June 30, 2008

When is a Willful Breach 'Willful'?

A Puzzle and Two Different Economic Solutions

Richard Craswell*

Liability for breach of contract is often described as a form of strict liability, in which the measure of damages is unaffected by the culpability of the breach.[1] However, courts sometimes do award higher damages, under various legal doctrines, if the behavior of the breacher seems especially culpable. When they do, they may describe the breacher's behavior using labels such as *willfully,* or *in bad faith,* or *fraudulently,* or *maliciously*— or, as Dickens once put it, 'otherwise evil-adverbiously.'[2]

Unfortunately, labels like these are not self-defining. Over fifty years ago, Corbin was scathingly critical of their use:

> The word most commonly used is 'wilful' [*sic*]; and it is seldom accompanied by any discussion of its meaning or classification of the cases that should fall within it. Its use indicates a childlike faith in the existence of a plain and obvious line between the good and the bad, between unfortunate virtue and unforgivable sin.[3]

---

* William F. Baxter–Visa International Professor of Law, Stanford University. Prior versions of this paper have benefitted from the comments of a great number of people, including participants in seminars at the American Law & Economics Association and at the Harvard, McGill, Northwestern, and Stanford law schools.

1. E.g., Globe Refining Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544 (1903).

2. Charles Dickens, *A Tale of Two Cities* [1859] 93 (Viking Penguin ed., 1970).

3. Arthur Linton Corbin, 5 *Corbin on Contracts* 545 (1951). As this passage demonstrates, we do not even have any consensus on spelling: 'willful' and 'wilful' are both common.

In this paper, I address two aspects of the 'willfulness' puzzle. First, I argue that willful breaches cannot sensibly be defined merely by reference to some fact about the breacher's mental state. Second, I briefly sketch two different economic rationales for requiring larger damage awards for certain kinds of breaches—and, hence, two different economic approaches to defining those breach that might be selected for harsher treatment. My aim here is not to endorse either of these approaches, but merely to point out the differences between them, for each approach makes very different demands of the courts.

I. The puzzle

One natural interpretation of a term like 'willful' is that it refers to the defendant's mental state: willful breaches are those where a party deliberately or intentionally breaches.[4] However, most breaches of contract result from an entire *sequence* of events, some of which will have been deliberate and some of which will have been accidental. By focusing on the deliberate events in the sequence, almost any breach can be characterized as willful. And by focusing instead on the accidental events, that characterization can always be disputed.

To illustrate, consider two staples of the contracts curriculum: *Jacob & Youngs, Inc. v. Kent,*[5] and *Peevyhouse v. Garland Coal & Mining Co.*[6] In *Kent,* a builder promised to use a particular brand

4. See, e.g., Patricia Marschall, *Willfullness: A Crucial Factor in Choosing Remedies for Breach of Contract,* 24 Ariz. L. Rev. 733, 733 (1982) (defining a willful breach as 'a knowing breach by a party not legally excused from performing, which is made for any primary purpose other than to confer a benefit on the aggrieved party').

5. 129 N.E. 889 (N.Y. 1921).

6. 382 P.2d 109 (Okla. 1962).

of pipe to build a house; in *Peevyhouse,* a mining company promised to make certain repairs to the land after they finished mining the coal. The builder in *Kent* used the wrong brand of pipe, apparently by accident; but the mining company in *Peevyhouse* decided the promised repairs would cost too much, so they simply refused to make the repairs. Described in this way, *Peevyhouse* sounds like a deliberate or 'willful' breach, while the breach in *Kent* sounds accidental.[7]

However, *Kent* can be characterized as a willful breach if we focus on other events in the sequence. After all, as soon as the builder discovered his mistake, he could have torn the house down and started over, this time using the right brand of pipe. (Much of the pipe was in the interior walls and foundations, and so could not easily be replaced without demolishing the house.) The builder chose not to do this, for demolishing the house would have been extremely expensive, but there is no question that this choice by the builder—that is, the choice not to demolish the house—was deliberate. Thus, if the intentionality of *this* part of the sequence is what matters, *Kent* must be classified with *Peevyhouse* as a deliberate or 'willful' breach.[8] To be sure, we can avoid this character

---

7. Consistent with this intuition, Marschall discusses *Peevyhouse* as a 'willful' breach, and appears to treat *Kent* as non-willful. Marschall, supra note 4, at 750–51 (discussing *Peevyhouse*), 743 (discussing *Kent*) (1982). *Peevyhouse* is also assumed to be a 'deliberate' breach in Lucian Arye Bebchuk & I.P.L. Png, *Damage Measures for Inadvertent Breach of Contract,* 19 Int'l Rev. L. & Econ. 319, 319–20 (1999).

8. See, e.g., William S. Dodge, *The Case for Punitive Damages in Contracts,* 48 Duke L.J. 629, 651–52 (1999) (defining a breach as 'willful' if the breaching party 'deliberately decides not to perform because performance has become more expensive than anticipated (though not so expensive as to raise the defense of impossibility)'). Dodge does not appear to notice the tension between this definition and his own characterization of *Kent* as an 'involuntary' or non-willful breach (id. at 652 n.127). The only commentator

ization of *Kent* if we focus instead on the builder's earlier, unintentional mistake about what brand of pipe was being installed. But why should the intentionality of *that* event control our characterization of the breach, rather than the intentionality of the subsequent decision not to tear down the house and start over?

Indeed, if we are free to pick and choose which decision to focus on, it is far from clear that the breach in *Peevyhouse* was 'willful.' True, the coal company deliberately chose not to repair the land once they learned how much it would cost to do so. At least on one reading of the facts, though, the coal company originally thought the vein of coal followed a particular route which would have made the promised repairs relatively easy. As it turned out, the vein was configured differently, and this made the repairs more expensive than they might have been.[9] Thus, if we focus on the coal company's mistake about the coal, that event in the sequence looks every bit as involuntary as the builder's mistake about the pipe. And if the answer is, 'the coal company should have known there was a risk it might be mistaken,' why not say that the builder should also have known there was a risk that it might get the brand of pipe wrong?

The problem here is fundamental. In the vast majority of cases, the parties to a contract do not intend to breach at the time they signed it. Instead, they hope the contract will be performed as

---

I have found who even mentions this similarity between *Peevyhouse* and *Kent* is Carol Chomsky, *Of Spoil Pits and Swimming Pools: Reconsidering the Measure of Damages for Construction Contracts,* 75 Minn. L. Rev. 1445, 1449–50 (1991).

9. For a detailed investigation into the facts of the case, see Judith L. Maute, *Peevyhouse v. Garland Coal & Mining Co. Revisited: The Ballad of Willie and Lucille,* 49 Nw. U. L. Rev. 1341 (1995). Other possible mistakes by the coal company, including uncertainty about the future price of coal and about the boundary lines marking the exact location of the promised repairs, are also discussed by Maute (id. at 1368–69 and 1419–24).

planned, but then something else happens. Costs go up, or a better offer is found elsewhere, or work is performed incorrectly, and what originally looked like a good deal becomes much less appealing to one party.[10] Sometimes that party grits her teeth and performs anyway, but the litigated cases are those in which she decides that she will not go through with the deal. If we focus on the defendant's *last* decisions, then, there will almost always be one that is deliberate, thus potentially allowing us to classify the breach as 'willful.' But there will also usually be some earlier event that was not deliberate—the increase in costs, or the work that was done incorrectly, or the better offer that comes along at the last minute—so if we focus on *that* event, we will classify the breach as resulting from a non-deliberate event.

Indeed, even when breaches were in some sense intended from the beginning, we can always (if we try) find non-deliberate events that played a role. For example, consider a sleazy aluminum siding company that lures customers in by quoting a very low price, planning all along to take their down payment and disappear.[11] While this sounds like the quintessential example of a deliberate breach, consider that even this company might have lived up to its contract if, say, an eccentric millionaire unexpectedly offered it a reward for completing the job. Thus, even this breach can be described as resulting from a sequence of two events: an earlier event that was beyond the siding company's control (the failure of any millionaire to offer a reward); followed

---

10. Goetz and Scott refer to this as the 'regret contingency.' Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract,* 89 Yale L.J. 1261, 1273 (1980).

11. In recent work, Ayres and Klass refer to this as an 'insincere promise.' Ian Ayres & Gregory Klass, *Insincere Promises: The Law of Misrepresented Intent* (2005). See also George M. Cohen, *The Fault Lines in Contract Damages,* 80 Va. L. Rev. 1225, 1252–1256 (1994).

by a later, deliberate decision about how to respond to that event (the decision not to install the siding). Focusing on the second of these events makes the breach seem deliberate—but if we focus instead on the first event, it is hard to distinguish this example in any formal way from cases like *Kent* or *Peevyhouse*.

Of course, quibbles like these do not stop most of us from condemning the siding company's breach as 'willful,' even if we cannot articulate a formal definition of that term. Apparently, in some cases (like my aluminum siding example) we naturally select the breacher's deliberate decisions to focus on, and we see the resulting breach as willful. In other cases (*Kent?*), we decide to focus instead on the chance event or the mistake, and see the the breach as accidental. Often, these choices are made without our being consciously aware of them—though behavioral researchers are beginning to investigate these choices more systematically, as I discuss below in Part I.C.

A. Analogies in other fields of law

Viewed in these terms, the problem is not unique to contract law. Indeed, a very similar point is often made about the legal concept of *causation*. When we identify the actions that caused a fire, for example, there will usually be any number of necessary prerequisites or but-for causes. The fire may have been started when the defendant applied a match to wood—but we could also say that the fire was 'caused' by the presence of oxygen in the air, or by the failure of the manufacturer to make the object out of steel rather than wood, for if either of those conditions had been different then the defendant's match would not have produced a fire. In tort law, then, it has long been recognized that some further principle must be invoked, over and above a mere factual inquiry, to select one of these necessary conditions as the legally responsible 'cause' of the

loss. While there is much disagreement about just which additional principle(s) should be used to select the legally relevant cause, the need for *some* such selection principle is undisputed.[12]

An even closer analogy can be found in criminal law, in cases where it matters whether the defendant acted 'voluntarily.' Here, too, the application of that label may depend on our choice to focus on earlier or later events in the sequence that led up to a crime. For example, a badly intoxicated driver may be literally unable to control her car, so if we focus entirely on her actions while she is behind the wheel, the resulting crash will seem involuntary. But if we look instead at her earlier decisions (made while she was sober) to drive to a party where she intended to drink, and to do so without making any arrangements for a designated driver, *those* decisions makes the accident seem more the result of a voluntary choice.[13]

Criminal law must also deal with the problem of conditional intentions, in cases where statutes impose longer sentences for

---

12. For discussions of this point see, e.g., John Borgo, *Causal Paradigms in Tort Law,* 8 J. Legal Stud. 419 (1979); Richard W. Wright, *Causation in Tort Law,* 73 Calif. L. Rev. 1735, 1741–58 (1985). For a survey of the psychology literature on how lay observers tend to attribute causation, see W.H. Dray, *Causal Judgment in Attributive and Explanatory Contexts,* 49 L. & Contemp. Prob. 13 (Summer 1986).

13. For a useful discussion of this issue in criminal law, see Mark Kelman, *Interpretive Construction in the Substantive Criminal Law,* 33 Stan. L. Rev. 591, 600–611 (1981). For an example of a closely analogous problem in contract law, compare Commercial Discount Co. v. Town of Plainfield, 180 A. 311, 313 (Conn. 1935) (decision by contractor to stop working, when the contractor was in severe financial difficulties and was simply unable to pay its workers, held not to be a 'willful' breach), with Billingmeier v. Concorde Marketing, Inc., 2001 WL 1,530,356 (Minn. App. 2001) (breach triggered by defendant's financial difficulties held to be 'willful' when the financial difficulties themselves were caused by the defendant's wrongful behavior).

crimes committed with a particular intent. For example, if a prison inmate takes a hostage and threatens to kill her *unless he is released from prison,* does this make the inmate guilty of assault 'with intent to kill'? Or is he guilty only of ordinary assault, since he did not intend unconditionally to kill the hostage, and probably hoped he would not kill her?[14] This issue is at least somewhat similar to trying to decide whether a breach of contract was intentional if the contractor intended to perform *unless it turned out to be too expensive,* or if the aluminum siding company intended to breach *unless a millionaire offered to reward it for performing.* And while criminal law scholars have not agreed on any general solution to this problem, they do agree that characterizing a conditional intent is not simply a matter of discovering some fact about what the defendant was actually thinking.[15]

B. Lay assessments of culpability

Rather than looking for solutions in the theories of scholars, we might instead look to laypeoples' intuitive judgments about which actions are 'willful' or otherwise culpable. As I noted earlier, few observers would hesitate to condemn my aluminum siding company as a willful breacher, even after they understand that the company would have been perfectly willing to perform if only a millionaire had offered them a bribe. I can also report that my first-year contracts students regularly (and, in most years, nearly unanimously) consider the breach in *Peevyhouse* to be an intentional breach, but do not apply that label to the breach in *Kent.*

Behavioral researchers have recently begun to study lay-

---

14. Cf. State v. Irwin, 285 S.E.2d 345 (N.C. Ct. App. 1982) (reducing the charge to simple assault without intent to kill).

15. For a recent review of the controversy, see Gideon Yaffe, *Conditional Intent and Mens Rea,* 10 Leg. Theory 273 (2004).

peoples' assessments of culpability when contracts are broken. While those studies have not focused specifically on terms like 'willful,' some of their findings are nevertheless of interest. For example, in one survey, lay subjects were asked to assess brief descriptions of hypothetical cases in which the breaching firm broke its contract either (a) to earn greater profits, when a better-paying opportunity unexpectedly arose elsewhere, or (b) to avoid suffering a loss, when the firm's costs of performance unexpectedly increased. Consistent with other work on heuristic distinctions between gains and losses, the subjects systematically tended to judge the first kind of breach as the more culpable.[16]

While this line of research may prove promising, though, it is subject to several limits. For one thing, research into lay judgments about breach is still at an early stage, so the patterns (if any) in those judgments are still unclear.[17] Moreover, even if we could identify precisely which breaches most lay observers considered culpable, we would still have to decide whether those lay judgments about culpability ought to be endorsed and embodied in the law, or whether they should instead be considered 'heuristic

---

16. Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract* (unpublished working paper, 2006). Interestingly, in describing their results, the authors at one point use the term 'willful' to characterize the first kind of breach (breach to gain greater profits elsewhere) but not the second kind (breach to avoid incurring losses). Id. at 4.

17. For another recent survey, also containing some intriguing results, see Steven Shavell, *Is Breach of Contract Immoral?* 56 Emory L.J. 439 (2006). An earlier survey, though one less useful for present purposes, can be found in David Baumer & Patricia Marschall, *Willful Breach of Contract for the Sale of Goods: Can the Bane of Business be an Economic Bonanza?* 65 Temple L. Rev. 159 (1992). Baumer and Marschall's questionnaire explicitly told respondents that their hypothetical breach was 'deliberate' and 'willful' (id. at 184), so their survey sheds no light on the question of when respondents themselves would use those labels.

errors' that the law should reject or try to overcome.[18] The answer to that question, of course, depends heavily on what we want to accomplish by singling out 'willful' breaches for extra punishment.

Accordingly, in the remainder of this paper I analyze the willfulness puzzle from a consequentialist perspective. If the legal *consequence* of characterizing a breach as willful is that the breacher must pay higher damages, economics has much to say about when higher damage awards might produce desirable effects. The following section introduces two possible economic answers, which are then explored at more length in Parts II and III.

C. The economics of augmented damage remedies

Writers who are not trained in economics sometimes assume that the only economic argument against large damage remedies is that they would deter efficient breaches.[19] These writers then note (correctly) that the threat of large awards should not block an efficient breach if the parties can renegotiate, for if performance is truly inefficient then the potential breacher should always be able to buy her way out of the contract. They conclude, as a result, that there should be no economic objection to higher damage awards as long as renegotiation costs are low.[20]

What this argument misses, however, is that the threat of higher damages will raise the price the potential breacher must pay in any subsequent renegotiation, and this can have further

---

18. Wilkinson-Ryan and Baron (supra note 16) are properly cautious on this point. For varying views on the potential moral and legal relevance of lay heuristics generally, see, e.g., Cass Sunstein, *Moral Heuristics,* 28 Behav. & Brain Sciences 531 (2005); John Mikhail, *Moral Heuristics or Moral Competence? Reflections on Sunstein,* 28 Behav. & Brain Sciences 557 (2005).

19. See, e.g., E. Allan Farnsworth, 3 *Farnsworth on Contracts* 290 (2d ed. 1998); Marschall, supra note 4, at 736–38.

20. E.g., Marschall, supra note 4, at 737–39; Dodge, supra note 8, at 663–87.

efficiency effects.[21] At a minimum, it makes such contracts less attractive to builders (since they then face the risk of having to make a larger payment if and when they make a serious mistake), so builders will probably have to raise the price of their houses. Builders may also take extra precautions to reduce the risk of making a mistake—for example, a builder may now find it worthwhile to instruct two employees rather than one to double-check every shipment of pipe—if a mistake will now put them in the position of having to make an even larger payment, because of the threat of larger damage awards.[22] To be sure, these may be good effects rather than bad ones, for there is some value (up to a point) in having builders take precautions. At some point, though, if the threatened payment becomes large enough, the builder will have an incentive to take too many precautions, so the legal rule will produce costs rather than benefits. In other words, as long as there is some chance that even an efficient breacher will be exposed to higher penalties—either by actually paying a higher damage award, or by having to pay too high a price to buy her way out of it—then damages that are too high can still reduce efficiency.

Notice, though, that this observation leaves two different ways that these efficiency costs might be avoided. First, the efficiency costs can be reduced or eliminated if the higher awards are never raised to 'too high' a level, in a sense to be defined below. Second, if the higher damage awards are assessed only against breachers who behave inefficiently, then they will not produce any adverse effects against any parties who can be confident that they always

---

21. For a more detailed discussion of these effects, see Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach,* 61 So. Cal. L. Rev. 629 (1988).

22. Id. at 646–650; Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution,* 73 Calif. L. Rev. 1 (1985).

behave efficiently. The next two parts discuss each of these possible strategies, showing their very different implications for which breaches should be singled out for extra punishment, and the very different informational demands that they place on courts.

II. The 'inefficient behavior' solution

Suppose that contract law contained the following two-part rule: (1) For all breaches of contract, the breacher must pay 'normal' contract damages, whatever normal damages are taken to be. (2) If the breacher is shown to have behaved inefficiently in some respect, she must also pay some additional, larger amount.

Obviously, the second clause of this rule increases the informational demands on courts, for it requires them to evaluate the efficiency of the breaching party's behavior. In the *Kent* case, for instance, it would not be enough for a court to find that the builder's use of the wrong brand of pipe violated the contract. Instead, in order to award higher damages under the second clause, the court would also have to decide whether the builder had behaved inefficiently in any way.

Moreover, in any given case there might be several aspects of the breacher's behavior that were debatably inefficient. A court might be have to decide whether the breach itself was inefficient—that is, did the cost of tearing down the house and rebuilding it really exceed whatever extra value the homeowner would have gotten from having the specified brand of pipe? But even if this question was answered in the affirmative, meaning that the breach was efficient, the builder might also have behaved inefficiently (or be *accused* of having behaved inefficiently) by failing to take efficient precautions to reduce the risk of a mistake with the pipe. For example, the court might have to decide whether the builder had an adequate system of record-keeping to keep track of its

purchases of different brands of pipe, or whether the builder trained its employees adequately in the use of that system.[23] Obviously, these inquiries are very similar to those required by the negligence standard in tort law.

Indeed, there are many other forms of contracting behavior that might in certain cases be criticized as culpable, and which could in principle be evaluated in negligence or cost-benefit terms. In some cases, the charge might be that the breacher had failed to efficiently investigate the potential risks before agreeing to perform the contract.[24] Alternatively, a breacher who adequately investigated the risks might nevertheless be accused of failing to disclose those risks to its contracting partner, if circumstances would have made such disclosures efficient.[25] Or if the risk of not being able to perform was sufficiently high (as in my aluminum siding example?), and if that risk was not adequately disclosed to the other party, it might be argued that it was inefficient for the breacher to offer the contract in the first place.[26]

If the efficiency of the breacher's conduct could be evaluated

---

23. Interestingly, the dissenting judge in *Kent* (who would have imposed harsher penalties on the builder) characterized the breach as 'either intentional *or due to gross neglect* which, under the uncontradicted facts, amounted to the same thing ....' Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 892 (N.Y. 1921) (McLaughlin, J., dissenting) (emphasis added). Unfortunately, his opinion did not elaborate on or attempt to justify this characterization.

24. For a mathematical model of the efficient level of investigation, see Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem,* 17 J. Legal Stud. 401 (1988). For a prose analysis, asserting a different conclusion about the measure of damages that would create optimal incentives to investigate, see Cohen, supra note 11, at 1245–1246.

25. I discuss the potential costs and benefits of disclosing additional information in Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere,* 92 Va. L. Rev. 565 (2006).

26. For a more detailed analysis, see Ayres & Klass, supra note 11, at 31–42.

perfectly by courts, augmented damages could then be assessed without any risk of deterring efficient behavior, because parties who behaved efficiently would never be subjected to the higher damages. In other words, under a perfectly operating negligence-like regime, it is theoretically possible to 'throw the book at' inefficient breachers (as Richard Posner once suggested[27]) without adverse economic effects. While this feature of negligence rules has not been emphasized in the contracts literature, the same point has often been made in connection with tort law.[28]

The catch, however, is that courts have to be able to identify inefficient behavior *perfectly* in order to avoid any adverse effects from augmented damage awards. Moreover, it is not enough if courts are always able to make perfect decisions with hindsight, after a case has come to trial. For this rule to work well, potential defendants must be able to anticipate in advance what kind of behavior will be judged inefficient by the courts, and hence subjected to potentially larger penalties. After all, the earlier argument was that large penalties would pose no risk of overdeterrence as long as defendants who behaved efficiently *knew* that they would not be subjected to the higher penalties, so these defendants would have nothing to worry about. But such certainty is difficult to achieve in the real world, especially if the legal criteria for higher damages are defined in such terms as 'willful' or 'malicious.'[29]

---

27. Richard A. Posner, *The Economic Analysis of Law* 130 (5th ed 1998). I discuss Judge Posner's argument at more length infra in Part IV.

28. For a relatively non-technical discussion, see Robert Cooter, *Prices and Sanctions,* 84 Colum. L. Rev. 1523 (1984). For discussions of the analogous point in connection with punitive damages, see Bruce Chapman & Michael Trebilcock, *Punitive Damages: Divergence in Search of a Rationale,* 40 Ala. L. Rev. 741, 806–808 (1989); Keith N. Hylton, *Punitive Damages and the Economic Theory of Penalties,* 87 Geo. L.J. 421 (1998).

29. Cf. Nicholas J. Johnson, *The Boundaries of Extracompensatory Relief*

Instead, if there is any uncertainty about how courts will apply these standards, then even defendants who behave efficiently will have to worry about the effect of larger penalties. This may produce a 'chilling effect,' as defendants may modify their behavior even further to reduce any risk that large penalties might be imposed. To be sure, the net effects of legal uncertainty are complex, for uncertainty about the law's requirements can also *reduce* the law's deterrent effect by giving defendants some hope that they might escape punishment entirely. All else equal, though, the larger the penalties that are imposed on defendants who do get punished, the greater will be the tendency toward overdeterrence, leading defendants to refrain even from efficient behavior.[30] In practice, then, this approach is unlikely to avoid adverse effects entirely unless the higher damage awards can be limited by extremely demanding standards for characterizing the breach as 'wilful' or 'culpable', so that those characterizations are applied *only* to breachers whose conduct was inefficient in some way.[31]

---

for Abusive Breach of Contract, 33 Conn. L. Rev. 181, 197 (2000) ('The inherent fluidity of common law rules invites porous, evolving boundaries and thus expanding risk – precisely the collateral risk that we must avoid.'). Similar concerns are expressed in Mark Gergen, *A Cautionary Tale About Contractual Good Faith in Texas,* 72 Tex. L. Rev. 1235, 1258 (1994), and Barry Perlstein, *Crossing the Contract-Tort Boundary: An Economic Argument for the Imposition of Extracompensatory Damages for Opportunistic Breach of Contract,* 58 Brook. L. Rev. 877, 889–990 (1992).

30. For a formal analysis of the factors that are likely to lead to overdeterrence or underdeterrence under conditions of uncertainty, see Steven Shavell, *Economic Analysis of Accident Law* 93–99 (1987); Richard Craswell & John E. Calfee, *Deterrence and Uncertain Legal Standards,* 2 J. Law, Econ. & Org. 279 (1986); John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards,* 70 Va. L. Rev. 965 (1984).

31. Ayres & Klass (supra note 11 at 76-77) adopt this approach. For a similar proposal regarding the standards for punitive damages generally, see Jason S.

III. The 'inadequate damages' solution

Consider now a different, three-part rule for contract law: (1) For all breaches of contract, the breacher must pay 'normal' contract damages, whatever normal damages are taken to be. (2) If normal damages are shown to be inadequate to create efficient incentives, the breacher must pay some higher amount, without regard to the efficiency or inefficiency of the breacher's behavior. (3) In any case covered by the second clause, the amount of damages will be increased only to the level that would create efficient incentives.

It is often said, with some plausibility, that normal contract damages are systematically too low to create efficient incentives.[32] If so, then there will be many cases in which clauses (2) and (3) of this hypothetical rule could be invoked, and courts would then be asked to increase the damage award up to whatever level *would* be more efficient.

Notice, though, that while clauses (2) and (3) do require the court to be relatively precise in calculating the appropriate level of damages to assess (i.e., whatever level would restore efficient incentives), they do not require courts to evaluate the efficiency or inefficiency of the breacher's actual behavior. In this respect—more specifically, in the informational demands it places on courts—the 'inadequate damages' rule is the mirror image of the

---

Johnston, *Bayesian Fact-Finding and Efficiency: Toward an Economic Theory of Liability Under Uncertainty,* 61 S. Cal. L. Rev. 137 (1987).

32. E.g., Alan Schwartz, *The Case for Specific Performance,* 89 Yale L.J. 271 (1979); Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract,* 66 Va. L. Rev. 1443 (1980). For an argument for punitive damages in contract cases based explicitly on the inadequacy of normal contract remedies, see Michael Dorff, *Attaching Tort Claims to Contract Actions: An Economic Analysis of Contort,* 28 Seton Hall L. Rev. 390, 396–401 (1997).

'inefficient behavior' rule discussed earlier in Part II. Under the 'inefficient behavior' rule, courts had to evaluate the efficiency of the defendant's behavior, but they did not need to precisely calibrate the damages assessed against any defendants found to have acted inefficiently. Indeed, under that rule courts could simply 'throw the book' at inefficient defendants – as long as they were sure that the defendant had in fact behaved inefficiently. Under the 'inadequate damages' rule, by contrast, courts are freed from any obligation to evaluate the efficiency of the defendant's behavior, because the damage measure itself should (under this rule) give defendants their own incentive to behave efficiently. To do this, however, the damage measure must be precisely set at whatever level will create the most efficient incentives – meaning that the court can no longer simply 'throw the book at' a defendant in any case in which ordinary contract damages are too low.

While this difference between the two approaches is rarely discussed in the contracts literature, it too is familiar from tort law. That is, just as the 'inefficient behavior' approach makes informational demands that are similar to a negligence rule in tort, the 'inadequate damages' approach makes informational demands that are much like strict liability. As is well known, strict liability spares courts from having to evaluate the reasonableness of the defendant's behavior, thus reducing (in this respect) the informational demand on courts. However, strict liability *increases* the informational demands on courts in a different respect, for it requires them to be more precise in setting damages.[33]

To be sure, it is sometimes suggested that determining the optimal damage measure must be easier than judging the

33. Cooter, supra note 22, at 1532–1537. Hylton, supra note 28, draws a similar distinction between what he terms 'classical deterrence' (negligence) and 'cost internalization' (strict liability).

efficiency of the breacher's behavior.[34] After all, if the optimal damage award is exactly compensatory, we can calculate it by knowing only the *costs* of the breacher's behavior, but to evaluate the actual efficiency of the breacher's behavior, we usually need to know both its costs and its *benefits*. Thus, it might seem as though it would always be easier to calculate the optimal damage award than to evaluate the efficiency of the breacher's behavior.

However, this conclusion does not always hold. For one thing, sometimes it may be possible to evaluate the efficiency of a breacher's behavior without knowing either its costs or benefits separately, as long as we can judge the likely *net* costs or benefits. For example, if a custom has developed under circumstances where we would expect the custom to be efficient (lots of informed parties; lots of repeat players on both sides of the transaction; etc), that might establish that the customary behavior is probably efficient, even if we can't measure its costs or its benefits separately.[35]

More important, in many cases the optimal damage award will *not* be exactly compensatory, so calculating the optimal award will require courts to know more than just the amount of the non-breacher's loss. For example, if the non-breacher has more control over some aspects of the loss, either by mitigating damages after the breach or by taking precautions of his own beforehand, it could be better to award a smaller amount, in order to improve

34. See, e.g., Steven Shavell, *Economic Analysis of Accident Law* 9 (1987) (making a similar point about the difference between strict liability and negligence).

35. Cooter, supra note 28, at 1532–36.

the non-breacher's incentives to control those losses efficiently.[36]

Smaller awards might also be more efficient if the non-breacher is less risk-averse than the breacher,[37] or if the loss is a non-monetary one that non-breachers prefer not to insure against,[38] or if the non-breachers differ in their susceptibility to damages in ways that the breacher cannot reflect by charging them a different price.[39] In some cases, smaller awards might also be a more efficient way of optimizing various incentives at the precontractual stage,[40] or of reducing problems caused by potentially judgment-proof defendants.[41] And if the size of the award affects the number of lawsuits that are brought (as seems likely), the resulting effect on litigation costs could also reduce the size of the optimal award.[42] Identifying the award that best balances all of these factors would challenge an expert economist, much less an ordinary judge or jury.

To complicate matters further, in some cases enforcement costs could argue for an award that is *larger* than the above analysis might suggest, or possibly even larger than strictly compensatory damages. In particular, if there is some chance that a breacher might escape having to pay damages at all, that

---

36. A similar point is made by Ayres & Klass, supra note 11, at 71–74 and 79–81.

37. A. Mitchell Polinsky, *Risk Sharing Through Breach of Contract Remedies,* 12 J. Legal Stud. 427 (1983).

38. Samuel A. Rea, Jr., *Nonpecuniary Loss for Breach of Contract,* 11 J. Legal Stud. 35 (1982).

39. Gwyn D. Quillen, *Contract Damages and Cross-Subsidization,* 61 S. Cal. L. Rev. 1125 (1988).

40. Craswell, supra note 24.

41. James Boyd & Daniel E. Ingberman, *Do Punitive Damages Promote Deterrence?* 19 Int'l Rev. L. & Econ. 47 (1999).

42. A. Mitchell Polinsky & Daniel Rubinfeld, *The Welfare Implications of Costly Litigation for the Level of Liability,* 17 J. Legal Stud. 151 (1988).

could reduce the deterrent effect of any given award. A common recommendation in these cases is to multiply whatever award would otherwise be optimal by one over the probability that the award will actually be assessed.[43] But this solution requires courts to be able to determine what that probability is, thus increasing the informational demands in one respect.

Moreover, in most cases the optimal solution will not involve a 'simple' correction like multiplying the damages by one over the probability of punishment. Though the point has not been widely recocgnized, that solution creates incentives for optimal decisions at the margin only under a few special circumstances that rarely hold in real legal institutions.[44] Specifically, that multiplier will be optimal only (1) if the probability of punishment is the same for all breachers, regardless of the severity of their breach, or (2) if the multiplier is adjusted individually case by case, to reflect the probability of punishment faced by each individual breacher. The first condition almost never holds, because more severe breachers usually cause greater damages and are more likely to be sued, and also more likely to be found to be in breach. And the second condition requires that the harshest penalties be imposed on those breachers who committed the *least* severe breaches (since those are the ones least likely to be held liable), which is exactly the opposite of how most punitive sanctions are used.

IV. A plea for clarity

In short, there are two very different ways in which higher damage

---

43. A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis,* 111 Harv. L. Rev. 869 (1998).

44. I discuss this issue at more length in Richard Craswell, *Deterrence and Damages: The Multiplier Principle and its Alternatives,* 97 Mich. L. Rev. 2185 (1999).

awards *might* be assessed against certain breaches without any loss of efficiency. However, these two solutions differ significantly in the breaches they single out for punishment, and in the size of punishment they recommend. They also differ in the demands they place on the legal system, either to decide which breaches to select for punishment or to calibrate the amount of the penalty.

Unfortunately, current doctrinal tests are strikingly insensitive to the differences between these two solutions. As Part I showed, tests based on the breacher's mental state ('willful' or 'intentional' breaches) are usually indeterminate, or too manipulable to provide guidance. But even in the law-and-economics literature, where greater clarity might normally be expected, the distinction discussed in Parts II and III is frequently overlooked.

For example, George Cohen has written extensively about what he calls 'fault' in contract law,[45] but he uses the term 'fault' to mean (roughly) any rule that takes the reason for breach into account in setting the measure of damages.[46] He therefore includes both (1) cases where courts alter the damage award after evaluating a party's actual behavior and find it wanting, using something like a negligence or cost-benefit standard,[47] and

---

45. Cohen, supra note 11; see also George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law,* 20 Hofstra L. Rev. 941 (1992).

46. Cohen, supra note 11, at 1225.

47. E.g., id. at 1252–1256 (discussing adjustments to the damage award where the breacher's promise is found to be one that, from an efficiency standpoint, should never have been made), or 1282 (discussing judicial reductions in the damage award in cases where the non-breacher is found to have failed to take efficient steps to mitigate his losses). Of course, a cost-benefit standard applied to the *non*-breacher's behavior could reduce, rather than increase, the liability assessed against the breacher; but the basic principle (and the resulting informational demands on courts) are still the same. For a more extended discussion of the use of cost-benefit standards in mitigation cases, see Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory*

(2) cases where courts alter the measure of damages in order to give one or both parties efficient incentives to adjust their own behavior, without the court evaluating the behavior that either party actually chose.[48] In other words, his use of 'fault' lumps together both the 'inefficient behavior' solution and the 'inadequate compensation' solution, without discussing the different demands made by those very different kinds of 'fault' regimes.

Similarly, Judge Richard Posner's writings about 'opportunistic' breaches appear to endorse each of these two solutions, without explicitly recognizing their differences. Consider the following passage:

> It makes a difference in deciding which remedy to grant whether the breach was opportunistic. If a promisor breaks his promise merely to take advantage of the vulnerability of the promisee in a setting (the normal contract setting) where performance is sequential rather than simultaneous, we might as well throw the book at the promisor. Such conduct *has no economic justification* and ought simply to be deterred.[49]

This language fits well with what I have called the 'inefficient behavior' solution, meaning that larger remedies should be limited to conduct that is inefficient or 'has no economic justification.'

---

of Contractual Obligation, 69 Va. L. Rev. 967 (1983).

48. Cohen, supra note 11, at 1245–1252 (discussing the use of reliance damages to optimize breacher's *incentives* to conduct optimal investigation prior to entering a contract, without actually evaluating the level of investigation chosen by the breacher in any given case), or 1258–1265 (discussing the use of reliance damages to optimize parties' incentives to take precautions against unforeseen contingencies, again without actually evaluating the precautions chosen by the breacher in any given case).

49. Posner, supra note 27, at 130 (emphasis added). For a similar proposal, see Perlstein, supra note 29.

If so, then (as Part II discussed) Judge Posner is correct that the law need not worry about the exact size of the damage award. Instead, it can 'throw the book at' the inefficient breachers—as long as courts can identify behavior that is, in fact, efficient.

In other cases, though, Judge Posner writes about 'opportunistic' breaches in ways that fit much better with what I have called the 'inadequate damages' solution:

> Not all breaches of contract are involuntary or otherwise efficient. Some are opportunistic; the promisor wants the benefit of the bargain without bearing the agreed-upon cost, *and exploits the inadequacies of purely compensatory remedies*....[50]

Similarly, he has suggested that at least one justification for augmented remedies is to make up for the inadequacy of ordinary damage awards when the defendant stands a good chance of escaping punishment:

> The award of punitive damages in this case thus serves the additional purpose of limiting the defendant's ability to profit from its fraud by escaping detection and (private) prosecution. If a tortfeasor is 'caught' only half the time he commits torts, then when he is caught he should be punished twice as heavily in order to make up for the times he gets away.[51]

To be sure, this passage is wrong in a minor way, for (as noted earlier) a simple multiplier of one over the probability of punishment is almost never correct if we want to give defendants optimal

---

50. Patton v. Mid-Continent Systems, Inc., 841 F.2d 742, 751 (7th Cir., 1988) (emphasis added).

51. Mathias v. Accor Economy Lodging, Inc. 347 F.3d 672, 677 (7th Cir. 2003).

incentives at the margin.[52] But the more important point (for present purposes) is that in this passage, Judge Posner is concerned with increasing damages in cases where normal damage awards are inadequate—in other words, he is endorsing what I have called the 'inadequate damages' solution. In keeping with that view, he advocates increasing the award *only* up to the point where it would restore the proper incentives (punish the tortfeasor 'twice as heavily,' in his example), rather than increasing the award to any arbitrarily high level ('throw the book' at her, as in the passage quoted earlier). Under this rationale, the court does *not* need to decide whether the defendant behaved inefficiently, but it *does* need to decide what the efficient level of damages would be.

In short, Corbin was right,[53] and not merely about terms like 'willful' or 'intentional.' Even terms such as 'opportunistic' or 'at fault,' if they are not used carefully, are not helpful in understanding the advantages and disadvantages of subjecting certain breaches to extra penalties. Instead, the key operational questions are usually (1) does the court have to evaluate the efficiency of a party's behavior (and how well can it do that?), and (2) does the court have to set the penalty at a level that would itself create efficient incentives for the parties (and how well can it do *that*)? If we can begin to address these questions explicitly, this should improve the clarity of the debate.

52. See the text supra at note 44.

53. See the passage quoted supra at note 3.