

Promissory Autonomy, Imperfect Courts, and the Immorality of the Expectation Damages Default

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Introduction

To a generation of law students, lawyers and legal scholars, Contract as Promise² has provided a liberal theory of contract that explains fundamental features of contract law and provides a normative foundation for evaluating the legal doctrine. As is well known by now, the promissory theory of contracts justifies the legal enforcement of contracts in terms of respect for individual freedom and autonomy to make binding commitments. The touchstone of contractual analysis from this perspective is the intent of the promisor. Together with other moral theories of promising, this perspective on contract law has generated voluminous scholarship. Thirty years after the book's publication, I am unlikely to shed new light on the merits of the perspective. Rather, I take the occasion of this symposium as an opportunity to explore how economic analysis since the book's publication might elaborate its thesis.

Significant insights have been made in the theory of incomplete contracts, particularly with respect to the existence and consequences of imperfect information. One might speculate as to how a hypothetical new edition of Contract as Promise, published today, might address the effect of imperfect information on the making and enforcement of promises. Working within or

¹ Professor of Law, Stanford University. This essay is forthcoming in a 2012 symposium issue of the **Suffolk University Law Review**, in tribute to the 30th Anniversary of the publication of my former colleague, Charles Fried's book, **Contract as Promise**. I am grateful to Rachel Crouch (Harvard Law 2012) for her valuable research assistance and comments on an earlier draft.

² **Charles Fried, Contract as Promise** (1981).

at least consistently with Professor Fried's perspective, this essay revisits the justification for expectation (compensatory) damages in light of two observations: (a) judicial determinations are costly and prone to error, and (b) parties have various motivations for promising beyond promoting reliance and collaboration (notably, credit and insurance). In light of this heterogeneity, I suggest that fully compensatory expectation damages may be preferred by no more than a plurality of contracting parties. In addition, the legitimacy given to expectation damages under various moral theories, such as the promissory principle, as well as the instrumental doctrine of efficient breach, in fact increases the cost of opting out and undermines the promissory autonomy they are thought to vindicate. In passing, I also take issue with the categorical distinction that Professor Fried and other moral theorists draw between contractual conditions and contract remedies, particularly damages. Damages, whether judicially measured or liquidated by contract, should be viewed as substitutes for conditions. Thus, if the parties are morally free to condition their promises, they should also be free to set their own level of damages or to let the court impose them by default.

I. Interpretation and Interpolation

To create a contract, the promisor invites a court to enforce her promise (or some part of it). In the event of a subsequent dispute between promisor and promisee, the court must determine (a) whether a legally binding promise has been made, and (b) the content of the promise. The promissory language of the promisor is the basis for both decisions,³ but the language may be vague, ambiguous or incomplete. Professor Fried distinguishes between two

³ Professor Fried would apply a presumption that actors who make rational, deliberate promises, particularly in bargains, also intend them to be legally enforceable, at least partly to protect the expectations of the promise. "No one supposes that two merchants who make a deal must entertain some additional intention to create legal relations in order for that deal to be binding in law. On the other hand, given the consensual basis of contract as promise, the parties should in principle be free to exclude legal enforcement so long as this is not a fraudulent device to trap the unwary. . . . In a particular case it may be a difficult problem of interpretation whether such a purpose is fairly to be implied." **Fried**, supra note 2, at 38 n.*. The Second Restatement of Contracts has a similar presumption. See Restatement (Second) of Contracts § 21 (1981) (pertaining to intent to be legally bound).

tasks facing the court: interpretation (determining what the promisor had in mind) and interpolation (filling the gap left by the absence of intention).⁴

In interpreting the promise, the court may imply elements from the circumstances. Professor Fried provides the example of a sale of a bolt for use in a machine, after which the bolt fails and damages the machine. He writes that

it is a fair implication of the simple-seeming original transaction that manufacturer not only delivered and promised to transfer good title to the bolt, but promised at the same time that the bolt would do the job it was meant to do. . . . [B]uyer justifiably relied on manufacturer . . . because of the (implied) promise or warranty, and of course it is a primary function of promises to induce reliance.⁵

Although there may be other grounds for liability, Professor Fried brings the implied warranty of fitness in this case under the promissory theory. Fried advocates interpreting the promisor's intent "against the background of normal practices and understandings in that kind of transaction."⁶ In fact, he goes farther when he argues "we can also see the absurdity of the desire of some classical contract theorists to limit the interpretive scrutiny of the promise to the four corners of the document itself."⁷ The promissory principle directs courts and scholars to examine contracting patterns empirically.

Where the parties have not established an intention, there is a gap. Courts must fill the gap (or interpolate) somehow in order to enforce the promise; if they fail to do so, they undermine the liberty of the individual to promise. In an insightful discussion of the relationship

⁴ See **Fried**, supra note 2, at 60-61.

"In contract law there is a vaguely marked boundary between interpreting what was agreed to and interpolating terms to which the parties in all probability would have agreed but did not. The further courts are from the boundary between interpretation and interpolation, the further they are from the moral basis of the promise principle and the more palpably are they imposing an agreement. That this is a term the parties might have agreed to is just one kind of reason courts may have for imposing a term on them to which they have not in fact agreed. That decision is the courts' and not the parties'" Id.

⁵ Id. at 22-23.

⁶ Id. at 86 (discussing implied duty of good faith).

⁷ Id. at 88.

between the promissory principle and contract default rules, Richard Craswell argues that the moral theory has no implication for the content of background rules. He writes:

The principle of individual freedom is . . . unhelpful, for it implies only that individuals should be left free to change whatever default rule the law adopts as a starting point. . . . [S]ome other value must be invoked to explain why one starting point ought to be picked by the law in preference to another.⁸

This value might be economic efficiency, for which transaction costs play a significant role. However, as suggested below, transaction costs are also relevant in the manner in which they promote or constrain contractual freedom and autonomy.

Alternative gap-fillers do not all have equal normative weight under the promissory theory. While Professor Fried argues that the judicial gap-filling (or interpolation) function does not flow directly from his promissory theory, he believes the function can be congenial to the theory in two respects. First, it should be consistent with the promisor's broad intent for the common enterprise.⁹ Second, it should not interfere with the promisor's freedom to remove the gap and establish an alternative intention at the time of the promise. These desiderata track the analysis of majoritarian default rules in more recent contracts scholarship: the value of such a default depends on the probability that parties would have (hypothetically) consented to the provision if they had taken the time to consider the provision and the cost to the others of opting out (or being bound by it).¹⁰

By referring to gap-filling as interpolation of the promisor's intent, Professor Fried suggests that the court should tailor the terms it imposes to the circumstances of the parties.

⁸ Richard Craswell, Contract Law, Default Rules, and the Philosophy of Promising, 88 **Mich. L. Rev.** 489, 490 (1989).

⁹ See **Fried**, supra note 2, at 73.

"[I]n filling the gaps it is natural to look to the agreement itself for some sense of the nature and extent of the common enterprise. Since actual intent is (by hypothesis) missing, a court respects the autonomy of the parties so far as possible by construing an allocation of burdens and benefits that reasonable persons would have made in this kind of arrangement. . . . [This task] does not threaten to overwhelm the promissory principle, for the simple reason that the parties are quite free to control the meaning and extent of their relation by the contract itself." Id.

¹⁰ See **Robert E. Scott & Jody S. Kraus**, **Contract Law and Theory** 93-95 (3d ed. 2002).

Tailored defaults are more likely than untailored majoritarian defaults (provisions reflecting what most parties would have agreed to) to be consistent with the general enterprise of the parties.¹¹ Both kinds of defaults reduce the cost of promising and thereby promote individual liberty to make promises by making it less costly to do so.¹² Untailored defaults, however, leave the parties with a choice between incurring the additional transaction costs necessary to agree to a different term ex ante and being bound by one they would not choose. The fact that untailored defaults are less costly to apply ex post than tailored interpolation is an advantage in the eyes of welfare economists, but it should also be relevant to promissory theory to the extent that the promisor anticipates bearing a portion of litigation costs.

Thus, as in the analysis of the choice between rules and standards,¹³ the comparative net welfare benefits of tailored and untailored gap-fillers depend on the heterogeneity of circumstances, the cost of specifying a rule ex ante, and the cost of applying a standard to facts ex post. The balance is context dependent. The promisor may make the choice herself and adopt standards or rules (or some combination) in her promise.¹⁴ If the choice is not express, the court may interpret the promise as implying one or the other. And, if required to interpolate, the court must decide on a meta-default governing interpretation and interpolation of substantive terms.

The next section turns briefly to the significance of imperfect courts—specifically, the impact of costly and error-prone judicial determinations—to promissory intent. In this environment, contracting parties decide what promises to ask courts to enforce and whether to

¹¹ Regarding the choice between tailored and untailored defaults, see generally Charles J. Goetz & Robert E. Scott, The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms, 73 **Cal. L. Rev.** 261 (1985); Ian Ayres, Making a Difference: The Contractual Contributions of Easterbrook and Fischel, 59 **U. Chi. L. Rev.** 1391, 1402-08 (1992).

¹² See Jody S. Kraus, The Correspondence of Contract and Promise, 109 **Colum. L. Rev.** 1603, 1633 (2009) (arguing failure to hold promisors bound to default terms increases costs of promising and violates individual liberty).

¹³ See Richard Craswell, Contract Law: General Theories, in 3 **Encyclopedia of Law and Economics** 4000, 5 (B. Bouckaert & G. De Geest eds., 2000) (comparing tailoring of default rules to choosing between rules and standards). For an analysis of the choice between rules and standards, see Louis Kaplow, Rules Versus Standards: An Economic Analysis, 42 **Duke L.J.** 557, 559-68 (1992).

¹⁴ See Robert E. Scott & George G. Triantis, Anticipating Litigation in Contract Design, 115 **Yale L.J.** 814, 839-56 (2006) (exploring choices between rules and standards in contracts).

specify the substantive terms themselves or leave the court to enforce default provisions. The promissory principle requires that the defaults (a) be easy to opt out of and (b) reflect what a majority of parties would want under the circumstances. Section III then argues that neither the current default of expectation damages, nor specific performance, satisfies those requirements.

II. Transaction Costs and the Promissory Theory of Contract

Transaction costs, including costs arising from imperfect information, are central in much of the contemporary economic analysis of contracts and contract law. Contract theorists have paid considerable attention recently to the problem of judicial verification of the parties' agreement and the realized state of the world. For example, if a court seeks to interpret an agreement on the basis of background understandings, this process involves costly evidence production and weighing, as well as the risk of erroneous judicial outcomes. At first blush, these concerns appear to be of secondary importance to non-instrumentalists. They are very significant, however, to a theory that rests on the will of the promisor who is aware of these imperfections *ex ante*. For such a promisor, the cost and potential error of judicial enforcement influence both the decision to make a legally binding promise and the content of the promise. This is apparent in practice when parties deliberately exclude judicial enforcement of all or part of their agreement and rely instead on relationship and reputational norms.¹⁵ These imperfections are also anticipated, for example, in contracts that provide expressly for dispute resolution procedures, allocation of litigation costs and limitations on liability.

As suggested in the preceding section, promisors can and often do establish intent not only as to the substantive content of their promises, but also as to the enforcement mechanism: including the forum for dispute resolution, the mode of interpretation and interpolation, and so on. Whether the issue is interpretation or interpolation, the promisor may wish to invite or to

¹⁵ One instance of this may be merchant contracts with consumers. As Professor Bebchuk and Judge Posner suggest, the consumer is not exposed to significant relationship or reputational sanctions if she does not honor her commitments. The merchant does face these sanctions (particularly in the Internet environment), and the parties may rationally choose to preclude costly litigation over merchant breaches. *See* Lucian A. Bebchuk & Richard A. Posner, One-Sided Contracts in Competitive Consumer Markets, 104 *Mich. L. Rev.* 827, 829-31 (2006) (considering asymmetry of parties' relationship regarding concerns about their respective reputations). Franchise contracts, apparently one-sided, are susceptible to this explanation as well.

preclude judicial consideration of extrinsic evidence such as industry practice or the promisor's pre- or post-contract relationship with the promisee. The promisor can use precise language in order to exclude extrinsic evidence, in order to avoid the cost and error of the judicial interpretation of alternative vague provisions. If the parties are concerned about such imperfections, they may choose to use more precise language to exclude extrinsic evidence. Indeed, in the face of costly and error-prone litigation, it seems remarkable that parties to complicated agreements in highly specialized circumstances would be willing to subject their disputes to judicial enforcement. Yet commercial parties routinely use vague contractual language, such as "good faith" or "reasonable efforts." The reason may be that promisees are not seeking to buy a lawsuit, but rather to promote the desired performance or renegotiation in the shadow of litigation. The shadow, of course, is costless ex post to the parties themselves and, as Professor Choi and I suggest elsewhere, even the prospect of significant judicial error can be accommodated in this shadow.¹⁶

The more difficult question with respect to the mode of interpretation and interpolation is, as with the substantive terms themselves, the choice of the default that governs if the parties either fail to agree or to express their intent. Here too, the heterogeneity of the parties presents the greatest challenge. Isolating the majority preference may be futile: there may be no easily articulated majority position. A majoritarian default may therefore have only modest effect in reducing the cost of promising. Instead, the focus should be placed on protecting promissory autonomy by structuring defaults so that they are loose and promisors can opt out at low cost.¹⁷

"Sticky" defaults—ones that cannot be easily opted out of—are antithetical to the promissory principle, particularly if promisor preferences are heterogeneous.¹⁸ As discussed in

¹⁶ See generally Albert Choi & George Triantis, Completing Contracts in the Shadow of Costly Verification, 37 **J. Legal Stud.** 503 (2008); Albert Choi & George Triantis, Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions, 119 **Yale L.J.** 848 (2010).

¹⁷ Whether it is easier to contract for a rule in the face of a standard default, or vice-versa, is a complicated question that has received some attention in the law and economics literature. See generally Ayres, supra note 11.

¹⁸ On the topic of sticky defaults, see generally Ian Ayres & Robert Gertner, Majoritarian Vs. Minoritarian Defaults, 51 **Stan. L. Rev.** 1591, 1598 (1999); Cass R. Sunstein, Switching the Default Rule, 77 **N.Y.U. L. Rev.** 106 (2002). With respect to the expectation damages default, see Robert E. Scott & George G. Triantis, Embedded Options and the Case Against Compensation in Contract Law, 104 **Colum. L. Rev.** 1428 (2004).

the next part, one of the stickiest is the default remedial provision for expectation damages, or generally the compensatory remedy. There are many causes of the stickiness, but the endorsement of and justification for compensation provided by many scholars is partly to blame. The unfortunate result is the expectation damages default can cause significant inefficiency in contracting and, from the promissory perspective, a large encumbrance on the autonomy of the promisor.

III. Distinguishing Between Conditions and Damages

In the final chapter of Contract as Promise, Professor Fried focuses on the sharp discontinuities in contract law doctrine that underscore “[t]he importance of not being in the wrong.”¹⁹ One set of doctrines relates to conditions. The consequences of a breach of condition can be “sharp and harsh.”²⁰ Fried gives the examples of a beneficiary of an insurance policy who loses her entire claim by failing to comply with conditions of notice, or option holders who lose their rights by being an hour late in exercising them.²¹ He justifies this distinction by recognizing the promisor’s will as the source of the sharpness:

Contractual obligation is based on promise, and promissory obligations are obligations freely undertaken. There is a threshold the obligor must willingly cross. He should be free of obligations he has not undertaken, and one way he can spell out the limit of his undertaking is just by stating how far he will be obliged A promisor may also limit his obligation by making it conditional When the condition fails, the promisee has no obligation to enforce.²²

In contrast, the failure to perform an unconditional promise is wrong, even if the promisor pays damages. In Fried’s analysis, the court orders the payment of expectation damages to correct the

¹⁹ **Fried**, supra note 2, at 118.

²⁰ Id. at 121.

²¹ Professor Fried also demonstrates the sharpness of the test of substantial performance. If the contractor, despite breaching, provides substantial performance, then the customer must perform as promised and sue for damages. If the contractor falls short of substantial performance, the customer is released completely from her contractual obligation to pay. See id. at 122.

²² Id. at 121.

wrong inflicted by the breach. In a cogent critique of Fried's endorsement of expectation damages, Professor Seana Shiffrin argues that morality dictates that the law specifically enforce contracts.²³ Yet, the two scholars are of one mind in drawing sharp distinctions between conditional promises and promises backed by damages.²⁴

Professor Fried recognizes that contracting parties use conditions as “an important method for nuancing the allocations of risks.”²⁵ A buyer, for example, might condition her promise on the availability of financing. Yet, Professor Fried seems to limit the promisor's freedom to addressing risks in a binary fashion by conditions alone: the buyer's promise is either binding or excused by the failure of the condition. Professor Fried defends the normative justification for the sharp discontinuity by invoking the morality of right and wrong in contract performance. He writes:

[T]here are sharp discontinuities, and these are disturbing to the economic or marginalist mentality. That mentality sees discontinuities as a symptom of irrationality. What I have tried to show is that such discontinuities are unavoidable, and indeed that they are a sign that we are in the domain of right and wrong, which is a domain of discontinuity. . . . [I]f the domain of right and wrong is seen as autonomous, it must contain sharp breaks: between the permissible and the impermissible, between the obligatory and the optional.²⁶

Professor Fried is correct in suggesting that lawyer economists are more likely to view conditional promises and remedial promises equally as terms of the contract.²⁷ There is no

²³ See Seana Valentine Shiffrin, The Divergence of Contract and Promise, 120 **Harv. L. Rev.** 708, 722 (2007) (“If contract law ran parallel to morality, then contract law would—as the norms of promises do—require that promisors keep their promises as opposed merely to paying off their promisees.”).

²⁴ Shiffrin writes: “Although one can declare within a promise some of the conditions under which the promised performance may not occur, those conditions cannot coherently extend so far as to include any situation in which the promisor has a change of heart or entertains a better offer.” Id. at 728-29.

²⁵ **Fried**, supra note 2, at 122.

²⁶ Id. at 132.

²⁷ See Richard A. Epstein, Beyond Foreseeability: Consequential Damages in the Law of Contract, 18 **J. Legal Stud.** 105, 106-8 (1989); **Foundations of Contract Law**, 125 (R. Craswell and A. Schwartz, eds., 1994).

categorical difference and the two sets of terms work together as a package of contingent rights transferred by the promisor to the promisee.²⁸ The obligation to pay damages is conditioned on the nonperformance of another promise and, reciprocally, the obligation to perform the other promise is conditioned on nonpayment of damages. Indeed, from this perspective there are no first-order or second-order obligations. Instead, a condition sets an extreme form of damages liability for failure to perform—the promisor is entitled to not perform and pay no damages. For example, the implied condition that excuses performance on grounds of commercial impracticability yields the same result as a contingent liquidated damages provision setting liability at zero. Indeed, because of the marginalist mentality to which Fried refers, economists might prescribe a more subtle treatment of unanticipated contingencies that would exploit the full range of possible damage levels to effect a more refined allocation of risk.²⁹

The promissory autonomy to choose between conditions and damages that Professor Fried defends in the quotations above would seem to extend to providing for stipulated or liquidated damages. As long as the promisor does so expressly (or perhaps by virtue of background understanding), it does not interfere with the line he draws between right and wrong. Indeed, as suggested below, a contract might provide for a set of contingent, stipulated damages. Thus, like conditions, stipulated damages are tools that a promisor may use to allocate risks. As suggested earlier, default rules can promote promissory autonomy by providing background rules that the promisor is likely to adopt but free to reject. This leaves us with an important question for Professor Fried and other moral theorists: is the expectation measure of damages compensation for the wrong committed by breach, or is it a default term of the contract, like implied conditions? Professor Shiffrin argues that contract remedies, whether damages or injunction, serve as a public act of punishing breach, so that privately stipulated damages circumvent the state's monopoly on punishment.³⁰ This is not a position Professor Fried takes in

²⁸ See generally George Triantis, The Evolution of Contract Remedies (and Why Do Contracts Professors Teach Remedies First?), 60 U. Toronto L.J. 643 (2010) [hereinafter Triantis, Evolution of Contract Remedies].

²⁹ See generally George G. Triantis, Unforeseen Contingencies. Risk Allocation in Contracts, in 3 **Encyclopedia of Law and Economics** 4500, 100 (B. Bouckaert & G. De Geest, eds., 2000).

³⁰ Shiffrin, supra note 23, at 734-36. "Punitive damage agreements allow parties privately to determine appropriate levels of punishment and then to commandeer the legal system to administer the punishment; this may threaten the

Contract as Promise, so he might be more inclined to see damages as part of the promissory package.

To many lawyer economists, the expectation measure of damages is the desirable default contract remedy, because most parties would consent to it. Their benchmark is the complete contract that fully specifies the intended contingent obligations in all possible future states of the world. Complete contracts are costly and infeasible, and damages provide an imperfect substitute. In theory, expectation damages compel the promisor to compensate, and thereby internalize, the loss incurred by the promise as a result of nonperformance. This is the celebrated virtue of efficient breach. As with other rules, economists suggest that surplus-maximizing terms are also those that are likely to have been chosen by the parties. On this basis, Professor Shavell argues that nonperformance, when combined with the payment of expectation damages, is not immoral if the contingency giving rise to the breach was not anticipated by the parties.³¹ The analysis in Contract as Promise suggests the possibility that Professor Fried might be persuaded by this position, but only if the parties expressly agreed that the monetary payment would serve as alternative performance or if it is consistent with the background understanding. This would be necessary to change the wrong to right; the payment would not be a breach. In fact, these conditions are often not met, and the question of gap-filling becomes important. I argue below that the default measure of expectation damages fits awkwardly with the promissory principle and is therefore a problematic default.

Too much ink has been spilled (and continues to spill) over the story of efficient breach.³² The harm it has generated in retarding contract law scholarship now outweighs the value of the

interest in horizontal equity and in the community's authority to determine appropriate, proportionate responses to wrongs." Id. at 734.

³¹ See Steven Shavell, Is Breach of Contract Immoral?, 56 **Emory L.J.** 439, 439 (2006).

³² Professor Craswell similarly observed in the late 1980s that too much ink had been spilled over the question of whether efficient performance could be attained as (or more) easily through renegotiation as through the enforcement of expectation damages. See generally Richard Craswell, Contract Remedies, Renegotiation, and the Theory of Efficient Breach, 61 **S. Cal. L. Rev.** 629 (1988). Professor Craswell has authored insightful articles tracing the impact and flaws of the Fuller and Perdue categorization of damage remedies, arguing persuasively that the success of their framework impeded the scholarly analysis of remedies. See generally Richard Craswell, How We Got This Way: Further Thoughts on Fuller and Perdue, 1 **Issues in Legal Scholarship** 2 (2001); Richard

initial insight.³³ Because I have developed this argument elsewhere, I now will only relate it to the challenge of designing default provisions under the promissory principle. The story of efficient breach, now in its fifth decade, is the most widely known economic theory of contract. Its success in this respect is at least partly due to the fact that it provided theoretical justification for the usual measure of damages under contract law.³⁴ One can observe the doctrinal thirst for such an external justification by comparing the First and Second Restatement of Contracts provisions relating to expectation damages and the penalty rule regulating liquidated damages. For example, the First Restatement simply stated the compensatory principle of expectation damages and offered no justification beyond the citation of judicial opinions. The Reporter's Note to the Second Restatement, which was written after the introduction of the efficient breach story, observed that efficient breach incentives "accord well with the assumption of contract law that the principal purpose of the rules relating to breach is to place the injured party in as good a position as he would have been in had the contract been performed."³⁵

While the alleged virtue of efficient breach was accepted eagerly by many doctrinal scholars, it raised objections from thoughtful, non-instrumental moral philosophers of contract law. I suspect that the economists instigated the controversy by using examples based on increases in opportunity cost, particularly the emergence of a better opportunity for the promisor (as in Judge Posner's early example).³⁶ In this type of situation, the promisor appears to make an abnormal profit from breach, rather than stemming a loss. The likelihood that the promisor would have paid for this opportunity *ex ante* leaves little impression on non-instrumentalists. Their moral outrage might have been softened if the seller, for instance, experienced a significant increase in costs, so that the out-of-pocket cost of performance would be clearly greater than the value to the promisee.

Craswell, Against Fuller and Perdue, 67 **U. Chi. L. Rev.** 99 (2000). My argument here, as well as in an earlier article, is a similar critique of the efficient breach insight that emerged in the 1970s. See Triantis, Evolution of Contract Remedies, *supra* note 28.

³³ See Triantis, Evolution of Contract Remedies, *supra* note 28.

³⁴ See Steven J. Burton, Principles of Contract Law 273 (3d ed. 2006) ("the compensation principle is easily understood at an abstract level. Its justification and practical implications are not so easy to grasp. In recent years, the advent of economic analysis of the law has made the way somewhat easier.")

³⁵ See Triantis, Evolution of Contract Remedies, *supra* note 28.

³⁶ See Richard A. Posner, Economic Analysis of Law 57 (1972).

If the cost of performance rises after contracting above a high threshold, it might be excused by the impracticability condition. If it falls just short of that threshold, nonperformance would be wrong and the promisor would be liable to fully compensate the promisee. As observed earlier, Professor Fried is comfortable with this discontinuity. Yet, the parties themselves, if they had adverted to these contingencies, are unlikely to have intended such discontinuous consequences. With or without the counsel of economists, they are more likely to have preferred a gradual schedule. If nothing else, it would have dampened the incentive to engage in costly litigation over whether performance had become impracticable. Given that the doctrinal threshold of impracticability invites costly and uncertain judicial determination, the parties may have replaced the condition itself with a schedule of contingent payment obligations.

IV. Heterogeneous Intents and the Moral Problem of a Sticky Damages Default

Although the moral basis for enforcement under the promissory principle is the will of the promisor rather than the reliance of the promisee, much of the discussion in Contract as Promise implicitly assumes that the promisor's motivation is to encourage reliance and collaboration on the part of the promisee.³⁷ Although reliance would be sufficient to reassure the promisee, the fact that the promisor invokes the convention of promising means to Professor Fried that she must provide the equivalent of the promise if she violates the convention.³⁸ Executory contracts serve other goals as well, including (a) the extension of credit and (b) risk allocation. The four examples below suggest that expectation damages may not be preferred by parties who pursue these goals in various circumstances, again bringing in sharp focus the question of how the courts should interpret or interpolate promissory intent if it is not evidenced in their language or background understandings.

³⁷ Fried, supra note 2, at 13.

³⁸ See id. at 17 (“what a promise is worth”).

“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. . . . 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.”

Id. at 17.

Example 1. Lender loans \$1 million to Borrower, who promises to make regular monthly repayments of principal and interest according to a schedule provided in the contract. The interest rate is 10 percent per annum. Borrower stops making the payments, clearly in breach of her promise. The market interest rate has fallen since the time of the contract and the lender can only earn a 5 percent return by relending to a borrower of similar risk profile.

The lender's contractual remedy is to accelerate and collect the principal and accrued interest. She does not have a claim for her expectation (even subject to requirements that the expectation loss be unavoidable and foreseeable), which would include the difference between the contract and market interest rate for the remainder of the loan period. This is consistent with the intent of the parties, as expressed in the acceleration clause as well as industry practice. The economic explanation may be that neither efficient breach nor the protection of reliance is a significant objective in this contract. If the funds are most valuable in the hands of the borrower, the parties can simply renegotiate to that outcome. Moreover, any reliance expenditures by the lender—costs of screening the borrower and administering the loan—are likely to have been reimbursed through fees. So, the goal of the contract is simply the extension of credit and risk allocation, including the risk of interest rate fluctuations. There are, of course, ways to frame the obligation to bind the borrower to pay the interest rate for the full term of the loan. For example, under a zero-coupon bond, default typically accelerates the obligation to pay the full face amount that would be due at the end of the term.

Example 2. Customer agrees to buy a flat-screen television from a department store. She pays and takes home the television set. A week later, she and her partner decide that they would prefer to use the money paid for the television to extend a vacation. Customer brings the television back to the store and requests a refund of her money.

Of course, the customer in this example has not “breached” the agreement if it provided for the right of return. Most stores have explicit policies permitting such returns. Indeed, a general understanding to this effect exists for purchases from all large retailers. Some retailers charge restocking fees and they make those clear at the time of the sale. Yet, the return of the appliance is often ex post inefficient. Returns often require expensive processing and ultimately are sold at a large discount on the Internet or otherwise. Yet, retailers clearly intend to incur the cost of granting this option to entice customers to try their products. In light of this observation,

even in the absence of an express entitlement to return, can we say that expectation damages flow naturally from the promise of the customer to buy merchandise from a store?

Example 3. A traveler purchases a ticket from an airline to fly round trip between Boston and Chicago. The economy fare is \$350. The contract provides that if the customer has a change of plans, she may cancel (and rebook if she wishes) by paying a penalty of \$150. The airline can accommodate such changes at low cost because of the number of passengers and flights, as well as sophisticated computer programs that allow them to anticipate and accommodate such contingencies in aggregate.

In contrast to the first two examples, in which one party assumes the risk of regret or default of the other by agreeing to lower-than-expectation damages, airlines impose a penalty (super-compensatory damages) on the traveler who has a change of plans. The restocking fee falls short of the cost of the return to the retailer (and might promote inefficient breach), while the cancellation fee exceeds the cost to the airline (and might promote inefficient travel). The inefficiencies of nonperformance and performance, while real, are outweighed by other gains. The airline's cancellation fee might be explained as a return on its investment in flexible booking and risk bearing techniques, while the undercompensatory stocking fee is designed to promote sales to reluctant customers. The point here is that the various contracting circumstances and goals lead to a wide range of "remedial" measures. Of course, the parties themselves do not call these payment obligations "damages," so as not to invoke the rule against punitive liquidated damages. They might be called "conditions" because they condition the customer's obligation to pay for the good or flight or the decision not to cancel and pay the penalty. But this elevates form over substance and blurs the sharp discontinuity favored in the last chapter of Contract as Promise.

Example 4. Acquirer contracts to purchase a target company and their agreement sets a closing date in 3 months. It also provides for a series of conditions for closing and for termination rights that may be exercised by the buyer. If the acquisition is not approved by the relevant government agency, the acquirer must pay \$5 million. If the acquirer's financing falls through, it can avoid the transaction but must pay \$10 million. And, if the acquirer wishes to terminate for any reason, it must pay \$20 million to do so.

These provisions avoid the sharp discontinuity between conditions and damage liability. The acquisition contract provides for a hybrid—conditional damages—that can be explained by a mix of goals, including allocation of risk and alignment of incentives.³⁹ Significantly, in real-world acquisition agreements, these numbers do not appear to be calculated to reflect the expected amount needed to compensate the target for the loss of the sale. Efficient performance and breach may be of secondary, if any, importance in these transactions because of the ability of the parties to renegotiate to the efficient outcome (and, in practice, renegotiation is common).

To be sure, in other contexts, parties intend that the promisor compensate the promisee if she does not perform. My goal here is to highlight the problem of heterogeneity in contract purposes and circumstances, which lead to different choices as to “remedy”. The measure of expectation damages is a majoritarian and untailored default. Majoritarian defaults are consistent with promissory autonomy if (a) they reflect what a majority of parties would prefer and (b) they are relatively cheap for the parties to displace. The foregoing examples and others suggest that the compensatory principle of damages may be at odds with the real or hypothetical choices of many contracting parties.⁴⁰

Of more immediate concern is the effect of the expectation damages default on the promissory autonomy of parties for whom goals other than efficient breach motivate agreements. Over the past couple of centuries, expectation damages have become entrenched as the common measure in contract law. Much effort has been devoted to providing a moral justification, including Professor Fried’s promissory principle and the economists’ theory of efficient breach. These efforts have made it more difficult for promisors to choose another measure because courts view expectation damages as compensation and regard compensation as presumptively fair or efficient.⁴¹ Perhaps the clearest manifestation of this is the rule against liquidated damages that exceed reasonable estimates of the promisee’s expectation loss from breach. The

³⁹ See generally Choi & Triantis, Strategic Vagueness, *supra* note 16.

⁴⁰ Some experimental research has been conducted to investigate what contracting parties believe is a desirable remedy for nonperformance; more empirical research would be helpful. See generally Tess Wilkinson-Ryan & Jonathan Baron, Moral Judgment and Moral Heuristics in Breach of Contract, 6 *J. Empirical Legal Stud.* 405 (2009).

⁴¹ This argument is developed more generally in Scott & Triantis, *supra* note 18, at 1476-90, and in Triantis, Evolution of Contract Remedies, *supra* note 28.

rule compels parties who wish to contract for higher damages to frame their obligations as alternative promises rather than damages. This imposes costs on them and leaves them with a non-trivial risk that the court will look to the substance and not the form of their agreement, thereby striking down their provision. This is a substantial encumbrance on promissory autonomy. While not subject to such a categorical rule, even attempts to set damages substantially lower than expectation can be subject to critical judicial review.⁴²

The task of choosing a default in the face of heterogeneity is a difficult one. A sensible preliminary approach from the perspective of the promissory principle might be to focus more on minimizing the cost of contracting away from the default rather than maximizing the proportion of parties who would (hypothetically) choose it. The courts may observe contracting practices of the type represented earlier and therefore reduce their skepticism and hostility to attempts to contract away from expectation damages. While expectation damages are tailored to the particular loss from breach, further tailoring may ask the courts to look at the purpose of the contract, which would entail higher costs and a significant risk of error. It may be that a more radical change in the default is needed to shake things up. Professor Scott and I grappled with this problem in an earlier article.⁴³ Briefly stated, we recommended the use of forcing defaults (instead of majoritarian) in order to induce promisors to express the remedial term. The legal default would permit a consumer to avoid performance without sanction in order to force the merchant to specify expressly a remedy in their agreement. Reciprocally, the default would threaten specific enforcement against the merchant unless the parties agreed otherwise.

Conclusion

I have argued in this essay that the promissory principle raises an interesting paradox. The purported moral legitimacy of expectation damages itself undermines promissory autonomy by increasing the cost of contracting for other damage measures. For reasons explored above, there are good reasons in various circumstances for promisors to prefer these alternatives, including contingent remedies. The expectation damages default suffers from the problem that

⁴² On the question of undercompensatory damages, contract law leaves the matter to a standard of fairness: the Uniform Commercial Code, for example, states that there must be “at least a fair quantum of remedy for breach of the obligations or duties outlined in the contract.” U.C.C. § 2-719 cmt. 1.

⁴³ See Scott & Triantis, supra note 18, at 1486-90.

Professor Fried identified in other nontailored default: the mere possibility that they may converge with the intent of the promisor is insufficient to justify them on the basis of individual liberty, particularly if they are costly to avoid. The very legitimacy that Professor Fried, along with other scholars of different stripes, has succeeded in bestowing on the default of expectation damages is part of the reason that promissory autonomy is being constrained in the manner described in this essay.