing in the possible gains. To see why this is so, realize that when the liquidated damages that the promisee would collect are large, the promisor is determined to perform. The promisee would have to make strenuous efforts to induce a determined promisor to breach. The more strenuous are these efforts, the more likely is it that third parties will recognize that the efforts had been made. Attempting to induce breach when the penalty is high thus disadvantages the promisee in two ways: it increases the promisee's reputational loss and it eases the promisor's task of proving in court that the promisee violated his duty of good faith. Therefore, the strategy of attempting to induce breach is least likely to pay off when it is most desirable to pursue—when the liquidated damages would be large. On the other hand, a promisee would not seek a small liquidated damage clause with the object of inducing its breach, nor would he engage in *ex post* strategic behavior just to collect slight damages. Thus the assumption that promisees cannot affect the likelihood of breach also is effectively true.

C. Both Parties Share the Same Breach Probability Estimate

This assumption's relevance to the argument should first be explained. The promisee wants a damage measure that equals the value he expects performance to have. The price that the promisee will pay for such a damage measure is this value times the probability he assigns to breach. A mistake in predicting the breach probability does not imply a mistake in predicting the value of performance unless these variables are correlated. When they are not, a promisee mistaken about probabilities will be willing to pay too much for a compensatory damage clause (if he overestimates) or unwilling to pay the correct amount (if

he underestimates), but will not buy the wrong sum. Hence, relaxing the assumption that promisees know the breach probability can affect the argument only when the two variables of breach probability and performance value are correlated.⁴⁹

The possibility that this correlation exists does not support the case for judicial review of liquidated damage clauses for three reasons. First, promisee mistakes may generate few penalties. Promisees in the correlated case will not seek penalties when they underestimate breach probabilities. Promisees who overestimate will seek penalties only sometimes, because overestimates may not only cause promisees to overestimate the value that performance will have but also may cause promisees to underestimate value. Respecting the former possibility, suppose that the likely cause of a breach is a foreign embargo. If the embargo occurs but the promisor nevertheless delivers, the product will be worth a lot. A promisee who overestimates the likelihood of an embargo thus may also overestimate the value that performance would have were an embargo to occur. Such a promisee will (inadvertently) contract for a penalty. Respecting the latter possibility, let the likely cause of breach be shrinking demand for the product (the promisor will get so few orders that she will do better not to produce). A promisee who overestimates the likelihood of a fall in demand will (inadvertently) purchase an undercompensatory damage measure, because when demand falls the product is worth little to him. In sum, overestimates in the breach probability will not systematically induce promisees to purchase penalty clauses while underestimates in this probability cannot generate penalties. Thus promisee mistakes may produce few penalty clauses in the correlated case.

Second, there is no reason to think that promisee errors are systematically high or low. If promisee estimates of the breach probability are unbiased—partly random but correct on average—judicial intervention could improve matters on average only if courts could shrink the error term. This would happen if courts acting *ex post* could create damage measures that are materially closer to the measures that the true economic variables imply than the parties could create *ex ante*.⁵⁰ This is unlikely. As argued in Part II.A, judicial review of liquidated damage clauses apparently has not been successful.

Third, the breach probability and promisee value variables seem uncorrelated much of the time. The factors that may induce a producer of ball bearings to breach, for example, seem uncorrelated with the value of ball bearings to each member of the heterogeneous set of ball bearing buyers. When these variables are uncorrelated, promisees will not contract for penalties. And

49. When the parties' estimates of the breach probability differ, there is an incentive to speculate respecting the damage measure. This outcome is ruled out here by the assumption that the parties prefer not to speculate with liquidated damage clauses. That assumption seems plausible. Hence, Part III.C. omits discussion of speculation.

50. The adverb "materially" is added to the sentence above because litigation is expensive. Thus minor improvements in the accuracy of liquidated damage clauses could not justify systematic judicial review.

for these three reasons, the likelihood that promisees sometimes mistake the breach probability should not affect the argument here.⁵¹

IV. POSITIVE COLLECTION COSTS AND PUNITIVE DAMAGES

Promisees sometimes do not sue because they are uninformed about their rights or because litigation is too expensive. The former difficulty can be ameliorated by disclosure.⁵² The latter difficulty is discussed here. The policy issues that "rational apathy" raises have generated a large literature. To make sense of the limited aspect of the subject analyzed below, three connected issues should be noted. The first concerns the relation between the private and public spheres. Sophisticated promisees know that litigation costs are an obstacle to enforcing legal rights; their contracts sometimes deal with these costs. The state, *prima facie*, should provide unsophisticated promisees with the protections that sophisticated promisees obtain. If these parties reject certain solutions, such as penalties and the awarding of counsel fees to a successful plaintiff, should the state provide the rejected solutions to ordinary people?

The second issue concerns whether there are economies of scale to promise keeping. When no economies of scale exist, positive collection costs are unlikely to cause inefficiency. The promisee will take the cost of enforcing the contract into account when he makes it. Regulation may be justified in this case only if the state could reduce collection costs more cheaply than private parties could.⁵³ In the scale economy case, it is uneconomical for a promisor to keep her promise to just one or a few promisees; rather, she will keep her promise to a large set of promisees or none. Here positive collection costs can cause inefficiency. The threat that a given promisee will sue cannot itself induce the promisor to perform; rather, a promisee who sues can only guarantee himself compensation. This is because when not every promisee will sue, the promisor will breach if the costs of keeping her promise are below the gains to promisees as a group but above the costs of compensating the promisees that litigate. What kind of regulation would best ameliorate this inefficiency?

51. Mistakes in the breach probability should not influence a promisee preference for specific performance because that preference is largely a function of whether a monetary remedy can be devised, not what the probable loss from breach will be.

52. Federal law and such statutes as the Uniform Consumer Credit Code often require firms to advise consumers of their legal rights in credit and sales contracts.

53. This sentence is put tentatively because the question when the state should encourage or discourage litigation in tort contexts is complex. A concise review of the issues is in Rose-Ackerman & Geistfeld, *The Divergence Between Private and Social Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. LEGAL STUD. 483 (1987). Also, the incentive to sue is a function not only of litigation costs but also of the variance in expected returns. See Cornell, *The Incentive to Sue: An Option Pricing Approach*, 19 J. LEGAL STUD. 173 (1990). Thus focusing only on one variable can be misleading. Part IV abstracts from these considerations: it asks whether punitive damages is an appropriate legal response when it is known (here assumed) that underenforcement of the law in consequence of high litigation costs would generate suboptimal promise keeping on the part of firms. A complete treatment of the relation between efficiency and incentives to sue would consider the contributions of the scholars cited here (and others).

The third issue concerns solutions. There are two ways to induce promisees to sue, by reducing their costs or by increasing their gains. Punitive damages increase the gains from suit. Should the state solve the "underenforcement problem" by reducing promisee costs or by increasing promisee gains?

This Part argues that sophisticated private parties prefer cost reduction when economies of scale exist and when they do not. Hence, the claim that promisees would not contract for penalties is unaffected when the assumption that collection costs are zero is relaxed. Part IV also argues that the state should prefer the cost reduction solution too when it assists unsophisticated promisees or responds to underenforcement inefficiencies. This second conclusion does not imply that punitive damages never should be awarded for behavior that is associated with a breach of contract. The analysis above showed that penal measures are inappropriate to vindicate the promisee's interest in realizing gains from trade, given that promisees sue to protect their expectation; and it is argued below that penal measures are an inappropriate means of inducing suit. Promisors sometimes may behave maliciously and despicably enough to justify a retributive sanction. This behavior seems rare in connection with the typical contract breach, but there is a plausible case for punitive damages when it occurs. Analyzing that case is beyond the scope of the analysis here.⁵⁴

A. *Private Contracts and Collection Costs*

Promisees could reduce collection costs in three ways: (1) contract for a penal damage measure out of which collection costs will be recovered; (2) require the promisor to pay these costs if the promisor is held liable for breach; (3) reduce dispute resolution costs cooperatively. The first response collapses into the second in the private context. A promisee does not want a damage measure that would award more than the sum of his lost expectation plus legal costs (for the reasons given above); and a damage measure that would award less will not solve the promisee's problem. Hence, a promisee who wants money would not purchase a penal damage measure but rather would bargain to receive legal and related costs.

54. The American Law Institute Project on Product and Process Injuries is likely to reject the punitive damages sanction to cure the underenforcement problem, if successful plaintiffs can recover legal fees, but retain the sanction to deal with cases of outrageous producer behavior. See ALI, *COMPENSATION AND LIABILITY FOR PRODUCT AND PROCESS INJURIES*, FINAL REPORT, PRELIMINARY DRAFT NO. 3, vol. 2, ch. 2 (Oct. 1990). A thoughtful argument for applying punitive sanctions to such conduct is provided by Grady. See Grady, *Punitive Damages and Subjective States of Mind: A Positive Economic Theory*, 40 ALA. L. REV. 1197 (1989). There also seems to be a case for punitive damages in thin markets, when a party takes another's entitlement to property or bodily integrity. This is because repairing the injured party's loss may be insufficient to deter such takings; rather, the taker must be "made whole" too, by being forced back to its status quo ante utility level. A punitive sanction sometimes is necessary to achieve this. See Haddock, McChesney & Spiegel, *supra* note 42. This is an interesting argument but seems unrelated to the concerns discussed in this part of the article. Part IV considers cases in which the parties operate in thick markets and just breach or perform.

Commercial parties, however, commonly reject this solution. This probably is because each party is the most efficient bearer of the risk that it will incur collection or defense costs. The magnitude of these costs is difficult to predict at contracting time; hence, the typical contract would have to award a party "reasonable" attorneys' fees on breach. This arrangement would cause the moral hazard problems associated with any cost plus contract. Counsel would have an incentive to devote excessive resources to the prosecution or defense of any case it may win because in such cases the party's litigation costs are less than the expected final burden; there is a positive probability that legal costs can be imposed on the other side. Also, the cost of an attorneys' fee clause is hard to calculate *ex ante*. Thus, each party probably would charge her contract partner too much for bearing the moral hazard risk. In addition, a party that requests a legal fee clause may be taken to signal that it would rather sue than work disputes out privately. This is a bad signal to send. Consistent with these analyses, legal fee clauses seldom are observed in commercial contracts although courts will enforce them.⁵⁵

The third response, to reduce collection costs jointly, seems more popular. Means to do this include: making contract clauses clear, which reduces the costs of litigating whether there was a breach and thus reduces the likelihood of breach itself;⁵⁶ stipulating damages, which eliminates the costs of having to prove them; using performance bonds, which have relatively low collection costs; using collateral that can be privately repossessed; and incorporating arbitration clauses. All of these methods of reducing dispute resolution costs are observed in practice.

When contractors are unsophisticated—consumers or unorganized employees—they seldom will contract for these cost-minimizing options. The state can help with the same set of responses listed above. If there are no economies of scale to promise keeping, the penalty solution collapses into the legal fee solution here as well. Unsophisticated promisees also do not want penal damage measures that award sums above or below their costs of suit. States sometimes do award legal fees to successful plaintiffs,⁵⁷ and the Magnuson-Moss Act and

55. Consumer contracts sometimes require the breaching consumer to pay the promisee firm's legal fees. The analysis here implies that the legality of these contracts should be rethought.

56. An interesting example of the effect that clarity has on breach is given by the coal industry, where contract indices in the early 1980's generated prices that were too high as measured by current spot market prices but buyers seldom breached. A knowledgeable analyst claimed that there was little breach "because the terms and conditions of long term coal contracts are typically fairly explicit and the obligations of the parties quite clear." Joskow, *The Performance of Long Term Contracts: Further Evidence From Coal Markets*, 21 RAND J. ECON. 251 (1990).

57. While no state has adopted across-the-board fee-shifting in commercial disputes, a number have legislated fee-shifting in specific areas. The major dispute so affected concerns warranties, especially the automobile warranty. See ALA. CODE § 8-20-8 (1984); CAL. CIV. CODE § 1794(d) (West 1985 & Supp. 1990); COLO. REV. STAT. § 42-12-103(3) (1990); MD. COM. LAW CODE ANN. § 14-1502(l)(1) (1990); N.Y. GEN. BUS. LAW § 742 (McKinney 1984 & Supp. 1990). New York also shifts fees to winning plaintiffs in consumer credit disputes. See N.Y. GEN. BUS. LAW § 458(i) (McKinney 1984 & Supp. 1990).

Truth in Lending Law also let winning plaintiffs collect legal fees.⁵⁸ Legislators may believe that the moral hazard risk is lower when individuals are plaintiffs. Finally, the state can reduce collection costs by encouraging the mediation and arbitration of certain disputes. These solutions also are becoming more common.⁵⁹

These reforms reduce promisee litigation costs, but the question remains whether the state should increase promisee litigation gains instead or as well. Before discussing this, it is helpful to analyze the economies of scale case and private responses to it.

B. *Private Contracting and Underenforcement*

The promisor, when deciding whether to perform, will compare the cost of compliance with the expected cost of a damage judgment.⁶⁰ When damages are undercompensatory or the promisee will sue with probability less than one, a promisor may not keep her promise although the cost of compliance is below the promisee's loss. Sophisticated promisees respond to the first cause of this inefficiency by purchasing compensatory damage measures; they respond to the second by the cost reducing methods just discussed. When there are economies of scale to promise keeping, these methods cannot ensure that the promisor will do as she agreed; they can only ensure that the sophisticated promisee will be compensated.

Economies of scale exist when a promisor must keep her promise to many promisees. For example, suppose that the promisor agrees to sell a product with a particular quality feature; it is uneconomical to install this feature on just one item. Then the promisor, when deciding whether to perform, will compare the cost of installing the feature on every item with the expected cost of promisee lawsuits. When many promisees will not sue, the costs of compliance may exceed the costs of compensating the promisees who litigate. Hence, when economies of scale exist, a promisee can assure himself of compensation, but cannot assure himself of performance, so long as the applicable damage measure provides only for compensation. Would such a promisee contract for a penalty?

58. The American Law Institute Committee on Product and Process Injuries will probably also recommend one way fee-shifting for injured individuals. ALI, *COMPENSATION AND LIABILITY FOR PRODUCT AND PROCESS INJURIES*, FINAL REPORT, *supra* note 54, at chap. 23.

59. Twenty states have adopted the Magnuson-Moss approach in connection with warranties of motor and farm vehicles. *E.g.*, ILL. ANN. STAT. ch. 121-½, para. 1204 (Smith-Hurd 1960 & Supp. 1990). The Magnuson-Moss Act specifies that if a manufacturer adopts a dispute resolution procedure complying with FTC guidelines, then a consumer with a warranty dispute cannot go to court until she has exhausted the arbitration procedure. Magnuson-Moss Warranty-FTC Improvement Act § 110, 15 U.S.C. § 2310(a)(3) (1988). The FTC guidelines require that the arbitration panel be well funded and independent of the manufacturer, that it charge no fee, and that it keep written records. 16 C.F.R. §§ 703.1-8 (1990).

60. For convenience, the text assumes that breach creates no reputational losses.

To understand how a private penal sanction would work, suppose that there are n promisees each of whom is injured with probability q and suffers the loss v .⁶¹ Then the expected total loss that all of the promisees would suffer from breach is the sum of the probability of harm times each promisee's lost value, or $\sum^n qv$. Let the promisor's cost of complying with a promise to produce a certain quality level be z per unit, and assume that this cost is less than the cost of breach ($\sum^n z < \sum^n qv$). The promisor thus should comply with her contracts. Promisees sue upon breach with probability Γ where $0 \leq \Gamma \leq 1$. The promisor's true expected cost of breach then is $\sum^n \Gamma qv$, and she will comply when $\sum^n z < \sum^n \Gamma qv$. Let Γ be low enough so that the promisor would rather breach and pay damages of v to any promisee who sues than keep her promise. She could be made to comply if each promisee bargained for a damage measure that would pay him his lost value divided by the portion of promisees who will sue, or v/Γ . Then the promisor's expected cost from breach would exceed the cost of compliance ($\sum^n \Gamma q \cdot v/\Gamma = \sum^n qv > \sum^n z$) and she will keep her promise.⁶² Because the portion of promisees who sue now is assumed to be less than one, the damage measure v/Γ exceeds the promisee's lost value v .

Promisees would not contract for this penal damage measure for two reasons. First, a promisee who buys a contract with a penal sanction is providing a public good, because the promisee pays the higher price associated with the sanction but would make no gain. As said above, a promisee could assure himself of full compensation by securing a compensatory damage measure and a reduction in his costs of collection. Even if promisees particularly want performance, each of them may reason that if he buys the compensatory measure v at a lower price than the promisor would charge for supplying the penal measure v/Γ , enough other promisees will purchase the penal measure to induce the promisor to supply the promised quality. If so, the promisee who buys only the damage measure v gets quality partly for free. Because each promisee has an incentive to freeloader in this way, the penal damage measure likely will not be seen.

The second reason why promisees probably would not purchase penal sanctions is that agreements with them are not equilibrium contracts. This is because Γ , the probability with which promisees sue, is endogenous; it is partly a function of the damage measure itself. To see why this creates a problem, assume that each promisee knows Γ and let p^p be the price if the contract's damage measure D generates a payment of v/Γ and p^c be the price if $D = v$; $p^p > p^c$ because the price increases when the promisor's expected damage pay-

61. Here v is the value that the promisee attaches to performance, just as in the analysis of Part I.

62. Commentators have observed that the underenforcement problem can be cured by "grossing up" compensatory damages—i.e., dividing the promisee's actual loss by the probability of suit. See, e.g., R. COOTER AND T. ULEN, *supra* note 20, at 391-96; Chapman & Trebilcock, *supra* note 44, at 818-19; R. Cooter, Punitive Damages For Deterrence: When and How Much? (University of California School of Law at Berkeley Program in Law and Economics Working Paper No. 89-4, 1989).

ment increases. Promisors will comply with promises when the proportion of active promisees—those that sue—is high enough. The idea of a compliance threshold can be captured by letting Γ^* be the proportion of active promisees that is high enough to induce the promisor to comply; the promisor performs when $\Gamma \geq \Gamma^*$ and breaches when $\Gamma < \Gamma^*$.

The optimal strategy for a promisee who wants performance apparently is to purchase the damage measure $D = v/\Gamma$ if $\Gamma < \Gamma^*$ at price p^p ; and to purchase the damage measure $D = v$ if $\Gamma \geq \Gamma^*$ at price p^c . In the former case, an insufficient number of promisees sue to induce compliance so the promisor will breach unless she faces the penal sanction v/Γ ; thus our illustrative promisee should be willing to buy this more expensive sanction. In the latter case, enough active promisees exist so the promisor can be induced to comply with her promise if the illustrative promisee only buys the contractual damage measure $D = v$; thus the promisee should be willing to buy only this less expensive measure.

This promisee strategy would not be pursued in equilibrium. To see why, first consider the case when an insufficient number of promisees sue ($\Gamma < \Gamma^*$). Then the strategy requires a promisee to purchase the expensive penal damage measure $D = v/\Gamma$. The proportion of promisees that sues is partly a function of the damage measure itself; more promisees will sue when they can collect v/Γ than when they can collect only v . Suppose next that enough promisees obtain the penal measure $D = v/\Gamma$ to cause the proportion of promisees that sue to rise above Γ^* . Then the posited strategy requires a promisee to shift to the less expensive damage measure $D = v$. But if promisees do this, the proportion of promisees that sues may again fall below Γ^* ; in that event, promisees must return to the penal measure $D = v/\Gamma$. This process has no natural stopping point—that is, it is not an equilibrium. The posited promisee strategy thus probably would be too difficult to use in practice. Promisees could not condition their contract choices on the proportion of litigating promisees— Γ —as the strategy requires, because Γ would be cycling up and down in consequence of the actions that promisees would be taking in accordance with the strategy.

This cycling problem is curable in theory if the parties play mixed strategies. To do this would require promisees to obtain the damage measure $D = v/\Gamma$ in a certain percent of their deals—say α percent—and the damage measure $D = v$ in $(1 - \alpha)$ percent of their deals ($0 < \alpha < 1$); and it would require promisors to comply with their promises a certain percent of the time—say ϕ percent—and to breach them $(1 - \phi)$ percent of the time. Then an equilibrium exists in which the promisees would have no reason to vary the proportion of the cases in which they pick one or the other damage measure, given the noncompliance probability that the promisors choose; and the promisors would have no reason to vary this probability given the promisees' actions. In this equilibrium, promisees sometimes would bargain for penal clauses and promisors sometimes would keep their promises.

This possibility seems more interesting theoretically than practically. Parties seldom are observed to use mixed strategies in life, apparently because it seems irrational to people to shift arbitrarily between courses of action—*i.e.*, to buy one damage rule and then for no apparent reason to switch and buy the other. Also, mixed strategies are complex to devise and play.⁶³ If the possibility of a mixed strategy equilibrium is rejected, the difficulty of contracting for a penal damage measure remains.⁶⁴

In sum, two reasons suggest that sophisticated promisees would not contract for a penal damage measure of the form v/Γ in the economies of scale case. First, to purchase the penal measure is to provide a public good. Second, the strategy of conditioning the magnitude of the damage measure on the current proportion of promisees that litigate would not be pursued in any plausible equilibrium. Because blatantly penal clauses are unenforceable, this argument cannot be tested by observing actual contracts; the law rather than the reasons discussed here may account for the lack of penal contract responses to the promisees' compliance concern. Nevertheless, the reasons seem plausible. They suggest that were penal clauses lawful, promisees still would not bargain for penal damage measures. Rather, promisees would respond to the underenforcement concern in the economies of scale case as they do in the usual case. An external benefit of the cooperative methods described above to reduce dispute resolution costs is that these methods increase the probability of contract enforcement generally and thus ameliorate the underenforcement concern.

C. *The Public Response to Underenforcement*

When there are no economies of scale to promise keeping, there is no first order efficiency case for intervention. Promisees commonly sue when the costs of suit are less than the gains, and pay less for performances when the utility

63. Both criticisms are made in A. Rubenstein, Comments on the Interpretation of Game Theory (London School of Economics Discussion Paper No. TE/88/181, 1988), who adds "that the use of mixed strategies is particularly problematic in any situation where the execution of mixed strategies is costly in terms of devoting attention or time." *Id.* at 10. When there is a cost, "a player strictly prefers to use any of the pure strategies which appear in the support of the mixed strategy." *Id.* A pure strategy equilibrium is possible in the circumstances above if there is exogenous heterogeneity among the promisees. Should some promisees never sue regardless of the size of the legal damages, then Γ may be fixed over relevant ranges of the parameters and the other promisees could condition on it. There seems no reason to suppose that a nontrivial portion of promisees is unaffected by the damage measure. The analysis in the text assumes that the promisor supplies performance in "lumpy" units—she makes all products more durable or none—rather than in continuous increments. The assumption is made for convenience and because it often is true. The conclusion that a pure strategy penal equilibrium does not exist also holds if continuous cost curves are assumed.

64. The observation that the enforcement probability is endogenous—more people sue when penalties increase—has led some commentators to question whether antitrust damages should be trebled. See Easterbrook, *Detrebling Antitrust Damages*, 28 J.L. & ECON. 445 (1985); Hovenkamp, *Treble Damages Reform*, 33 ANTITRUST BULL. 233 (1988).

calculus would go the other way.⁶⁵ The state apparently should intervene in this case only when it can reduce litigation costs more cheaply than the parties could. In the consumer case, this comparative advantage sometimes exists. When there are economies of scale, there is an efficiency case for regulation; promisors may fail to keep promises even when the aggregate gains from promise keeping exceed the costs. The state also could respond to this case by reducing promisee litigation costs. Should it instead (or in addition) permit promisees who sue to recover the penal sanction v/Γ ? Two considerations suggest that punitive damages should not be used.

First, a public decisionmaker seldom would know the enforcement error—the proportion of promisees who will not sue—especially as this proportion is partly context dependent.⁶⁶ Second, the equilibrium problem exists here too. The parties' ability to respond to penal damage rules by altering purchase contracts makes questionable the strategy of using these rules to increase the suit probability.⁶⁷

To see why, suppose that the state requires contracts to contain the penal damage measure v/Γ and Γ is caused to rise above Γ^* . Then promisees would prefer a different damage measure but the promisors are prohibited from supplying it. The parties thus will be induced to contract out indirectly. Promisors will supply contracts that differ from the "old contract," but that

65. This assumes that promisees know their legal rights or that the state has responded to imperfect information by requiring disclosure. Awarding punitive damages apparently could not cure underenforcement resulting from ignorance of legal rights; promisees would be uninformed about their right to recover punitive damages.

66. Cooter suggests that courts sometimes could infer the degree of underenforcement by comparing the ratio of the marginal decisionmaker's precaution costs to the social harm that breach could cause. See R. Cooter, *supra* note 62, at 9-10. For example, if the costs of precaution are \$100 and the harm that precaution would avoid is \$200, the ratio of the two is $\frac{1}{2}$. A firm would be on the margin between taking precautions and not only if its expected liability for not doing so equalled the precaution cost. In the example, given that the harm from noncompliance is \$200 the expected liability could equal the \$100 precaution cost only if the enforcement error (Γ in the text above) is 50%. This is the same value as the ratio between precaution costs and breach costs. Thus the enforcement error can be inferred from this ratio. Cooter's method for finding the enforcement error is imaginative, but may not help in real cases. The method requires a jury to recover ex post what would have been a correct ex ante promisor estimate of expected harm (including nonpecuniary harm) as well as the promisor's precaution costs at the margin. Juries seldom could find these facts accurately enough to enable the enforcement error to be inferred with sufficient confidence.

67. An interesting analysis of positive litigation costs when parties do not bargain is in Polinsky & Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability*, 17 J. LEGAL STUD. 151 (1988). Some commentators suggest that punitive damages are an appropriate contract law sanction because breaches can go undetected. See Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980); Sebert, *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565 (1985). Undetected breaches also create an underenforcement concern. This possibility is not discussed here. Undetected breaches could exist in product or service markets only in connection with what in the economics of information are called credence goods. Something is a credence good if the purchaser would have difficulty knowing whether he needs it or not or, if he knows that he needs it, whether it was appropriately supplied. Examples include a subset of automobile repairs and medical operations. Though undetected breaches in connection with credence goods are a concern, responding to them with penal sanctions encounters the problems discussed here. For example, a public decisionmaker is unlikely to know the percentage of undetected breaches, and so could not use a penal sanction of the form v/Γ .

promisees prefer only because the state has amended the old contract by adding a compulsory penal damage measure. When $\Gamma > \Gamma^*$, however, the promisees would prefer the old contract with $D = v$. As a concrete example, under strict products liability promisors may respond to a compulsory penal damage measure by making safer products than promisees want, because the promisor is liable to all victims and they can collect supracompensatory damages. A contract that is identical to the old contract and that generates excess safety would not exist in equilibrium. The parties would prefer a contract that supplies less product variety or a larger downpayment, etc., to restore them to the utility level they would have been on had the punitive measure not been imposed. Solving the underenforcement problem by requiring a penal measure of the form v/Γ will produce an overenforcement problem that itself leads to contracting inefficiencies. The question is whether a better strategy exists than requiring promisors always to supply the penal damage measure $D = v/\Gamma$.

The state could use another type of penal measure. Three exist. Under each of them the jury is asked whether punitive damages should be awarded given the applicable legal standard. If the answer is yes, then (1) the jury has discretion over the sum; or (2) the jury must award damages of kv , where $k > 1$ and is set by statute (i.e., damages are some multiple of actual losses);⁶⁸ or (3) the jury has discretion to award punitive damages up to a statutorily specified sum.⁶⁹ These penal measures do not respond to the underenforcement concern that purportedly justifies the resort to punitive damages, because none of them make the size of the sanction a function of the extent of underenforcement. In addition, the first penal measure creates considerable uncertainty for promisors. Thus it seems better all in all to respond to the likelihood that some promisees will not sue by reducing the costs of suit rather than by increasing the gains.⁷⁰

V. TWO APPLICATIONS

A. *The Insurance Cases*

Courts sometimes award punitive damages when individual insureds are denied benefits. In some of these cases, the insurance company promisor denied benefits because it made a mistake. In other cases, the company apparently acted under a plan. Courts reject punitive damages when they believe that the

68. See, e.g., CAL. CIV. CODE § 1794 (West 1985) (punitive damages in warranty disputes limited to twice compensatory damages); CONN. GEN. STAT. ANN. § 52-240b (West Supp. 1989) (punitive damages limited to twice compensatory damages). The ALI Committee on Product and Process Injuries probably will recommend the specified multiplier solution for cases in which it believes punitive damages are appropriate.

69. See, e.g., VA. CODE ANN. § 8.01-38.1 (Supp. 1990) (punitive damages limited to \$350,000).

70. In addition to these considerations, any damage multiplier should be low when there is a probability of legal error. See Calfee & Craswell, *Deterrence and Uncertain Legal Standards*, 2 J.L. ECON. & ORG. 279, 292-95 (1986).

company made an honest mistake⁷¹ but authorize them when the company behaved badly. The courts may be granting punitive damages too frequently.

Courts award punitive damages for three reasons: to vindicate the promisee's interest in making gains from trade; to induce promisees to sue; and to punish despicable promisor behavior. The first two reasons cannot justify the award of punitive damages. In some of the insurance cases, the promisor's behavior seems to have reflected the incompetence of low level employees rather than actual malice. Because incompetence is regrettable but not despicable, punitive damages perhaps are awarded too frequently in the insurance context.⁷²

B. *The Employment Cases*

Wrongful dismissal cases come in three kinds. First, the dismissal is without good cause; a foreman takes an unjustified dislike to an employee. In this case, if the dismissal is a breach of contract, the employee loses the expectation of receiving future wages. Punitive damages should not be awarded in addition to this expectation; the ability to claim them would reduce the value of the employment contract just as it reduces the value of other contracts. In the second case, the dismissal violates a public policy. For example, the employee was discharged for cooperating with a public agency investigating the company or its customer.⁷³ The question whether punitive damages should be awarded in this case is complex. On the one hand, awarding them encourages employees to help enforce the law. On the other hand, since the expected cost of punitive judgments is reflected in wages, employees as a group are drafted in the service of the state. The appropriate resolution of this conflict is beyond the scope of this Article.

In the third case, the employee is dismissed under humiliating circumstances, causing her to incur a noncommercial loss.⁷⁴ Punitive damages would be inappropriate here because there are no economies of scale to good firm behavior. The promisor's ability to discharge a particular promisee employee with dignity is independent of its ability to discharge any other employee with

71. *E.g.*, *Garule v. Illinois Mut. Life and Casualty Co.*, 152 Ariz. 600, 734 P.2d 85 (1987); *California Shoppers, Inc. v. Royal Globe Ins. Co.*, 175 Cal. App. 3d 1, 56, 221 Cal. Rptr. 171, 201 (1985).

72. Courts affirm large punitive damage awards in these cases apparently because they believe that legal fees deter insureds from suing on moderate claims, and that the companies, in consequence, are too reluctant to pay these claims. The punitive sanction is thought to encourage the companies to pay. The companies' reluctance to comply with their contracts is unfortunate (if it exists), but awarding legal fees is a better solution for the reasons given.

73. *E.g.*, *Palmateer v. International Harvester Co.*, 85 Ill. 2d 124, 421 N.E.2d 876 (1981) (where employee was discharged in retaliation for supplying information to local law enforcement officials, action is in tort and punitive damages are appropriate).

74. *E.g.*, *Agis v. Howard Johnson Co.*, 371 Mass. 140, 355 N.E.2d 315 (1976); *Harless v. First Nat'l Bank*, 169 W. Va. 673, 289 S.E.2d 692 (1982).

dignity. This third case may involve unsophisticated promisees, however. Thus here the state may wish to reduce collection costs for individual employees.⁷⁵

VI. CONCLUSION

Contract Law had been consistent in its treatment of liquidated damage clauses, punitive damages, and specific performance. The courts refused to enforce contractually specified sums that appeared to be penalties; refused to permit disappointed promisees to recover penal damages; and refused to enforce contract clauses that required specific performance. Recently, this consistency has been breaking down; the liquidated damage and specific performance rules are unchanged, but there has been greater leniency in granting punitive damages to certain classes of promisees, such as insureds whose claims were wrongfully denied. This Article urges courts to be consistent on a deeper level. It shows that promisees do not want contracts that would award them greater compensation than the expectation provides. Thus courts should enforce all liquidated damage and specific performance clauses; there is no persuasive justification for the current practice of treating these contract terms specially. Promisees that reject contractual penalties also prefer not to receive punitive damages for contract breach; the rules authorizing penal awards are just implied terms in the promisees' contracts. Consequently, punitive damages should not be granted to vindicate a promisee's interest in making gains from trade.

The analysis that generates these conclusions rests on several assumptions, of which the most controversial is that promisees always sue to protect their expectation. Because promisees do not always sue, there is a case for legal intervention. The state can increase the frequency of suit by reducing litigation costs or by increasing litigation gains. The latter is done by awarding punitive damages to disappointed promisees. Private parties prefer the cost reduction solution and so, it is argued, should the state. Hence, punitive damages should not be awarded to encourage parties to vindicate their contractual rights. There remains a retributive case for punitive damages when promisors behave in a despicable fashion. Such behavior constitutes a tort and so is beyond the scope of the analysis here.

This Article's argument rests on the premise that because the rules criticized here presuppose a promisee preference for supracompensatory remedies, showing that that presupposition is mistaken is a sufficient justification for reform. The rules, however, seem also to be the product of a "court centered-

75. For example, California requires the losing defendant in a dispute involving the nonpayment of wages or benefits to pay the plaintiff's legal fees. CAL. LABOR CODE § 218.5 (West 1985). Punitive damages are granted in medical malpractice cases, where patient and doctor are in a contractual relationship. The analysis above applies to these cases, except that the retributive justification for a punitive sanction may exist more frequently in the malpractice context because the defendant is an individual person. See *Nelson v. Gaunt*, 125 Cal. App. 3d 623 (1951) (punitive damages awarded against doctor who injected patient with illegal substance after having been previously arrested for prescribing the substance).

ness" that is at Contract Law's core. Court centeredness, loosely defined, holds that courts should ensure that performance under a fair reading of a contract's terms would not contradict the parties' "deeper" intentions and fairness.

Court centeredness produced the famous and still influential opinion in *Jacob & Youngs v. Kent*.⁷⁶ As is well known, the contract there required plaintiff contractor to install "Reading" pipe in the defendant's home, but the contractor installed a substantial amount of "Cohoes" pipe. The market value of defendant's home seemed trivially affected by the substitution, but defendant's architect refused to certify that the work was completed properly. The defendant then refused to make the final payment. Judge Cardozo relied on "considerations partly of justice and partly of presumable intention" to hold that when the value diminution was small and the remedial cost large, the home owner was limited to the value diminution. This result seemed precluded by the contract, which explicitly dealt with remedies. It recited that work "which is defective or which is not fully in accordance with . . . the specifications, in every respect, will be rejected and is to be immediately torn down, removed . . . or replaced in accordance with the . . . specifications, whenever discovered" However, "The owner shall have the option at all times to allow the defective or improper work to stand and to receive from the Contractor a sum of money equivalent to the difference in value of the work as performed and as herein specified."⁷⁷ The contract thus gave defendant the power to choose between the cost of completion and diminution in value damage measures, but the court reserved this power for itself.

A similar reluctance to yield control over remedies is reflected in the rules criticized here. Liquidated damages law permits sophisticated commercial parties to agree only to those monetary damage measures that courts will find "reasonable." Specific performance law reserves to courts the power to decide when specific or substitutional relief is appropriate. The recent expansion of punitive damage awards reflects court centeredness of a different kind. The underenforcement of substantive rules can be ameliorated by reducing the parties' litigation costs or increasing the litigation gains for disappointed promisees. The parties and the legislatures can best reduce litigation costs. Courts can increase the gains, and have actively done so. Court centeredness in Contract Law extends beyond remedial issues. An example is the courts' tendency to restrict party efforts to contract out of statutory rules that were explicitly meant to be defaults.⁷⁸

Court centeredness as well as a mistaken view of the economics of contract thus seems to explain the existence of the rules analyzed above. This Article argues that a better understanding of the economics shows that the commitment

76. 230 N.Y. 239, 129 N.E. 889 (1921).

77. The quoted clause is set out in R. SCOTT & D. LESLIE, *CONTRACT LAW AND THEORY* 78 (1988).

78. This tendency is analyzed in Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261 (1985).

to court centeredness as applied to contract remedies is misplaced. Another way to put this conclusion is that the parties will choose appropriate remedies when left to their own devices. Similar arguments have been made respecting other aspects of contract. The question now, it seems, is whether defenders of court centeredness can show how their commitment to it is reconcilable with Contract Law's parallel commitment to party autonomy. Absent this showing, one of these foundational commitments must be abandoned.