

Expectation Damages and the Theory of Overreliance

by

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Introduction

The basic remedy for breach of a bargain contract is the expectation measure of damages, which puts the injured party where she would have been if the contract had been performed. It is generally accepted that the expectation measure provides efficient incentives to a 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 promisee. The theory is that the expectation measure insures the promisee's reliance, and therefore may cause the promisee to overrely—that is, to invest more heavily in reliance than efficiency requires. 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 measure is the gold standard in a bargain context.

The model upon which the theory of overreliance is based provides an important insight into the theory of contract damages. As time went on, however, law-and-economics scholars lost sight of the fact that the model only showed that under certain conditions the expectation measure *can* provide inefficient incentives to promisees. Instead, they widely began to assume, explicitly or implicitly, that the expectation measure normally *does* provide inefficient incentives to promisees. The objective of this Article is to rehabilitate the expectation measure by showing that when institutional considerations are taken into account, expectation damages normally do not provide inefficient incentives to promisees. In particular, we

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show that as a result of institutional considerations: (1) In most cases, overreliance normally cannot or is highly unlikely to occur. (2) Even in cases in which overreliance can occur, the expectation measure does not fully insure a 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 contract 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. We focus for the moment on the incentive effects of damage measures on (1) the amount of precaution that a promisor takes to ensure that he will be able to perform, and (2) a promisor's decision whether to perform or breach when performance has become unprofitable or an alternative performance has become more profitable.¹ The expectation measure places on the promisor the promisee's loss of her share of the contract's value in the event of breach, and thereby efficiently sweeps that value into the promisor's calculus of self-interest in making decisions on both precaution and breach.

The effect of expectation damages on the promisor's calculations can also be stated in terms of externalities. A negative externality exists when one person is not required to pay for imposing a cost upon another. Incentives for precaution and performance are efficient if they compel a promisor to balance the gains to him of not performing against the losses to the promisee. If the promisor does not perform, the promisee loses her 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. Accordingly, expectation damages create efficient incentives for the promisor's precaution and 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 reliably, because once a contract is made she can engage in private

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.

ordering with some confidence that she 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.

Despite these and other justifications, the expectation measure has come under various kinds of scholarly criticism. One of these criticisms is the theory of overreliance, first developed by Steven Shavell² 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 a contract 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—when in fact there is always a chance that the promisor will breach.

Here is the theory in more detail:

In a bargain context, a promisee can often increase the value of a contract by relying upon it. For example, take the following hypothetical, developed by Robert Cooter and Thomas Ulen⁴: 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 occupancy by September 1. Many things could prevent Xavier from completing on time—bad weather, a plumbers' strike, overscrupulous or unscrupulous city inspectors, and so on. To serve the new customers who 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, since she will then be able to serve more customers in the period following September 1.

2. See Steven Shavell, *Damage Remedies for Breach of Contract*, 11 BELL J. ECON. 466, 472 (1980); Steven Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121, 124 (1984).

3. See Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 11–19 (1985); Aaron S. Edlin, *Cadillac Contracts and Up-Front Payments: Efficient Investment Under Expectation Damages*, 12 J. ECON. & ORG. 98, 98–101 (1996); Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach Remedies, and Optimal Investment*, 86 AM. ECON. REV. 478, 487–91 (1998); Lewis A. Kornhauser, *Reliance, Reputation, and Breach of Contract*, 26 J.L. & ECON. 691, 693 (1983); William P. Rogerson, *Efficient Reliance for Breach of Contract*, 15 RAND J. ECON. 39, 47–48 (1984).

4. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 248–57 (3d ed. 2000).

Under the standard calculation of expectation damages, a promisee will increase expenditures in reliance on a contract up to the point where the expected gain from an incremental increase in such expenditures equals the cost of the incremental increase. Now, even if the promisor fully internalizes all the costs of breach that are borne by the promisee, there is some chance that the promisor (Xavier, in the hypothetical) will breach—for example, if the costs of performing unexpectedly turn out to be prohibitive. In choosing the socially optimal amount of reliance on the contract, the promisee (Yvonne, in the hypothetical) should take this chance of non-performance into account. However, the standard expectation measure does not give the promisee an incentive to choose the socially optimal level of reliance. In particular, when calculating the expected gain from an increase in reliance expenditures, the promisee will not discount that expected gain by the probability that the promisor will breach. 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 on the promise consistent with that assumption. The level of reliance so chosen will be higher than the level that would be chosen if the promisee assumed that the promisor had a positive probability of breach. Choosing the higher level is inefficient. Accordingly, the expectation measure is flawed.⁵

5. We present here the algebraic formulation of the Cooter and Ulen hypothetical because we will be drawing on the formulation at several points below to help illustrate and deepen our logic. See *infra* notes 9, 17, 25, 26, 28, 29, 31, 40. Let x be Xavier's expenditures on measures to assure that construction is not delayed, and p be the probability that construction is completed on time. Then p is a function of x , $p(x)$, with $dp/dx > 0$. 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 $dR/dy > 0$. The expected social gain is $p(x)Rp(y) + (1 - p(x))Rnp(y) - x - y$. The optimal choice of precaution x is given by this expected first order condition with respect to x : $p'(x)(Rp(y) - Rnp(y)) = 1$. The optimal choice for reliance y is given by this first order condition with respect to y : $p(x)Rp'(y) + (1 - p(x))Rnp'(y) = 1$. Suppose that damages, which may vary with reliance, are set at $D(y)$, and that the contract price is K . Then Xavier's net income is $K - x - (1 - p(x))D$. 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—expectation damages internalize the cost of breach borne by Yvonne, and thus cause Xavier to set the optimal level of precaution. (Actually, there is a subtle difference from the optimum. Xavier's choice of x depends on Yvonne's choice of y , which we shall see in a moment is too big. This makes Xavier's choice of x higher than at the social optimum. But, Xavier's choice of x is at a socially optimal level given Yvonne's choice of y .) 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 $p(x)Rp'(y) + (1 - p(x))(Rnp'(y) + D'(y)) = 1$. Comparing this to the condition for the optimal choice of y 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

To facilitate the analysis, we will employ several defined terms. By a *promisor*, we mean a contracting party who is or may be in breach. By a *promisee*, we mean a contracting party who is aggrieved 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 contract 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.

In this Article, we accept the validity of the theory of efficient breach. However, we show that the applicability of the theory to actual contracting activity is exceptionally narrow, partly as a result of institutional considerations (including the way in which expectation damages are actually calculated in various contexts) and partly because expectation damages provide much less than full insurance of a promisee's reliance. More specifically, in Part II we show that as a result of institutional considerations, in most cases overreliance normally either cannot occur or is highly unlikely to 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 in the residual cases in which overreliance may be a problem, the costs of modifying the standard expectation measure to eliminate overreliance would probably far exceed the benefits.

II. In Most Cases, Overreliance Normally Cannot Occur

In this Part, we show that as a result of institutional considerations, the likely incidence of overreliance is so low that the theory of overreliance fails to provide a significant reason to abandon or even modify the standard expectation measure. We begin this Part by showing that only one of the many categories of contractual reliance—beneficial reliance—could normally give rise to overreliance (Section A). Next, we show that even in the case of

yields $R'p(y) = 1$, which is the first order condition that 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. Notice that Yvonne's first order condition for choosing y reduces to the socially optimal condition when $D'(y) = 0$, which is where the damages received do not vary with Yvonne's choice of reliance expenditure, y . This fact becomes important later in discussing reforms that economists have suggested.

beneficial reliance, the great majority of contractual transactions either cannot or are highly unlikely to give rise to overreliance (Section B).

A. Disaggregating Reliance

To understand the problem of overreliance properly, it is necessary to disaggregate the concept of reliance itself. In this Part, we consider four types of reliance: beneficial reliance, profit-diminishing reliance, necessary reliance, and timing costs.

(1) Beneficial Reliance

Beneficial reliance is reliance on a contract that increases the value of the contract to the promisee.⁶ Xavier-Yvonne is one example: If Yvonne orders the food before Xavier completes construction, the contract with Xavier is worth more to her. Here is another: Suppose Boatmaker agrees to build a commercial yacht—to be named *Seafarer*—for Charterer, who plans to charter out the yacht for luxury cruises. The parties agree 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' contract by advertising the concert in advance. The advance advertising constitutes beneficial reliance.

Under the theory of overreliance, beneficial reliance can lead to overreliance: A promisee who seeks to make a contract more valuable to herself, 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.⁷

6. Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1267 (1980).

7. Typically, an increase in beneficial reliance increases the promisee's damages by increasing her expected profits. An increase in beneficial reliance may also increase the

(2) *Profit-Maximizing and Profit-Diminishing Reliance*

Even if the expectation measure were not utilized in contract law, a promisee might spend an inefficient amount on beneficial reliance simply because she 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. In the Xavier-Yvonne hypothetical, for example, even if the standard expectation measure fully insures Yvonne against breach, Yvonne will, if rational, make food expenditures only up to that point where the cost of additional expenditures equals their added benefit. We will call such reliance *profit-maximizing reliance*.

Some actors, however, may rely in a way that is profit-diminishing. 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 she miscalculates the effect of additional advertising. For example, Producer might have an overoptimistic disposition, or she may simply exercise poor judgment and make a bad call. We will call that portion of beneficial reliance that is suboptimal even if the promisor's performance was perfectly insured *profit-diminishing reliance*. Profit-diminishing reliance will not increase the promisee's damages, because such reliance will decrease rather than increase the promisee's lost profits. Put differently, if the promisor performs rather than breaches, the promisee's profits will be reduced by the amount of profit-diminishing reliance. Therefore, if the promisor

promisee's damages by increasing her 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. Suppose further that if the Blue Angels give the concert, the proceeds of the concert will be \$225,000. If the Blue Angels cancel at the last moment, and their fee has not yet been paid, then to put Promoter where she would have been if the concert had been performed, she must be awarded damages of \$125,000: if the concert had been performed, Promoter would have covered her \$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, she will have to eat the \$50,000 advertising expenses, and therefore will not be as well off as she would have been had the concert been performed. Characteristically, however, expenses like the advertising are not a separate element of damages. Instead, the promisee recovers these costs indirectly: The promisee's damages will be based on the lost gross revenues minus any variable costs saved by virtue of the promisor's breach (in this case \$225,000 minus the \$100,000 fee to the Blue Angels). That measure will automatically compensate the promisee for the wasted costs she incurred prior to breach.

breaches, the damages that the promisee recovers must be correspondingly reduced.⁸

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.

(3) *Necessary Reliance*

A party to a contract often must incur some costs just to make the contract work. For example, a buyer often 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 her contract, she must first incur the cost of renting a venue. Similarly, if a buyer contracts to purchase a die press that requires a concrete foundation, she cannot take delivery of the die press unless she first incurs the cost of putting in the foundation. We call such costs *preparatory costs*. Similarly, sellers often must incur 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, 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 either not discretionary at all or discretionary only within very narrow limits. For example, a seller normally cannot significantly vary his performance costs in response to the buyer's rate

8. Reliance may be profit-diminishing regardless of the damages rule. In contrast, whether reliance is profit-maximizing may depend on what damages rule is employed. 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 her 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 she would know or have reason to know that her damages may be adjusted downward to reflect her overreliance. In this Article, we take the standard expectation measure as a starting-point, and therefore we define *profit-maximizing* to mean reliance that is profit-maximizing given that measure. As will be seen, nothing substantive turns on this definition; it is adopted simply for ease of exposition.

of breach, because if he fails to incur performance costs he will be unable to perform and will himself be in breach. Accordingly, in the apples hypothetical, regardless of Buyer's rate of breach Seller must purchase 40,000 apples at some point prior to the time for delivery. In other words, 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 her preparatory costs, because if she does not incur such costs she 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 does not rent a venue prior to the concert, she nevertheless will be required to pay the Blue Angels \$75,000.⁹

It is true that the amount of preparatory costs may sometimes be variable at the margin. For example, in the Blue Angels case Promoter might be able to rent a better or worse venue, and in the die press case the buyer might be able to build a better or worse foundation. We regard this qualification as largely immaterial, for two reasons.

First, often and perhaps even typically, the amount of preparatory reliance will not practicably be variable: In many cases, there is only one realistic choice (for example, if in the Blue Angels case only one venue in the area is available for a rock concert at the relevant time). In other cases, the quality of the commodity in which the buyer must invest—a concert venue, a concrete foundation—cannot be easily reduced below the otherwise-optimal quality without reducing or even destroying the benefit of the contract.

Second, even where the quality of the commodity in which the buyer must invest can be reduced below the level that would be optimal except for the problem of overreliance, by hypothesis reducing the expenditure on preparatory costs, to take account of the

9. 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 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 choosing how high to set y is still as in note 5—it remains unchanged by the addition of Y . Our concept of necessary versus beneficial reliance is closely related to the distinction between fixed and variable costs. It is also and perhaps even more closely related to the distinction, drawn in L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pt. 1), 46 YALE L.J. 52, 78 (1936), between "essential reliance" (loosely, what we call necessary reliance) and "incidental reliance" (loosely, beneficial reliance).

issue of overreliance in this way, will result in a quality of preparation that would be less than optimal if the issue of overreliance was put aside. Observation suggests that generally speaking, the probability of performance is very high and the probability of material breach is very low. There is a good reason for this. Actors are very unlikely to deal with promisors who have a high rate of material breach. For one thing, reliability is important to most contracting actors, given the need to coordinate elements of production and distribution. In addition, as we show below, the expected value of damages based on lost profits is much lower than perfect-world damages, so that the value of performance will greatly exceed the value of damages for nonperformance. Accordingly, promisors with more than a very low rate of material breach are likely to be driven out of the market. Assuming that the rate of material breach is very low and the rate of substantial performance is very high, the expected cost of a suboptimal investment in the quality of preparation will be very high, while the expected cost of overreliance will be very low. Accordingly, the social loss that would result from underinvesting in the quality of preparation will normally swamp any social loss that would result from not taking into account the possibility of breach.

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 probability of breach is also rarely likely to be efficient.

(4) *Timing Costs*

One set of contract-related costs falls 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 provider and a buyer have entered into a contract—say a contract for the sale of apples or for the construction of a building. Assume further that while the provider must incur minimum performance costs to perform the contract, he has some discretion when to begin incurring these costs. For example, suppose that in the apples contract the provider can fill the buyer'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 in the construction contract, the provider can construct the building on time either by beginning right away or by beginning later.

Under these assumptions, if the probability of the buyer's breach is disregarded, then the provider 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. The provider will also be conscious of the fact that beginning performance early is a kind of precaution, in the sense that the earlier the provider begins performing, the more likely he will perform on time. If the provider 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 the buyer is greater than zero. It is possible that total costs will be minimized if the provider begins at time T_2 , which is later than T_1 , because if it becomes clear after T_1 but before T_2 that the buyer will breach, the provider can forgo a wasteful investment in the costs of a performance that may have only limited value if the buyer wrongfully refuses to accept and pay for it. We call such a delay a *timing cost*, because the provider's profits will always be reduced by beginning performance at T_2 rather than T_1 , since by hypothesis the optimum time for the provider to begin performance (not taking into account the possibility of a breach by the purchaser) is T_1 , not T_2 .

Other kinds of costs may also be deemed timing costs. For example, assume the following facts in the apples case: The provider has a window of time to purchase apples for resale to the buyer. The optimal time for the provider to purchase apples for resale to the buyer is T_1 , and if the provider purchases the apples at that time he will need to incur minimum performance costs (the cost of the apples) of \$18,000. The provider can instead pay \$500 at T_1 for an option to purchase apples for \$18,000 at T_2 (a later time). If the provider does so and the buyer defaults, the losses under the contract will be less. However, but for the risk of the buyer's breach, the provider should purchase apples, rather than purchasing an option, at T_1 because if the provider purchases the option and the buyer performs, the provider will increase his costs from \$18,000 to \$18,500 without any corresponding increase in the price paid by the buyer.

Nevertheless, the possibility of incurring (or forgoing) timing costs of any sort will seldom lead to inefficient overreliance. For example, assume that to reduce the possibility of the social costs that will result if the buyer breaches after the provider has begun performance, the provider delays the beginning of performance beyond the time, T_1 , that would be efficient but for the 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 the provider to begin performance at T_2 , and also because beginning at T_1 rather than T_2 is a type of precaution against the provider himself ending up in breach by

delaying performance too long. If, as we believe to be the case, generally speaking the rate of substantial performance is very high and the rate of material breach is very low, the efficiency losses from such a delay will normally swamp the efficiency gains, so that timing costs normally should not be incurred.

What if, instead of merely presenting a statistical probability of breach, the buyer takes an action or makes a statement that renders it uncertain that she will perform? Such cases are out of the realm of overreliance: Under general principles of contract law, in these circumstances the provider can demand reasonable assurance of performance by the buyer. If such assurance is not forthcoming, the provider 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: (i) Whether reliance is profit-maximizing or profit-diminishing depends on efficiency considerations other than the promisor's rate of breach. (ii) Assuming that the probability of substantial performance is generally very high and the probability of material breach is generally very low, necessary reliance can seldom be efficiently varied in response to the probability of breach. (iii) The same is true of preparatory reliance and timing costs. Therefore, for most practical purposes the theory of overreliance concerns only beneficial reliance. Accordingly, generally speaking in the balance of this Article we will consider only whether the standard expectation measure induces too much beneficial 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 other than beneficial 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, inefficient beneficial overreliance normally cannot or is highly unlikely to occur, because of institutional elements based on the economics of contracting and the way in which the standard expectation measure is actually administered. These categories are:

Cases in which the promisee's damages under the standard expectation measure will not vary with changes in her costs: If a promisee's damages under the standard expectation measure will not vary with changes in 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 whether the promisor performs: Where a promisee's payoff from reliance does not depend on whether the promisor performs, the efficient level of the promisee's investment in costs is independent of the probability of breach by the promisor.

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, the theory is either inapplicable or trumped in cases where an overreliance rule would be inefficient.

We now consider these categories in detail.

(1) *Cases in Which the Promisee's Damages Under the Standard Expectation Measure Will Not Vary with Changes in Her Costs*

We begin with cases in which the prospect of expectation damages is not an incentive for beneficial overreliance because the promisee's damages under the standard expectation measure will not vary with changes in her costs. When damages do not vary with changes in costs, an incentive to overrely does not arise.¹⁰

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 she would have been in if the contract had been performed. In the actual law of damages, however, the general principle is instantiated in a number of specific rules based on various types of categorization. The theory of overreliance must be considered in light of these specific 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, such as 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, regardless of the particular circumstances of the parties. A contracting party is normally liable for all general damages that result from his breach. For example, if a seller fails to deliver under a contract for the sale of goods, the buyer—regardless of her circumstances—normally incurs general damages equal to any excess of the market price of the goods over the contract price. *Consequential damages* are the damages that result only from the particular circumstances of the parties. For example, in case of a seller's breach of a contract for the sale of goods, depending on the

10. See *supra* note 5.

circumstances, the buyer may lose an expected profit 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 the damages were reasonably foreseeable at the time the contract was made.¹¹

Against that background, we now consider how the various categorical rules of expectation damages impact on beneficial reliance by sellers and buyers.

(a) Sellers

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. Two basic formulas are employed to calculate 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 replacement price that the seller can realize by disposing of the commodity in a replacement sale. (R can be either the market price of the relevant commodity or the actual resale price.)¹²

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 profit and his costs incurred.) The second 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 and economically equivalent.

Under either of the two basic formulas, a seller's expectation damages normally cannot vary with his costs.

11. 156 Eng. Rep. 145, 151 (Ex. 1854).

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

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. As a result, this expression of the formula 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 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. 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 above 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. Such a rule would often require a seller to incur more costs than would otherwise be optimal. Moreover, the risk that the seller will himself end up in breach increases in tandem with the postponement of performance. True, a few cases might occur in which (1) earlier performance would lead to higher damages than later performance under the formula $K - C_r$, and (2) 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. However, we believe that such cases are 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."¹³

In short, the prospect of expectation damages normally cannot give a seller an incentive to engage in beneficial overreliance—that is, an incentive to incur more costs than would be efficient considering the buyer's probability of breach. First, the formulas for calculating a seller's general damages normally provide sellers with no incentive for increasing their costs. Second, 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

Since sellers normally cannot overrely, we now shift our focus to buyers.

(i) *Buyers Who Have No Compensable Consequential Damages*

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 for nonperformance by sellers 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 the market value of the performance that was promised, and V_r is the market value of the performance that was rendered.¹⁴

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 the buyer's costs.

13. U.C.C. § 2-710 prelim. cmt. 2 (Prop. Amends. 2001).

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

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 a buyer has no consequential damages at all, or when the buyer's consequential damages were not reasonably foreseeable by the seller at the time the contract was made.

In addition, a seller's breach will seldom result in consequential damages to a 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 law of contracts, it normally does not.¹⁵ True, scenarios can be constructed in which a consumer will have consequential damages. For example, a consumer who contracts for a custom-made yacht might suffer consequential reliance damages if she orders custom-made fittings that cannot be used for any other yacht, and the seller fails to deliver. This kind of scenario, however, is hardly an everyday occurrence. Moreover, even in this kind of scenario, under the principle of *Hadley v. Baxendale* the consumer's consequential damages will not be compensable unless at the time the contract was made the seller was on notice that the consumer planned to engage in reliance of this kind.¹⁶

(ii) *Nonmaterial Breach*

Even a commercial buyer, who purchases to make a profit, will normally have consequential damages only if 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

15. See RESTATEMENT (SECOND) OF CONTRACTS § 353 (1981).

16. Of course, while this limit on damages reduces the buyer's incentive to overrely, it also reduces the seller's incentive to take precautions against breach.

We put to one side problems of liability for harm caused by a defective product to the person or property of a consumer or bystander. 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 do not have consequential damages.

fails to meet specifications in certain nonmaterial respects—some of the carpeting is not the specified color and a few office doors do not close properly. If the defects do not 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 by the difference in value between the building as contracted for and the building as delivered, or by the cost of getting repairs made. In either case, Owner's investment in beneficial reliance will not be wasted as a result of the breach.

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 the seller will breach to the extent that this probability concerns only minor breaches. If, as we believe to be the case, the rate of material breach is generally very low, then generally speaking overreliance will not be a problem. Put more accurately, taking contracting as a whole, the problem of overreliance will not be economically significant.

(2) *Cases in Which the Promisee's Payoff from Beneficial Reliance Does Not Depend on Whether the Promisor Performs*

We have shown that sellers normally cannot overrely, and that buyers frequently cannot overrely, partly as a result of the actual rules of expectation damages, as opposed to the general principle of expectation damages. In this section and the next, we show that overreliance is often unlikely even when it is theoretically possible.

To begin with, in many cases the promisee's payoff from beneficial reliance does not depend on whether the promisor performs. In such cases the promisee will not be induced to overrely by the prospect that her damages are insured.

Here is the reason that is so: The concept of overreliance primarily concerns cases in which a party—now, we can see, a buyer—overinvests in beneficial reliance. The buyer overinvests in the sense that she behaves 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. 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 her investment in beneficial reliance whether the seller performs or breaches.¹⁷ (Of course, the

17. In the Xavier-Yvonne example, consider Yvonne's choice of y in note 5. If the payoff from reliance expenditure y does not depend on whether Xavier performs, then

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.) We discuss two such cases: those in which a performance identical to that which the seller has promised is readily available on the market and those in which the buyer's investment in reliance will hold its value even if the seller breaches.

(a) Cases in Which an Identical Performance Is Readily Available on the Market

Where a performance identical to that which 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.¹⁸ For example, a buyer of wheat (or any other relatively homogeneous commodity) cannot overrely. 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 a seller agrees to remodel a building for a buyer, all of the buyer's beneficial reliance (such as ordering custom-designed furniture for the building) will be protected, even if the seller breaches, if the buyer can reasonably expect that in the event of breach she can procure a substitute contractor to complete the remodeling on time.

(b) Cases in Which Reliance Holds Its Value After Breach

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 standard 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 the 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.

$R'p(y) = R'np(y)$, so damages do not vary as y varies. As explained in note 5, in such circumstances an incentive to overrely does not occur.

18. See George M. Cohen, *The Fault Lines in Contract Damages*, 80 VA. L. REV. 1225, 1319 (1994).

(3) *Cases in Which It Would Be Inefficient for a Buyer to Take the Seller's Rate of Breach into Account in Calibrating Her Reliance*

In some cases, even if neither of the first two conditions hold, it would be inefficient for a buyer to take the seller's rate of breach into account in determining her level of reliance. We discuss three such cases: those in which the buyer's reliance is lumpy, those in which the buyer's reliance consists of entering into coordinated contracts, and those in which the seller's probability of breach is very low.

(a) Lumpy Reliance

To begin with, it will be inefficient to take the seller's probability of breach into account where the buyer's beneficial reliance occurs in lumps that cannot be scaled down at the margin to take account of that probability. For example, assume that in the *Seafarer* hypothetical, Charterer cannot charter the yacht out upon its completion unless she has purchased various types of fittings and other equipment, including a radar, in advance. Suppose that a radar for the yacht, which costs \$15,000, must be purchased two months in advance; that Charterer will therefore lose two months of net revenues, equal to \$100,000, if she does not order a radar until the yacht is delivered; that the probability of Boatmaker's breach is ten percent; and that the radar would fall in value by twenty-five percent if Boatmaker breaches and Charterer must resell it on the market. Since Charterer will lose \$100,000 if she does not purchase the radar in advance, and since she 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 her 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 her beneficial reliance to the probability of Boatmaker's breach by purchasing fewer 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.¹⁹

(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 ten artists is ten percent, 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.

19. The lumpiness constraint assumes that beneficial reliance is justifiable. In some cases, that is not true. For instance, suppose in the *Seafarer* example it would cost \$90,000 to outfit the boat in advance. If Boatmaker does not breach, Charterer will receive net revenues of \$100,000 for the first two months. Under the standard expectation measure, if Boatmaker breaches by making delivery two months late, he must pay \$100,000 in damages. Given these expectation damages, Charterer might incur costs without regard to Boatmaker's probability of breach. However, if the probability of breach is fifteen percent, 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, unless the investment would hold most or all of its value in the event of Boatmaker's breach.

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 the investment even with ordinary damages, while if the investment was under \$85,000, it would be unobjectionable. It is only if the lumpy reliance falls into the intermediate range that a problem exists. As the probability of breach decreases, this intermediate range narrows. Even in the example, with a high fifteen percent rate of breach, 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 social loss will similarly narrow. Moreover, the \$90,000 investment would probably hold most or all of its value in the event of breach, thereby making the investment efficient to undertake in any event.

It is also possible that a promisee could scale down the level of her 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 the rate of material breach is very low, then the expected cost of purchasing a less-than-otherwise-optimal radar would be much higher than the expected cost of purchasing the optimal \$15,000 radar, even considering the probability of breach.

(c) Seller's Probability of Material Breach Is Very Low

If the seller's probability of material breach is very low, it would normally be inefficient to take that probability into account in calibrating the efficient amount of beneficial reliance; by definition the probability is not significant. Furthermore, just 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 marginally less than certain.

(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. 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 timely 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."²⁰)

(4) *Summary*

Generally speaking: (1) A seller normally cannot overrely. (2) A buyer normally cannot overrely if she will have no consequential damages, or is a consumer, or if the probability of the seller's material breach is generally very low, 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 particular sellers who have a very low rate of breach, because in such cases a buyer can treat the seller's performance as virtually assured. Similarly, overreliance is unlikely to be a problem 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 in most cases, the likelihood of overreliance seems very small. The mere possibility that overreliance may occasionally occur does not provide a good reason either to deem the standard

20. U.C.C. § 2-609 cmt. 1 (2002).

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

In Part II, we showed that as a result of institutional elements based on the economics of contracting and the way in which the standard expectation measure is actually instantiated in specific rules, overreliance is very unlikely to often occur. In this Part, 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 her 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 moral hazard problem that arises under any full insurance scheme, for it means that B can ignore the risk that S's nonperformance might leave B's reliance expenditures wasted."²¹ 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"²²

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 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, in deciding how much to invest in beneficial reliance, what matters to the promisee 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

21. Richard Craswell, *Performance, Reliance, and One-Sided Information*, 18 J. LEGAL STUD. 365, 376–77 (1989).

22. Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN L. REV. 481, 494 (1996).

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.²³ 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 promisor may prove to be judgment-proof—indeed, breach may often be due in part to the promisor's financial difficulties.

Given all these factors, it seems safe to assume that at the time a risk-neutral promisee invests in beneficial reliance, the expected value of damages based on beneficial reliance is unlikely to often exceed seventy to eighty percent of perfect-world damages, even without regard to litigation costs. The expected value of such damages will be significantly less if, as is likely, the promisee is risk-averse. In effect, therefore, the promisee is likely to co-insure at least twenty to thirty percent of her 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.”²⁴ The same is true of co-insurance.²⁵

(This discussion of litigation risk has a complication. It is possible that the extent of the litigation-risk discount is partly a function of the degree of reliance. Two opposing stories can be told. On the one hand, greater reliance may lead to more relationship-specific spending by the promisee, the effect on which of breach may

23. It is theoretically possible that the promisee's actual damages would be more than perfect expectation damages, rather than less. If the chances of overly high damages were as great as the chances of overly low damages, 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. For example, the requirement of certainty and the principle of *Hadley v. Baxendale* are always used to cut back a promisee's recovery, never to expand a promisee's recovery.

24. Cooter, *supra* note 3, at 39.

25. 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.

be especially hard to measure. In such cases, the litigation-risk discount would increase with increased reliance, and would do even more to discourage overreliance. On the other hand, increased reliance may lead to more concrete, observable damages in case of breach, thereby decreasing the degree of litigation risk. In such cases, the litigation-risk discount would decrease, and would do less to discourage overreliance. Indeed, if this effect occurs litigation risk would do less to reduce overreliance than we have suggested, because promisees would have a strengthened incentive to increase reliance expenditures, since doing so would increase the chances that a court will be able to measure and award damages in the event of breach. Accordingly, if this effect occurs there would be two opposing tendencies: the litigation risk's very existence, which reduces the incentive to overrely, and the reduction of litigation risk with increased reliance, which would increase the incentive to overrely. If the latter effect outweighs the former it would lead to a greater overreliance problem than if there were no litigation risk.²⁶)

In addition to the 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.²⁷ On the basis of casual empiricism, the minimum legal fee for even a relatively straightforward commercial contract case would likely be around \$10,000, and the minimum fee for a complex commercial contract case would not be much less than \$50,000 to \$100,000. Indeed, a partner in a New York boutique litigation firm told us that his firm's minimum fee for complex high-stakes commercial contract litigation would seldom be much less than \$1 million, based strictly on billable hours. In effect, litigation costs are like a variable deductible whose amount depends on the complexity

26. We are indebted to Omri Ben-Shahar for this point. The point can be made more precisely in terms of the extension to the Xavier-Yvonne example in the previous footnote. Now suppose Yvonne expects to recover $r(y)D(y)$ of damages, where r is a function of y . In the first order condition the damage term, originally $D'(y)$, then $rD'(y)$, now becomes $rD'(y) + r'(y)D(y)$. If $r'(y) < 0$, that is, if an increase in y leads to greater litigation risk, then litigation risk does even more to reduce overreliance, as it makes the change-in-damages term even smaller. Indeed, if $rD'(y) < -r'(y)D$, it could even lead to *underreliance*. However, if $r'(y) > 0$, then the reduction of the damage term caused by r is lessened. Still, so long as $r'(y) < (1 - r)D'(y)/D(y)$, overreliance is still less in the presence of litigation risk than if there were no such risk.

27. This may not be true where the contract includes a provision that if suit is brought under the contract, the losing party pays the fees of the winning party. However, most contracts do not contain such a provision. Moreover, even when such a provision is included, it is risky to rely on it, because a party who brings suit and loses must absorb his losses under the contract, his own attorney's 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 she sues without settling, she will prevail in court, while if she settles, the amount of the settlement will include her litigation expenses.

of the case and other factors, such as customary hourly rates. If the promisee's damages are less than her litigation costs, then the promisee may 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.²⁸ (We do not deny that cases whose expected value is less than the litigation costs 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.)

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.²⁹ 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 that is at stake, the more a promisee will be willing to invest. Litigation costs will tend to rise much less steeply than the expected value of damages. Therefore, litigation costs 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.³⁰ As a result, even in cases where a prospective

28. In Xavier-Yvonne, suppose Yvonne must incur a fixed cost L to collect damages. Then her expected net income becomes $p(x)Rp(y) + (1 - p(x))Rnp(y) + (1 - p(x))(D - L) - K - y$. The first order condition for her choice of y is unchanged from that in note 5—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 *infra* Part IV.A.

29. In the Xavier-Yvonne example, one can see this point on the basis of the formulas 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.

30. We can make the point algebraically. Let D_1 be damages at a lower level of reliance and D_2 damages at a higher level. Then $D_2 - D_1$ is how much damages would increase with greater reliance in the absence of litigation costs—the source of the overreliance incentive. Now, suppose that the promisee only collects a fraction λ of damages, with $1 - \lambda$ going to her lawyer. This fraction may change as D changes, with a smaller fraction going to the lawyer (i.e., λ rising) as D increases. Then, $\lambda_1 D_1$ is how much the promisee receives at low reliance, and $\lambda_2 D_2$ is how much she receives at high reliance, with $\lambda_2 > \lambda_1$. How do expected damages change as reliance increases? The absolute amount that the lawyer receives does increase. That is, $(1 - \lambda_2)D_2 > (1 - \lambda_1)(D_1)$. A little algebraic manipulation then reveals that $D_2 - D_1 > \lambda_2 D_2 - \lambda_1 D_1$. The left-hand side is the

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 fifty percent. For example, if the prospective recovery is \$200,000, and the litigation costs 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 (twenty percent 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 her litigation expenses upon breach by the promisor. She may, however, have at least a rough idea. In any event, 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 overreliance could potentially occur.

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 litigation costs—and litigation costs can run very, very high—are likely to be effectively uninsured, and even damages in excess of the litigation costs 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, even in the residual cases in which overreliance could potentially occur, it is highly implausible that 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 the promisee's litigation risks and costs on the promisor. After all, the promisee's litigation risks and costs could reduce the promisee's 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. Accordingly, to the extent that litigation risks and costs reduce the

increase in damages received in the absence of litigation costs. The right-hand side is the increase in net damages received by the promisee in the presence of litigation costs. The latter is less than the former, so the incentive to overrely is decreased.

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 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. Accordingly, 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.³¹ After factoring in litigation risk and costs, therefore, although the standard expectation measure as actually experienced gives little or no incentive for the promisee to overrely, it 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 the problem of overreliance is limited to a small number of residual cases by virtue of institutional considerations, such as the economics of contracting and the way that expectation damages are actually measured. In Part III, we showed that even in the residual cases where overreliance could potentially occur, as a result of litigation risks and costs the standard expectation measure provides limited or no insurance to the promisee. When combined, these considerations drastically reduce, if they do not entirely eliminate, the 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

31. If Xavier incurs a net cost of L in a suit for damages, but as a result of litigation risk Xavier can expect to pay out only a fraction r of damages to Yvonne, his net income is $K - x - (1 - p(x))(rD + L)$. Then his first order condition 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 D back closer to the proper level.

occasionally. We proceed on the premise that in these remaining cases 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. We ask what, if anything, should be done about these cases.

One way to eliminate the incentive to overrely in these 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 increasing her beneficial reliance up to the point where it becomes value-diminishing increases her potential profits and, correspondingly, her damages in the event of breach, so that her beneficial reliance is partially insured. In contrast, if the amount of the damages that Yvonne would receive upon breach were to remain invariant with respect to her level of reliance, then her incentive to overrely would disappear.³²

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 the amount is set in the contract, damages do 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.³³ 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 against breach will be too low, while if the liquidated amount is too high, the incentive to take precautions against 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.³⁴ 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 not employed in many or most contracts. We therefore

32. See Cooter, *supra* note 3, at 16.

33. See *id.* at 15, 42.

34. See Craswell, *supra* note 22, at 491-94.

turn our attention to the formulation of possible legal rules that would make damages invariant to reliance.

A. A No-Damages Rule

In those remaining cases in which overreliance may occur, an extreme way to remove a promisee's incentive to overrely would be to adopt a rule that a promisee will 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 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 she becomes 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 promisee] 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 *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.³⁵

35. Craswell, *supra* note 22, at 492. 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

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—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 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 profit of \$40 million on the movie. There is a ten percent 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 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 ninety percent chance that Star will perform, Producer's expected profit on *Dark Matter* is \$36 million (ninety percent of \$40 million). Accordingly, Producer's investment of \$20 million will have an expected payoff of \$36 million, or around a seventy-five percent return, and if he is risk-neutral he will make the investment even under a limited no-damages rule.

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, 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 sources cited *supra* note 3.

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.³⁶ Actors are also loss-averse; that is, the response of actors to given losses is more extreme than their response to gains of the same amount.³⁷ Therefore, the greater the possible loss, the more

36. 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 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).

37. The phenomenon of loss-aversion can be expressed in several different ways: changes that would 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 does not 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, 1327–28 (1990); Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, reprinted in THE LIMITS OF RATIONALITY 60 (Karen S. Cook & Margaret Levi eds., 1990); RICHARD H. THALER, THE WINNER'S CURSE: PARADOXES AND ANOMALIES OF ECONOMIC LIFE 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 described in Jeffrey Evans Stake, *The Uneasy Case for Adverse Possession*, 89 GEO. L.J. 2419, 2459–62 (2001) (footnotes omitted):

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

risk-averse an actor is likely to be. So for example, even though an investment in *Dark Matter* would have a high expected rate of return, Producer would be unlikely to take the risk of losing \$20 million under a limited no-damages rule. Accordingly, 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 in which 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* amount 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 the promisee actually chooses, and the promisee would have no incentive to overrely. The promisor's incentives to guard against breach and to perform would also be correct.³⁸

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.

38. 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 precise extent of the promisee's beneficial reliance is reasonable. Whether a given element of damages that the promisee may suffer (such as Yvonne's loss of profits if construction is not timely completed) is reasonably foreseeable may not always converge with whether the precise extent of the promisee's beneficial reliance (such as the amount of Yvonne's food purchases) is reasonable.

The modified expectation measure achieves a nifty trick, in theory, by creating what Cooter calls “double responsibility at the margin.”³⁹ The essential theoretical 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 would receive in damages would 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 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 would 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. Both observation and theory indicate that the average probability of material breach is almost certainly very low, and correspondingly the probability of substantial performance is very high. Under those conditions, the actual level of reliance is likely to be very close to the optimal level.

Furthermore, any overreliance that does occur normally will involve only 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 puts one in a region where the social loss is greater than the gain from that additional expenditure, but the difference will generally be very small.

39. Cooter, *supra* note 3, at 22.

As an example, consider the Blue Angels hypothetical. Assume that the Blue Angels' fee is \$100,000 and Promoter has no other costs. If Promoter spends \$50,000 on advertising, and if the Blue Angels give the concert, gross revenue will be \$225,000. Under the standard expectation measure, Promoter will earn a profit of \$75,000. To analyze whether Promoter's \$50,000 advertising expenditure is overreliance, we must know what gross revenue would be if there was no advertising. Suppose that it would be \$170,000. Then if Promoter spends nothing on advertising, his profits will only be \$70,000, after paying the Blue Angels their \$100,000 fee. Therefore, Promoter will spend \$50,000 on advertising. Now assume that there is a ten percent probability that the Blue Angels will breach. On these figures, spending \$50,000 on advertising is overreliance, but the net loss due to that overreliance is small: The net expected social benefit if the advertising is purchased is \$62,500 $((225,000 \times 0.9) - (100,000 \times 0.9) - 50,000)$. The net expected social benefit if the advertising is not purchased is \$63,000 $((170,000 \times 0.9) - (100,000 \times 0.9))$. Thus, not spending on advertising creates a net expected benefit that is \$500 greater than spending on advertising—that is the social loss due to overreliance in this example. If the revenue without advertising was just \$560 less, purchasing the advertising becomes socially optimal. On the other hand, if the revenue without advertising was just \$5,000 more, Promoter would prefer to not spend on advertising even under the standard expectation measure. 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. Put differently, even where overreliance can occur, it is likely to occur only for a relatively narrow range of values.⁴⁰

Since the benefits of a modified expectation measure are likely to be very slight, we turn to the costs of such a measure. These costs 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 the promisor's probability of 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

40. We can see this point in the Xavier-Yvonne example. In that example, the optimal choice of y is given by $p(x)Rp'(y) + (1 - p(x))Rnp'(y) = 1$. 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.

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 ingenious 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.⁴¹

In the absence of the rule that Craswell proposes, inefficient overreliance is not a coherent concept, because a promisee cannot practicably determine what constitutes efficient reliance. Craswell's rule, however, presents its own difficulties, because 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 his cost of performance will exceed the contract price plus the damages he would be required to pay if he breached. However, a promisor will almost never know, at the time the contract is made, the amount of the promisee's damages if he breaches. Typically, a promisee will not disclose to the promisor the amount of profits she expects to make. In fact, until breach actually occurs the promisee herself often will not know how much her damages will be, because circumstances often change between the time a contract is made and the time of breach. The promisor's costs of performance, which also influences the probability that he will breach, may also change during that time. Finally, Craswell's model of breach is incomplete, because it does not take into account that in determining whether to breach the promisor will consider the affect of breach on his reputation for reliability. This element will also 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. The bottom line is that even under Craswell's model of breach, a promisor typically will not know, at the time the contract is made, the probability that he will breach. Accordingly, a promisor's statement of that probability normally will be inaccurate. Because the social costs of overreliance depend on the actual probability of breach, not on the promisor's stated probability of breach, if the theory of overreliance otherwise had any bite Craswell's rule would not resolve the central difficulty that he addresses.

41. See Craswell, *supra* note 21, at 367-68.

(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 probability of the promisor's overreliance would have to be determined. As has just been shown, it is extremely unlikely that this probability could be determined with a reasonable degree of accuracy.

Second, the optimal amount of reliance would have to be determined. 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. Accordingly, in deciding how much to rely, the promisee would have to 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. This calculation would be extremely difficult, and under the modified expectation measure a court would have to replicate this calculation in determining how much reliance was optimal.

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

Finally, if the court determined that the promisee had overrelied, it would have to determine how much profit 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 would be likely to 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, for two reasons: uncertainty in the returns to investment in reliance would make such investments less attractive, and courts might be inclined to push the overreliance rule too far and not compensate promisees 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. For example, suppose the efficient level of beneficial reliance if the promisor had a zero probability of breach was \$10,000, and the probability of breach was ten percent. 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 involve a highly imperfect estimate of optimal reliance. To begin with, this rule of thumb would not work where reliance was lumpy and the lumps were larger than probability of breach, or where two or more contracts had to be coordinated in advance of performance. Next, 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 will be able to sell 6,000 units per week at the new facility. The units must be ordered seven days before the week in which they will be delivered. Yvonne would like to order 6,000 units on August 25, seven days before the scheduled completion date of the new facility, September 1. If Yvonne orders the 6,000 units on August 25 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 ten percent probability that Xavier 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. If she reduces the number of units of food she orders by ten percent, 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 (\$12,000 lost profits plus a loss of \$600 on resale of the 6,000 units). If she orders 5,400 units, her

damages will be only \$11,340 (\$10,800 lost profits plus a loss of \$540 on resale of the 5,400 units)—a difference of \$1,260. But since the probability of Xavier's performance is ninety percent while the probability of breach is only ten percent, the *expected value* of Yvonne's extra profits if she orders 6,000 units is \$1,080 (.90 x \$1,200) while the *expected cost* of Xavier's extra damages if Yvonne orders 6,000 units is only \$126 (.10 x \$1,260). Therefore, a reduction of Yvonne's beneficial reliance by ten percent would be inefficient.

A final possibility is that the modified expectation measure should be applied where, but only where, that measure is easy to apply. 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, however, nontrivial overreliance is likely to occur only in residual cases; of those residual cases, there are not many where the difference between the standard expectation measure and the modified expectation measure 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 identifying these 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, such as it is. In cases where the parties believe there might be significant overreliance, an agreed-upon cap on damages, based on the amount of beneficial reliance that would be efficient in the circumstances, would be appropriate. Alternatively, the promisee's damages on breach could be made invariant to her beneficial reliance through contractual techniques such as liquidated damages.

Conclusion

The theory of overreliance states that the standard expectation measure provides inefficient incentives to a promisee because it insures the promisee's reliance. In the absence of institutional considerations, the theory could have significant consequences in designing the law of contract damages. When institutional considerations are taken into account, however, the theory has

virtually no consequences. In most cases, overreliance normally cannot occur, because of the way in which the standard expectation measure is instantiated in specific rules, the economics of actual contracting, 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 to occur in most cases, and partly because where overreliance does occur it is likely to involve only 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.

Finally, the theory of overreliance implicitly assumes that expectation damages are perfect—that the expectation measure actually does put a promisee where she would have been if the promisor had performed. In practice, however, that is far from the case, because of limits on the manner in which expectation damages are actually determined (such as the requirement of certainty, the principle of *Hadley v. Baxendale*, and the lack of compensation for the costs of successful litigation), and the litigation risks and costs to which those limits give rise. Indeed, given these limits, risks, and costs, it is likely that in practice, rather than overinvesting in reliance, promisees will tend to *underinvest* in reliance.⁴²

42. We are indebted to Aaron Edlin for this observation.