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The Failure of Economic Interpretations of the Law of Contract Damages

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Abstract

The law of contracts is complex but remarkably stable. What we lack is a widely accepted interpretation of that law as embodying a coherent set of normative choices. Some scholars have suggested that either economic efficiency or personal autonomy provide unifying principles of contract law. These two approaches, however, seem incommensurable, which suggests that we must reject at least one of them in order to have a coherent theory. This Article dissents from this view and has a simple thesis: Economic accounts of the current doctrine governing contract damages have failed, but efficiency arguments remain key to any adequate theory of contract law. Contractual liability—like virtually all civil liability—is structured around the concept of bilateralism, meaning that damages are always paid by defeated defendants to victorious plaintiffs. Ultimately, economic accounts of this basic feature are unpersuasive. This criticism, however, leaves untouched many of the key economic insights into the doctrine of contract damages. The limited failure of economic interpretations points toward a principled accommodation of both autonomy and efficiency in a single vision of contract law where notions of autonomy provide the basic structure and economics fills in most of the doctrinal detail.

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I. Introduction

The law of contracts is a complex but remarkably stable field. To be sure, new factual situations provide novel challenges for old doctrines, and the interstitial development of the law continues.[1] Still, there is widespread agreement about the doctrinal shape of modern contract law.[2] What we lack is

1. *See, e.g.*, Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1148 (7th Cir. 1997) (considering the enforceability of contractual terms contained "in the box" of a Gateway 2000 System); ProCD, Inc. v. Zeidenberg, 86 F.3d 1447, 1448–49 (7th Cir. 1996) (considering the enforceability of shrink-wrap license agreements); Step-Saver Data Sys., Inc. v. Wyse Tech., 939 F.2d 91, 97–98 (3d Cir. 1991) (considering the enforcement of a box-top software license).

2. *See* JAMES GORDLEY, PHILOSOPHICAL ORIGINS OF MODERN CONTRACT DOCTRINE 1

a widely accepted interpretation of that law. We have historical narratives of how the law developed and innumerable suggestions for how it should be reformed.[3] What this work does not offer is an interpretation of current contract law as embodying a coherent set of normative choices. Indeed, much of the scholarly discussion of contract law implicitly or explicitly assumes that any such interpretation is impossible and that the law we have represents, at best, a collection of essentially random and disconnected choices resulting from a series of historical accidents.[4] One of the central questions facing students of contract law is whether this theoretically pessimistic view of the law is correct, or whether it is possible to understand it as a coherent normative system.[5]

One of the most promising contenders for the role of a unified theory of contract law is economics. On this view, contract law as we have it represents a choice to promote efficiency, and the particular rules we find in contract doctrine are best seen as creating economically optimal incentives for contracting parties.[6] The dominant alternative is that contract law is about advancing the liberal ideal of personal autonomy by giving legal effect to the private decisions of contracting parties.[7] The apparent success of economics as a methodology comes from the fact that, unlike autonomy, it seems to provide concepts that generate conclusions that are fine-grained enough to account for contract law doctrine.[8] The duty to keep one's promises may be a normatively

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(1991) ("Both 'common law' systems . . . and 'civil law systems' . . . have a similar doctrinal system based on similar legal concepts.").

3. *See generally* D.J. IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS (1999) (explaining how the common law of obligations developed and suggesting ways to increase continuity within the area of law).

4. *See, e.g., id.* at v ("[Legal ideas] are indeterminate and flexible, always at least potentially in a state of flux.").

5. *See, e.g.*, Brian H. Bix, *Contract Law Theory* 35 (Univ. Minn. Law Sch. Legal Studies Research Paper No. 06-12, 2006), *available at* http://ssrn.com/abstract=892783 ("Skepticism about the tenability of a single unified theory of contract law is hardly new. However, given the number of prominent theorists who propose or defend general theories of contract law, it is an issue worth revisiting.").

6. *See generally* Richard Craswell, *Two Economic Theories of Enforcing Promises*, *in* THE THEORY OF CONTRACT LAW: NEW ESSAYS 19, 26–32 (2001) (arguing that economic analysis sees contract law as being about which rules created the optimal incentives for contracting parties).

7. *See generally* CHARLES FRIED, CONTRACT AS PROMISE (1981) (presenting an autonomy position).

8. *See* Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 503–16 (1989) (discussing why certain contract rules cannot be derived from philosophical theories based on individual liberty).

attractive ideal, but it lacks the conceptual power to specify most of the rules of contract law.[9]

Notwithstanding this sunny assessment of economic theories of contract, criticism remains very much alive. Partisans of autonomy theories have stubbornly insisted that efficiency is such a morally bankrupt ideal that economic theories of contract must be rejected, while others have attacked efficiency theories on economic grounds.[10] Navigating a route through these competing claims is one of the central tasks for the philosophy of contract law. Some have suggested that rather than seeking a jurisprudential silver bullet that will allow us to reject either autonomy or efficiency once and for all, philosophers of contract law should turn their energies to a theory that provides a principled accommodation of both approaches in a single vision of contract law.[11] This Article is part of that project. It has a simple thesis: Economic accounts of the current doctrine governing contract damages have failed, and the nature of that failure places limits on the role of economics in an integrated theory of contract law.

Economic theories of contract law are offered as—among other things—an explanation of contract doctrine as we have it.[12] They purport to show to us the underlying normative logic of the law. When it comes to contract damages, however, the economic explanation ultimately falls short of success because it

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9. The hope that the two approaches would converge on the same outcomes has been largely rejected as implausible in a world of transaction costs. *See* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 241–68 (1993) (arguing that the claim of convergence of autonomy and welfare values is tenuous).

10. *See* STEPHEN A. SMITH, CONTRACT THEORY 106–66 (2004) (summarizing normative critiques of efficiency theories of contract); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 864–68 (2003) (arguing that the economic analysis of contract law has failed because of ambiguities in transaction costs). *But see* Ian Ayers, *Valuing Modern Contract Scholarship*, 112 YALE L.J. 881, 881 (2003) (responding to Posner's arguments); Richard Craswell, *In That Case, What is the Question? Economics and the Demands of Contract Theory*, 112 YALE L.J. 903, 903 (2003) (same).

11. *See* Jody S. Kraus, *Legal Theory and Contract Law: Groundwork for the Reconciliation of Autonomy and Efficiency*, 1 SOC. POL. & LEGAL PHIL. 385, 389–90 (2002) (explaining how to reconcile apparently incompatible legal theories by distinguishing between their purpose, nature, object, and structure); Jody S. Kraus, *Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy, in* SOCIAL, POLITICAL, AND LEGAL PHILOSOPHY 420, 421 (Ernest Sosa & Enrique Villanueva eds., 2001) ("[The vertical integration strategy] reconciles efficiency and autonomy contract theories by construing them as comprising logically distinct elements within one unified theory."); *see also* Nathan Oman, *Corporations and Autonomy Theories of Contract: A Critique of the New* Lex Mercatoria, 83 DENV. U. L. REV. 101, 142–44 (2005) (discussing the use of the vertical integration strategy); Nathan Oman, *Unity and Pluralism in Contract Law*, 103 MICH. L. REV. 1483, 1505–06 (2005) (same).

12. *See infra* Part II.B (presenting several economic accounts of contract law).

cannot account for the bilateralism of contractual liability, which then renders the dominant economic interpretation of damages fundamentally contradictory. Generally speaking, the remedy in contract law involves a transfer from a breaching party to an aggrieved party. The sum paid by the wayward promisor is exactly equal to the sum paid to the disappointed promisee.[13] For example, if Jack enters into a contract to fetch water for Jill in return for a fee and Jack then fails to deliver the water as promised, the law of contracts allows Jill to sue Jack for the value of his failed performance. If Jill is successful, the law will require Jack to deliver Jill money. The sum that he pays and she receives will be identical. The law does not provide that Jack pays a fine to some third party (like the state) for breaching his contract, nor does it provide Jill with government-funded contract insurance against breach by those with whom she enters into contracts. Rather, it provides a way for Jill to extract money from Jack.[14] This is what is meant by bilateralism.

Bilateralism has been a much-discussed topic in the philosophy of tort law.[15] There, the argument has centered on the question of whether bilateralism signals a commitment on the part of the law to ex post rather than ex ante moral theories.[16] It has played a much smaller role in contract theory, although its appearance in that field has also been marked by a recapitulation of the supposed normative challenge that it poses to the efficiency norm.[17] My argument is different. I do not believe that bilateralism presents a problem for the idea of efficiency as a normative criterion per se. Ex post normative criteria provide one possible explanation of the bilateralism of contract law, but contrary to the claims made by some autonomy theorists, there is no reason to

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13. For ease of exposition, throughout this Article, I will refer to the breaching party as the "promisor" and the breachee as the "promisee." Of course, in actual contracts, the victim of breach can be a promisor as well. Also, for ease of exposition, I will assume that promisors are male and promisees are female, which ought to help readers identify the proper antecedents for the pronouns in the various hypotheticals below.

14. *See* Benjamin C. Zipursky, *Philosophy of Private Law*, *in* THE OXFORD HANDBOOK OF JURISPRUDENCE & PHILOSOPHY OF LAW 623, 623 (Jules Coleman & Scott Shapiro eds., 2002) (arguing that one of the key features of private law is that it gives plaintiffs the right to attack those that have harmed them).

15. *See, e.g.*, JULES COLEMAN, RISKS AND WRONGS 234–51 (1992) (discussing the economic analysis of torts); JULES COLEMAN, THE PRACTICE OF PRINCIPLE 13–24 (2001) (discussing bilateralism).

16. *See, e.g.*, ERNEST J. WEINRIB, THE IDEA OF PRIVATE LAW 136 (1995) ("[L]ike tort law, contract law is a regime of correlative right and duty.").

17. *See, e.g.*, SMITH, *supra* note 10, at 134 ("[D]efenders of efficiency must offer an explanation as to why legal reasoning appears largely unconcerned with efficiency.").

suppose that bilateralism commits the law to an ex post moral perspective. The challenge of bilateralism turns out to be considerably less "meta."[18]

Economic theorists have long recognized that specifying efficient contract damages is plagued by the problem of overreliance.[19] In a nutshell, damages that create efficient incentives for promisors will create inefficient incentives for promisees. The economic discussion of this paradox has generally bustled to the question of how one would design institutions to cope with the problem without pausing to consider what overreliance tells us about the role of economics in explaining the contract law that we have now. Seen from the perspective of the philosophy of contract law, however, overreliance is a result of bilateralism. Accordingly, economic theories of contract fail to explain current contract law, not because bilateralism per se commits one to an opposing value but because one simply cannot construct efficient incentives using a bilateral structure. Philosophically, bilateralism remains an unexplained mystery for economic explanations of contract law.

This failure to account for bilateralism, however, leaves many of the insights of economics into the current law of contract damages untouched. It does, however, mean that economic arguments must be combined with some other set of theories if we are to have a complete and coherent account of contract doctrine. Autonomy theories of contract can account for the bilateralism of contract damages. They cannot, however, generate arguments one way or another in support of most of contract doctrine, including much of the doctrine that specifies remedies for breach. In short, the failure of economic explanations of contract damages demonstrates that both efficiency and autonomy theories need one another if we are to provide a coherent account of contemporary contract law. The apparent incommensurability of autonomy theories, which are essentially deontological, and efficiency theories, which are essentially consequentialist, can be managed by the fact that contract law provides a hierarchical arrangement of the two values in which autonomy specifies the basic structure of contract law and efficiency provides most of the doctrinal detail.

The remainder of this Article is organized as follows. In Part II, I discuss what we mean when we talk about explaining a body of law, laying the methodological groundwork for my critique of economic theories of the current law of contract damages. In Part III, I summarize the law of contract damages, providing the data that an explanatory theory must cope with. In Part IV, I lay

18. *See infra* Part V.B (presenting bilateralism as an objection to economic explanations of contract damages).

19. *See infra* Part V.B.1 (describing efficient breach and the problem of overreliance).

out the economic explanation of this doctrine. In Part V, I explain how the bilateralism of contractual liability undermines this explanation. In Part VI, I explain what the failure of economic theories of contract damages tells us about the project of explaining the law and the limits of economic analysis.

II. Explaining the Law

A. On the Variety of Legal Theories

Legal theorists spend a great deal of time constructing arguments that purport to explain or illuminate the law, but they are not always as clear as one might wish on the precise nature of their philosophical ambitions.[20] Broadly speaking, legal theories can be normative or descriptive. As we shall see, this distinction breaks down to a certain extent, as theories on both sides of this divide have descriptive and normative elements.

To illustrate normative legal theories, consider the example of Jeremy Bentham.[21] Bentham was convinced that he had found the master norm for social design.[22] Claiming to ask only what will produce the greatest happiness for the greatest number, he imagined what an ideal legal system would look like.[23] The result was a torrent of suggestions on the construction of every possible sort of legal institution.[24] In his work, Bentham was contemptuous of existing legal institutions.[25] He did not see their current form as providing any sort of criterion for theoretical success.[26] To be sure, his project had a descriptive aspect to it. In criticizing existing institutions and making suggestions for their reform, it was necessary to identify and decide which of

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20. *See, e.g.*, Meir Dan-Cohen, *Listeners and Eavesdroppers: Substantive Legal Theory and Its Audience*, 63 U. COLO. L. REV. 569 (1992) (explaining why legal theorists might be reluctant to share their philosophical ambitions with practitioners).

21. *See generally* GERALD J. POSTEMA, BENTHAM AND THE COMMON LAW TRADITION (1986) (discussing Bentham's voluminous criticisms of the common law).

22. *See* Jeremy Bentham, *Principles of Morals and Legislation*, *in* THE ENGLISH PHILOSOPHERS FROM BACON TO MILL 791, 843 (Edwin A. Burtt ed., 1939) ("The general object which all laws have, or ought to have, in common, is to augment the total happiness of the community; and therefore, in the first place, to exclude, as far as may be, everything that tends to subtract from that happiness: in other words, to exclude mischief.").

23. *See id.* at 791–92 (presenting the principle of unity as the ideal system's foundation).

24. *See* POSTEMA, *supra* note 21, at 465 (presenting a bibliography of Bentham's legal and political writings).

25. *See* Bentham, *supra* note 22, at 795 (stating "whatever principle differs from [the principles of utility] in any case must necessarily be a wrong one").

26. *See id.* at 795–99 (describing the principles adverse to that of utility).

his proposed alternatives should be substituted for which actually existing institution.[27] In all of this, however, Bentham took the ability to maximize utility as the sole evidence of success.[28]

In contrast, a descriptive theory of the law takes the explanation of the law as it currently exists as its primary task. Hence, unlike normative theories, descriptive theories use the current shape of the law to generate criteria of theoretical success. H.L.A. Hart drew a distinction between what he called the internal and external view of law.[29] The external approach to the law is essentially social scientific.[30] It views the law as a nexus of human behavior and seeks to explain it by reference to familiar explanatory concepts such as the rational actor model, the interaction of "ideal types," and other tools of the social sciences.[31] An internal account of law seeks to capture the structure of the law from the point of view of a participant.[32] On this view, the law is a social practice but one that cannot be reduced to the behavior of social actors. Rather it is a normative structure, and the task of the legal theorist is to explain the nature and meaning of this structure.[33] The internal approach shares with the external point of view a belief that theoretical success requires some sort of "fit" with the law as it exists but takes "law" to refer to a set of norms rather than a set of behaviors. It shares with normative theories a concern for justification, but rather than seeking the best possible legal system, it searches for the norms that structure the law that we actually have.[34] This Article is concerned solely with this internal and descriptive variety of legal theory.

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27. *See id.* at 800–02 (describing the four sanctions of pain or pleasure that should be used to fashion behavior).

28. *See id.* at 800 ("It has been shown that the happiness of the individuals of whom a community is composed . . . is the end.").

29. *See generally* H.L.A. HART, THE CONCEPT OF LAW (1994) (explaining the distinction between internal and external statements of law).

30. *See id.* at 255 ("The external point of view of social rules is that of an observer of their practice.").

31. *See generally* ENCYCLOPEDIA OF LAW AND SOCIETY: AMERICAN AND GLOBAL PERSPECTIVES (David S. Clark ed., 2006) (discussing sociological approaches to law).

32. *See* HART, *supra* note 29, at 255 ("[T]he internal point of view is that of a participant in [a] practice who accepts the rules as guides to conduct and as standards of criticism.").

33. The analogy of games can illustrate the distinction. If I study chess by examining the behavior of chess players from a sociological or anthropological point of view, I am offering an external account. If I study chess by examining the rules of chess and chess tactics, I am offering an internal account.

34. *See* COLEMAN, RISKS AND WRONGS, *supra* note 15, at 7 (presenting such a theory). Coleman states:

> [I]nterested in providing an explanation of our practices, or important parts of them, but explanations that make sense of the practice in light of the norms it claims are inherent in it, norms, moreover, that could withstand the test of rational

B. What Sort of Theories are Economic Accounts of Contract Law?

There can be little doubt that much of the economic theorizing on contract law is frankly normative. However, much of the attraction of economic theories of the law comes from their apparent ability to explain current structure. Richard Posner has written that "many areas of the law, especially . . . the great common law fields . . . bear the stamp of economic reasoning."[35] Others have been even more enthusiastic; one lawyer-economist has gushed, "Contract law is best understood from the perspective of law-and-economics, which is the touchstone of private law scholarship, a key that appears to unlock every door."[36]

Even if economics provides descriptive theories, however, one still might argue that it provides external rather than internal accounts of the law. On this view, the efficiency of contract law is understood as a social scientific claim.[37] For example, some have offered evolutionary accounts of the common law whereby institutional incentives cause it to evolve toward efficiency.[38] Alternatively, one might argue that efficiency is an instrumentalist explanation of judicial behavior. For example, Milton Friedman argued that economic theories do not depend on the truth of the rational actor model but only on whether the predictions generated by the model are empirically verified.[39]

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reflection. This sort of explanation focuses on the reason-giving or normative dimension of social practices.

Id.

35. RICHARD POSNER, THE ECONOMIC ANALYSIS OF LAW 25 (6th ed. 2003).

36. FRANK H. BUCKLEY, JUST EXCHANGE: A THEORY OF CONTRACT xi (2005).

37. *See* HART, *supra* note 29, at 255 (describing the external point of view as social scientific).

38. *See, e.g.*, Peter H. Aranson, *Economic Efficiency and the Common Law: A Critical Survey*, *in* LAW AND ECONOMICS AND THE ECONOMICS OF LEGAL REGULATION 51, 51–84 (1986) (summarizing several evolutionary models that attempt to explain judicial behavior as efficient); Martin J. Bailey & Paul H. Rubin, *A Positive Theory of Legal Change*, 14 INT'L REV. L. & ECON. 467, 472 (1994) ("[C]ommon law will tend to evolve toward favoring the type of litigant that is less numerous with respect to a particular type of case."); Paul H. Rubin, *Common Law and Statute Law*, 11 J. LEGAL STUD. 205, 211–22 (1982) (arguing that common law evolved toward efficiency in the nineteenth and early twentieth centuries when it was more costly to organize interest groups); Paul H. Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51, 51 (1977) (arguing that disputants are more likely to resort to in-court settlement where legal rules are inefficient, and thus inefficient rules evolve into rules from "the utility maximizing decisions of disputants rather than from the wisdom of judges"); Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 NW. U. L. REV. 1551, 1562–1632 (2003) (describing certain historical institutional developments and explaining how they provided a framework for the common law to evolve in favor of efficiency-enhancing rules).

39. *See* ALEXANDER ROSENBERG, PHILOSOPHY OF SOCIAL SCIENCE 74–79 (1988)

Analogously, one could argue that regardless of what judges say or think, efficiency provides a good predictor of what they will actually do.[40] Regrettably, economic theorists of contract are not always as explicit about their theoretical goals as one might wish, and no doubt to a certain extent, law-and-economics scholarship does seek to provide an external account of contract law. However, there is no reason to suppose that providing such external accounts is the dominant ambition for economic theories of contract law, particularly in light of the peripheral role of such claims in the law-and-economics literature on contract law. In short, while economic theories can be understood as being normative or external, a large part of their appeal lies in the fact that they purport to offer an internal explanation of the law as we have it. That being the case, we can judge the success of economics as an internal account of contract law by the extent to which it explains current contract doctrine as resting on a set of economic justifications.[41] This is ultimately something that it cannot do with regard to the law of contract damages.

III. The Law of Contract Damages

The basic rule in American law is that "[i]n awarding compensatory damages, the effort is made to put the injured party in as good a position as that in which he would have been put by full performance of the contract."[42] There is some dispute as to when this rule became entrenched. After the modification of the action of assumpsit in *Slade's Case*[43] made the common law courts into a workable forum for the resolution of contractual disputes, the amount of damages was left to the jury.[44] Some historians claim that early juries awarded expectation damages, while other scholars suggest that the expectation measure became established later as judges limited juror discretion.[45] As late as 1776,

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(discussing Friedman's methodological arguments).

40. *See* Jody S. Kraus, *Philosophy of Contract Law*, *in* THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 687, 689 (2002) (arguing that efficiency theories are primarily concerned with predicting case outcomes).

41. *See, e.g.*, Posner, *supra* note 10, at 830 (documenting "the failures of economic models to explain [current] contract law").

42. RESTATEMENT (FIRST) OF CONTRACTS § 329 cmt. a (1932).

43. *See* Slade's Case, (1602) 76 Eng. Rep. 1074, 1077–78 (K.B.) (modifying the action of assumpsit).

44. *See* A.W.B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT 297–315 (1975) (discussing the importance of *Slade's Case* and the rise of the action of assumpsit).

45. *Compare* IBBETSON, *supra* note 3, at 213 ("Juries may . . . have gone their own ways; but there is no good reason to believe that they did so . . . ."), *with* E. ALLAN FARNSWORTH,

Chief Justice DeGrey doubted the expectation measure, saying, "I do not think that the purchaser can be entitled to any damages for the fancied goodness of the bargain, which he supposes he has lost."[46] Regardless, however, under modern law, the rule is that a disappointed promisee is entitled to damages that will put her in the position that she would have been in had the contract been performed.[47]

This simple formula does not, of course, exhaust the issues involved. The first complicating rule is that "[d]amages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made."[48] This principle is most often associated with the case of *Hadley v. Baxendale*.[49] There, a carrier breached its contract to deliver a mill shaft to a mill owner.[50] As a result, the mill stood idle for several days.[51] The question was whether the owner could recover his lost profits from the days of idleness.[52] At trial, the jury apparently awarded damages for lost

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CONTRACTS 873 (1990) ("For roughly two centuries after the final extension of assumpsit in *Slade*'s *Case* at the beginning of the seventeenth century, the common law courts paid little attention to this problem."); *see also* E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1157–58 (1970) (arguing that juries had unconstrained control over damage measures for breach of contract until the nineteenth century); George T. Washington, *Damages in Contract at Common Law II: The Period Transitional to the Modern Law*, 48 L.Q. REV. 90, 108 (1932) ("In the early law the problem of compensation was treated as one of fact for the jury.").

46. Flureau v. Thornhill, (1776) 96 Eng. Rep. 635, 635 (K.B.).

47. *See* RESTATEMENT (SECOND) CONTRACTS § 347 cmt. a (1981) ("Contract damages are ordinarily based on the injured party's expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will . . . put him in as good a position as he would have been in had the contract been performed."); RESTATEMENT (FIRST) OF CONTRACTS § 329 cmt. a (1932) (same). My discussion focuses on the common law of contracts and hence does not include the law of sales, which is governed by Article 2 of the Uniform Commercial Code (U.C.C.). *See generally* U.C.C. § 2 (2003). Although the U.C.C. gives a disappointed promisee a variety of remedies in addition to money damages, when money damages are awarded under Article 2, the expectation measure is used. *See, e.g.*, *id.* § 2-706(1) ("[T]he seller may resell the goods concerned or the undelivered balance thereof. If the resale is made in good faith and in a commercially reasonable manner the seller may recover the difference between the contract price and the resale price . . . less expenses saved in consequences of the buyer's breach.").

48. RESTATEMENT (SECOND) OF CONTRACTS § 351(1) (1981).

49. *See* Hadley v. Baxendale, (1854) 156 Eng. Rep. 145, 356 (Exch. Div.) (holding that "lost profits here cannot reasonably be considered such a consequence of the breach of contract as could have been fairly and reasonably contemplated by both the parties when they made the contract"); Richard Danzig, Hadley v. Baxendale*: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 251–54 (1975) (providing background information on *Hadley*).

50. *Hadley*, 156 Eng. Rep. at 146.

51. *Id.*

52. *Id.*

profits.[53] On appeal, the Court of Exchequer reversed and remanded for a new trial.[54] Baron Alderson summarized the rule to be applied:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally . . . from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.[55]

The continued viability of this rule is demonstrated by frequent citation to the *Hadley* rule by modern courts.[56]

A second limitation on the expectation measure of damages is the so-called "duty to mitigate."[57] The rule is nicely illustrated by the case of *Rockingham County v. Luten Bridge Co.*[58] A construction firm contracted with some county commissioners to construct a bridge.[59] After beginning performance and spending roughly $1,900, the county repudiated the contract.[60] The firm, however, continued work on the bridge, ultimately spending more

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53. *Id.* at 147.

54. *Id.*

55. *Id.* at 151.

56. *See, e.g.*, Rexnord Corp. v. DeWolff Boberg & Assocs., Inc., 286 F.3d 1001, 1004 (7th Cir. 2002) (discussing the rule in *Hadley*); Bongam v. Action Toyota, Inc., 14 F. App'x. 275, 282 (4th Cir. 2001) (same); Draft Sys., Inc. v. Rimar Mfg., Inc., 524 F. Supp. 1049, 1052 n.4 (E.D. Pa. 1981) (mem.) (same); Marquette Cement Mfg. Co. v. Louisville & Nashville R.R. Co., 281 F. Supp. 944, 947 (E.D. Tenn. 1967) (same); *In re* Constr. Diversification, Inc., 36 B.R. 434, 438 (Bankr. E.D. Mich. 1983) (same); Lawrence v. Will Darrah & Assocs. Inc., 516 N.W.2d 43, 45 (Mich. 1994) (mem.) (same); Franklin Mfg. Co. v. Union Pac. R.R. Co., 248 N.W.2d 324, 325 (Minn. 1976) (same); Livermore Foundry & Mach. Co. v. Union Storage & Compress Co., 58 S.W. 270, 273 (Tenn. 1900) (same).

57. *See* RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (1981) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.").

58. *See* Rockingham County v. Luten Bridge Co., 35 F.2d 301, 307 (4th Cir. 1929) (finding that "the plaintiff must so far as he can without loss to himself, mitigate the damages caused by the defendant's wrongful act").

59. *Id.* at 302.

60. *Id.* at 303.

than $18,000, and then sued the county for breach of contract.[61] Judge Parker wrote for the court:

> It is true that the county had no right to rescind the contract, and the notice given plaintiff amounted to a breach on its part; but, after plaintiff had received notice of the breach, it was its duty to do nothing to increase the damages flowing therefrom.[62]

Finally, there is the murky issue of reliance damages for breach of contract. The *Restatement (Second) of Contracts* suggests that an injured party has a right to reliance damages—in other words, a right to be put in the position she would have been in had the contract never been made.[63] It is easy, however, to misunderstand the reach of this doctrine. In the 1930s, Lon Fuller and William Perdue published *The Reliance Interest in Contract Damages*.[64] The article set out clearly for the first time the distinction between expectation and reliance damages, capturing academic thinking on the question of damages ever since.[65] Notwithstanding the influence of Fuller and Purdue, however, it would be a mistake to think of the reliance measure as a free-standing alternative to expectation damages.

Generally, reliance damages are sought only when the plaintiff cannot show the value of her expectation or when the value of reliance exceeds the

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61. *Id.*

62. *Id.* at 307.

63. *See* RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) ("As an alternative to the [expectation measure of damages], the injured party has a right to damages based upon his reliance interest . . . .").

64. *See generally* L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pts. 1 & 2), 46 YALE L.J. 52, 373 (1936–1937).

65. *See id.* (pt. 1) at 71–75 (distinguishing between the reliance and the expectation interest). The influence of Fuller and Perdue can plainly be seen in the evolution of the *Restatement*. Although Section 90 of the *Restatement (First)* famously acknowledged that reliance could give rise to an enforceable contract in the absence of consideration, when it came to damages there was no attempt to formulate reliance as an alternative measure of recovery. *See* RESTATEMENT (FIRST) OF CONTRACTS § 90 (1932). In contrast, Section 344 of the *Restatement (Second)* explicitly adopts Fuller and Purdue's typology of expectation, reliance, and restitution interests in a doctrinally gratuitous section entitled "Purposes of Remedies." *See* RESTATEMENT (SECOND) OF CONTRACT § 344 (1981). No other topic in the *Restatement (Second)* has a section that contains neither a rule nor a definition but merely sets forth the "purpose" of a particular area of contract law. Indeed, the idea of reliance so captured academic thinking about contracts that in the years immediately preceding the final promulgation of the *Restatement (Second)*, Grant Gilmore famously suggested that reliance would ultimately undermine the whole of contract, which would simply become a species of tort. *See generally* GRANT GILMORE, THE DEATH OF CONTRACT (1974). For a more philosophically sophisticated defense of the priority of reliance, see P.S. ATIYAH, PROMISES, MORALS, AND LAW 66 (1981).

value of her expectation.[66] For example, in anticipation of a huge demand for widgets, Jill contracts with Jack to build her a factory and purchases some of the materials that Jack will use. After starting work, Jack abandons the job, breaching the contract. However, by this time, the bottom has fallen out of the widget market, so that the value of a completed widget factory is zero. Jill sues Jack and seeks to recover her reliance damages (i.e., the amount that she spent on materials) rather than her expectation damages (i.e., zero). In such a situation, Jack can reduce Jill's damages by the amount that she saved as a result of his breach, which would include the full value of the additional materials that Jill would have had to purchase in order for Jack to complete the factory.[67] The functional result of this rule is that no award of reliance damages can exceed expectation damages.

Additionally, while the *Restatement (Second)* suggests that reliance damages may be awarded when the enforceability of a contract depends on reasonable reliance rather than consideration, this seldom seems to happen in practice.[68] In actual fact, the courts tend to award expectation damages in such cases, using reliance damages only as a rebuttable surrogate for expectation when measuring its value is difficult.[69] Hence, rather than providing an

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66. *See* Fuller & Perdue, *The Reliance Interest* (pt. 1), *supra* note 64, at 73–80 (distinguishing between the reliance and the expectation interests and questioning whether the expectation interest should set the limit of recovery).

67. *See* RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) (stating that a disappointed promisee has a right to reliance damages "less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed").

68. *See id.* § 349 cmt. b ("[I]f a promise is enforceable because it has induced action or forbearance . . . relief may be limited to damages measured by the extent of the promisee's reliance rather than by the terms of the promise.").

69. *See, e.g.*, Randy E. Barnett, *The Death of Reliance*, 46 J. LEGAL EDUC. 518, 521 (1996) (stating that the "much ballyhooed reliance revolution in contract law was not to be"); Daniel A. Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. CHI. L. REV. 903, 909 (1985) ("[R]eliance plays little role in the determination of remedies."); Jay M. Feinman, *The Last Promissory Estoppel Article*, 61 FORDHAM L. REV. 303, 306 (1992) ("[D]amages are restricted to reliance recovery only in cases in which the expectation measure is not available for some reason."); Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111, 130 (1991) ("Those rare instances in which courts award reliance damages involve either a problem with the promise or a difficulty in assessing expectation damages."). Some scholars, of course, have expressed skepticism about the results of these studies. *See, e.g.*, E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203, 212 (1990) ("If the prospective purchaser was successful in demonstrating promissory estoppel, the purchaser would be entitled to compensation in the amount of its reliance interest, but not its full expectation interest."); Robert A. Hillman, *Questioning the "New Consensus" on Promissory Estoppel: An Empirical and Theoretical Study*, 98 COLUM. L. REV. 580, 580 (1998) (arguing there is a "fundamental misunderstanding of how courts apply the theory of obligation called promissory estoppel"); Phuong N. Pham, Note, *The Waning of Promissory Estoppel*, 79

alternative measure of damages as such, in practice, a suit for "reliance damages" simply shifts the burden of showing the value of expectation damages from the plaintiff to the defendant.

This summary of the law of contract damages suggests four basic features that economic theories must explain: first, the basic choice of expectation damages; second, the limitation of damages to those that are reasonably foreseeable; third, the duty to mitigate; and fourth, the burden shifting inherent in so-called "reliance" damages.[70]

IV. Economic Accounts of Contract Damages

Law-and-economics has apparently been quite successful in explaining the four basic features of contract damages identified in the previous section. The expectation measure can be explained by the theory of efficient breach. The rule of *Hadley v. Baxendale* can be explained as a penalty default rule. The duty to mitigate can be explained as creating an incentive to avoid wasteful

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CORNELL L. REV. 1263, 1263 (1994) (arguing that "reliance continues to exact an even greater influence on judicial application of promissory estoppel").

70. Benjamin E. Hermalin, Avery W. Katz & Richard Crawell, *Chapter on the Law & Economics of Contracts*, *in* THE HANDBOOK OF LAW AND ECONOMICS (forthcoming 2007) (manuscript at 97–98, *available at* http://ssrn.com/abstract=907678) (providing an overview of default remedies and stating that each remedy can be adjusted depending on the behavior of the parties). There are, of course, other limitations on the award of expectation damages, and as we seek for finer-and-finer grained explanations of contract doctrine, these rules could be offered as further phenomena to be accounted for. I focus on the four principles above as the most important features of the current law of contract damages. For other limitations, see, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 352 (1981) ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty . . . ."); *id.* § 353 ("Recovery for emotional disturbance will be excluded."); *id.* § 355 ("Punitive damages are not recoverable for a breach . . . ."). Economic theorists have offered explanations of some of these doctrines. *See, e.g.*, Hermalin, Katz & Craswell, *supra*, at 111 (presenting an explanation for the "various legal and practical limits on contract damages"). One explanation states:

> [T]he non-breacher must prove the amount of his loss with "reasonable certainty"; often this will exclude recovery of "speculative" losses whose amount was uncertain. Also . . . contract law only rarely allows compensation for emotional losses. . . .
>
> By reducing the effective amount of the remedy, doctrines such as these weaken many of the seller's incentives. . . . Of course, by shifting more of the loss to the buyer, the same doctrines may also strengthen the buyer's incentive to take carious precautions. . . . Finally, if buyers differ in the extent to which they suffer non-recoverable losses, excluding those losses from the damage measure may reduce the cross-subsidization that could otherwise result.

Id. at 112.

activity. Finally, so-called reliance damages improve the accuracy of determining expectation damages by aligning the informational needs of the court with the litigation incentives of the parties.

The economic explanation of the expectation measure is one of the earliest and most enduring insights of the law-and-economics movement: the theory of efficient breach.[71] This theory builds on Oliver Wendell Holmes's claim that "[t]he duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else."[72] Rather than forcing people to keep their contracts, the common law simply requires that they pay in order to breach them.

After forming a contract, a promisor may find a higher value use for his performance than the one to which he is obligated under the contract. It is wasteful for the promisor to forgo this opportunity simply because of his commitment to the promisee. At the same time, merely opportunistic behavior can lead to social waste and inefficiency. The trick is to find a way of deterring not all breaches of contract but only those that are inefficient. This is exactly what the expectation measure accomplishes. By requiring any would-be breacher to pay the amount necessary to put the disappointed promisee in the position that she would have been in had the promisor performed, expectation damages guarantee that there will be no breach unless the benefit generated by the new use of the performance exceeds the benefit foregone by the promisee.[73] Put in economic terms, expectation damages force the promisor to internalize the cost of his breach to the promisee, resulting in inefficient incentives.[74]

Economic theorists explain the rule in *Hadley v. Baxendale* in terms of incentives and information.[75] When parties enter a contract, they have

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71. *See id.* at 99 (defining efficient breach as the circumstance where the breaching party's "gain[] from breach exceed both parties' losses").

72. Oliver Wendell Holmes, Dedication, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897); *see also* POSNER, *supra* note 35, at 119 ("This dictum, though overbroad, contains an important economic insight. In many cases it is uneconomical to induce completion of performance of a contract after it has been broken.").

73. *See* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 31–34 (1989) (detailing why the expectation remedy leads to an efficient outcome in breach of contract cases).

74. An alternative formulation is the claim that expectation damages provide a rule that mirrors that which the parties themselves would have chosen had they been able to fully specify their contract. *See* STEVEN SHAVELL, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW 307 (2004) ("[M]oderate damage measure lead to performance in circumstances resembling those . . . under mutually beneficial completed specified contracts.").

75. *See* Ian Ayers & Robert Gerner, *Filling the Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 101–04 (1989) (discussing the holding in *Hadley* as a penalty default rule). The Ayers and Gerner theory of penalty default rules has recently been challenged as resting on flawed economic assumptions, and others have denied

imperfect information about the other party's situation, which can result in inefficiencies. For example, it is efficient for the promisor to take any precaution to avoid breach that costs less than the value of the promise to the promisee. At the time of contracting, however, the promisor may not know the value of the promise to the promisee. Indeed, during negotiations the promisee has incentives to conceal the true value of the potential promise in order to get a better price. As a result, the promisor may take inefficiently few precautions to avoid breach. By limiting the promisee's damages, however, to those that are reasonably foreseeable, the rule in *Hadley* creates incentives for parties to negotiate around this problem.[76] Because the promisee cannot recover damages for losses that are invisible to the promisor at the time of formation, this rule gives the promisee an incentive to disclose this information when negotiating.[77] Once the hidden information is communicated, the promisor then has an incentive to take the efficient level of precaution to avoid breach because he will be liable for the full amount of the promisee's damages.

The duty to mitigate damages also has an economic explanation. The law requires that disappointed promisees modify their post-breach behavior to limit promisors' damages.[78] This rule, in turn, pushes resources to their highest value uses. Consider again the *Luten Bridge* case.[79] By continuing work, the contractor insured that those resources could not be invested elsewhere in the economy. His actions were wasteful precisely because the county was no longer a willing purchaser of his services and a willing purchaser could not do so because the contractor continued to invest in the bridge. By creating an incentive to find alternative purchasers of the rejected services, the duty to mitigate moves resources to higher-value uses.[80]

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that *Hadley v. Baxendale* represents a default rule of any kind. *See* Eric Maskin, *On the Rationale for Penalty Default Rules*, 33 FLA. ST. U. L. REV. 557, 557 (2006) (arguing that Ayers and Gerner's analysis is flawed); Eric Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563, 574–75 (2006) (arguing that *Hadley* is not a default rule). Ian Ayers has responded at length to both criticisms. *See generally* Ian Ayers, *Ya-Huh: There Are and Should Be Penalty Defaults*, 33 FLA. ST. U. L. REV. 589 (2006).

76. *See* Ayers & Gerner, *supra* note 75, at 101–02 ("[S]o long as transaction costs are not prohibitive, a [promisee] with high consequential damages will gain from revealing [the] information and contracting for greater insurance from the [promisor] because the [promisor] is the least-cost avoider.").

77. *See id.* at 104 ("*Hadley* penalizes high-damage [promisees] for withholding information that would allow [promisors] to take efficient precautions.").

78. *See* RESTATEMENT (SECOND) CONTRACTS § 350(1) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden, or humiliation.").

79. *See* Rockingham County v. Luten Bridge Co., 35 F.2d 301 (4th Cir. 1929) (finding that a plaintiff who received notice of breach has a duty to mitigate).

80. *See* Hermalin, Katz & Craswell, *supra* note 70, at 104–05 (discussing the duty to

Finally, the law's treatment of reliance damages can be explained in economic terms. Rather than compensating promisees for their reliance per se, so-called reliance damages shift to promisors the burden of proving the value of the expectation damages in cases where expectation damages are much less than reliance damages. This is because plaintiffs have no incentive to ask for reliance damages in other cases. The upshot of this burden shifting is that the cost of proving the value of expectation damages rests with the party who stands to benefit the most from its accurate determination. Accordingly, that party has an incentive to bring evidence regarding the value of the expectation damages to the court's attention. This in turn reduces error costs associated with courts incorrectly determining the value of expectation damages. In short reliance damages align the litigation incentives of the parties with the informational needs of the court.

V. The Problem of Bilateralism

The arguments above seem to offer an elegant account of the key doctrines of the modern law of contract damages.[81] Upon closer examination, however, the economic arguments leave unexplained a fundamental feature of contract damages: The bilateralism of contractual liability. Bilateralism, in turn, causes the basic economic justification for expectation damages to come unraveled.

A. Bilateralism and its (Mis-)Uses

Bilateralism is such an obvious feature of civil liability that it has only recently acquired a name, but once focused upon, it has proven to be a fruitful topic.[82] Any private lawsuit brings together a plaintiff and a defendant. The plaintiff will offer reasons that the state should transfer some amount of wealth from the defendant to her. If the plaintiff is successful, then the court will award damages. The amount of money that the defendant will be forced to pay will be exactly equal to the amount of money that the court deems the plaintiff to be entitled to, and the defendant's payment will be made directly to the

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mitigate damages).

81 *See supra* Part III (providing the basic formula for contract damages and several doctrines through which the damage award is limited).

82. *See generally* Jules Coleman, *The Structure of Tort Law*, 97 YALE L.J. 1233 (1988) (reviewing WILLIAM LANDES & RICHARD A. POSNER, THE ECONOMIC STRUCTURE OF TORT LAW (1987), and STEVEN SHAVELL, ECONOMIC ANALYSIS OF ACCIDENT LAW (1987)).

plaintiff.[83] Bilateralism is simply the most elegant term among some equally ugly competitors for naming this aspect of civil liability.[84]

Writing in the field of tort law, Jules Coleman has claimed that bilateralism is a basic feature of the field that any successful theory of tort law must account for.[85] He writes:

> Tort law's structural core is represented by case-by-case adjudication in which particular victims seek redress for certain losses from those whom they claim are responsible. In the event a victim's claim to recover is vindicated, her right to recover takes the form of a judgment against the defendant (a judgment which the defendant can discharge either directly or by some contractual relation, e.g. insurance). . . . Any plausible account of tort law must explain why claims are taken up in this case-by-case fashion.[86]

Bilateralism, however, is a feature not only of tort law but of virtually all civil liability. Accordingly, the ability to explain this feature of the law can be used as a criterion not only of successful theories of tort law, but also successful theories of contract law. Critics of economics have invoked bilateralism to make two sorts of arguments. The first set of arguments claim that bilateralism commits the law to an ex post normative theory while economic theories necessarily rest on an ex ante perspective.[87] The second set of arguments is related to the first and claims that the bilateralism of civil liability means that the reasons judges give for their opinions are necessarily ex post and economic theories leave this judicial reasoning unexplained.[88] Neither of these criticisms is justified.

The problem with the first argument is that it misunderstands the relationship between moral and legal reasoning. It is true that the bilateralism

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83. *See id.* at 1247–53 (discussing corrective justice and the economics of tort law).

84. The other chief contender for the title is "correlativity," a term used by Ernest J. Weinrib. *See* WEINRIB, *supra* note 16, at 120 ("[C]orrelativity structures the normative content of corrective justice."). Some theorists have adopted Weinrib's terminology. *See, e.g.*, SMITH, *supra* note 10, at 148–49 (explaining the theory of correlativity and citing to Weinrib). I adopt Coleman's terminology for the good and sufficient reason that I am not entirely sure how to pronounce the word "correlativity," and I take it to have essentially the same meaning as "bilateralism."

85. *See* JULES COLEMAN, THE PRACTICE OF PRINCIPLE: IN DEFENSE OF A PRAGMATIST APPROACH TO LEGAL THEORY 16 (2001) ("A plausible account [of tort law] must also explain the bilateral nature of litigation.").

86. *Id.*

87. *See* SMITH, *supra* note 10, at 134 ("[D]efenders of efficiency must offer an explanation as to why legal reasoning appears largely unconcerned with efficiency.").

88. *See id.* at 132–33 (describing the ex post and ex ante debate in the context of common law adjudication).

of civil liability requires that plaintiffs and defendants be linked together on the basis of past conduct.[89] However, there is no reason that this link must itself be justified on the basis of an ex post moral theory. Consider, for example, a *qui tam* action.[90] During the Civil War, the Lincoln Administration became concerned about the existence of widespread fraud in government contracting.[91] The federal government was dealing with suppliers on an unprecedented scale, and the opportunities for fraud massively exceeded the government's policing capacity.[92] The result was the Civil False Claims Act of 1863.[93] Under the Act, a party who became aware of fraud against the government could bring a suit against the defrauding party to recover money. Part of the judgment in the case would then be paid to the *qui tam* plaintiff and the remainder would go to the government.[94] In its modern form,[95] the False Claims Act continues to be a major source of civil litigation in the federal courts.[96]

A suit between a *qui tam* plaintiff and a government contractor has a bilateral form. The plaintiff is claiming an entitlement to have money

89. *See* Coleman, *supra* note 82, at 1233 (describing tort law as both "backward-looking and conservative").

90. *See infra* notes 91–100 and accompanying text (explaining the *qui tam* action and providing literary sources and statutory authority).

91. *See* Dan L. Hargrove, *Soldiers of Qui tam Fortune: Do Military Service Members Have Standing to File Qui tam Actions Under the False Claims Act?*, 34 PUB. CONT. L.J. 45, 54–57 (2004) (recounting the Civil War background of the original federal *qui tam* statute).

92. *See* Patricia Meador & Elizabeth S. Warren, *The False Claims Act: A Civil War Relic Evolves Into a Modern Weapon*, 65 TENN. L. REV. 455, 458 (1998) ("The Civil War revived interest in the *qui tam* action due to the inability of the federal government to effectively police defense contractor fraud."). *Qui tam* is a shortened version of the Latin tag *qui tam pro domino rege quam pro seipso*, meaning "he who as much for the king as for himself." *See* Note, *The History and Development of Qui Tam*, 1972 WASH. U. L.Q. 81, 83 (1972) (providing the translation and its historical relevance). *Qui tam* actions have a very long history in the common law stretching back into the late medieval period. *See id.* at 81–91 (providing the history of *qui tam* actions). Indeed, by expanding the jurisdiction of the royal courts they were one of the key weapons in the common law's long battle to supplant local, manorial law. *See id.* at 85 (stating that *qui tam* was one of the "[v]arious techniques [] devised to expand the jurisdiction of royal courts").

93. *See* Civil False Claims Act of 1863, ch. 67, 12 Stat. 696 (codified as amended at 31 U.S.C. §§ 3729–3732 (2000)) ("An Act to prevent and punish Frauds upon the Government of the United States.").

94. *See* 31 U.S.C. § 3730(d) (2000) (providing the procedure by which *qui tam* recoveries are divided between the government and the *qui tam* plaintiff).

95. *See* 31 U.S.C. §§ 3729–3732 (providing the law on false claims (§ 3729), civil actions for false claims (§ 3730), false claims procedure (§ 3731), and false claims jurisdiction (§ 3732)).

96. *See* Meador & Warren, *supra* note 92, at 456 ("Due to its *qui tam* provisions, which allow private actors to act as attorneys general and pursue cases of alleged fraud, the [Federal False Claims] Act has become a favorite weapon in today's environment.").

transferred to her from the defendant. The existence of her entitlement will hinge on an evaluation of the defendant's past conduct.[97] Furthermore, the plaintiff will have to make certain showings about herself to demonstrate that she is the one entitled to payment from the defendant.[98] Yet none of this ostensibly ex post reasoning rests on an ex post post-normative justification. Indeed, the reasons behind the *qui tam* statute are frankly forward looking. The goal of the law is to create ex ante incentives for private parties to investigate wrongdoing by government contractors and punish those that defraud the government. The bounty paid to the *qui tam* plaintiff is not compensatory in any way.[99] Rather, *qui tam* actions allow the government to threaten its contractors with fines that deter them from future misconduct.[100] In short, there is no necessary connection between the ex ante arguments that justify the *qui tam* regime and the ex post concepts that allocate liability under that regime. The fact that the doctrinal concepts involved in *qui tam* adjudication are backward looking tells us nothing about the moral concepts involved in its normative justification. The *qui tam* example illustrates that there is no necessary connection between the ex post structure of civil litigation and the structure of the moral theories that justify any particular form of civil liability. Put in starker terms, ex post legal concepts do not imply ex post moral concepts.

The second set of arguments based on bilateralism is related to the first. It goes like this: Judges justify their decisions in ex post terms, linking defendants and plaintiffs together with arguments about blame and fault rather

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97. *See* 31 U.S.C. § 3729(a) (setting forth the conditions under which a defendant can be liable under the Federal False Claims Act); *see also* United States *ex rel.* Crews v. NCS Healthcare of Ill., Inc., 460 F.3d 853, 855–56 (7th Cir. 2006) (same); United States *ex rel.* Vargas v. Lackmann Food Serv., Inc., No. 6:05-CV-712-ORL-19, 2006 WL 1460381, at *2–3 (M.D. Fla. May 23, 2006) (same).

98. *See, e.g.*, 31 U.S.C. §§ 3730(b)–(c) (setting forth the conditions under which a private plaintiff may bring a *qui tam* action under the Federal False Claims Act); United States *ex rel.* Siller v. Becton Dickinson & Co., 21 F.3d 1339, 1355 (4th Cir. 1994) (setting forth the necessary showing for a successful *qui tam* plaintiff); United States *ex rel.* Fowler v. Caremark Rx, Inc., No. 03 C 8714, 2006 WL 1519567, at *2 (N.D. Ill. May 30, 2006) (same).

99. *See* 31 U.S.C. § 3730(d) (setting forth the rules by which *qui tam* recoveries are divided between the government and the *qui tam* plaintiff). Although, admittedly, the portion of a *qui tam* judgment paid directly to the government could be justified as ex post compensation.

100. *See* Hargrove, *supra* note 91, at 55 ("The need for *qui tam* action [in the Civil War] was predicated on the gravity of the consequences which resulted from unscrupulous contractors supplying inferior goods to the Union military when the Government's resources were too strapped by war effort to enable effective prosecution of these crimes." (internal quotations omitted)); *see also* United States *ex rel.* Hays v. Hoffman, 325 F.3d 982, 987 (8th Cir. 2003) (noting that the modern Federal False Claims Act is "intended to encourage private enforcement suits by legitimate whistleblowers").

than arguments about incentives for future conduct.[101] Economics cannot offer an explanation of contract law because the reasons that judges offer for their decisions are part of the "law" that must be explained.[102] Legal reasoning, so the argument goes, purports to be "transparent," revealing its own normative basis.[103] Economic theories, in turn, deny this transparency.[104] The problem is that this objection overstates the place of judicial reasoning in pre-theoretic understandings of the common law. Non-economic theorists of the law—including judges and lawyers—regularly speak as though the law consisted of "the holding" in a case rather than judicial reasoning or "dicta."[105] Indeed, if economists are to be cast from the temple of the law for their inattention to judicial reasoning, we must also cast out Holmes, Williston, and others, all of whom regarded case holdings rather than explicit judicial reasoning as the primary legal data.[106] Furthermore, this objection recapitulates the confusion of legal reasoning with moral reasoning. The fact that a judge uses ex post concepts to determine that a party has a particular legal entitlement need not imply that the law assigns the entitlement based on a commitment to a moral

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101. *See* Coleman, *supra* note 82, at 1241–42 (explaining how the "backward looking dimension of existing tort law limits the extent to which it can be used to pursue economic goals").

102. *See id.* at 1242 (stating that an "[e]conomic analysis can therefore only assume, but never explain, the structure of tort law").

103. *See* SMITH, *supra* note 10, at 134 ("[T]o successfully explain a self-reflective human practice, such as the law, one of the things that must be explained is how that practice understands itself.").

104. *See id.* at 132–36 (explaining the "transparency objection"). Smith writes:

> Law is comprised not just of rules and results in cases, but also reflects a characteristic form of reasoning, all of which must be accounted for by a complete theory. A theory that reveals legal reasoning as nothing more than meaningless rhetoric fails in this task. Instead of making legal reasoning intelligible, the theory leaves us with a mystery: [W]hy do judges and lawyers explain the law as they do if the real explanation is entirely different? Indeed, it is this discontinuity between legal and efficiency-based explanations that explains the hostility that many practicing lawyers and judges express towards efficiency theories of law. Legal actors are understandably uncomfortable with an explanation of the law that is so at odds with how they understand what they are doing.

Id. at 134; *see generally* Patrick S. Atiyah, *Executory Contracts, Expectation Damages, and the Economic Analysis of Contract*, *in* ESSAYS ON CONTRACT 150, 150 (1986) (critiquing economic accounts of contract damages).

105. *See, e.g.*, Kokkonen v. Guardian Life Ins. Co. of Am., 511 U.S. 375, 379 (1994) ("It is to the holdings of our cases, rather than their dicta, that we must attend . . . .").

106. *See* Jody S. Kraus, *The Jurisprudential Origins of Contemporary Contract Theory* 5 (June 6, 2006) (unpublished working paper, on file with the Washington and Lee Review) (arguing "that the choice a theorist makes between the two views of precedential authority is likely to be influenced by the relative weight the theorist assigns to each of the two prongs of a conception of adjudicative legitimacy").

theory with an ex post structure. Finally, contrary to the claims of the critics, judges—including judges who have not been infected by modern law-and-economics scholarship—do use ex ante reasoning when explaining the basis of substantive legal rules rather that the legal entitlements of particular parties.[107]

Despite the fact that the most common arguments made against economic theories of contract on the basis of bilateralism should be rejected, bilateralism does pose a major challenge to economic explanations of the law of contract damages. The problem, however, is simpler and less "meta" than has generally been assumed. Even if bilateralism does not pose a deep normative challenge to economic theories, it does create major problems for the economic mechanics of those theories.

B. Bilateralism as an Objection to Economic Explanations of Contract Damages

Simply stated, bilateralism is a basic problem for the economic explanation of the expectation measure of damages, and without a justification for the basic choice of that measure, economic explanations of other aspects of contract damages are left without a necessary foundation. Furthermore, economic theories have generally taken the bilateralism of contract law for granted and have thus left it unexplained.[108] To be sure, one can justify a regime of contract damages on the basis of efficiency, but such a regime would look quite different than the one that the common law currently provides. Accordingly, economic theories standing alone fail to provide an explanation of current law. For such an explanation, we must look elsewhere.

1. Efficient Breach and the Problem of Overreliance

Economic problems with the theory of efficient breach have long been recognized.[109] What has not been clearly seen is the role of bilateralism in

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107. *See* Oman, *Unity and Pluralism*, *supra* note 11, at 1494–96 (arguing that judges rely on ex ante arguments when discussing normative foundations of the law).

108. *See, e.g.*, Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 5 (1985) (recognizing that damages will flow from the injurer to the victim).

109. *See, e.g.*, *id.* at 11–19 (arguing that the expectation measure provides an incentive to a promissee to over rely or rely on promises to a greater extent than is efficient); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J.L. ECON. & ORG. 98, 98 (1996) (discussing the phenomenon of expectation damages causing overinvestment); Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach*

those problems. The most important economic objection to the theory is the problem of overreliance.[110] Robert Cooter and Thomas Ulen summarized the economic paradox:

> (1) In order for the promisor to internalize the benefits of precaution, he or she must pay full compensation to the promisee for breach. (2) In order for the promisee to internalize the costs of reliance, he or she must receive no compensation for breach. (3) In contract law, compensation paid by the promisor for breach equals compensation received by the promisee. Therefore, contract law cannot internalize costs for the promisor and the promisee as required for efficiency.[111]

The problem of overreliance can be illustrated with a simple example. Imagine that Jack promises to supply Jill with a widget-making machine, and Jill informs Jack that in reliance on the contract she will be purchasing a large supply of widget materials to manufacture widgets for the insatiable widget market. Jack then finds that Jane, who is a more efficient widget maker, will offer him an amount for the widget machine such that he can fully compensate Jill and still make a profit. True to the efficient breach theory, Jack reneges on his agreement, Jill sues to recover her expectation damages, and Jack pockets the difference between Jill's damages and the price paid by Jane for the widget-making machine. Unfortunately, one problem mars this otherwise delightful picture of social efficiency: The effort and resources spent in procuring the unused bales of widget materials in Jill's warehouse are a waste. The problem is that once Jack and Jill have contracted, Jill has no incentive to consider the likelihood of Jack's performance. If Jack breaches, Jill will be fully compensated by the expectation damages. It would be more efficient, however, for Jill to consider the likelihood of Jack breaching, and structure her reliance accordingly. Simply stated, it is socially wasteful for promisees to act as

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Remedies, and Optimal Investment, 86 AM. ECON. REV. 478, 487–91 (1996) (offering economic proof that expectation damages do not promote efficiency); Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691, 693 (1983) (arguing that without reliance, the rule of law produces damages that are not Pareto optimal); William P. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39, 47–48 (1984) (noting that expectation and reliance damages produce inefficient results); Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 472 (1980) (discussing the problems of breach in reaching Pareto efficiency); Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121, 124–27 (1984) (describing the relationship between efficient breach and the Pareto efficient production contract).

110. *See generally* Shavell, *Damage Measures*, *supra* note 109 (explaining the problem of overreliance).

111. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 233 (2d ed. 1997).

though their promisors' eyes will never stray to other opportunities after the contract is signed.

In order to induce efficient reliance, we want a damage measure that gives promisees an incentive to consider the probability that promisors will not perform. For example, a restitution measure would restore to the promisee only what she gave the promisor in return for his now breached promise. In other words, the promisee would be protected against the sort of crass opportunism that would result if a promisor could take money in return for a promise that he never performed. Accordingly, restitution measures provide the basic trust necessary to induce parties to deal in the first place.[112] However, the restitution measure gives the promisee absolutely no compensation for any expenses incurred in reliance on the promisor.[113] Accordingly, the promisee will have every incentive to consider the probability of the promisor's breach when making her reliance decisions, thus avoiding inefficiently high levels of reliance.[114]

Law and economics theorists have long understood this problem and have put on as brave a face as possible.[115] A. Mitchell Polinsky has summed it up:

> [I]n general, there does not exist a breach of contract remedy that is efficient with respect to both the breach decision and the reliance decision. With respect to breach, the expectation remedy is ideal, whereas with respect to reliance, the restitution remedy is ideal. Thus, which remedy is best overall depends on whether the breach decision or the reliance decision is more important in terms of efficiency.[116]

What lies at the root of this problem is the bilateral structure of contract damages. By taking this structure for granted rather than recognizing it as an important phenomenon to be explained, however, the role of bilateralism in the problem of overreliance has been obscured. An examination of the economic responses to the problem of overreliance illustrates this.

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112. *Cf.* COLEMAN, RISKS AND WRONGS, *supra* note 15, at 105–93 (arguing that contract law is justified by the need to provide "transaction resources" to encourage cooperation between strangers).

113. *See* POLINSKY, *supra* note 73, at 38 ("[U]nlike under the reliance remedy, [the promisee] does not get his reliance investment back in the event of breach.").

114. *See id.* (stating that the promisee "needs to know the probabilities of performance and breach" before spending more money in reliance).

115. *See generally* Shavell, *Damage Measures*, *supra* note 109 (setting forth the problem of overreliance).

116. POLINSKY, *supra* note 73, at 38.

2. Alternatives and Explanations

Those looking for an economic explanation of contract damages have responded to the problem of overreliance in basically two ways. First, they have sought to show that ultimately overreliance is not an important objection, because in actual fact it seldom occurs.[117] Second, they have suggested that on a more nuanced view of contract doctrine, current law avoids the problem of overreliance.[118] The first response concedes the problem but seeks to minimize it, while the second solution ultimately cannot be squared with current law and is best viewed as a normative critique of the common law of contracts rather than as an explanation of it.

The most ambitious attempt to show that in practice overreliance is not a problem was offered by Melvin Eisenberg and Brett McDonnell.[119] According to them, in actual fact, various institutional features of contracting keep overreliance from occurring very much.[120] For example, certain kinds of reliance will occur if a party makes any preparations to perform a contract.[121] This decision will be relatively insensitive to the availability or absence of expectation damages, particularly when the probability of breach is quite low.[122] They provide as compelling a case as can be made in the absence of real empirical evidence for the empirical irrelevance of efficient reliance. However, this response in effect concedes that a theory that could account for the bilateralism of contract damages would be a superior explanation to that offered by economics. They concede that overreliance is a possibility under the expectation measure, and a rule that could deliver efficient reliance while maintaining the efficient breach would be preferable.[123]

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117. *See, e.g.*, Melvin A. Eisenberg & Brett H. McDonnell, *Expectation Damages and the Theory of Overreliance*, 54 HASTINGS L.J. 1335, 1336 (2003) ("In most cases, overreliance normally cannot or is highly unlikely to occur.").

118. *See, e.g., id.* at 1346 (arguing that in "most contracts cases . . . overreliance normally cannot or is highly unlikely to occur[] because of institutional elements based on the economics of contracting and the way in which the standard expectation measure is actually administered").

119. *See generally id.* (rejecting the argument that the expectation measure causes the promisee to over rely).

120. *See id.* at 1339–56 (arguing that institutional considerations cause the incidence of overreliance to be very low).

121. *See id.* at 1342–44 (defining necessary reliance as the preparatory and performance costs that must be incurred over the contract is made).

122. *See id.* at 1343–44 (explaining the inverse relationship between the probability of substantial performance and the expected cost of overreliance).

123. *See id.* at 1357–73 (finding that the standard expectation measure does not guarantee reliance and proposing possible modifications to the standard expectation measure).

Robert Cooter and Thomas Ulen claim to have discovered such a rule within the doctrine governing contract damages. They write:

> The paradox [of overreliance] has a solution. In fact, efficient incentives do not require internalization of total costs. Instead, efficient incentives require the internalization of marginal costs. Perfect expectation damages solve the paradox by setting damages so that the promisor bears the marginal benefits of precaution and the promisee bears the marginal cost of reliance.[124]

Unfortunately, despite their attempts to demonstrate the contrary, the common law of contracts does not adopt Cooter and Ulen's measure of "perfect expectation damages," and it is doubtful that it could.

Cooter and Ulen's argument is ultimately quite simple. Their solution is to limit both the promisor's liability and the promisee's recovery according to an objective standard of efficient behavior.[125] Under these so-called "perfect expectation damages," the value of the promisee's expectation is not the difference between the profits that she did realize and the profits that she would have realized had the promise been performed given her actual level of reliance. Rather, the value of the promisee's expectation equals the difference between her profits given breach and the profits that she would have realized had the contract been performed in a world in which the she had the efficient level of reliance.[126] In other words, if the promisee engages in reliance that would increase her profits ex post in a world of performance but that are inefficient when discounted by the probability of breach ex ante, she receives no compensation for that reliance. At the same time, because the amount paid by the breaching promisor does include the profits that would have been made by the promisee had she efficiently relied, he has an incentive to consider those costs in his breach decision. Thus the Gordian Knot looks to have been cut.

There are, however, at least two problems with this solution. First, it places huge demands on the ability of courts to gather and assess information. Second, despite Cooter and Ulen's argument to the contrary, current contract doctrine does not award "perfect expectation damages."[127] In order for Cooter

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124. COOTER & ULEN, *supra* note 111, at 233.

125. *See id.* at 229 ("[W]e defined *perfect* expectation damages as enough money to restore the promisee to the position that he or she would have enjoyed if the promise had been kept and if reliance had been *optimal*.").

126. *See id.* (stating that "perfect expectation damages" do not reflect "actual reliance" but "optimal reliance").

127. *See* Robert Cooter & Ariel Porat, *Anti-Insurance*, 31 J. LEGAL STUD. 203, 223 (2002) (stating that current contract doctrine only somewhat restrains reliance). They state:

> Contract law has not developed a burden of reasonable reliance. Rather, contract

and Ulen's solution to work, the courts must determine ex post what the efficient level of reliance would have been ex ante. This is most likely beyond their capacity. First, determining efficient reliance requires knowing the relationship between the increase in the promisee's reliance and her payoff under the contract.[128] This marginal benefit would then have to be discounted by the ex ante probability of the promisor's breach so as to arrive at the efficient level of reliance where the discounted marginal benefit of reliance equals the actual cost of reliance.[129] Determining the ex ante probability of breach, however, involves the promisor's general trustworthiness, the availability of resources to invest in precautions, foreseeable ex ante opportunities for alternative deals, and—not least of all—his response to the threat damages that are a function of efficient reliance that is in turn a function of the probability of his breach.[130] Courts lack the ability to accurately determine most of these variables, to say nothing of their capacity to calculate correctly their interactions.[131]

> law has developed the doctrine that plaintiffs are entitled to the foreseeable losses caused by breach. The burden of unforeseeable losses falls on the promisee unless he can shift them by giving notice to the promisor. This doctrine, which offers some restraint on reliance, stops far short of providing optimal incentives for reliance.

Id.

128. *See* Eisenberg & McDonnell, *supra* note 117, at 1338 ("Under the standard calculation of expectation damages, a promisee will increase expenditures in reliance on a contract up to the point where the expected gain from an incremental increase in such expenditures equals the cost of the incremental increase.").

129. *See id.* (stating that the probability of promisor's breach is usually not taken into account). The authors state:

> In choosing the socially optimal amount of reliance on the contract, the promise . . . should take [the] chance of non-performance into account. However, the standard expectation measure does not give the promisee an incentive to choose the socially optimal level of reliance. In particular, when calculating the expected gain from an increase in reliance expenditures, the promisee will not discount that expected gain by the probability that the promisor will breach.

Id.

130. Mathematically, this means that either judges or juries would need to perform advanced calculus in order to calculate the proper level of damages, an implausible prospect to anyone who has ever spent much time with law students, lawyers, and judges most of whom are severely math-phobic. *See, e.g.*, Myrna S. Raeder, *Cost-Benefit Analysis, Unintended Consequences, and Evidentiary Policy: A Critique and a Rethinking of the Application of a Single Set of Evidence Rules to Civil and Criminal Cases*, 19 CARDOZO L. REV. 1585, 1590 (1998) ("Unquestionably, math phobia was the impetus for many of us to attend law school, rather than pursue other professions.").

131. *Cf.* Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749, 754 (2000) (arguing that "courts are radically incompetent" to meet "the demands that are placed on them by relational contracts").

Surprisingly, however, Cooter and Ulen claim that not only can courts perform such calculations but that they routinely do.[132] They write, "Various legal doctrines define overreliance. An important doctrine in the common law concerns foreseeability.... The famous case of *Hadley v. Baxendale* established the principle that overreliance is unforeseeable and, consequently, noncompensable."[133] This conclusion, however, rests on both an implausible reading of *Hadley*'s facts and a misstatement of the rule in the case. In *Hadley*, the court concluded that the carrier did not reasonably foresee that the mill would close as a result of late delivery because most mills have replacement shafts.[134] This is a claim about what one could assume about the world in the absence of specific inquiry. In the hands of Cooter and Ulen, however, it is transformed into an economic conclusion about optimal levels of investment in mill shafts.[135] In order for the foreseeability doctrine to do the work of identifying efficient reliance, we must assume that the only foreseeable reliance is efficient reliance. In applying *Hadley*, however, courts have not looked to the economic wisdom of the promisee's reliance, but only to whether or not the behavior is foreseeable.[136] Indeed, by making promisors liable for specially communicated consequences of breach (including future reliance on the contract), courts hold promisors to what they actually know rather than what is economically efficient.

The perfect expectation measure of damages, however, has a deeper problem from the point of view of interpretive theory. It allows the promisee to capture the equivalent of the profits from optimal reliance even though nonperformance of the contract means that these profits were never actually earned.[137] By its own terms, this transfer payment from promisor to promisee is not necessary to encourage optimal reliance by the promisee.[138] In order for the

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132. *See* COOTER & ULEN, *supra* note 111, at 221–31 (presenting equations that account for all the variables that should be taken into account by the court when determining compensation).

133. *Id.* at 231.

134. Hadley v. Baxendale, (1854) 156 Eng. Rep. 145, 151 (Exch. Div.).

135. *See* COOTER & ULEN, *supra* note 111, at 228–31 (basing the expectation award on optimal, rather than actual, reliance).

136. *See* Melvin Aron Eisenberg, *The Principle of* Hadley v. Baxendale, 80 CAL. L. REV. 563, 567 (1992) ("[T]he principle of *Hadley* [] normally turns or should turn on some standard of foreseeability.").

137. *See* COOTER & ULEN, *supra* note 111, at 229 ("[P]erfect expectation damages equal the difference between [promisee]'s revenues when [promisor] performs and her revenues when he breaches.").

138. *See id.* (stating that the expectation award does not vary depending on the promisee's actual reliance).

promisor to have the proper incentives, it is necessary for him to pay these "lost profits,"[139] but the payment of this fine to the promisee is an economically pointless transfer. The "lost profits" paid by the promisor could be burned or thrown down a rat hole with precisely the same economic consequence. Fining the promisor for optimal reliance does have an economic rationale, but compensating the promisee for lost profits does not. In other words, even if perfect expectation damages could avoid the problem of overreliance, they cannot account for their own bilateral structure.[140]

One might argue that the bilateral structure of contractual liability can be thought of as a second-best response to the inadequacy our enforcement technology and defended as such on efficiency grounds. Rather than charging the state itself with an impossible task, enforcement is decentralized by giving aggrieved promisees a private cause of action. Allowing the plaintiff to benefit from the fine imposed on the defendant gives potential plaintiffs an incentive to press their grievances in court, thus policing the conduct of promisors. The problem with this response is that while it provides a completely plausible reason for dispersing enforcement, it still does not save economic theories from the basic contradiction between efficient breach and efficient reliance. This problem is compounded by the fact that there is no reason why enlisting private lawsuits to create the proper incentives necessarily implies the particular relational structure of liability that we see in contract law. For example, it seems possible to create a system of optimal contract enforcement based on the model of *qui tam* statutes. In a *qui tam* action, the successful plaintiff is essentially paid a bounty for bringing a lawsuit that, rather than righting a personal wrong, serves simply to enforce a public policy.[141] Likewise, one could argue that promisees in contract suits are simply acting as private attorneys general, seeking efficient levels of sanctions against breaching promisors.

Economics, however, suggests that the amount of money that a plaintiff can recover bears no relationship to the magnitude—if any—of the plaintiff's

139. *See id.* at 228 ("[T]he efficiency of the promisor's incentives for *precaution* depend upon the *level* of damages.").

140. Robert Cooter and Ariel Porat have made an analogous argument, noting that in many situations optimal incentives for both performance and reliance are best obtained by paying damages to a third party. Cooter & Porat, *supra* note 127, at 216–18.

141. *See* Meador & Warren, *supra* note 92, at 459 (stating that a *qui tam* relator can bring on action on behalf of the government and receive a certain percentage of the damages and forfeitures).

loss.[142] Indeed, there is no requirement that the plaintiff be harmed at all,[143] and most *qui tam* relators have suffered no personal loss at the hands of the defendant.[144] Rather, the amount of money that the plaintiff recovers should be set so as to maximize the government's goals—recovery of money defrauded and increased incentives for honesty among government contractors[145]—considering the costs imposed by the payment to the plaintiff itself. Applied in the contract law context, this reasonably suggests that an optimal regime would be one where a defendant would be required to pay the full amount of the plaintiff's expectation but where the plaintiff would recoup only an amount sufficient to encourage the optimal level of lawsuits, which is presumably the level at which the marginal social cost of litigation (including the cost of inefficient reliance) is exactly equal to the marginal social benefit from more efficient incentives for the breach of contract. There seems to be no particular reason why this optimal level of reward for plaintiffs should correspond exactly to the optimal level of the fine imposed on defendants.

3. The Economic Explanations that Remain

The failure of the efficient breach theory, however, does not metastasize through economic arguments about other doctrinal aspects of contract damages. Consider the argument that *Hadley* is an information-eliciting default rule.[146] Strictly speaking, the failure to account for the bilateralism of contractual liability and the economic incoherence of arguments for the expectation measure leaves the economic arguments in favor of the *Hadley* rule unchanged. Whatever damage rule we adopt, we want promisors to consider the value of their performance to promisees, and we want promisees to disclose sufficient information for promisors to make that decision. By penalizing closed-mouth promisees with idiosyncratic consequential damages, we encourage disclosure of information that will increase the efficiency of contracting parties.

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142. *See* A. Mitchell Polinsky & Yeon-Koo Che, *Decoupling Liability: Optimal Incentives for Care and Litigation*, 22 RAND J. ECON. 562, 563 (1991) ("[T]he optimal award to the plaintiff may be less than or greater than the optimal payment by the defendant.").

143. As shown by Cooter and Porat, optimal incentives may require payments to a third party. *See generally* Cooter & Porat, *supra* note 127.

144. *See* Hargrove, *supra* note 91, at 51 (stating that a *qui tam* relator can obtain "a bounty for their information, even if they [have] not suffered an injury themselves").

145. *See id.* at 92 ("Congress's ultimate public policy goal in amending the [False Claims Act] in 1986 was to deter fraud and recover the Government's money.").

146. *See* Hermalin, Katz, & Craswell, *supra* note 70, at 108–09 ("Under the rule of *Hadley v. Baxendale* . . . a buyer facing large losses from breach is more likely to be allowed to recover those losses if she has told the seller about them in advance.").

The *Hadley* rule, however, can be applied regardless of the efficiency of the underlying damage rule. Hence, even if expectation damages are economically inefficient, the addition of the *Hadley* rule nevertheless increases the efficiency of the system. Likewise, requiring parties to mitigate their damages increases efficiency regardless of the underlying damage measure. Regardless of the efficiency of expectation damages, they are made less inefficient if we refuse to compensate promisees for avoidable post-breach reliance on their promisors' promises. At the same time, both the *Hadley* rule and the duty to mitigate damages require that the law adopt some sort of a damages remedy.[147] While economic arguments in favor of these rules cannot account for the bilateralism of contract damages, once the rule governing those damages—whatever it is—is in place, the arguments can function. This does mean that despite their continued success, however, these economic arguments can do nothing to save a purely economic account of contract damages from the bilateralism critique. Without an argument for the bilateral structure of contractual liability and the basic choice of expectation damages, these admittedly successful theories are left hanging in mid-air without the support that they need to function.

VI. Implications

The critique of economic accounts of contract damages offered above is neither devastating nor trivial for economic explanations of contract law.[148] The failure of efficiency theories to account for the bilateralism of contract damages leaves many of the insights of economics into the current structure of contract law untouched. It does mean, however, that an adequate theory of current contract law will require that efficiency be combined with an account of the bilateral structure of contractual liability. Autonomy theories provide such accounts and can be combined with efficiency arguments to provide a theory of contract that is at once pluralistic, principled, and explanatorily powerful.

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147. *See* RESTATEMENT (SECOND) OF CONTRACTS § 350(1) (1981) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation."); Ayers & Gerner, *supra* note 75, at 101–04 (stating that the *Hadley* rule requires that the law adopt a damages remedy that correlates with the level of information the parties received).

148. *See supra* Part V.B (presenting several contract doctrines and explaining why the doctrines provide objections to economic explanations of contract damages).

A. The Scope of the Critique

The failure of economic explanations of contract damages can give rise to two possible responses. The first, to which ideological foes of law and economics are prone, is to cast economists from the temple of contract law theory. The second, to which practitioners of law and economics are prone, is to declare that the failure to explain contract doctrine is trivial and serious theorists have more important things to do. Both reactions are mistaken because they misunderstand what is at stake in creating an interpretive theory of a body of law.

The goal of interpretive theories of the law is not to specify what an ideal body of law would look like. Rather, the goal is to render the law as it actually exists intelligible as a normative practice with a coherent normative logic.[149] Economic theories of contract damages fail to render the common law of contract damages as it exists normatively coherent because they cannot account for the bilateral nature of those damages, and bilateralism, in turn, renders economic arguments for the expectation measure incoherent by tying both the promisor's and the promisee's incentives to a single measure.[150] The failure of economic theories, however, is explanatory, not normative. Their inability to account for contract damages does not mean that efficiency is a morally bankrupt normative guide. Furthermore, much of the economic theorizing about contract survives the problem of bilateralism. In short, the failure of the economic explanation of damages does not mean that it can be banished on either normative or explanatory grounds. It simply means that economics cannot operate as a solely sufficient explanation of contract law as it exists.

A hard proponent of economic theories of contract might respond that the failure of economics as an interpretive theory is trivial. "So what?" such a thinker might respond. "The failure of economics to explain contract doctrine clearly doesn't vitiate efficiency as a normative criterion. That being the case, I can continue to theorize about contract law in purely normative terms. I simply don't need an interpretive theory of contract damages."[151] On one level, this response is entirely valid. There is nothing incoherent about imagining what an efficient contract law would look like regardless of the shape of the law that we

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149. *See supra* Part II (explaining the law through legal theories).

150. *See supra* Part V (presenting the problem of bilateralism).

151. *Cf.* Richard Craswell, *Expectation Damages and Contract Theory Revisited* 55 (Stanford Law Sch. John M. Olin Program in Law & Econ., Working Paper No. 325, 2006), *available at* http://ssrn.com/abstract=925980 ("In my own analysis of default rules, I am interested in the explicitly normative (or 'law reform') question of what the law *ought* to do with contract disputes.").

actually have. Such a project requires skill and intelligence and will likely yield important insights about the design of legal institutions. On the other hand, standing alone it cannot give us the resources to evaluate its own normative suggestions.

First, we cannot make a decision about whether the law should be changed without knowing something about the value choices inherent in the law that we already have. We cannot know whether we should choose efficiency unless we know what it is replacing. In this sense, the final choice about legal design is normative, but it is comparatively so. In making suggestions for changing the law we are always dealing with an institution that is up and running, and deviations from past practice must be justified by showing the superiority of the new suggestions in relation to that practice. In short, a final judgment about normative theory requires that we engage in interpretive theory. Otherwise, we cannot know whether the new choices that we propose to make are superior to the choices reflected in the law that we have inherited.

Second, depending on one's view of the institutional context in which normative legal choices are made, interpretive theory may become necessary. Legislatures are, of course, free to make changes in the law based on their views of what, all things considered, makes for the best legal policy. Contract law, however, is a common law field where most of the development of new law is left to judges. Hence, to a greater or lesser extent normative theorizing about contract law is addressed to common law judges. The extent and nature of legitimate innovation in common law judging is, of course, an enormously complicated question.[152] It is not one that I propose to tackle here. However, at least one plausible and widely accepted theory, that common law judges are bound to follow precedent and deviations from—or creative elaborations of—old rules, must be justified in terms of the normative choices inherent in the law as a whole.[153]

There are, of course, alternative theories. For example, one view states that common law judges are free to act as interstitial legislators, adopting new rules on the basis of what they view—all things considered—to be the best

152. *See generally* BENJAMIN N. CARDOZO, THE NATURE OF THE JUDICIAL PROCESS (1921) (discussing the way judicial rulings are guided by information, precedent, custom, and standards of justice and morals); Ronald Dworkin, *Hard Cases*, *in* RONALD DWORKIN, TAKING RIGHTS SERIOUSLY 81 (1977) (arguing that judges should look to moral philosophy when deciding cases); MELVIN ARON EISENBERG, THE NATURE OF THE COMMON LAW (1988) (developing a coherent set of principles courts should use in establishing common law rules).

153. *Cf.* Dworkin, *supra* note 152, at 86 ("Lawyers believe that when judges make new laws their decisions are constrained by legal traditions but are nevertheless personal and original.").

policy.[154] It is not clear that the use of efficiency as a normative criterion necessarily commits one to any particular theory of adjudication. To the extent, however, that one addresses decisionmakers who believe that common law judges should decide cases in accordance with the choices inherent in the law, interpretive theory becomes necessary, and economic theorists cannot escape the necessity of understanding how their theories fit into the current structure of the law.

Ultimately the real value in understanding the failure of economic explanations of contract damages lies not in justifying the rejection of economics per se, but rather in understanding the proper role of economics in contract theory. This is the topic to which I now turn.

B. Toward a Pluralistic Theory of Contract

Most of the debate between autonomy and efficiency theories has focused on the search for a conceptual silver bullet that will allow one side to declare victory.[155] Generally speaking, those with a vision of contract law having multiple normative goals have been anti-theoretical pragmatists who endorse a "good gray compromise of competing concerns."[156] Very few scholars have focused their attention on the possibility of creating a principled but conceptually pluralistic theory of contract. Thinking through the implications of the failure of economic accounts of contract damages, however, shows us a very plausible structure for such a pluralistic theory.

1. The Vertical Integration Strategy

There are two basic strategies for resolving the conflict between autonomy theories and efficiency theories.[157] The first approach is to show that despite

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154. *See generally* RICHARD POSNER, PROBLEMS OF JURISPRUDENCE (1990) (arguing that judges do not rely on logic or science, but an array of informal methods that are not dependent on legal training or experience).

155. *Compare* BUCKLEY, *supra* note 36, at xi (stating that "[c]ontract law is best understood from the perspective of law-and-economics"), *with* FRIED, *supra* note 7, at 57 ("The moral force behind contract as promise is autonomy: [T]he parties are bound to their contract because they have chosen to be.").

156. Jean Braucher, *Contract Versus Contractarianism: The Regulatory Role of Contract Law*, 47 WASH. & LEE L. REV. 697, 701 n.14 (1990).

157. *See generally* Kraus, *Legal Theory*, *supra* note 11 (stating that "autonomy theories tend to treat the doctrinal statement as the principal legal data . . . . In contrast, economic theories tend to treat the outcomes of cases as the principal legal data").

the fact that both economic and autonomy theorists discuss "contract law," they are in fact constructing theories about different things.[158] Jody Kraus, for example, suggests that economists are largely concerned with case outcomes while autonomy theorists are concerned with legal reasoning.[159] The work of Alan Schwartz and Robert Scott provides another example.[160] They argue that autonomy theories of contract cannot be applied to contracts between corporations, which accordingly are the preserve of economic theories.[161] The second approach to reconciling autonomy and efficiency is the vertical integration strategy, which seeks to show that principles of autonomy and efficiency can be arranged hierarchically so that both can be deployed to explain and justify contract law.[162]

There are several different forms that a vertical integration strategy might take. First, one could argue that one value is foundational while the other value is derivative. For example, Daniel Farber has argued that while the law should primarily be concerned with personal autonomy, respect for such autonomy implies that efficiency is the sole goal of commercial law.[163] In support of this claim, he offers an argument for why parties in a Rawlsian original position would choose a contract law specified solely according to economic

158. *See, e.g.*, Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 541 & n.1 (2003) (noting that efficiency theorists and autonomy theorists concentrate on different scopes of inquiry).

159. *See* Kraus, *supra* note 40, at 689 (arguing that "autonomy theories tend to treat the doctrinal statements as the principal legal data for contract theory to explain" while "economic theories tend to treat outcomes of cases as the principal legal data for contract theory to explain").

160. *See generally* Schwartz & Scott, *supra* note 158 (discussing the types of contract law commercial parties would want the state to provide).

161. *See id.* at 543 ("Normative theories that are grounded in a single norm . . . have foundered over the heterogeneity of contractual contexts to which the theory is to apply."); *see also* Ethan J. Leib, *On Collaboration, Organizations, and Conciliation in the General Theory of Contract*, 24 QUINNIPIAC L. REV. 1, 2–9 (2005) (discussing the central importance of corporations for contract theory and lamenting the absence of more attention to the issue on the part of scholars). Elsewhere, I have criticized Schwartz and Scott's key philosophical claim (rather than their economic claims). *See generally* Oman, *Corporations and Autonomy Theories*, *supra* note 11 (arguing that autonomy theories can account for and justify the law governing contracts between corporations).

162. *See* Kraus, *Reconciling*, *supra* note 11, at 421 (stating that the vertical integration strategy "reconciles efficiency and autonomy contract theories by construing them as comprising legally distinct elements within one unified theory").

163. *See* Daniel A. Farber, *Economic Efficiency and the Ex Ante Perspective*, *in* THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW 54, 56 (Jody S. Kraus & Steven D. Walt eds., 2000) ("My thesis is that critics were right about Posner's failure to establish economic efficiency as a universal, let alone supreme, moral norm.").

efficiency.[164] The failure of economic accounts of contract damages discussed above, however, makes such a reconciliation difficult.[165] On one hand, efficiency cannot account for the bilateralism of contractual liability, which renders economic arguments for expectation damages incoherent. On the other hand, efficiency explanations of other aspects of contract damages, such as the rule in *Hadley v. Baxendale*, are quite successful. If, however, efficiency is derived from autonomy, (or vice versa), we would expect to see a law specified according to a single normative criterion. In contrast, the common law of contracts that we have has some areas that lend themselves to economic explanations and other doctrinal areas where this is not true.

Another possible vertical integration strategy would be to arrange the two values in an explicitly normative hierarchy. For example, elsewhere I have suggested that "[c]ontract law ought to be understood in terms of a two-tiered ordering of autonomy and efficiency. Both values ought to be pursued, but where they conflict, autonomy should act as a 'trump' value."[166] Yet the failure of economic accounts discussed above also throws this version of vertical integration into doubt.[167] Assume for a moment that autonomy theories provided a compelling reason for adopting the expectation measure of damages. The problem that such a vertical integration would immediately run into is the fact that while the law awards expectation damages, it also limits them, for example, through the duty to mitigate damages and the requirement that consequential damages be reasonably foreseeable. These rules, of course, have good economic explanations, but the fact that they exist suggests that in at least some cases of conflict, economic efficiency is being allowed to trump concerns about autonomy.[168] Yet contract law cannot rest on a normative hierarchy in

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164. *See id.* at 74–75 (hypothesizing a scenario in which parties would choose the Rawlsian approach).

165. *See supra* Part V.B (presenting an objection to economic explanations of contract damages).

166. Oman, *Unity and Pluralism*, *supra* note 11, at 1499. In support of this claim, I offer an argument for why parties in a Rawlsian original position would choose a contract law specified solely according to economic efficiency. *See id.* at 1500 ("[W]e seem to have at least an initially plausible reason for choosing efficiency in one sphere (those areas where liberty is not implicated) while placing emphasis on autonomy in another sphere (those areas where liberty conflicts with other concerns).").

167. *See supra* notes 165–66 and accompanying text (providing economic arguments that throw the first version of vertical integration into doubt).

168. In *Unity and Pluralism in Contract Law*, I suggested:

> [L]imitations on contractual freedom . . . need to be justified in terms of preserving equal liberty [for all]. The priority of liberty does not mean that there are no restrictions on personal freedom. It simply means that those restrictions must be justified with reference to the concept of liberty rather than with reference to

which efficiency is allowed to consistently trump autonomy.[169] If this was the case, we would not have the current rule of expectation damages, as there are more economically efficient alternatives.[170]

The final version of the vertical integration strategy sees the two values as operating so that one value authorizes the other value to proceed in the specification of rules within some limited domain.[171] The Rawlsian idea of the basic structure provides an example of such a conceptual relationship.[172] Rawls argues for the priority of justice as he defines it.[173] He does not, however, believe that all social relationships must pursue the principles of justice.[174] Rather, he says, these principles apply only to the basic structure of a society.[175] Once that basic structure complies with the rules of justice, society is free to make choices that apparently conflict with the demands of justice.[176] As Jody Kraus puts it:

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welfare, distributive justice, or some other value.

Oman, *supra* note 11, at 1502. Assuming that autonomy theories imply expectation damages, one might be able to justify limitations on the full expectation measure by reference to the notion of autonomy itself. To the extent, however, that such arguments cannot be made, I am forced to admit that the particular version of the vertical integration strategy that I endorsed previously must be modified. *See id.* at 1505–06 (presenting *Unity and Pluralism in Contract Law* as an example of the vertical integration strategy).

169. *Cf.* LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE xvii (2002) ("Our thesis is that social decisions should be based *exclusively* on their effects on the welfare of individuals—and, accordingly, should not depend on notions of fairness, justice, or cognate concepts.").

170. *See supra* Part V.B (presenting bilateralism as an objection to economic explanations of contract damages).

171. *See* Kraus, *Reconciling*, *supra* note 11, at 423–29 (explaining how the vertical integration strategy can be used to reconcile normative and explanatory theories).

172. *See* JOHN RAWLS, A THEORY OF JUSTICE 6 (rev. ed., 1999) ("[T]he primary subject of justice is the basic structure of society, or more exactly, the way in which the major social institutions distribute fundamental rights and duties and determine the division of advantages from social cooperation.").

173. *See, e.g.*, *id.* at 475 ("The equal liberties can be denied only when it is necessary to change the quality of civilization so that in due course everyone can enjoy these freedoms.").

174. *See, e.g.*, *id.* ("The principles of justice for institutions must not be confused with the principles which apply to individuals and their actions in particular circumstances.").

175. *See, e.g.*, *id.* at 47 ("The primary subject of the principles of social justice is the basic structure of society, the arrangement of major social institutions into one scheme of cooperation.").

176. *See, e.g.*, *id.* at 7 ("There is no reason to suppose ahead of time that the principles satisfactory for the basic structure hold for all cases. These principles may not work for the rules and practices of private associations or for those of less comprehensive social groups."); *see also* John Rawls, *The Basic Structure as Subject*, 14 AM. PHIL. Q. 159, 159 (1977) (defining the basic structure of society as the background social framework of the main social and political institutions).

> [Q]uite apart from its substantive content, the form of Rawlsian institutional justification, which calls for a division of labor between the basic and non-basic structure of society, implies that the justification of these two kinds of analytically distinct but related structures within society must be provided by an overall theory composed of analytically distinct, but therein unified, justificatory principles.[177]

Likewise, one can argue that autonomy theories justify a law of contracts with a basic structure, namely one in which at least some voluntary obligations will be protected by a rule of providing compensation in the event of breach. In this way, the normative credentials of autonomy theory are brought to bear to justify the basic bilateral structure of contract law. However, once that basic structure is in place, efficiency—which has some normative force and considerable conceptual power—is used to specify additional rules. Such an approach to vertical integration provides a good account of what we see in the law of contract damages: A basic structure that cannot be defended on economic grounds, which is nevertheless encrusted with secondary rules that can be explained in economic terms.

2. Bilateralism and Default Rules

Autonomy theorists purport to be able to account for the bilateral structure of contractual liability and the basic choice of expectation damages. For example, Charles Fried, the most widely recognized contemporary defender of an autonomy theory of contract, has written:

> If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance. In contract doctrine this proposition appears as the expectation measure of damages for breach. The expectation standard gives the victim of a breach no more or less than he would have had had there been no breach—in other words, he gets the benefit of his bargain.[178]

Notice that his argument has two claims. First, he explains why law links the promisor and the promisee together by civil liability, rather than adopting an insurance scheme or a rule punishing breaching promisors. The reason is that the promise itself creates a link between promisor and promisee so that entitlement flows from one to the other.[179] This is an explanation of

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177. Kraus, *Reconciling*, *supra* note 11, at 425.

178. FRIED, *supra* note 7, at 17.

179. While he does not explicitly discuss the issue of bilateralism, Fried's discussion of the rules of offer and acceptance does provide an extensive discussion of how promising relates the

bilateralism. Second, he justifies the expectation measure by noting that it is fair to require one to hand over the equivalent of performance. Strictly speaking, it is not clear from Fried's analysis whether the fairness that demands one to render the equivalent is the same thing as the respect for autonomy in which he grounds the obligation of promising or some other value, such as corrective justice. Other promissory theorists, however, have argued that the expectation measure is logically entailed by the very idea of a binding promise. For example, David Friedmann has written:

> Suppose that in consideration of $300 D [the "Defendant"] undertook to transfer to P [the "Plaintiff"], within 6 months, certain shares. After 5 months, when the price of the shares reaches $1000, D reneges. If we assume that the contract was valid so that it vested in P the right to the promised performance, it follows that P would be entitled either to specific performance (the value of which is $1000) or to the substitutionary remedy of damages, which will be based upon the value of the promised performance, namely $1000. . . .
>
> To claim that the contract is binding, i.e. that P was entitled to D's performance, and yet that the recovery can be confined to P's expenditure ($300), is a contradiction in terms.[180]

One objection to this claim is the argument that respect for autonomy requires a remedy of specific performance.[181] After all, if we believe that people create

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promisor to the promisee via a binding obligation. *Id.* at 14 ("[P]romising is a way for me to bind myself to another so that the other may expect future performance . . . ."). He writes:

> The case of the vow shows that a promise is something essentially communicated to someone—to the promisee in the standard case. . . . A promise is relational; it invokes trust, and so its communication is essential. . . . A promise cannot just be thrust on someone—he must in some sense be its beneficiary. . . . [Hence], we identify as a further necessary condition of promissory obligation *that the promise be accepted.*

Id. at 42–43.

180. David Friedmann, *The Performance Interest in Contract Damages*, 111 L.Q. REV. 628, 637–38 (1995). Other theorists have offered analogous autonomy arguments in favor of the expectation measure. *See generally* Peter Benson, *The Unity of Contract Law*, *in* THE THEORY OF CONTRACT LAW: NEW ESSAYS 118 (Peter Benson ed., 2001); DORI KIMEL, FROM PROMISE TO CONTRACT: TOWARD A LIBERAL THEORY OF CONTRACT (2003); Randy Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986); Peter Benson, *Abstract Right and the Possibility of a Nondistributive Conception of Contract: Hegel and Contemporary Contract Theory*, 10 CARDOZO L. REV. 1077 (1989); Peter Benson, *The Idea of a Public Basis of Justification for Contract*, 33 OSGOODE HALL L.J. 273 (1995); Dori Kimel, *Remedial Rights and Substantive Rights in Contract Law*, 8 LEGAL THEORY 313 (2002); Daniel Markovits, *Contract and Collaboration*, 113 YALE L.J. 1417 (2004).

181. *See generally* Randy Barnett, *Contract Remedies and Inalienable Rights*, 4 SOC. PHIL. & POL'Y 179 (1986) (arguing in favor of a default rule of specific performance based on an

obligations to act when they enter into valid contracts, why not force them to perform? The fact that specific performance is not the default remedy therefore suggests that autonomy theories do not account for the law of contract damages. Autonomy theories can meet this objection in two ways.

First, one might argue that autonomy itself places limits on the sort of remedies that the law can impose. The basic intuition behind this argument is that specific performance represents a greater intrusion into personal freedom than do money damages, and so long as damages compensate the promisee for her loss, we ought to choose the remedy that intrudes on liberty the least.[182] Applying this principle, for example, John Stuart Mill argued that "even without [a] voluntary release there are perhaps no contracts or engagements, except those that relate to money or money's worth, of which one can venture to say that there ought to be no liberty whatever of retraction."[183] A more elaborate version of this argument can be made using the concept of inalienability. There are certain kinds of rights, so the argument goes, that are neither morally nor practically alienable. For example, one cannot alienate the right to exercise independent moral judgment such that one could be relieved of all personal responsibility in choosing to obey an otherwise uncoerced command. Likewise, it is not possible—absent imaginary mind control machines—to alienate the ability to control one's body. These inalienable rights, in turn, track the category of obligations—personal service contracts—for which specific performance is unavailable.[184]

A second response to the specific performance objection lies in the idea of private law itself. Aristotle identified corrective justice as a unique and independent normative principle based on what he called an arithmetic principle.[185] By this he meant that corrective justice was concerned not with the distribution of rights or the punishment of wrong doing, but only with the

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autonomy theory on contract) (on file with the Washington and Lee Law Review).

182. *Cf.* Arthur v. Oakes, 63 F. 310, 318 (7th Cir. 1894) (holding that a decree of specific performance for breach of an employment contract would be involuntary servitude under the Thirteenth Amendment).

183. John Stuart Mill, *On Liberty*, *in* THE ENGLISH PHILOSOPHERS FROM BACON TO MILL 949, 1031 (Edwin A. Burtt ed., 1939).

184. *See* Barnett, *supra* note 181, at 180 (noting the court's reluctance to "specifically enforce contracts for personal services"). Note, however, that Barnett believes that while inalienability justifies the refusal to award specific performance for some contracts, he believes that the current defaults between damages and injunctions should be switched, so that specific performance is ordered unless some special showing is made. *See id.* (reforming the rules governing contract remedies).

185. *See* ARISTOTLE, NICHOMACHEAN ETHICS 125–28 (Terence Irwin trans., 1985) (presenting a concept of corrective justice).

compensation of those harmed by others.[186] Private law, one could argue, is the domain of corrective justice.[187] It is the set of institutions we have created to provide this particular sort of justice in our society.[188] It is this fact that accounts for the pervasiveness of bilateralism not only in contracts, but also in torts and property.[189] Corrective justice, however, does not specify the contours of the rights whose violation merits compensation.[190] It justifies a system of compensation, but leaves the substance of what is to be compensated to other values and principles.[191] This is the point at which autonomy enters the picture. Just as within the vertical integration strategy that I endorse above, the principle of autonomy creates a basic structure that then authorizes the pursuit of efficiency within the context of that basic structure, so autonomy finds itself nested within the principle of corrective justice just as contract law is nested within the private law as a whole. One of the advantages of this approach is that it explains the existence of bilateralism across the entire spectrum of the private law, a fact that becomes entirely—and implausibly—accidental if we assume that bilateralism in contract law rests entirely on principles unique to that body of law.

Such autonomy arguments, however, proceed at a very high level of abstraction. Ultimately, they do little more than justify a legal regime that recognizes the obligation to keep at least some promises and the right to compensation roughly the equivalent in value of the promise. Autonomy theories do very little, however, to specify most of contract doctrine, including much of the doctrine governing damages. Richard Craswell, for example, has argued that promissory theories suffer from a fatal flaw, namely their inability to specify the content of default rules.[192] He suggests that although promissory theories may be useful for specifying rules of contract formation or

186. *See id.* at 126 ("[Where] the action and the suffering are unequally divided [with profit for the offender and loss for the victim] . . . the judge tries to restore the [profit and] loss to a position of equality, by subtraction from [the offender's] profit.").

187. *See generally* WEINRIB, *supra* note 16 (arguing that private law can be understood as a single coherent normative institution structured around the idea of corrective justice).

188. *See id.* at 19 (noting the "categorical difference between private law and other legal orderings").

189. *See, e.g.*, Jody S. Kraus, *Transparency and Determinacy in Common Law Adjudication: A Philosophical Defense of Explanatory Economic Analysis*, 93 VA. L. REV. 287, 342 (2007) ("[B]ilateralism is an essential property of tort law.").

190. *Cf.* ARISTOTLE, *supra* note 185, at 126 (stating that "parties to a dispute resort to a judge, and an appeal to a judge is an appeal to what is just").

191. *See id.* at 126–27 ("[The parties] seek the judge as an intermediary . . . assuming that if they are awarded an intermediate amount, the award will be just.").

192. *See* Craswell, *supra* note 8, at 491 ("This frequently leads to careless or ad hoc statements concerning the proper content of contract law's background rules.").

interpretation, they cannot be used to explain much of what we think of as contract law.[193] Since the publication of his article, autonomy theorists have provided a number of responses to Craswell's criticisms, showing that their theories can explain more of the law of contracts than he supposed.[194] While many of these responses are persuasive, I believe that the fundamental thrust of Craswell's article remains sound: Autonomy theories simply cannot fully specify the content of contract law. Strangely enough, no one has taken up his suggestion to offer an account of contract law where both autonomy and efficiency peacefully coexist. This is not wholly surprising, of course. While Craswell admits that certain rules, which are derived from economic theories, can also be derived from promissory theories, other legal economists are not inclined to concede this contested ground.[195] For their part, autonomy theorists seem to have been content to fend off the charges of irrelevancy leveled against them by Craswell.[196] The failure of economic explanations of contract damages, however, suggests a structure for precisely the kind of pluralistic integration of contract theory that Craswell alluded to (but made no attempt to provide).

Craswell's insight about default rules can be coupled with both the bilateralism-induced failure of economic accounts of expectation damages and the relatively abstract success of autonomy accounts of the expectation measure to provide a pluralistic theory. The autonomy theories provide a basic justification for the existence of contract law and its core remedial structure. This justification, in turn, then authorizes the use of efficiency to fill in the massive gaps that the indeterminacy of autonomy leaves. Furthermore, so long as the basic structure prescribed by autonomy theories—compensation for the lost value from breach of binding promises—remains in place, one may even limit or compromise expectation damages at the margins because such compromises do not undermine the basic structure of contract law. This, of

193. *See id.* at 503–16 (explaining why the content of contract rules cannot be derived from such theories).

194. *See, e.g.*, Kraus, *supra* note 40, 689–90, 715–30 (explaining and weighing in on the dispute between Fried's autonomy theory and Craswell's economic approach); Randy Barnett, *The Sounds of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 826 (1992) (showing how "the concept of default rules bolsters the theoretical importance of consent").

195. *See* Craswell, *supra* note 151, at 22 (conceding that autonomy theories are not "completely vacuous").

196. *See, e.g.*, Charles Fried, *The Convergence of Contract and Promise*, 120 HARV. L. REV. F. 1, 1 (2007) (stating that the argument "that contract doctrine is not and should not be rooted in the morality of promising, but rather in the economics of efficiency" is "frequently made but mistaken").

course, is exactly what the law of contracts does. As discussed above, the extent of a promisee's compensable expectation is limited by various doctrines that are best explained in economic terms, even while the basic structure of expectation damages itself is best explained in terms of autonomy.[197]

While Craswell is ultimately interested in purely normative rather than interpretive theories of contract law,[198] he nevertheless would likely object to this proposed reconciliation for the simple reason that he does not believe that autonomy theories of contract can justify expectation remedies.[199] Craswell's argument begins with the unobjectionable observation that parties could explicitly set forth a remedy in their contract itself.[200] For example, a promisor might say, "I will deliver to you 500 widgets next week or else pay to you the market price of 500 widgets at that time." When the law provides expectation damages for breach of a promise that simply says, "I will deliver to you 500 widgets next week," it is in effect supplying a default term. Taking Fried as his foil, Craswell writes:

> Fried's position was that the proper remedy for breach is to make the breacher hand over "the equivalent of the promised performance." But if, as I have argued, the equivalent of the promised performance itself depends on the full and exact scope of what was promised—*including the exact scope of what was promised in the event of breach*—then Fried's argument tells us nothing about the appropriate remedy until after we have already decided the exact scope of what was expressly or implicitly promised. . . . In short Fried's conclusion about what remedy should actually be awarded seems to require a prior decision as to what remedy was expressly or implicitly promised.[201]

The precise meaning of Craswell's argument is unclear. There are at least two possible interpretations. One might interpret the argument as claiming that in the absence of an express agreement on remedy in the event of breach, we cannot know anything about a promise's value by recourse to its express provisions. In other words, if we have some background rule—say one in

197. *See supra* Part III–IV (discussing doctrines governing contract damages and their economic explanation).

198. *See* Craswell, *supra* note 151, at 52 ("In my own analysis of default rules, I am interested in the explicitly normative (or 'law reform') question of what the law *ought* to do with contract disputes.").

199. *See id.* at 21 (claiming that "the selection of [expectation damages] is not dictated, even presumptively, by anything in the entitlement theories").

200. *See id.* at 3 ("[D]efault rules are legal doctrines that govern the obligations of contracting parties only to the extent that the parties themselves have not provided otherwise in their contract.").

201. *Id.* at 12.

which a promisor who breaches pays restitution damages—we can use that background rule to determine the real value of the promise, but in the absence of such a background rule we cannot determine a promise's value. The problem with this view is that it requires in effect that we treat promises made without either an express provision covering remedies for default or a background remedy rule as being worthless. As a conceptual matter, however, this is implausible. A promise involves at the very least a description of some action that the promisor commits to take in the future. We can determine the value of the promise by asking what the described behavior is worth. We look to the described behavior not because there is some promise-independent background rule requiring the expectation measure, but rather because we understand the promise as creating an obligation. In other words, we look to the value of the promised behavior because that is what the promisor *ought* to do.

There is a second possible interpretation of Craswell's argument, namely that while autonomy theories can justify expectation damages at some rather abstract level, they cannot generate all of the concrete rules necessary to translate the abstract commitment into something with the specificity of the contract doctrine governing damages. Such a claim, however, is entirely consistent with the vertical integration between autonomy and efficiency that I am proposing here.[202] Autonomy theories lack the conceptual power to specify most of contract law doctrine. Efficiency theories, on the other hand, cannot account for the basic bilateral structure of contractual liability.[203] Indeed, Craswell concedes that "entitlement theories" (i.e. autonomy theories of contract that claim that legally enforceable promises give the promisee an entitlement to the value of the contract at the moment of formation) provide an adequate response to Fuller and Purdue's famous claim that expectation damages cannot be justified as a form of compensation.[204] He writes:

> As a response to this argument, the entitlement theories . . . work perfectly well. That is, if a contract has already transferred to the promisee an entitlement to expectation damages, then the promisor's failure to perform can easily be characterized as inflicting actual *harm* on the promisee just as theft inflicts a harm, by depriving the promisee of something that is rightfully his. Moreover, the remedy of expectation damages undoes that

202. *See supra* Part VI.B.1 (presenting the vertical integration strategy).

203. *See supra* Part V.B (presenting bilateralism as an objection to economic explanations of contract damages).

204. *See* Craswell, *supra* note 151, at 22–24 (presenting entitlement theories "as a response to Fuller [and] Perdue").

> harm by restoring to the promisee the exact value that he has wrongfully been deprived of.[205]

Put in simpler terms, Craswell concedes that autonomy theories provide an explanation for the bilateral structure of contractual liability. Elsewhere Craswell suggests that autonomy theorists are "harken[ing] back to a pre-modern, pre-realist, pre-Calabresi-and-Melamed approach to remedies."[206] Hence, he sees the claim that expectation damages compensate a promisee for the breach of her promisor as somehow obsolete or primitive. However, one could just as easily see the insight in logical rather than historical terms. The admittedly abstract claims of autonomy theorists are not outdated shibboleths from which modern thought has liberated us. Rather, they provide a justification for the basic bilateral structure of contract law—a structure that economic theories cannot adequately account for—that then serve as a framework authorizing and organizing doctrinal elaborations based on concerns for economic efficiency. On this view, autonomy accounts of contract damages are logically, rather than merely historically, prior to economic accounts of contract doctrine. Both accounts, however, are necessary to render the current law of contract damages coherent.

VII. Conclusion

The common law of contracts is an enormously complicated phenomenon. There is a more or less unbroken line of precedents stretching back well over 400 years.[207] Detailed contemporary treatises run into the dozens of volumes.[208] Given this development and complexity, it is reasonable to suppose

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205. *Id.* at 23. Craswell, of course, asserts that this argument rests on the assumption that promisees become entitled to expectation damages, an assumption that he believes cannot be found in the idea of promising itself. *See id.* at 24–26 (responding to the historical association between expectation damages and freedom of contract). For my response to this argument, see *supra* Part VI.A.

206. Craswell, *supra* note 151, at 20. The reference to "Calabresi-and-Melamed approach" is to the justly celebrated article on legal remedies by Guido Calabresi and A. Douglas Melamed. *See generally* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972).

207. Roughly speaking, I date the rise of the common law of contracts to *Slade*'s *Case*, (1602) 76 Eng. Rep. 1074 (K.B.), which cleared the way for the rise of the action of assumpsit. Of course, one can trace the law of contract back much farther than this. *See* IBBETSON, *supra* note 3, at 11 (beginning with medieval common law).

208. The most recent edition of *Corbin on Contracts* runs to twenty-one volumes with supplements. *See* CORBIN ON CONTRACTS (Perillo ed., 1993 & Supp. 2007). Not to be outdone by his student even in his posthumous existence, *Williston on Contracts* comes in at no less than forty-two volumes once supplements, forms, and indexes are included. *See* WILLISTON ON

that no unifying theory of contract law is possible. On this view, contract doctrine represents little more than the random final product of a long chain of historical accidents.[209] Even if a perfect philosophical account of contract law is not possible, however, we may still hope for theories that render the bubbling, nominalistic mass of the law less confusing and more coherent than it appears in the absence of those theories. In the face of similar skepticism by the Legal Realists more than a half century ago, Benjamin Cardozo warned:

> The misleading cult that teaches that the remedy of our ills is to have the law give over, once and for all, the strivings of the centuries for a rational coherence, and sink back in utter weariness to a justice that is the flickering reflection of the impulse of the moment.[210]

The failure of economic accounts of the law of contract damages, far from contributing to the "utter weariness" and "flickering . . . impulse" that Cardozo feared, points toward a route by which "the strivings of the centuries for a rational coherence" may be carried forward.[211]

Economics has proven to be a tremendously powerful way of looking at private law generally and contract law specifically. Although economic theories are seldom entirely clear about their own philosophical ambitions, they seek in part to provide an explanation of contract law as it currently exits, showing how the law embodies a set of coherent choices that create incentives for contracting parties to behave efficiently. One of the centerpieces of this explanatory ambition has been the attempt to explain the current law of contract damages in terms of efficiency. Ultimately, this attempt has failed because economics cannot account for the basic bilateral structure of contract damages. Bilateralism in turn, renders economic explanations of expectation damages incoherent. This failure, however, leaves untouched the successes of economics in explaining the ancillary doctrines of contract damages. Coupled with the failure of autonomy theories to explain most doctrinal detail, this suggests that contract law has a pluralistic normative structure where efficiency is subordinated to the concerns of autonomy in specifying the basic structure of contract law but is not banished from the realm of explaining the law that we have.

CONTRACTS (4th ed. Richard A. Lord ed., 1990 & Supp. 2007).

209. *Cf.* Peter Alces, *The Moral Impossibility of Contract*, 48 WM. & MARY L. REV. 1647, 1647–71 (2007) (arguing that the nature of contract doctrine precludes the construction of moral theories that explain or justify it).

210. Robert H. Jackson, *Full Faith and Credit—The Lawyer's Clause of the Constitution*, 45 COLUM. L. REV. 1, 25 (1945).

211. *Id.*