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Expectation Damages and the Theory of Overreliance

By Melvin A. Eisenberg and Brett McDonnell

Introduction

The basic remedy for breach of a bargain contract is expectation damages, which puts the injured party where she would have been had the contract been performed. It is generally accepted that the expectation measure provides efficient incentives to a bargain-promisor. Beginning about twenty years ago, however, law-and-economics scholars developed a model of damages which showed that the expectation measure can provide inefficient incentives to a bargain-promisee. The theory is that the expectation measure insures the promisee's reliance, and may thereby cause the promisee to overrely – that is, to invest more heavily in reliance than efficiency requires. We call this the theory of overreliance. The theory of overreliance is not limited in its application to the expectation measure, but it is most salient to that measure, just because the expectation damages is the gold standard in a bargain context.

The model upon which the theory of overreliance is based provided an extremely important insight into damages. However, as time went on, law-and-economics scholars started to lose sight of the fact that the model was just that, a model, and began to widely assume, explicitly or implicitly, that the expectation measure not only can but does provide inefficient incentives to promisees. The objective of this Article is to rehabilitate the expectation measure of damages, by showing that when institutional considerations are taken into account, expectation damages normally do not provide inefficient incentives to the promisee. In particular, we show that given such considerations: (1) In

most cases, overreliance normally cannot occur. (2) Even in cases in which overreliance can occur, the expectation measure does not in fact fully insure the promisee's reliance. (3) Although the expectation measure could be modified to address the few residual problems that might remain, the costs of such a modification would almost certainly exceed the benefits.

I. The Justifications of the Expectation Measure of Damages, and the Overreliance Critique

The basic remedy for breach of a contract -- for breach of a legally enforceable promise – is expectation damages, that is, damages measured by the amount required to put the injured party into the position she would have been in if the contract had been performed. There are a number of justifications for using this measure. One justification concerns incentive effects.

We focus for the moment on the incentive effects of damage measures on the amount of precaution a promisor takes to ensure that he will be able to perform and on his decision whether to perform; that is, on the rate of precaution and the rate of breach.[1] A contract involves a promise by at least one party, and it is always possible that events will induce a promisor to breach because performance has become unprofitable or because an alternative performance has become more profitable. The expectation measure places on the promisor the promisee's loss of his share of the contract's value in

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[1] Damage measures will affect other decisions as well, such as whether to enter into a contract, what information to reveal to other contracting parties, and how much the promisee should rely upon a contract. We consider the reliance incentive in depth, but touch only briefly on the other issues.

the event of breach, and thereby efficiently sweeps that value into the promisor's calculus of self-interest in making decisions on precaution and breach.

The effect of expectation damages on the promisor's calculations can be stated in terms of externalities. A negative externality exists when one person imposes a cost upon another without paying for it. Incentives for performance are efficient if they compel a promisor to balance the gains to him of not performing against the losses to his promisee. If the promisor does not perform, the promisee loses his share of the value of the contract. If the promisor is liable for that loss, he internalizes the full value of performance to the promisee. Thus expectation damages create efficient incentives for the promisor's performance.

By directly affecting the probability that the promisor will perform, the expectation measure has an indirect effect upon the promisee's behavior, which can be stated in terms of planning. Under a regime of expectation damages the promisee can plan more effectively, because once a contract is made he can engage in private ordering with some confidence that he will realize the expected value of that ordering, whether by performance or damages.

Furthermore, it is in the promisor's interest that the promisee be able to plan reliably, because the ability to do so will make the promisee willing to pay a higher price for the promise. The promisee will be willing to pay more because she is more certain about the expected return under the expectation measure, and is willing to pay more for a more certain return. This reduction in uncertainty is a social gain.

These ideas can also be expressed in institutional terms. The purpose of the social institution of bargain is to create joint value through exchange. In recognition of the

desirability of creating value in this manner, the legal institution of contract supports the

social institution of bargain with official sanctions. It is rational to design the legal

sanctions so that the joint value from exchange is maximized. This goal is achieved by

protecting the expectation interest with the expectation measure.

Despite these and other justifications, the expectation measure has come under

various kinds of criticism in the scholarly literature. One of these criticisms is the theory

of overreliance, first developed by Steven Shavell[2] and later elaborated by others,

including Lewis Kornhauser, Robert Cooter, William Rogerson, Aaron Edlin, and Stefan

Reichelstein.[3] In brief, the theory is that the expectation measure provides an incentive to

a promisee to rely on promises to a greater extent than is efficient, by selecting a level of

reliance as if performance of the contract is certain -- is, in effect, insured -- while in fact

there is always a chance that the promisor will breach.

In detail, even if the promisor has fully internalized all the costs of breach borne

by the promisee, there will be some circumstances in which the promisor will breach his

promise -- for example, if the costs of performing unexpectedly turn out to be prohibitive.

Under the theory of overreliance, in choosing the socially optimal amount of reliance the

promisee should take this chance of non-performance into account. Under the standard

calculation of expectation damages, the promisee will increase reliance expenditures up

to the point where the expected gain from an incremental increase in such expenditures

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[2] *See* Steven Shavell, *Damage Remedies for Breach of Contract*, 11 Bell J. Econ. 466 (1980); Steven
Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. Econ. 121 (1984).
[3] *See* Lewis A. Kornhouser, Reliance, *Reputation, and Breach of Contract*, 26 Share Econ. 691 (1983);
Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 75 Cal. L. Rev. (1985);
William P. Rogerson, *Efficient Reliance for Breach of Contract*, 15 Rand J. Econ. 39 (1984); Aaron S.
Edlin, *Cadillac Contracts and Up-front Payments; Efficient Investment Under Expectation Damages*, 12 J.
Econ & Org. 98 (1996); Aaron S. Edlin and Stefan Reickelsfein, *Holdups, Standard Breach Remedies, and
Optimal Investment*, 86 Amer. Econ. Rev. 478 (1998).

equals the cost of the incremental increase. The increased expected gain from increased reliance expenditures increases the value of the contract to the promisee, assuming the expenditures are made and the promisor performs.

However, the argument goes, the standard expectation measure as so calculated does not give the promisee an incentive to choose the socially optimal level of reliance. In particular, when calculating the expected gain from an increase in reliance expenditures, the promisee will not discount that expected gain by the possibility that the promisor will breach. If the promisor does breach, he will be forced to compensate the promisee, and expectation damages will put the promisee in as good a position as if the contract had been performed. From the promisee's point of view, it is as if the promisor had insured the promisee that the contract would be performed. The promisee thus acts as if performance is certain, and chooses a level of reliance consistent with that assumption. The theory of overreliance posits that the level of reliance so chosen will be higher than the level that would be chosen assuming a positive probability of breach; that choosing the higher level is inefficient; and that accordingly there is a flaw in the principle of expectation damages.

Robert Cooter and Thomas Ulen provide a good exemplification of the received theory of overreliance.[4] We present this example in some detail here to illustrate the theory and make clear its arguments.

Here is the Cooter and Ulen hypothetical:

Yvonne owns a restaurant for economists called the Waffle Shop. Business is going well, and Yvonne contracts with Xavier to build a new facility to be ready for

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[4] Robert Cooter and Thomas Ulen, *Law and Economics* 248-58 (3nd ed. 2000).

occupancy by September 1. Many things could prevent Xavier from completing on time—bad weather, a plumbers strike, nosy city inspectors, and so on. Xavier can choose how much to spend on precaution to avoid such an event from occurring—the more he spends, the less likely it will be that construction will be delayed past September 1.[5] To serve the new customers that will patronize the new facility, Yvonne must order more food, and she must order it before September 1. Greater expenditures on food will increase her profits from the restaurant; however, if the opening is delayed she will have to pay storage costs for the food, reducing her profits somewhat.[6]

The efficient levels of expenditures by Xavier and Yvonne are most easily understood by assuming that one person, Perry, alone bears both sets of costs, and also receives all of the revenue from Yvonne's business. In that case there are no externalities, and Perry has the proper incentives in making both expenditure decisions.[7] Perry would choose the level of expenditures to ensure timely completion and food-ordering expenditures that would maximize his expected net revenue -- that is, expected gross revenue minus variable costs. Thus precaution expenditures would be set at the level where, if the expenditures were to be increased just a tiny amount further, the gain in expected revenue would be exactly offset by the cost of the change. An increase in precaution expenditures leads to a slight increase in the probability that construction will be completed on time. The increase in expected net revenue is this increase in the

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[5] Formally, let x be Xavier's expenditures on measures to assure construction is not delayed, and p be the probability that construction is completed by September 1. Then p is a function of x, $p(x)$, with $dp/dx > 0$.
[6] Let y be Yvonne's expenditures on food orders. Her revenues are $Rp(y)$ if Xavier performs on time, and $Rnp(y)$ if Xavier breaches, with $Rp(y) > Rnp(y)$ and $dR/dy > 0$.
[7] To be sure, operating as one unified business creates costs of its own. The choice between contracting versus operating as one business is thus based on comparative transactional costs. For here, though, we ignore the costs involved in operating as one business—the point is simply to illustrate how expenditures

probability of on-time completion multiplied by the difference in net revenue if construction is on time versus net revenue if construction is delayed.[8] In other words, the gain from increasing expenditures to speed construction is the incremental net revenue gained from on-time completion multiplied by the increased probability of realizing that gain by completing construction on time.

The expenditures on ordering food will be set similarly. Thus, food expenditures will be set at the level where a small further increase would increase expected revenue by an amount exactly equal to the cost of the increased cost. The increase in expected revenue due to such a small change in food expenditure is a weighted average of two calculations. The first calculation is the change in net revenue from added food expenditures assuming that construction is completed on time. The second calculation is the change in net revenue from the added food expenditure assuming the construction is delayed. The weight given to the change in revenue assuming construction is completed on time is the probability of on-time completion.[9] Thus, if delay is very unlikely, food expenditures should be close to the level that would be chosen if timely completion were certain, whereas if delay is extremely likely, food expenditures should be close to the level chosen if delay were certain. This weighting by the probability of breach in deciding how to set food-ordering expenditures is crucial: the heart of the theory of overreliance is that as a result of the expectation measure, Yvonne will fail to properly weight the probability of breach.

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should be chosen in the absence of externalities created by the effects that Xavier's and Yvonne's decisions have on each other.

[8] The first order condition with respect to x is $p'(x)(Rp(y) - Rnp(y)) = 1$. $p'(x)$ is the marginal increase in the probability of on-time completion with a small increase in x, and $Rp(y) - Rnp(y)$ is the gain from on-time completion versus delay, so the left hand side is the marginal expected gain from a small increase in x.

[9] The first order condition with respect to y is $p(x)Rp'(y) + (1 - p(x))Rnp'(y) = 1$.

We now return to the case where Xavier and Yvonne run separate businesses and contract with each other. The expectation measure of damages gives Xavier the correct incentive to choose expenditures for precaution against breach, that is, for assuring timely completion. Xavier bears the full cost of these expenditures. Expectation damages force Xavier to also bear the difference between Yvonne's net revenue if the contract is performed and Yvonne's net revenue if the contract is breached. As just shown, the gain from a small increase in expenditure on precaution against breach is the change in the probability of breach due to the increased expenditure multiplied by the difference between net revenue in performance versus net revenue in breach.[10] Since expectation damages are measured precisely by that difference, Xavier now takes the benefit of changed construction expenditures as well as the cost, because by increasing precaution against breach he reduces the chance he will have to pay damages to Yvonne. Xavier therefore has the proper incentive in choosing the level of expenditures to avoid breach.[11]

In contrast, the theory of overreliance takes the position that the expectation measure gives Yvonne an incentive to set food expenditures above the efficient level. Under this measure Yvonne will always receive the level of net revenue that would result if the contract were performed, assuming that standard expectation damages are perfectly

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[10] *See supra* note 8 and accompanying text. That text speaks of expenditures on construction. In the context of a contract between two parties, that is Xavier's expenditures on precaution against breach.

[11] If K is the contract price, then Xavier's net income is $K - x - (1 - p(x))D$, where D is the damage measure. The first order condition for this function is $p'(x)D = 1$. If we set $D = Rp(y) - Rnp(y)$, the expectation measure, then this condition becomes $p'(x)(Rp(y) - Rnp(y)) = 1$, which is the efficient first order condition given in note 8 above.

There is actually a subtle difference here from the social optimum. Note that Xavier's choice of x depends on Yvonne's expected revenue, $Rp(y) - Rnp(y)$, which in turn depends on y. The expectation measure should induce Xavier to choose the optimal level of x *given* Yvonne's choice of y. However, as we are about to see, Yvonne sets y too high. Given a higher level of y, the optimal level of x increases—at a higher level of reliance the cost of breach increases, hence it is efficient to taker greater precaution against breach. Since Yvonne sets y too high, Xavier will then set x higher than the socially efficient level, as

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calculated and costlessly recovered. If Xavier performs, Yvonne will receive this net

revenue directly. If Xavier breaches, Yvonne will receive less net revenue directly, but

Xavier will make up the difference in damages. Yvonne will thus choose the level of

food expenditure as if performance were certain, which, under the theory of overreliance,

is not equal to the level of food expenditure that is optimal given a chance of breach.[12]

This difference between the efficient level of reliance and the level of reliance that

Yvonne would choose under the expectation measure illustrates the theory of

overreliance as conceived by law-and-economics contract scholars.

Note, however, that this example does not show that the expectation measure is

inferior to its main competitor, the reliance measure. First, to the extent that the reliance

measure results in a lower award than the expectation measure, it will give Xavier an

incentive to invest too little in precautions against breach. Second, the reliance measure

need not give any better incentive for Yvonne's reliance than does the expectation

measure—indeed, we show in the margin that, using the measure of reliance suggested

by Cooter and Ulen for this example, the expectation and reliance measures lead to the

same level of overreliance by Yvonne.[13] Indeed, in Shavell's initial paper on overreliance

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calculated above. Xavier will, however, choose the best level of x *given* Yvonne's choice of y. The choice
of x is, in other words, second-best.

[12] Yvonne's net income is $p(x)Rp(y) + (1 - p(x))Rnp(y) + (1 - p(x))D - K - y$. The first order condition for
choosing y is $p(x)R'p(y) + (1 - p(x))(R'np(y) + D'(y)) = 1$. Comparing this to the condition in note 9
above, Yvonne has the proper incentive only if $D'(y) = 0$, that is, only if the damages she will receive
remain unchanged by her choice of y. However, if $D = Rp(y) - Rnp(y)$, then $D'(y) = R'(y) - R'np(y)$.
Plugging this expression into Yvonne's first order condition yields $R'p(y) = 1$, which is the first order
condition which would result from the social choice if performance were certain. In general this will lead
to a different choice of y than the socially optimal level, given a chance of breach. The non-optimal level
of y which Yvonne chooses will be greater than the efficient level assuming the second derivative of $Rp(y)$
and $Rnp(y)$ is negative—that is, while increasing y increases revenue, it does so at a decreasing rate. If the
second derivative were positive, the first-order condition, above, would not maximize profits. One would
then need to analyze a "corner solution," that is, Yvonne would choose the maximum or minimum level of
y allowed.

[13] Cooter and Ulen use as the reliance measure in this model $[Rnp(y_0) - y_0] - [Rnp(y) - y]$, where y_0 is the
amount Yvonne would have spent on food in the old restaurant. The derivative of this expression with

he argued that the expectation measure dominates the reliance measure, because both measures encourage overreliance, but the expectation measure gives the proper incentive for breach decisions while the reliance measure encourages too much breach. Shavell also argued that the comparison of the expectation measure with either a restitution measure or no-damages regime is ambiguous: Unlike the expectation measure, restitution and a no-damages regime give the proper incentive for the reliance decision, but they do not give the proper incentive for breach decisions.[14]

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To facilitate the analysis of the theory of overreliance, we will employ various defined terms. To begin with, by a *promisor* we mean a contracting party who is or may be in breach. By a *promisee*, we mean a party who is or may be injured by a promisor's breach. By *overreliance,* we mean reliance by a promisee that inefficiently disregards the promisor's rate of breach or, to put it differently, that inefficiently treats the promisor's performance as insured. By the *Standard Expectation Measure,* we mean expectation damages as presently conceived. By the *theory of overreliance* we mean the concept that the Standard Expectation Measure gives a promisee an incentive to rely on a promise to an inefficiently great extent. By an *overreliance rule,* we mean a legal rule under which the Standard Expectation Measure would be modified so as not to provide such an incentive.

Other defined terms will be developed in the course of the paper.

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respect to a change in y is $1 - R'np(y)$. Substituting this expression into Yvonne's first order condition given in the previous footnote yields $R'p(y) = 1$—the same condition yielded by the expectation measure.
[14] *See* Shavell, *Damage Remedies*, *supra* note 2, at xxx.

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In this paper, we show that the theory of overreliance fails to take adequate account of institutional considerations. In Part II, we show that as a result of institutional considerations, in most cases overreliance normally cannot occur. In Part III, we show that even in cases in which overreliance can occur, the promisee's reliance is not fully insured by the expectation measure. In Part IV, we show that even in the residual cases in which overreliance could occur, and may occur despite the fact that the promisee's reliance is not fully insured by expectation damages, the costs of modifying the Standard Expectation Measure to eliminate overreliance would almost certainly exceed the benefits.

II. In Most Cases, Overreliance Normally Cannot Occur

In this Part, we show that even if the theory of overreliance were correct, given institutional considerations, the actual incidence of overreliance would be so low that the theory would fail to provide a significant reason to abandon or even modify the expectation measure. We begin this Part by disaggregating contractual reliance, and showing that of the many kinds of contractual reliance, only beneficial reliance would normally give rise to overreliance (Section A). Next, we show that even when the focus is limited to beneficial reliance, the great majority of contractual transactions normally cannot not give rise to overreliance (Section B).

A. Disaggregating Reliance

To properly understand the problem of overreliance, it is necessary to disaggregate the concept of reliance itself. In this Part, we consider several types of

reliance, which we call beneficial reliance, Profit-diminishing reliance, necessary

reliance, and timing costs.

      1 . *Beneficial reliance*. *Beneficial reliance* is reliance on a promise that increases

the value of the promise to the promisee.[15] For example, suppose Boatmaker agrees to

build a commercial yacht, to be named *Seafarer*, for Charterer, who plans to charter out

the yacht for luxury cruises. It is agreed that Boatmaker is not responsible for providing

or installing furnishings, navigational equipment, safety equipment (such as lifeboats), or

other ancillary items. Boatmaker has a backlog of orders, and promises delivery in six

months. The navigational equipment that Charterer wants for *Seafarer* must be ordered

sixty days in advance. Charterer might choose to wait to order this equipment until

Seafarer is delivered. However, Charterer will probably prefer to order the equipment

sixty days before delivery of *Seafarer*, so that he can charter out *Seafarer* for a cruise as

soon as it is delivered, thereby increasing the value of the contract to him. The advance

purchase of navigational equipment constitutes beneficial reliance.

      Or suppose that the Blue Angels, a rock group, contracts with Promoter to give a

concert in three months for a fixed fee of $100,000. Promoter can greatly increase the

value of the Blue Angels promise by advertising the concert in advance. The advance

advertising constitutes beneficial reliance. Xavier and Yvonne also present a problem of

beneficial reliance: if Yvonne orders the food before Xavier completes construction, the

contract is worth more to her.

      Under the theory of overreliance, beneficial reliance can lead to overreliance,

because a promisee who seeks to make a contract more valuable to himself, by increasing

the profits that the contract will generate, may invest in beneficial reliance as if the promisor's performance is insured -- that is, without taking into account the probability of breach.[16]

2. *Profit-maximizing and profit-reducing reliance.* Even if the expectation measure were not utilized in contract law, a promisee might spend an inefficient amount on beneficial reliance, simply because he is imprudent. Suppose, for example, that a promisee's beneficial reliance was fully and perfectly insured -- by which we mean that if the promisor breaches, the promisee will costlessly get expectation damages without any discount for overreliance. Even in such a case, a prudent promisee will not invest in unlimited beneficial reliance. Instead, she will invest in beneficial reliance only to the point where the last dollar spent on such reliance just equals the marginal revenue that the additional expense will generate. For instance, in the Xavier-Yvonne example, if the Standard Expectation Measure fully insures Yvonne against breach, Yvonne will, if rational, choose food expenditures only up to that point where the cost of additional expenditures equals their added benefit, assuming performance is certain or damages are a perfect substitute for performance. We will call such reliance *profit-maximizing reliance.*

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[15] Charles J. Goetz and Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 Yale L. J. 1261 (1980).

[16] Typically, an increase in beneficial reliance increases the promisee's damages by increasing his expected profits. An increase in beneficial reliance may also increase the promisee's damages by increasing his compensable costs. For example, suppose that in the Blue Angels case, Promoter spends $50,000 on advertising, and has no other expenses besides advertising and the Blue Angels' $100,000 fee. If the Blue Angels gives the concert, the proceeds of the concert will be $225,000. If the Blue Angels cancels at the last moment, and its fee has not yet been paid, then to put Promoter where he would have been if the concert has been performed, he must be awarded damages of $125,000: if the concert had been performed, Promoter would have covered his $50,000 advertising expense and made a profit of $75,000 to boot. If Promoter is awarded as damages only $75,000 for lost profit, he will have to eat the $50,000 advertising expenses, and therefore will not be as well off as he would have been had the concert been performed.

Some actors, however, including some promisees, may rely in a way that is profit-reducing. In the Blue Angels case, for example, Promoter might spend an amount on advertising that was suboptimal even if performance by the Blue Angels was perfectly insured, because he miscalculates the effect of additional advertising. For example, Producer might have an overoptimistic disposition. Or, since in the end a judgment must be made, and some actors have better judgment than others, Producer may simply have made a bad call. We will call that portion of beneficial reliance that is suboptimal even if the promisor's performance was perfectly insured. We will call such reliance *profit-diminishing reliance*. Profit-diminishing reliance will not increase the promisee's damages, because it will decrease, rather than increase, the promisee's lost profits. To put this differently, if the promisor performs rather than breaches, the promisee's profits will be reduced by the amount of profit-diminishing reliance. Therefore, in a suit by the promisee based on its lost profits, the damages it recovers must be correspondingly reduced.

Profit-diminishing reliance is presumably atypical, although not unknown. We mention it here principally to make clear that even if the promisee's beneficial reliance was perfectly insured by the Standard Expectation Measure, a rational, well-informed and prudent promisee would not engage in unlimited beneficial reliance. Instead, the beneficial reliance of such a promisee will be constrained by a natural economic limit.

Reliance may be profit-diminishing regardless of the damages rule. In contrast, whether reliance is profit-maximizing may depend in part on the damages rule. Under the Standard Expectation Measure, reliance may be profit-maximizing even though it takes no account of the probability of breach, because the promisee knows or has reason

to know that his damages will not depend on that probability. Under an overreliance rule, on the other hand, a promisee who does not take the promisor's rate of breach into account may be imprudent, because he would know or have reason to know that his damages may be adjusted downward. In this Article we take the Standard Expectation Measure as a starting-point, and therefore we define *prudent reliance* to mean reliance that is prudent given that measure. As will be seen, nothing substantive turns on this definition; it is adopted simply for ease of exposition.

3. *Necessary reliance*. A party to a contract must often incur some costs just to make the contract work. For example, a buyer must incur some costs to get any benefit at all from the seller's performance. Thus in the Blue Angels case, if Promoter is to get any benefit at all from his contract, he must first incur the cost of renting a venue. Similarly, if a buyer contracts to purchase a machine that requires a concrete foundation, he cannot take delivery unless he first incurs the cost of putting in the foundation. We call such costs *preparatory costs.* Similarly, sellers often must incur certain certain costs to render an agreed-upon performance. For example, assume that Seller, a middleman, agrees to deliver 40,000 apples to Buyer at 25¢ an apple. To perform, the Seller must incur the cost of buying 40,000 apples. We call such costs *performance costs.* We call preparatory costs and performance costs, taken together, *necessary reliance*, because but for the contract they would not be incurred, but once the contract is made they must be incurred.

Necessary reliance may be viewed as only a special case of beneficial reliance. Typically, however, beneficial reliance is economically discretionary once the contract is made, while necessary reliance is not. Once a contract has been entered into, necessary

reliance is largely or even entirely invariant to the promisor's actions, and therefore normally cannot result in overreliance.

For example, a seller normally cannot significantly vary his performance costs in response to the buyer's rate of breach, because if he fails to incur performance costs he will be unable to perform, and will himself be in breach. Thus in the apples hypothetical, regardless of Buyer's rate of breach, at some point prior to the time for delivery Seller must purchase 40,000 apples. To put this differently, generally speaking once a contract has been entered into, the amount of the seller's performance costs is largely unaffected by whether the seller treats the performance of the buyer as insured or uninsured.

Similarly, a buyer generally cannot significantly vary the amount of his preparatory costs, because if he does not incur such costs he will lose the benefit of the contract, and nevertheless will have to pay the contract price or damages to the seller. In the Blue Angels case, for example, if Promoter doesn't rent a venue prior to the contract, he nevertheless will be required to pay the Blue Angels $75,000.[17]

It is true that the amount of preparatory costs may sometimes be variable at the margin. In the Blue Angels case, for example, Promoter might be able to rent a better or worse venue, and in the machine case the buyer might be able to build a better or worse foundation. We regard this qualification as largely immaterial, for two reasons. First, in many or most cases the amount of preparatory reliance will not be practicably variable, either because there is only one realistic alternative (for example, in the Blue Angels

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[17] Similarly, in Xavier-Yvonne the overreliance problem may figure in deciding how much beneficial reliance Yvonne *should* engage in at the margin, but may not figure in how much preparatory reliance she *must* engage in (for example, by expanding her refrigeration capacity to store the new food units).Formally, one could assume that Yvonne's reliance expenditures are equal to y + Y, where y is as above and Y is a fixed cost that Yvonne must incur in order to do any amount of food ordering at all. Yvonne's net income

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case, if there is only one suitable venue in the area for a rock concert that is available during the relevant time period), or because the quality of the commodity the buyer must invest in – a concert venue, a foundation -- cannot be easily reduced below the otherwise-optimal quality without destroying the benefit of the contract. Second, even where the quality of the commodity can be reduced below the level that would be optimal except for the problem of overreliance, by hypothesis reducing the expenditure on preparatory reliance will result in a level of quality that would be less than optimal if the issue of overreliance is put aside. Where the probability of performance is high and the probability of material breach is very low, as will typically be the case, the social loss that would result from underinvesting in quality will normally swamp any social loss that would result from not taking into account the possibility of breach, because the expected cost of a suboptimal investment in quality will be very high, while the expected cost of overreliance will be very low.

Performance costs may also be variable at the margin, but for reasons discussed in the following section, the variation of performance costs to take account of the possibility of breach is also rarely likely to be efficient.

4. *Timing costs.* There is a set of contract-related costs that fall into a zone between necessary reliance, on the one hand, and beneficial reliance, on the other. We call these *timing costs.* These are principally costs that will result if a party delays the beginning of his performance to minimize the losses that may follow if breach occurs.

Here is an example: Assume that A and B have entered into a contract -- say a contract for the sale of apples by A to B, or a contract under which A will construct a

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would then become $p(x)Rp(y) + (1- p(x)Rnp(y) + 1 - p(x)D - K - y - Y$. But her first order condition in

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building for B. Assume further that while A must incur minimum performance costs of $X to perform either contract, he has some discretion when to begin incurring those costs. For example, suppose that A can fill B's order on time either by purchasing apples soon after the contract is made, or by purchasing apples just prior to the time of delivery. Or suppose that A can construct the building on time either by beginning right away or by beginning later.

Under these assumptions, if the probability of B's breach is disregarded, then A will make a straightforward efficiency decision on timing, based on such considerations as his forecast of future prices, the increased difficulty of completion if he begins later rather than earlier, the cost of tying up capital if he begins earlier rather than later, and so forth. A will also be conscious of the fact that beginning performance early is a kind of precaution, in the sense that the earlier A begins performing, the more likely he will perform on time. If A is rational and well informed, he will begin performance at the time, T_1, that is optimal given these kinds of considerations.

Now suppose that the probability of material breach by B is greater than zero. It is possible that total costs will be minimized if A begins at time T_2, which is later than T_1, because if it becomes clear after T_1, but before T_2, that B will breach, A can forgo a wasteful investment in the costs of a performance that may have only limited value if B wrongfully refuses to accept and pay for it. We call such a delay a timing cost, because A's profits will always be reduced by beginning performance at T_2 rather than T_1, since by hypothesis the optimum time for A to begin performance (not taking into account the possibility of a breach by B) is T_1, not T_2.

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choosing how high to set y is still as in note 12 - it remains unchanged by the addition of Y.

Other kinds of costs may also be deemed timing costs.   For example, assume that in the apples case, Seller has a window of time to purchase apples for resale to Buyer, the optimal time for Seller to purchase apples for resale to Buyer is T_1, and that if Seller buys the apples at that time he will need to incur minimum performance costs (the cost of the apples) of \$18,000. Suppose it is possible for Seller to instead pay \$500 at T_1 for an option to purchase apples for \$18,000 at a later time, T_2, and that if Seller does so and Buyer defaults, the losses under the contract will be less.   By hypothesis, but for the risk of Buyer's breach it is optimal for Seller to buy apples, rather than an option, at T_1. Accordingly, if Seller buys the option he will reduce his profits, and therefore the value of the contract, because he will increase his costs from \$18,000 to \$18,500 without any corresponding increase in the price paid by Buyer.

However, timing costs will seldom lead to inefficient overreliance. For example, assume that to reduce the possibility of the social costs that will result if Buyer breaches after Seller has begun performance, Seller delays the beginning of performance beyond the time, T_1, that would be efficient but for Buyer's possible breach. Then there will be a possible efficiency gain, based on the probability of wasted costs in the event of breach. There will also be an efficiency loss, because by hypothesis in the absence of breach it will be more costly for Seller to begin performance at T_2, and also because beginning at T_1 rather than T_2 is a type of precaution against Seller himself ending up in breach by delaying performance too long. However if, as will usually be the case, the probability of material breach is low, the efficiency losses from such a delay will normally swamp the efficiency gains.

But what if, instead of merely a statistical probability of breach, Buyer takes an action or makes a statement that renders it uncertain whether Buyer will perform? We are then out of the realm of overreliance: Under general principles of contract law, in such a case Seller can demand reasonable assurance of performance by Buyer, and if such assurance is not forthcoming, Seller can withhold further performance and bring suit for breach of contract.

5. *Summary.* The problem of overreliance does not apply to most kinds of reliance. Whether reliance is profit-maximizing or profit-decreasing depends on efficiency considerations other than the promisor's rate of breach. Assuming that the probability of material breach is low, necessary reliance can seldom be efficiently varied in response to the probability of breach. The same is true of timing costs.

Therefore, for most practical purposes, the theory of overreliance concerns only beneficial reliance. Accordingly, in the balance of this Article we will for the most part consider only the effect of the Standard Expectation Measure on that type of reliance.

B. In Most Contracts Cases the Standard Expectation Measure Cannot Provide an

Incentive for Overreliance.

In the previous Section, we disaggregated reliance, partly to facilitate the analysis of overreliance, and partly to show that most kinds of reliance do not raise an overreliance problem. In this Section, we show that in three major categories of contracts cases, which collectively account for most contracts cases, overreliance normally cannot occur, because of institutional elements based on the economics of contracting and the

way in which the Standard Expectation Measure is actually administered. These categories are --

- *Cases in which the promisee's damages under the Standard Expectation Measure will not vary with her costs:* If a promisee's damages under the Standard Expectation Measure will not vary with her costs, the prospect of standard expectation damages will not affect the level of the promisee's investment in costs.

- *Cases in which the promisee's payoff from reliance does not depend on performance by her counterparty:* Where a promisee's payoff from reliance does not depend on performance by her counterparty, the efficient level of the party's investment in costs is independent of the counterparty's probability of breach.

- *Cases where it would be inefficient for a promisee, in setting the appropriate level of beneficial reliance, to take her counterparty's probability of breach into account:* Because the theory of overreliance is based on efficiency, it is either inapplicable or trumped in cases where it would be inefficient to adopt an overreliance rule.

We now consider these categories in detail.

1. *Cases in Which the Promisee's Damages Under the Standard Expectation Measure Will Not Vary with Her Costs.* We begin with cases in which the prospect of expectation damages is not an incentive to overreliance because the promisee's expectation damages will not vary with her costs. As shown in Part II, when damages do not vary with changes in costs, an incentive to overrely does not arise.[18]

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[18] *See supra* note 12 and accompanying text. In the Xavier-Yvonne example, notice that in note 12, Yvonne's first order condition for choosing y reduces to the socially optimal condition when $D'(y) = 0$, which is precisely where the damages received do not vary with Yvonne's choice of reliance expenditure, y.

Much of the literature on overreliance suffers from the defect that it takes expectation damages as a monolithic entity. Of course, there is a general principle of expectation damages – put the injured party in the position that he would have been in if the contract had been performed. In the actual law of damages, however, the general principle is reconstructed into specific rules based on various types of categorization. The theory of overreliance must be considered in light of these rules.

One way in which expectation-damage rules are categorized is by the construction of formulas that apply the general principle of expectation damages to particular kinds of cases, like breach by a seller and breach by a buyer. Another kind of categorization divides expectation damages into general and consequential damages. *General damages* are the damages that normally follow from a particular kind of breach -- for example, a breach by a seller in a contract for the sale of goods -- regardless of the particular circumstances of the parties. A contracting party is normally liable for all general damages that result from his breach. *Consequential damages* are the damages that result only from the particular circumstances of the parties. For example, if a seller fails to deliver under a contract for the sale of goods, the buyer, regardless of his circumstances, normally incurs general damages equal to any excess of the market price of the goods over the contract price. Depending on the circumstances, however, the buyer may also incur other damages, such as expected lost profits on resale of the goods. Under the principle of *Hadley v. Baxendale*, a contracting party is normally liable for consequential damages that result from his breach only if, at the time the contract was made, it was reasonably foreseeable that the damages would result from breach.

We now consider the theory of overreliance in light of rules in these two categories.

(a) Seller's Damages. In the overwhelming majority of contracts, one party is required to provide a commodity (using that term in its broadest sense, to include physical goods, intangibles, real property, and services), while the other party is required only to pay cash (either immediately or over time). We will call a contracting party who is required to provide a commodity a *Seller*, and a party who is required only to pay cash for a commodity a *Buyer.* We will first show that except in outlying cases, the prospect of damages under the Standard Expectation Measure cannot provide a Seller with an incentive to overrely, because a Seller's expectation damages normally do not vary with his costs.

Consider, for example, a Seller's general damages for breach by the Buyer. There are two basic formulas for calculating such damages.

The first formula is $K - R$, where K is the contract price that the Buyer agreed to pay for a commodity, and R is the price that the Seller can realize by disposing of the commodity in a replacement sale. (R can be either the market price that the Seller could have realized at the time and place of breach, or the actual resale price.) [19]

The second formula has two, normally equivalent, expressions. The first expression is $P + C_i$, where P equals the contract price minus the Seller's *total* variable costs for performing the contract, and C_i equals the portion of variable costs incurred by the Seller *prior* to the breach. (In effect, this formula awards the Seller his expected net revenues from the contract plus the variable costs incurred prior to breach.) The second

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expression is $K - C_r$, where K equals the contract price and C_r equals the variable costs remaining to be incurred by the Seller at the time of breach. The two expressions are normally algebraically equivalent.

Under either formula, a Seller's expectation damages normally cannot vary with his costs.

This is most readily apparent where the Seller's damages are measured by the first formula, K - R. In this formula K (the contract price) is fixed, and R (the market or resale price) is invariant to the Seller's costs. Accordingly, an increase in the Seller's costs will not increase his damages, and indeed will decrease his net gain. Contracts in which the Seller's expectation damages are measured under this formula therefore cannot provide an incentive to a Seller to inefficiently increase his costs by overrelying.

The same result obtains where the Seller's damages are measured under the second formula.

Under the first expression of that formula, $P + C_i$, an increase in the Seller's variable costs drives up C_i (variable costs incurred by the Seller prior to the breach), but typically drives down P (contract price minus total variable costs) dollar for dollar, so that the Standard Expectation Measure does not provide an incentive to the Seller to increase his costs.

Under the alternative expression of the formula, $K-C_r$, the contract price, K, is fixed. Although an increase in the Seller's variable costs prior to the time of breach drives down C_r, and therefore drives up the Seller's damages, it also typically drives down the

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[19] We put to one side, throughout this paper, wrinkles on the formulas that concern payments made prior to breach. These wrinkles do not affect our analysis.

Seller's profit, dollar for dollar. Therefore, this expression also provides no incentive for a Seller to overrely.

It might sometimes happen that by incurring costs earlier rather than later, the Seller can decrease its total costs, because spending earlier may allow the Seller to plan better, lock in better prices, and so forth. In such cases, the timing of the Seller's costs might increase net revenues, rather than decreasing net revenues dollar-for-dollar. However, as we showed in Section A.4, a rule that put pressure on a Seller to postpone his performance until he could determine whether the Buyer would be in breach would probably be inefficient rather than efficient, because such a rule would often require a Seller to spend more costs than would otherwise be optimal, and because starting early is a precaution against the Seller's own breach thereby decreasing his net revenues and the wealth that the contract could create. Accordingly, while a few cases might occur in which early performance would lead to higher damages under the formula K-Cr, than later performance, and later performance would be more efficient, factoring in the optimality of the time at which costs are incurred, on the one hand, and probability of breach, on the other, we regard such cases as rare outliers that can safely be disregarded for present purposes.

Of course, a Seller who stands to make *consequential* profits from a sale may be able to increase his expected profits, and therefore his damages, by increasing his beneficial reliance. However, "Sellers rarely suffer compensable consequential damages. A Buyer's usual default is failure to pay. In normal circumstances the disappointed seller

will be able to sell to another, borrow to replace the breaching buyer's promised payment, or otherwise adjust its affairs to avoid consequential loss."[20]

In short, the prospect of expectation damages normally cannot give a Seller an incentive to overrely -- that is, an incentive to incur more costs than would be efficient considering the Buyer's probability of breach--because the formulas for calculating a Seller's general damages normally provide Sellers with no incentive for increasing their costs, and Sellers normally do not incur consequential damages. Accordingly, overreliance normally cannot be a problem for half of all contracting parties, that is, Sellers. And, as we will show in the next few Sections, overreliance also either cannot be or is highly unlikely to be a problem for most Buyers.

(b) Buyers' Damages. Since Sellers normally cannot overrrely, we will now shift our focus to Buyers.

 (i) *Buyers who have no compensable consequential damages; introduction.* Buyers, like Sellers, will normally incur general damages as a result of a breach. As in the case of Sellers, the general damages of Buyers are normally measured by one of two formulas. The first formula is $R - K$, where R is the price of a replacement transaction and K is the contract price. (Here again, the price of a replacement transaction can be measured either by the market price for the contracted-for commodity at the time of breach, or by an actual replacement transaction, such as the cost of cover or the price charged by a replacement service-provider). The second formula is $V_p - V_r$, where V_p is

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[20] ALI, Proposed Amendments to Article 2, section 2-710, preliminary comment 2 (April 16, 2001).

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the market value of the performance that was promised, and V_r is the market value of the performance that was rendered.[21]

Under either formula, the Buyer's gain from general damages will not be increased by an increase in his costs. This is most readily apparent in the case of the first formula, R – K, because neither R (the cost of a replacement transaction) nor K (the contract price) is affected by changes in a Buyer's costs. The same result also holds true of the second formula, $V_p – V_r$, because both V_p (the market value of the performance promised) and V_r (the market value of the performance rendered) are measured independently of Buyer's costs.

Accordingly, as to Buyers who have only compensable general damages, the Standard Expectation Measure normally does not and indeed cannot provide an incentive for overreliance. Many Buyers fall into this category; that is, many Buyers have no compensable consequential damages. This will be true, for example, whenever the Buyer's consequential damages are not reasonably foreseeable by the Seller at the time the contract is made.

In addition, a Seller's breach will seldom result in consequential damages to the Buyer if the Buyer is a consumer. Consumers normally purchase commodities for personal consumption and use, rather than to make a profit. Accordingly, in most cases a consumer's consequential damages consist only of loss of personal satisfaction. In a perfect world, lost satisfaction might count in expectation damages. Under the common law of contracts, it normally doesn't.[22] It is true that scenarios can be constructed in

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[21] The second formula is commonly referred to as the diminished-value measure. As in the case of Seller's damages, there are wrinkles in the formulas, but they can be ignored for present purposes.

[22] *See* Restatement Second of Contracts § 353.

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which a consumer will have consequential damages. For example, a consumer who

contracts for a custom-made yacht from Seller might suffer consequential reliance

damages if she orders custom-made fittings that can't be used for any other yacht, and

Seller fails to deliver. This kind of scenario, however, is hardly an everyday occurrence,

and even in this kind of scenario, under the principle of *Hadley v. Baxendale* the

consumer's consequential damages won't be compensable unless the seller was on notice,

at the time the contract was made, that the consumer planned to engage in reliance of this

kind.[23]

Even a Buyer who is in business will normally have consequential damages only

when a breach is material. For example, suppose Contractor agrees with Owner to build a

commercial building to certain specifications, the building to be completed and ready for

occupancy on July 1. Contractor substantially completes the building by July 1, but the

construction fails to meet specifications in certain nonmaterial respects -- some of the

carpeting is not the specified color, and some of the office doors don't close properly. If

the defects don't prevent Owner from taking immediate occupancy, and can be remedied

either by a money allowance or by contracting with a third party to make repairs, owner's

damages will be measured under the formula V_p-V_r, and owner's investment in beneficial

reliance will not be wasted as a result of the breach.

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[23] Of course, while this limit on damages reduces the Buyer's incentive to overrely, it also decreases the
Seller's incentive to take precautions against breach.
   We put to one side problems of liability for harm caused to the person or property of a consumer or
bystander by a defective product. Such harms are typically not recompensed by expectation damages, and
as far as we are aware it has not been suggested in the overreliance literature that a consumer's or
bystander's remedies for such harms should be affected by whether the consumer or bystander has
organized her life to take into account the probability that an injury might result from a product that has no
apparent defects. Of course, consumers may occasionally suffer economic harm from product defects, but
that is consistent with our position that consumers *usually* don't have consequential damages.

To generalize, what matters under the theory of overreliance is not the prospect of breach as such, but the prospect of material breach. Accordingly, a Buyer can efficiently invest in beneficial reliance without regard to the probability that Seller will breach, to the extent that this probability concerns only minor breaches.

(ii) *Very high and very low rates of material breach*. Now assume that a Seller has a probability of material breach. If the probability of material breach is very low, it would normally be inefficient to take it into account in calibrating the efficient amount of beneficial reliance, both because by definition the probability is not significant, and because for that reason the cost of determining exactly how much reliance would be efficient would normally exceed any resulting gains. In such cases, efficiency therefore requires the Buyer to treat the Seller's performance as if it were certain, even if it was not.

Suppose the Seller's probability of material breach *is* very high? In that case, Buyers are unlikely to contract with the Seller. Parties contract not only to shift risks, but also to enable them to make reliable plans. To begin with, many contracts are based in significant part on the Buyer's need to coordinate production or distribution by ensuring control over inputs. If, in such a case, a contracted-for input is not timely delivered, the Buyer's entire production may be seriously disrupted. Few Buyers who contract on this basis are willing to substitute the prospect of future damages for the present delivery of the input. As stated in the Comment to the Uniform Commercial Code, "the fact is [that] the essential purpose of a contract between commercial [actors] is actual performance and [such actors] do not bargain merely for . . . . a promise plus the right to win a lawsuit

and that a continuing sense of reliance and security that the promised performance will be forthcoming when due, is an important feature of the bargain."[24]

Furthermore, contract damages in any kind of case are a poor substitute for actual performance, because the present expected value of contract damages is significantly less than the amount of the damages in a perfect world, due to litigation costs and litigation risks. This point will be elaborated in Part III. Suffice to say at this point that even where a contract is not made to coordinate production or distribution, damages are such a poor substitute for performance that few actors will enter into contracts with parties who are highly unreliable.

2. *Cases in Which the Promisee's Payoff From Reliance Does Not Depend on Whether the Promisor Performs.* The concept of overreliance primarily concerns cases in which a party –- now, we can see, a Buyer –- overinvests in beneficial reliance, in the sense that she invests in beneficial reliance as if the Seller's performance is insured, when in fact the Seller has a positive rate of breach. Accordingly, the Buyer cannot overrely if the payoff from beneficial reliance does not depend on whether the Seller performs, because in such cases the efficient level of the Buyer's investment in costs is independent of the probability of Seller's breach. To put this differently, in such cases the Buyer will reap the same return on his investment in beneficial reliance whether the Seller performs or breaches.[25] (Of course, the buyer may engage in profit-diminishing reliance, but that has to do with the Buyer's business acumen, not with a faulty assumption that the Seller's performance is insured.)

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[24] UCC Section 2-609, Comment 1.

[25] In the Xavier-Yvonne example, consider Yvonne's choice of y in note 12. If the payoff from reliance expenditure y does not depend on whether Xavier performs, then $R'p(y) = R'np(y)$, so damages do not vary as y varies. As explained in note 12 , in such circumstances the incentive to overrely does not occur.

(A) *Cases in Which an Identical Performance is Readily Available on the Market.*

Where the performance that a Seller has promised is readily available on the market, that availability insures that the Buyer's investment in beneficial reliance will be protected even if the Seller breaches.[26] So, for example, a Buyer of wheat (or any other relatively homogeneous commodity) cannot overrely, because if the Seller breaches the Buyer can always buy replacement wheat on the market and put that wheat to the use planned for the Seller's wheat. Similarly, if Seller agrees to remodel a building for Buyer, all of Buyer's beneficial reliance, such as ordering custom-designed furniture for the building, will be protected even if Seller breaches, if Buyer can reasonably expect that in the event of breach he can procure a substitute contractor to complete the remodeling on time.

(B) *Reliance that Holds its Value.* The payoff from an investment in beneficial reliance is also independent of the Seller's performance where the investment will hold all or almost all of its value in an alternative use even if the Seller breaches. (For example, suppose that if Xavier breaches, Yvonne can re-sell the food to other restaurants at her cost, with only very minor transaction costs.) In such cases, the expectation measure does not provide an incentive for inefficient overreliance. On the contrary, the Buyer should rely as if the Seller's performance was certain, because her reliance will have the same value whether Seller breaches or performs.

More generally, in such cases there can be no overreliance, because the Buyer's damages are invariant to her costs. That is, if a Buyer's reliance holds its value after breach, the reliance will not factor into the Buyer's expectation damages, either directly or indirectly.

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[26] *See* George M. Cohen, *The Fault Lines in Contract Damages*, 80 Va. L. Rev. 1225 (1994).

3. *Cases in Which it Would be Inefficient For a Buyer to Take Rate of Breach Into Account in Calibrating His Reliance.* In some cases, it would be inefficient for a Buyer to take the Seller's rate of breach into account in determining his level of reliance.

(A) *Lumpy reliance*. To begin with, this is normally true where beneficial reliance is justified and must occur in lumps that cannot be scaled down at the margin to take account of the Seller's probability of breach. For example, recall that in the *Seafarer* hypothetical, Charterer cannot charter the boat out upon its completion unless he has purchased various types of fittings and other equipment in advance. Suppose that a radar for the boat, which cost $15,000, must be purchased two months in advance; that Charterer will therefore lose two months of net revenues, equal to $100,000, if he does not order a radar until the boat is delivered, that the probability of Boatmaker's breach is 10%, and that the radar would fall in value by 25% if Boatmaker breaches and Charterer must resell it on the spot market. Since Charterer will lose $100,000 if he doesn't purchase the radar in advance, and since he cannot purchase less than all of a radar, even under the theory of overreliance Charterer should not take the probability of Boatmaker's breach into account in incurring the cost of a radar.

Similarly, suppose that under Coast Guard rules the *Seafarer* cannot be operated without ten life preservers on board, and life preservers, which cost $100 apiece, must be ordered four weeks in advance. It is then efficient for Charterer to purchase ten life preservers in advance, rather than nine, because nine life preservers do him no good at all.

The lumpiness constraint can apply even to a collection of disparate items. For

example, suppose that to charter out the *Seafarer*, the yacht must be equipped with ten

different items for the galley -- a range, a set of dishes, a set of cutlery, and so forth --

and that all these items must be ordered in advance at a total cost of $30,000. Here too it

would be inefficient for Charterer to calibrate his beneficial reliance to the probability of

Boatman's breach by purchasing less than ten items -- for example, by forgoing purchase

of the range, the dishes, or the cutlery. Similarly, it would make no economic sense to

order furnishings for the galley but not to order the life preservers and the radar.[27]

(B) *Coordinated contracts.* Often a buyer must coordinate a number of contracts

to create or further an enterprise. For example, a film producer may need to make

advance contracts with ten key artists to launch a movie -- a writer, a director, five actors,

a photographer, a composer, and a film editor. Even if the rate of breach of each of the

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[27]   The lumpiness constraint assumes that beneficial reliance is justifiable. In some cases, that's not
true. For instance, suppose in the *Seafarer* example it would cost $90,000 to outfit the boat in advance. If
Boatman does not breach, Charterer will receive net revenues of $100,000 for the first two months. Under
the Standard Expectation Measure, if Boatman breaches by making delivery two months late, he must pay
$100,000 in damages. Given these expectation damages, Charterer may incur costs without regard to the
probability of breach. However, if the probability of breach is 15%, then the expected social return from the
$90,000 investment is only $85,000, and under the theory of overreliance Charterer should not order
anything in advance.
    Although such overreliance is possible, it is not terribly likely, nor a great concern. Note in this
example that if outfitting the boat cost more than $100,000, the Charterer would not make it even with
ordinary damages, while if the investment was under $85,000, it would be unobjectionable. It's only if the
lumpy reliance falls into the intermediate range that a problem exists. As the probability of breach
decreases, this intermediate range narrows. Furthermore, in the example note that the expected net social
loss from the overreliance is only $5,000 (=$90,000 - $85,000). As the range of possible overreliance
narrows with a decreasing probability of breach, the range of possible loss will similarly narrow. Moreover,
in this example itself much of the $90,000 investment would probably hold much of its value in the event
of breach, probably making the investment efficient to undertake.
    It's also possible that a promisee could scale down the level of his investment in an item of lumpy
reliance below the otherwise-optimal level, to take into account the probability of breach. For example, if
an otherwise-optimal radar would cost $15,000, Boatmaker might buy, say, a $14,000 radar instead.
However, if, as we believe is usually the case, the rate of material breach is low, then the expected cost of
purchasing a less-than-otherwise-optimal radar would be much higher than the expected cost of purchasing
the $15,000 radar, even considering the probability of breach.

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ten artists is 10%, if production could not be started unless all ten artists had been signed to contracts, and if the market is such that each artist must be signed well in advance of production, then it would be inefficient for the producer to reduce his reliance by making contracts with less than ten artists. To generalize this point, whenever a venture requires multiple advance contracts to get off the ground, it is inefficient to enter into less than all the contracts even though there is a positive probability of breach for each contract.

4. *Summary*. Generally speaking: (1) A Seller normally cannot overrely. (2) A Buyer normally cannot overrely if he will have no consequential damages, or is a consumer, or if the breach is not material, or if the Seller's performance can be readily replaced on the market, or if the Buyer's reliance will hold its value on breach, or is lumpy, or involves coordinated contracts. Overreliance is also unlikely to be a problem in the case of Sellers who have a very low rate of breach, because in such cases a Buyer can treat the Seller's performance as virtually insured, and in the case of Sellers who have a very high rate of breach, because few Buyers will contract with such Sellers. Since at least one of these conditions will usually be satisfied, even if the theory of overreliance is correct, overreliance can occur in only a minority of cases. The mere possibility that overreliance may occasionally occur does not provide good reason either to deem the Standard Expectation Measure to be inefficient, or to graft an overreliance rule onto that measure.

III. The Standard Expectation Measure Does Not Fully Insure a Promisee's Reliance

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In Part II we showed that institutional elements based on the economics of

contracting, and the way in which the Standard Expectation Measure is actually

administered, made it unlikely that overreliance would often occur. In this Part III, we

consider two further institutional elements that make overreliance unlikely: litigation

risks and litigation costs. These elements bear on the incentives provided by damage

measures in a variety of ways. We focus on the promisee's incentives to rely, but we also

consider the promisor's incentives to take precaution against breach.

A central tenet of the theory of overreliance is that under the Standard

Expectation Measure a promisee will inefficiently fail to take account of the promisor's

rate of breach in determining the level of his investment in beneficial reliance, because

that Measure fully insures the promisee's reliance. This tenet is expressed in statements

like, "Because the expectation measure guarantees B [the promisee] full compensation

whether S [the promisor] performs or not, it generates the problem that arises under any

full insurance scheme, for it means that B can ignore the risk that S's nonperformance

may leave B's reliance expenditures wasted"[28] Or, "[E]xpectation damages allow B to

capture all of the upside potential of his reliance without making him bear any of the

downside potential . . . ."[29]

When institutional factors are taken into account, however, this central tenet is

incorrect in some cases and exaggerated in others. At the time a promisee determines the

level of her investment in beneficial reliance, she cannot rationally expect to be fully

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[28] Richard Craswell, *Performance, Reliance, and One-Sided Information*, 18 J. Leg. Stud 365, 376-79
(1989).
[29] *Id.* At 376-79.

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insured by Standard Expectation Damages. On the contrary, she knows that she will bear much or even all of the downside potential of such reliance.

To begin with, what matters to the promisee, in deciding how much to invest in beneficial reliance, is not the damages that she would receive in a perfect world without transaction costs and information costs, but the damages that she will receive in the actual world. To put this differently, what matters to the promisee is the net present expected value of damages at the time she makes her reliance decision (hereafter, *the expected value of damages*). In determining the expected value of damages, the promisee must discount the damages that she would receive in a perfect world to reflect litigation risks and litigation costs.

Litigation risks consist of the risk of error by the law-finder or the fact-finder, and the possibility that the promisor may successfully establish a defense to the promisee's claim. Damages based on beneficial reliance present particularly high litigation risks. Typically, such damages consist in whole or in part of lost profits, which are both difficult to measure and subject to special defenses, such as the principle of *Hadley v. Baxendale* and the requirement of certainty. [30] Moreover, because lost profits are unliquidated, the court may not award pre-judgment interest, so that the value of a future recovery may also need to be discounted by the time value of money. Another possible litigation risk is that the defendant may prove to be judgment-proof – indeed, breach may often be due in part to the promisor's financial difficulties.

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[30] It is theoretically possible that the promisee's actual damages would be more than perfect expectation damages, rather than less. If that was a realistic possibility, the promisee would not discount for litigation risk. However, we do not regard that possibility as realistic, because courts have historically tended to be very conservative in awarding damages based on lost profits.

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Given all these factors, at the time a risk-neutral promisee invests in beneficial reliance, the expected value of damages payable in the future is unlikely to often exceed 70-80% of perfect-world damages, even without regard to litigation costs. The expected value of damages will be significantly less if, as is likely, the promisee is risk-averse. In effect, therefore, the promisee co-insures at least 20-30% of his beneficial reliance. As Cooter points out, deductibles "in effect divide liability between insured and insurer, giving the insured incentive to take more precaution than he would have otherwise."[31] The same is true of co-insurance.[32]

In addition to this element of co-insurance, the promisee knows that she will have to deduct, from any future recovery, the amount of her litigation costs, such as attorney's fees and the value of her own time.[33] On the basis of casual empiricism, it seems likely that the minimum legal fee for even a relatively straightforward contract case would be around $10,000, and the minimum fee for a complex contracts case would not be much less than $50,000 - $100,000. (Indeed, a partner in a New York litigation firm told us that his firm's minimum fee for complex contract litigation would seldom be much less than $1 million, based strictly on billable hours.) In effect, the applicable minimum legal fee

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[31] Cooter, *Unity in the Common Law* 73 Calif. L. Rev. 1, 39 (1985).

[32] We can make the point in terms of the Xavier-Yvonne example. Suppose that Yvonne can expect to recover only a fraction r of damages D, where $1 - r$ is the fraction expected to be lost due to litigation risks. The first order condition for Yvonne's choice of y then becomes $p(x)R'p(y) + (1 - p(x))R'np(y) + r*D'(y) = 1$. This is identical to the optimal choice of y only where the $D'(y)$ term disappears. Thus, the smaller r is, the closer this condition will approach that giving rise to the optimal choice.

[33] This may not be true where the contract includes a provision which provides that if suit is brought under the contract, the losing party pays the fees of the winning party. However, most contracts don't contain such a provision. Moreover, even when such a provision is included, it is risky to rely on, because a party who brings suit and loses must absorb his losses under the contract, his own attorneys' fees, and the other party's attorney's fees. Therefore, such a provision will have little impact unless the promisee has a very high level of confidence that if he sues without settling, he will prevail in court, while if he settles, the amount of the settlement will include his litigation expenses.

is like a variable deductible whose amount depends on the complexity of the case and other factors, such as customary hourly rates. If the promisee's damages are less than the applicable minimum legal fee, the promisee will be unable to bring suit, and the effect is as if the contract was governed by a no-damages rule. As a first approximation, under a no-damages rule the overreliance problem is eliminated. [34] (We do not deny that cases whose expected value is less than the applicable minimum legal fee may nevertheless have a settlement value. Such cases may get settled informally, without the aid of lawyers, either on a basis that the parties deem equitable, or out of reputational concerns, or because the promisor as well as the promisee must pay litigation costs and therefore will be anxious to avoid litigation. However, the chance that a case may have a settlement value is a far cry from insurance, and in any event the settlement value under these circumstances is unlikely to be heavily controlled by the Standard Expectation Measure.)

The effects of litigation costs above the applicable minimum legal fee are more complex. If litigation costs are fixed irrespective of the level of damages, then if the costs are low enough that it still pays to sue, these costs will not affect the reliance decision – they are a fixed cost, and do not affect decisions on the margin. [35] However, litigation costs typically are not fixed relative to the size of damages. As the stakes get higher, the costs of litigation are likely to rise, because the more money is at stake, the more a

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[34] In Xavier-Yvonne, suppose Yvonne must incur a fixed cost L in order to collect damages. Then her expected net income becomes $p(x)Rp(y) + (1 - p(x)Rnp(y) + (1 - p(x))(D - L) - K - y$. However, the first order condition for her choice of y is unchanged from that in note 12—the L term drops out because it does not vary with y. However, if $D<L$, then presumably Yvonne would not choose to sue to collect damages, and hence the damage term would drop out of net income entirely—which leaves Yvonne with the proper incentive in choosing y. For more on a no-damages rule, see, part IV.A., infra.

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promisee will be willing to invest. Above the applicable minimum legal fee, however, litigation costs will tend to rise much less steeply than the expected value of damages. Thus if the expected value of damages exceeds the applicable minimum legal fee, the costs in excess of that fee will have the effect of downward-sloping co-insurance. If suit can be brought at all, the prospective recovery must be discounted by those extra costs as well as by litigation risks.[36] As a result, even in cases where a prospective recovery will likely exceed the litigation costs, the promisee will effectively co-insure a very large proportion of her beneficial reliance, often much more than 50%. For example, if the minimum legal fee for a case of a given complexity is $100,000, the prospective recovery is $200,000, and the fee for a case of that amount is $110,000, then the present net expected value of the recovery is around $50,000 ($200,000 minus $110,000 in litigation costs and around $40,000 (20% of $200,000) for litigation risk.

Of course, when the promisee decides how much to invest in beneficial reliance, she may not know exactly the amount of the applicable litigation expenses upon breach by the promisor. She may, however, have at least a rough idea. In any event, it is enough that she will know that litigation is extremely expensive, and that the present value of a recovery for breach may well be less than, or only somewhat more than, the costs of litigation. Once she knows that, she knows that her reliance will be either completely uninsured or only marginally insured by the Standard Expectation Measure, and she will be unlikely to overrely, either at all or significantly, even in those few cases where overrelience could potentially occur.

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[35] In the Xavier-Yvonne example, one can see this point in the previous footnote. The first order condition is unchanged by the introduction of fixed litigation costs, L. If D>L, L does not affect Yvonne's decision.

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In short, even in cases where overreliance could potentially occur, it is not true, as the theory of overreliance assumes, that a promisee's beneficial reliance is fully insured by the Standard Expectation Measure. On the contrary, expenditures on beneficial reliance that would generate damages less than the applicable minimum legal fee—and minimum legal fees can run very, very high —will be completely uninsured, and even damages in excess of the minimum legal fee will be significantly co-insured by the promisee. These deductible and co-insurance elements dramatically scale down the incentive to overrely in those limited number of cases in which overreliance can occur. To put this differently, considering the co-insurance and deductible elements, and the fact that most actors are risk-averse, it is highly implausible that even in the residual cases in which overreliance could occur, the Standard Expectation Measure would often lead a promisee to invest in beneficial reliance without regard to the promisor's rate of breach.

We cannot leave this Part without noting the incentive effect of litigation risks and costs on the promisor. After all, the promisee's litigation risks and costs could reduce her incentive to overrely at the cost of reducing the promisor's incentive to take precautions against breach. As we have seen, the Standard Expectation Measure provides the proper incentive to the promisor. Thus to the extent that litigation risks and costs reduce the amount the promisor can expect to pay in damages, those risks and costs also lessen the promisor's incentive to take precautions against breach.

However, the promisor's own litigation costs have the opposite effect. To the degree that the promisor expects to become involved in litigation if he breaches, litigation

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[36] In terms of Xavier-Yvonne, the effect would be formally similar to the litigation risk term described above in note 32. A realistic model would be a little more complicated in that the r term would itself be a function of y.

costs increase the costs that the promisor will bear after breaching, above what he actually pays to the promisee in damages. These increased expected costs tend to increase the incentive to take precaution against breach. Thus there are two contrasting effects: the promisee's litigation risks and costs weaken the promisor's incentives to take precaution against breach, but the promisor's litigation costs strengthen those incentives. To the extent that the two roughly balance out, then the incentive effects of the Standard Expectation Measure on the promisor's incentives may remain relatively unchanged.[37] Accordingly, after factoring in litigation risk and costs the Standard Expectation Measure as actually experienced gives a much weaker incentive for the promisee to overrely than the theory of overreliance suggests, but may still provide roughly the right incentive for the promisor to take precaution against breach.

IV. The Costs of Modifying the Standard Expectation Measure to Prevent Overreliance Would Probably Far Exceed the Benefits

In Part II we showed that the theory of overreliance does not cast significant doubt on the efficiency of the Standard Expectation Measure, because as a result of institutional considerations the problem of overreliance applies to only a limited number of cases. In Part III we showed that even in the residual cases where overreliance could potentially occur, as a result of institutional considerations the Standard Expectation Measure provides limited or no insurance to the promisee. When combined, these institutional considerations drastically reduce, if they do not entirely eliminate, the

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[37] If Xavier incurs a net cost of L in a suit for damages, but litigation risk means that Xavier can expect to pay out only a fraction r of damages to Yvonne, then his net income is $K - x - (1 - p(x))(rD + L)$. His first order condition then for choosing x becomes $p'(x)(rD + L) = 1$. This yields the optimal choice of x if $rD + L = Rp(y^*) - Rnp(y^*)$. Thus, if the co-insurance elements discussed above tend to lower D below the standard expectation measure by the percentage r, the L term may serve to raise it back closer to the proper level.

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concern that the Standard Expectation Measure produces an economically significant frequency of overreliance. In this Part we will assume that overreliance does occur at least occasionally, on the premise that in the residual cases in which overreliance could occur, some promisees may believe that their damages on breach will exceed the minimum cost of litigation, so that they will capture all the upside of their beneficial reliance while the promisee will subsidize some percentage of the downside.

An obvious way to eliminate the incentive to overrely in these residual cases is to make the promisee's damages invariant to the amount of her reliance. Consider again Xavier and Yvonne. Recall that Yvonne's incentive to overrely arises because by increasing her beneficial reliance Yvonne increases the amount of her potential profits and, correspondingly, the amount of damages in the event of breach, so that her profit-enhancing reliance costs are partially insured. In contrast, if the amount of the damages that Yvonne would receive upon breach were to remain invariant with respect to Yvonne's level of reliance, then any incentive to overrely would disappear.

Liquidated-damages provisions may have this effect. Under such provisions, a contractually determined amount must be paid to the promisee in the event of breach by the promisor. Because this amount is set in the contract, it does not vary based upon how much the promisee actually chooses to rely, or upon how much the promisee is actually damaged by the breach. Because the incentive to overrely disappears if the damage measure is invariant with respect to the actual level of reliance, a liquidated-damages

provision may eliminate the overreliance problem.[38] Thus a liquidated-damages

provision potentially can get both the breach and the reliance incentives right.

However, if the liquidated amount is too low, the incentive to take precautions

will be too low, while if the liquidated amount is too high, the incentive to take

precautions breach will be too great. Furthermore, Richard Craswell has pointed out that

liquidated damages will give the correct incentives for reliance only if the promisee

correctly estimates the promisor's probability of breach.[39] If the promisee misestimates

that probability, then liquidated damages will lead to too little reliance if she

overestimates the chances of breach, and too much reliance if she underestimates them.

Similarly, liquidated damages will give the correct incentives for precaution only if the

parties correctly estimate damages on breach. In any event, liquidated-damages

provisions are not a rule of law, and are used only in a fraction of all contracts. We

therefore turn our attention to the formulation of possible legal rules that would make

damages invariant to reliance.

A.   A No-Damages Rule

One -- extreme -- way to remove a promisee's incentive to overrely is to adopt a

rule that a promisee would receive no damages at all in the event of a breach by a

promisor. We call this a No-Damages Rule. Under such a rule, the promisee would bear

all the cost of investing in reliance, and therefore would have no incentive to overrely.

Such a rule would virtually put an end to contract law. If there were no damages

for breach of contract, the law would provide no incentive to enter legally enforceable

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[38] *See* Cooter, *supra* note 3, at xxx.

contracts. More particularly, such a rule would fail to give the promisor the correct

incentives to take precautions and to perform. Although there is debate concerning the

effect of expectation damages on the *promisee's* incentives, it is generally accepted that

the expectation measure is required to give the *promisor* correct incentives.

Furthermore, a No-Damages Rule would cause promisees to underrely, because

the more a promisee relies, the more vulnerable he becomes to breach, and therefore the

more exposed he is to an exploitive demand for renegotiation under the threat of

nonperformance. This has been well put by Richard Craswell, building on the work of

Goetz & Scott:

> [A]ny reliance by B [the promise] must make consummation of the deal
>
> more important to him, since reliance increases the difference between the benefit
>
> B receives if S performs, and the loss B suffers if S fails to perform. But once
>
> consummation of the deal becomes more important to B, S [the promisor] can
>
> exploit this by threatening not to perform unless B agrees to pay her a higher
>
> price. To be sure, S's threat would be an empty one if she would be liable for
>
> damages if she refused to perform. But if S is free to walk away from the deal
>
> without paying damages . . . . then S can credibly hold out for a larger share of B's
>
> profits.
>
> S's ability to hold out for a share of B's profits is what distorts B's
>
> reliance incentives in the absence of a binding commitment. B must still
>
> bear all the downside risks of his reliance, for if it becomes inefficient for

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[39] *See* Craswell, *supra* note 28, at xxx.

S to perform, then she will walk away from the deal without paying

anything. But . . . . if it becomes efficient for S to perform . . . then B will

not capture all of the gains from his reliance because S may extract some

of those gains by holding out for a higher price. In short, unless B can

induce S to commit, B will bear all of the costs of unsuccessful reliance

but will not capture all of the benefits of successful reliance. This

asymmetry will often lead B to choose too little reliance, relative to the

efficient level. [40]

B. A Limited No-Damages Rule

One alternative to a No-Damages Rule would be a rule under which expectation

damages are awarded *except* for the lost profits that would have been generated by the

promisee's beneficial reliance in the absence of breach -- as opposed, for example, to lost

profits due to market shifts. We call this a Limited No-Damages Rule.

It might be thought that under such a Rule a promisee would never engage in

beneficial reliance. However, even under such a Rule a risk-neutral promisee would

invest in beneficial reliance where the expected profit from such reliance – that is, the

expected profit discounted by the prospect of breach – was positive.

For example, suppose that on January 15, Producer enters into a contract with Al

Star under which Star agrees to appear in Producer's new movie, *Dark Matter*. Star

promises to be available to start production on October 1. Producer expects to make a

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[40] Craswell, *supra*, at xxx. This point is a variant of the classic holdup problem, which is central to Oliver
Williamson's analysis of the theory of the firm, and also to the work in that area of Oliver Hart and his co-
authors. *See* Oliver Williamson, *The Economic Institutions of Capitalism* (1985); Oliver Hart, *Firms,*

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profit of $40 million on the movie. There is a 10% probability that Star will breach. If

Producer is to be ready to start shooting *Dark Matter* on October 1, he must also make

contracts with a director, supporting players, a film editor, and so forth. However, *Dark*

Matter is not is not a viable project without Star. Therefore, if Star breaks his contract

with Producer, Producer will have to break his other contracts. Producer's liability for

expectation damages under these other contracts will be $20 million. (Assume that

damages for breach of these other contracts will be based on lost wages, not beneficial

reliance, and therefore will be awarded even under a Limited No-Damages Rule.)

Under a Limited No-Damages Rule, Producer's damages against Star will not

include Producer's $20 million liability on his other contracts, because entering into those

contracts constituted beneficial reliance. Nevertheless, if Producer is risk-neutral he will

enter into both the contract with Star and the other contracts: Producer will lose $20

million if Star breaches, but because there is a 90% chance that Star will perform,

Producer's expected profit on *Dark Matter* is $36 million (90% of $40 million).

Accordingly, Producer's investment of $20 million will have an expected payoff of $36

million, or around a 75% return, and if he is risk-neutral he will make the investment

even under a Limited No-Damages Rule.

Nevertheless, a Limited No-Damages Rule would be inappropriate.

First, such a Rule would not provide a *promisor* with the correct incentives to take

precautions and perform.

Second, most actors are risk-averse.[41] Actors are also loss-averse; that is, the

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Contracts, and Financial Structure (1995). The point has been formally analyzed in the contract remedy
literature by William Rogerson, Aaron Edlin, and Stefan Reichelstein. *See supra*, note 3.

[41] The shareholders of a public corporation will normally prefer that it act in a risk-neutral way. However,
the managers who actually control such corporations will have all of their human capital, and much of their

response of actors to given losses is more extreme than their response to gains of the

same amount.[42] Therefore, the greater the possible loss, the more risk-averse an actor is

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financial capital, tied up in the corporation, and hence are likely to behave in a risk-averse way in their capacity as managers (for example, by causing the corporation to purchase commercial insurance, rather than self-insuring, even for less-than-catastrophic risks).

[42] The phenomenon of loss-aversion can be expressed in several different ways: changes that make things worse for an actor loom larger than changes that would make things better; perceived losses, such as out-of-pocket costs, are more painful than forgone gains, including potential profits and opportunity costs; the disutility of giving up what one has is greater than the utility of acquiring what one doesn't have. See, e.g., Daniel Kahneman, Jack L. Knetsch & Richard H. Thaler, *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. Pol. Econ. 1325 (1990); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions, in The Limits of Rationality* 60 (Karen S. Cook & Margaret Levi, eds. 1990); Richard H. Thaler, The Winner's Curse 63-78 (1992).

Loss-aversion, the endowment effect (on which loss-aversion is partly based), and some of the evidence for loss-aversion, are nicely summarized in Jeffery Evans Stake, *The Uneasy Case for Adverse Possession*, 89 Geo. L. Rev. 2419, 2459-62 (2001):

> The endowment effect is a pattern of behavior in which people demand more to give up an object than they would offer to acquire it. This difference between the amount a person is willing to pay . . . and the amount she is willing to accept . . . has been explained by reference to the theory of loss aversion. According to the theory of loss aversion, losses have greater subjective impact than objectively commensurate gains. In graphical terms, utility curves are asymmetrical in that the disutility of giving up an object is greater than the utility of acquiring it. . . .

> . . . In one experiment, subjects were given either a lottery ticket or $2.00 cash. When they were given the chance to trade their initial endowment for the other endowment, somewhat surprisingly, very few subjects chose to switch. Almost everyone preferred what they were initially given. . . .

> In a test for endowment effects reported by Professors Kahneman, Knetsch, and Thaler, subjects were randomly assigned to one of three groups: sellers, buyers, or choosers. Sellers were given a coffee mug and a chance to sell it at various prices. Buyers were given a chance to buy a mug at various prices. Choosers were given an opportunity to get either a mug or cash. Put another way, choosers were given an option to get a mug (without paying anything) and given the chance to sell the mug-option at various prices. The only difference between choosers and sellers was that choosers were not actually endowed with a mug before they were put to the task of deciding their selling price. The major difference between choosers and buyers was that buyers were already endowed with the cash they would have to spend to get a mug whereas the cash was merely a prospect for choosers. The prices at which trades, or choices, could take place were varied across a range, and the results--how many subjects in each group would trade-- were recorded. In this way, a median valuation (or reservation price) was determined for each group: sellers, $7.12; choosers, $3.12; buyers, $2.87. In a replication of the experiment, in which the price tags were left on the mugs, the results were: sellers, $7.00; choosers, $3.50; buyers, $2.00. These results confirmed conclusions from other loss-aversion experiments. People are biased toward the status quo. Losses have a subjectively larger impact than equivalent financial gains, and the difference is greater than would be predicted from declining marginal utility alone. . . .

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likely to be. So for example, even though an investment in *Dark Matter* would have a high expected rate of return, it's pretty unlikely that Producer would take the risk of losing $20 million under a Limited No-Damages Rule. Thus the rate of contract-formation will be too low under a Limited No-Damages Rule; that is, under such a Rule many contracts that would be profitable for both parties, and therefore should be made, will not be made.

Finally, the problem of underreliance that would arise under a No-Damages Rule, for the reason that Craswell points out, would also for the most part arise under a Limited No-Damages Rule, for the same reason.

C. A Modified Expectation Measure

There is a more moderate alternative to a No-Damages Rule. Cooter and others have suggested a modified version of the Standard Expectation Measure, to give the right incentives to both the promisor and the promisee. Under the Standard Expectation Measure, damages are the amount required to put the promisee in the position that she would have been if the contract had been performed, given the amount of beneficial reliance that she *actually* engaged in. Under the modified version of that measure, the promisee would be put in the position that she would have been in if the contract had been performed and she had engaged in the *optimal* level of reliance. We will call this the Modified Expectation Measure. Because this Measure is based on the damages the promisee would incur if she had set reliance as she should have, damages would be invariant to the level of reliance she actually chooses, and there would be no incentive to

overrely. The promisor's incentives to guard against breach and to perform would also be correct. [43]

The Modified Expectation Measure achieves a nifty trick, in theory, by creating what Cooter calls "double responsibility at the margin." The essential problem in the area of damages for breach of contract is that for the promisor to have the correct incentive to take precaution against breach and to perform, he must bear responsibility for the costs that breach would impose upon the promisee. However, if the promisee's beneficial reliance is at least partially insured by the promisor, then in theory she will not bear responsibility for the entire costs of relying too much, because the promisor will bear at least part of those costs. In contrast, under the Modified Expectation Measure both parties would be responsible for -- would bear -- the costs of their decisions. The promisor would bear the costs that breach would impose upon the promisee if the promisee had invested in reliance at no more than the optimal level. The promisee, in turn, would bear the costs created by relying too much, because the amount that she will receive in damages will not increase once she exceeded the optimal level of reliance.

Nevertheless, in our view a Modified Expectation Measure should not be adopted, because the benefits of such a Measure would be very small, and its costs would be very large.

To begin with, such a Measure would have only a very limited practical impact. The literature on overreliance assumes that under the Standard Expectation Measure actual reliance will normally exceed optimal reliance. This is not so. For the reasons

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[43] It has been suggested that the courts already make this adjustment under the principle of *Hadley v. Baxendale*. However, that principle requires only that an element of damages is reasonably foreseeable, not that the promisee's reliance is reasonable.

described in Parts II and III, in most cases the Standard Expectation Measure either cannot or will not induce overreliance. As a corollary, in most cases damages under the Standard Expectation Measure will be identical to damages under the Modified Expectation Measure.

Moreover, any remaining overreliance that may be induced by the Standard Expectation Measure is likely to have a low social cost. The average probability of material breach is almost certainly very low, because actors are highly unlikely to deal with promisors who have a high rate of material breach. For one thing, reliability is important to most actors, given the need to coordinate elements of production and distribution. In addition, because the expected value of damages based on lost profits is much lower than perfect-world damages, the value of performance will greatly exceed the value of damages for nonperformance. Accordingly, promisors with more than a very low rate of breach are likely to be driven out of the market. And because the average probability of material breach is probably very low, the optimal level of reliance is likely to be very close to the optimal level in cases where performance is almost certain (that is, where the probability of breach is close to zero).

Furthermore, any overreliance that does occur normally will occur only on reliance expenditures that are near the margin. In the case of these marginal expenditures, for most cost and benefit functions the net social gain from the added expenditure will generally be close to the net loss. Going only a little past the optimal level of expenditure does puts one in a region where the net loss is greater than the net gain from that additional expenditure, but the difference will generally be very small. For this reason too, the loss from any overreliance that does occur is likely to be small in most cases.

As an example, consider the Blue Angels hypothetical. Assume that the Blue Angels' fee is $100,000 and Promoter has no other costs. Suppose that this fee exactly covers their costs if the Blue Angels perform. Promoter spends $50,000 on advertising. If the Blue Angels gives the concert, gross revenue will be $225,000. To analyze whether Promoter's $50,000 advertising expenditure is overreliance, we must know what gross revenue would be if there were no advertising. Suppose that it would be $170,000. Then using the Standard Expectation Measure, if Promoter expends $50,000 on ads he will earn a guaranteed profit of $75,000 (putting aside the problems of litigation risks and costs). If he expends nothing on ads, his profits will be $70,000. Therefore, the Promoter will spend $50,000. Recall that there is a 10% probability that the Blue Angels will breach. On these figures, that expenditure is overreliance, but the net loss due to that overreliance is small: The net expected social benefit if the ads are purchased is $62,500 (= 225,000*0.9 – 100,000*0.9 – 50,000). The net expected social benefit if the ads are not purchased is $63,000 (=170,000*0.9 –100,000*0.9). Thus, not spending on ads creates a net expected benefit that is $500 greater than spending on ads—that is the social loss due to overreliance in this example. If the revenue without ads were just $560 less, purchasing the ads becomes socially optimal. On the other hand, if the revenue without ads were just $5000 more, the Promoter would prefer to not spend on ads even with Standard Expectation Damages. If this example can be generalized, as we believe to be the case, the expected social loss due to overreliance will rarely be very large relative to the overall stakes in the contract, and overreliance is likely to occur, if at all, only for a relatively narrow range of values. [44]

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[44] We can see the point in the Xavier-Yvonne example. In that example, the optimal choice of y is given by

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Since the benefits of a Modified Expectation Measure are likely to be very slight, we turn to the costs of such a measure. These fall into two categories: the difficulty of determining the probability of the promisor's breach, and the difficulty of operationalizing and applying a Modified Expectation Measure.

(1) *The difficulty of determining the promisor's probability of breach.* We begin with the problem of determining probability of the promisor's breach, which is needed to calculate the optimal level of reliance. The promisor is the lowest-cost provider of information about the probability of his own breach. In fact, for most practical purposes the promisor is the only practicable source of that information. How then can a promisee or a court determine what constitutes optimal reliance, which depends on knowledge of the probability of breach? Richard Craswell has proposed an ingenuous rule to solve this problem: the promisor would be required to state the probability that he will breach, and the promisee would be entitled to base the amount of her reliance on that statement, whether or not the statement was accurate. Under this rule, the actual probability of breach would be irrelevant; only the probability stated by promisor would count.[45]

In the absence of the rule Craswell proposes, inefficient overreliance is not a coherent concept, because a promisee cannot practicably determine what constitutes efficient reliance. But Craswell's rule presents its own difficulties, because as a practical matter the rule would itself often lead to overreliance in those few remaining cases in which overreliance might occur.

$p(x)Rp'(y) + (1 - p(x))Rnp'(y) = 1$. The Standard Expectation Measure leads to Yvonne setting y according to $R'p(y) = 1$. As $p(x)$ gets close to 1, these two equations will generally converge to each other.

[45] *See* Craswell, *supra* note 28, at xxx.

For one thing, even the promisor is unlikely to have a good fix on the probability that he will breach any given contract. Craswell employs a model in which a promisor will breach if the cost of performance exceeds the price the promisee is to pay plus the damages the promisor must pay if he breaches. One problem with this model is that a promisor will frequently not know his costs for performing until well after he states the probability of breach, so that the actual probability of breach, as circumstances develop, may differ significantly from the stated probability of breach. A second problem is that in a more complete model the promisor would take account not only of the damages payable on breach, but also the cost of any loss in reputation resulting from breach, where a reputation for reliability is important in the promisor's line of business. This element too will be difficult for the promisor to quantify, especially because the injury to the promisor's reputation will vary according to the circumstances of the breach and the injury that the breach inflicts on the promisee.

(2) *The costs of operationalizing and applying a Modified Expectation Measure.*
Next, the costs of operationalizing and applying a Modified Expectation Measure would be very high. The problem here is that typically each element of the formula for determining damages under a Modified Expectation Measure would be extremely difficult to practicably determine in any given case.

First, the optimal amount of reliance would have to be determined. This amount will be extremely difficult to calculate, even if the probability of breach is assumed. Optimal decisions by contracting parties require each party to take into account the effect of its decisions on the other, and to weigh the interests of the other party as equal to its own. Thus in deciding whether to breach, the promisor would weigh the benefits to him

from breaching against the costs that breach would impose on the promisee, and would breach only if the former outweighs the latter. Correspondingly, in deciding how much to rely, the promisee would weigh the expected benefits to her from reliance against the increased cost of liability that such reliance would impose upon the promisor in the event of breach, and would rely only up to the point where the benefits exceed those costs. If both parties behaved in this way, then there would be optimal breach and optimal reliance. This calculation would be extremely difficult, and under the Modified Expectation Measure, in case of breach a court would have to replicate this calculation in determining how much reliance was optimal.

Second, the court would have to make a difficult calculation whether, given what constituted optimal reliance, the promisee had optimally relied.

Finally, if it is determined that the promisee had overrelied, the court would have to make a third difficult determination - - how much profits the promisee would have made if she had optimally relied.

The difficulty of determining damages under a Modified Expectation Measure would result in two kinds of costs, direct and indirect. The direct costs would consist of the efforts that courts would have to expend in calculating damages under this Measure and the efforts that lawyers would have to expend in arguing about these calculations. The indirect costs would consist of the errors that courts would inevitably make in undertaking the difficult and problematic determinations that would be required. The prospect of such errors might increase the uncertainty surrounding the calculation of damages, thereby forcing parties to bear more uncertainty and making it more difficult for them to plan. The prospect of such errors also might induce promisees to underrely,

both because uncertainty in the returns to investment in reliance would make such investments less attractive, and because courts might be inclined to push the overreliance rule too far, and not compensate promises on the basis of reliance that was actually efficient.

The costs of administering a Modified Expectation Measure might be lower if there were a simple rule of thumb for measuring the amount of reliance. The only obvious possibility for such a rule of thumb would be to limit expectation damages for lost profits to the amount of lost profits that would have been produced by a level of beneficial reliance equal to (i) the level that would have been efficient if the promisor had a zero probability of breach, discounted by (ii) the promisor's actual probability of breach. Thus if the efficient level of beneficial reliance if the promisor had a zero probability of breach was $10,000, and the probability of breach was 10%, under this rule of thumb any amount of beneficial reliance in excess of $9,000 would be deemed inefficient, and the maximum damages for lost profits would be the amount of profits that would have been produced by an investment of $9,000 in beneficial reliance.

This rule of thumb, however, would produce inefficient results, because it would be a highly imperfect estimate of optimal reliance. What reliance is optimal in any given case depends not only on the probability of breach, but also on the shape of the relevant benefit and cost functions. These can take many different forms. For example, assume the following variation of the Xavier-Yvonne example: Yvonne orders her food in units. The average price of a unit is $2.00, and the average profit that Yvonne makes on the sale of each unit is $2.00. Yvonne can sell 6,000 units per week at the new facility. The units must be ordered seven days in advance. Yvonne would like to order 6,000 units over the seven-day period prior to the completion date of the new facility. If Yvonne orders the

6,000 units and the facility is not ready, she will need to re-sell the units on the open market. Because Yvonne does not have access to wholesale distribution channels, she will realize only an average of $1.90 per unit on such a resale. There is a 10% probability that Xaviar will breach by late completion.

Assume first that Xavier *performs.* In that case, if Yvonne orders 6,000 units of food prior to completion of the new facility she will realize a profit of $12,000 in the first week after the facility opens, while if she reduces the number of units of food she orders by 10%, to 5,400, she will realize a profit of only $10,800 in the first week – a difference of $1,200. Assume now that Xavier *breaches*. In that case, if Yvonne orders 6,000 units, her damages will be $12,600, while if she orders 5,400 units her damages will be $11,340 – a difference of $1,260. But since the probability of Xavier's performance is 90% while the probability of breach is only 10%, the *expected value* of Yvonne's extra profits if she orders 6,000 units is $1,080, while the *expected cost* of Xavier's extra damages if Yvonne orders 6,000 units is only $126. Therefore, a reduction of Yvonne's beneficial reliance by 10% would be inefficient.

A final possibility is that the Modified Expectation Measure should be applied in cases where it is easy to apply that Measure. Under such a regime, however, all promisors would claim that it was easy to apply that Measure in their case, so that the costs and uncertainty that the Measure brings in its trail would remain. If there were many cases in which it was easy to apply that Measure, and in which that Measure would make a significant difference, the cost might be justified. In our judgment, there are not many cases where more than trivial overreliance is likely to occur; of those residual cases, there are not many where the difference between Standard Expectation Damages and Modified

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Expectation Damages is likely to be significant; and of those remaining cases, there are

not many in which the Modified Expectation Measure would be easy to apply. Therefore,

even if there are a few cases in which the Modified Expectation Measure would be easy

to apply and would produce significantly different results (and provide significantly

different incentives) than the Standard Expectation Measure, the cost of screening all

contract disputes to determine which few cases satisfy these conditions would probably

far exceed the benefits of locating such cases. Accordingly, the most efficient way for the

concept of overreliance to figure in contracts is to allow the contracting parties

themselves to deal with the problem, in cases where they believe there might be

significant overreliance, by setting a cap on damages based on the amount of beneficial

reliance that would be efficient in the circumstances, or by making the promisee's

damages on breach invariant to her beneficial reliance though techniques such as

liquidated damages.

<div align="center">Conclusion</div>

The theory of overreliance states that the Standard Expectation Measure provides

inefficient incentives to a promisee, because that measure insures the promisee's reliance.

In the absence of institutional considerations, the theory therefore could have significant

consequences in designing the law of contract damages. When institutional

considerations are taken into account, however, the theory has virtually no such

consequences. In most cases overreliance normally cannot occur, because of the way in

which the Standard Expectation Measure plays out in specific contexts, because of the

economics of the transaction, or both. Overreliance is also unlikely to occur even in most

of the residual cases, because as a result of litigation risks and litigation costs, the Standard Expectation Measure either does not insure the promisee's reliance at all or does not fully insure the promisee's reliance.

In principle, the Standard Expectation Measure could be modified to prevent overreliance in those few remaining cases where overreliance might occur. However, the benefits of such a modification would be very low, partly because overreliance is unlikely occur in most cases, and partly because where overreliance does occur it is likely to involve only small marginal increments. In contrast, the costs of a Modified Expectation Measure would be very high, because of the direct costs that would be entailed in applying the theory of overreliance to actual cases and the indirect effect of those costs on the behavior of contracting parties.

It might be argued that if the Standard Expectation Measure provides inefficient incentives in even a small number of cases, the measure is inefficient. But compared to what? If the Standard Expectation Measure provides inefficient incentives in only a small number of cases, and even then usually affects only small marginal increments, and a Modified Expectation Measure would be less efficient than the Standard Expectation Measure, then either the Standard Expectation Measure is efficient relative to its best competitor, or the inefficiency is trivial and can be safely disregarded.