Measuring Recovery for Non-Contractual Investment

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ABSTRACT

Parties who make investments that generate externalities may sometimes recover from the beneficiaries, even in the absence of contract. Previous scholarship has shown that granting recovery, based on *either* the cost of the investment *or* the benefit it confers, can provide optimal incentives to invest. However, this article demonstrates that the law often awards recovery that is neither purely cost-based, nor purely benefit-based, and instead equals either the *greater-of* or *lesser-of* the two measures. These hybrid approaches to recovery distort incentives to invest. The article demonstrates the prevalence of these practices, and explores informational and related reasons why they emerge. It argues that they generally are ill-suited to promote rational policies.

RECOVERY FOR NON-CONTRACTUAL INVESTMENT

INTRODUCTION

Private parties often make investments that benefit others. Such investments are usually made under contract with the beneficiaries. The contract determines the investing party's right to recover and the measure of that recovery. Sometimes, however, a party considering making an investment is unable to contract with its potential beneficiaries. In these situations, the investing party must rely upon the law to create an obligation on the part of others to pay for the service.

Indeed, private law is replete with doctrines enabling an investing party to recover in the absence of contract. For example, a co-owner may recoup the costs of repairs she makes to co-owned property, and a doctor may recover a fee for treating an unconscious accident victim. In measuring the recovery, the law normally utilizes one of two approaches. In some instances, recovery is measured by the benefit from the investment: the obligor has to pay in accordance with the actual benefit she enjoyed. In other instances, recovery is measured by the investment's cost. A great deal of legal order has been created along this cost versus benefit distinction (Atiyah (1979, pp. 149-152, 184-189). For example, the law of torts defines obligations that are cost-based, whereas the law of restitution defines obligations that are benefit-based.

The right to recover in the absence of contract has been rationalized from an economic (that is, incentive-oriented) perspective (Landes and Posner 1978; Levmore 1985). In particular, it has been defended on the grounds that it encourages parties to make desirable investments that they would otherwise forego, usually because of the difficulty of contracting with the beneficiaries. This paper does not directly take issue with the economic literature demonstrating the desirability of imposing liability in such circumstances. Rather, it explores a systematic and puzzling inconsistency in the way the law actually determines the *magnitude* of liability. Using economic analysis, it exposes confusion concerning the use of cost versus benefit to measure recovery, and the resulting distortion in incentives.

The common situation in which this inconsistency arises involves an investment that is expected to yield an uncertain benefit to another party. This is an investment that confers a *chance*, or probabilistic value, as opposed to certain benefit. Examples are abundant: owners of land make investments to repair or improve co-owned property that might, but are not certain to, increase the market value of the property; insured parties take precautions that might, but are not certain to, reduce the losses that their insurers have to cover; attorneys pursue legal actions that might result in favorable judgments or settlements for their clients. By the time the law has to determine the recovery *ex-post*, the actual benefit—or lack thereof—becomes known and (usually) can be verified by the court.

If the investing party is entitled to recover, it might be expected that courts would measure the recovery either on the basis of the recipient's benefit, or on the basis of the investor's costs. The benefit-based measure would depend on (and is potentially equal to) the actual benefit that materialized. This is an *ex-post* recovery regime: the investing party will enjoy a high recovery when the court observes that the benefit is high, and a low recovery when the court observes a low benefit. The cost-based measure, alternatively, would *not* depend on any *ex-post* realization of benefit. Instead, and irrespective of whether the actual benefit is high or low, this measure would award a recovery that is fixed, equal to the reasonable economic cost of undertaking the investment. Under either the benefit-based or the cost-based regimes, if appropriately applied, the investment would be taken if and only if it is cost-justified.[1]

[1] Whether the benefit-based approach is superior to the cost-based approach (e.g., for reasons of fairness, information and administration costs, or risk) is beyond the scope of this analysis. *See, e.g.,* Polinsky and Shavell (1994) and Wittman (1985).

It turns out, however, that in many circumstances, the law takes neither a pure benefit-based nor a pure cost-based approach to measuring recovery. Instead, it often uses one of two "hybrid" recovery approaches. Under one approach, the investing party can recover either the *ex-post* benefit enjoyed by the beneficiary, or the cost of the investment, and *can elect the greater of the two*. This approach, which we label the "*greater-of*" regime, permits the investing party to recover the full benefit when it is high, or recover the cost of the investment when the benefit is low (or zero). The expected recovery under this approach is greater—potentially far greater—than the expected benefit of the investment, creating excessive incentives to invest.

Under a second hybrid approach, which we label the "*lesser-of*" regime, the investing party can again recover either the *ex-post* benefit enjoyed by the beneficiary, or the cost of the investment, but this time she is *limited to the lesser of the two*. The investing party can effectively recover the full benefit only when it is low; when the benefit turns out to be high, recovery is capped at the cost of the investment. The expected recovery under this approach is lower than the expected benefit of the investment, creating insufficient incentives to invest.

For example, consider a party who invests in a project potentially adding value to a neighbor's land, in a setting that gives rise to a restitutionary right of recovery. A benefit-based regime would set the recovery equal to the actual enhancement value enjoyed by the neighbor. A cost-based regime would set the recovery equal to the cost of the investment, if it is adjudged reasonable. A *greater-of* regime would permit the investing party to recover the full benefit when the enhancement value is high, and recover her costs when the enhancement value is low. Section II.E of the paper will demonstrate that this is a recovery strategy available to investing co-owners under the repairs and improvements doctrine in property law. On the other hand, a *lesser-of* regime would limit the investing party to recover the full benefit when this benefit is low and only her costs when the benefit is high. Section II.F of the paper will demonstrate that this is the recovery schedule available to mistaken improvers under the Restatement of Restitution.

The distortion this article attributes to the hybrid recovery regimes can be further illustrated with a lottery metaphor. Suppose party A owns a lottery ticket that provides a 1% chance of winning $1000, and a 99% chance of winning 0. The *ex-ante* value of such a ticket—its actuarial cost—is $10. Party A mistakenly loses her lottery ticket at party B's home and discovers the loss after the lottery draw was announced. Under the pure benefit-based recovery regime, party A can recover from party B (who found and cashed the ticket) either 0 or $1000, depending on the ticket's actual draw. Under the pure cost-based recovery regime, party A can recover the *ex-ante* value, or the cost of the ticket, $10, independent of the actual draw. The expected recovery under both regimes is $10, correctly reflecting the value of the ticket at the time it was lost. Consider, in contrast, the two hybrid approaches described above. Under the *greater-of* approach, party A can recover $1000 if the ticket wins, and can recover $10 if the ticket's draw is 0. The expected recovery is approximately $20, twice the *ex-ante* expected value of the ticket (the ticket is worth more if lost; party A would have an incentive to lose it!). Under the *lesser-of* approach, party A can recover only $10 if the ticket wins, and recover 0 when the ticket's draw is 0. The expected recovery is 10 cents, well below the *ex-ante* expected value of the ticket.

The article proceeds in three steps. First, Section I develops a formal economic model of the distortion in investment incentives created under the hybrid regimes. Next, Section II of the paper briefly surveys several prominent recovery doctrines in private law, and demonstrates that hybrid regimes are of significant practical concern. Finally, the third, and perhaps the most interesting part of the article, explores why the hybrid approaches are used so frequently in the law, despite the obvious distortions they create. This inquiry, which is developed in Section III, demonstrates that courts occasionally employ hybrid rules inadvertently, due to information problems and the difficulty of drawing boundaries between related causes of action. Other times, when hybrid regimes are employed deliberately to adjust the magnitude of recovery, economic analysis shows that they often fail to serve their stated purposes. The paper concludes by offering possible extensions and interpretations of the analysis.

I. A SIMPLE MODEL OF INVESTMENT WITH UNCERTAIN BENEFIT

A. The Framework of Analysis

Suppose that party A can spend a cost C that would yield a random benefit to party B (and 0 benefit to party A). For simplicity and without loss of generality, assume that the benefit to party B might be either high or low, with the high benefit denoted by V and the low benefit fixed at 0. The exogenous probabilities of V and 0 are p and $1-p$, respectively. Assume also that the parties are both risk-neutral and are unable to form a contract governing this investment. (Some of these assumptions are relaxed later.)

It is socially desirable for party A to spend C if and only if:

$$C \leq pV.$$

Party A's private decision whether to incur C would depend, however, on the legal regime governing her right to recover for her efforts.

B. The Pure Benefit-Based and Cost-Based Regimes

Under the benefit-based recovery regime, party A can recover the full *ex-post* benefit conferred upon party B. Thus, party A can recover V with probability p and 0 otherwise, for an expected recovery of pV. Party A will invest if and only if $C £ pV$, which is socially optimal.[2]

Under the cost-based regime, party A's recovery is independent of the *ex-post* realization of benefit, and equals the *ex-ante* value of her investment. We consider two versions of an *ex-ante* regime. In theory, a "pure" *ex-ante* regime is one in which the measure of recovery is the average, or expected benefit pV. If party A is entitled to recover pV regardless of the realization of benefit, she will invest if and only if $C £ pV$, which guarantees socially optimal investment. The more practically significant version of the *ex-ante* regime is the pure cost-based regime, in which the recovery is equal to party A's cost of investment, C. To guarantee that party A will invest C only when socially optimal, recovery should be conditional on $C £ pV$; namely, on the cost being "reasonable." Like the benefit-based regime, the cost-based regime generates optimal incentives to exert effort.

C. The Hybrid Regimes

1. *The* greater-of *regime*

Under one type of hybrid regime, the *greater-of* regime, party A receives the *ex-post* benefit measure when the realization of benefit is high, and receives her cost when the realization of benefit is low. Thus, party A receives a recovery of V when the benefit is V and receives a recovery of C when the benefit is 0. Party A's net expected payoff is:

$$pV + (1 - p)\,C - C = p(V - C),$$

which is greater than $pV - C$, the net social gain from investment, for all $p < 1$. Party A will over-invest: whenever $pV < C \leq V$, party A will invest although it is too costly from a social

[2] Other hypothetical "*ex-post*", or benefit-based recovery rules which make recovery dependent on—but not exactly equal to—the actual benefit, still provide optimal incentives, as long as the expected recovery equals the expected benefit. For example, optimal incentives are provided under an entire family of "multiplier rules", under which, for all $m = 1$, party A can recover mV from a fraction $1/m$ of the V-type beneficiaries, and 0 otherwise. The expected recovery under such rules is again pV. The m multiplier can represent, for example, a recovery enhancement in situations where the likelihood of successful suit is only $1/m$. *See, e.g.*, Polinsky and Shavell (1998).

point of view. Intuitively, the distortion in this case arises from the fact that, with some likelihood, the investing party will externalize her cost. If a high benefit occurs, the investing party internalizes both the cost and the benefit; but if the benefit is low, the cost of the investment is externalized.[3]

To illustrate, consider an investment of $120 that yields an expected benefit of $100. Socially, it is inefficient. If, however, the benefit is probabilistic, with 50% chance of $150 and 50% chance of $50, party A will take it. Under the *greater-of* regime, party A will get either $150 (when the benefit is $150) or $120 (when the benefit is $50), for an expected recovery of $135, well exceeding the cost of the investment. The greater the variance of the benefit, the greater are party A's excessive incentives to invest (e.g., if the benefit is either $200 or $0, equally likely, the expected recovery balloons to $160.)

This illustration can be generalized: the *greater-of* regime is equivalent to a benefit-based regime compounded by a put option for party A – an option to "sell" the benefit for C. If the *ex-post* value arising from the investment falls below C, party A will exercise the option and receive C; and if the *ex-post* value realizes above C, party A will not exercise the option and will receive instead the full *ex-post* value, V. Thus, the distortion under the *greater-of* approach depends on factors similar to those that affect option prices, such as the variance of the distribution of benefits,[4] and the time period that party A has to exercise the option (Jackson 1978).

[3] A similar distortion arises when the *ex-ante* measure of recovery equals pV, rather than C. In this case, a *greater-of* regime entitles party A to recover the actual benefit or the expected benefit whichever is higher. Accordingly, party A's expected recovery under this hybrid rule is $pV + (1 - p)pV = pV(2 - p)$, which exceeds the expected social benefit, pV, whenever $p < 1$.

[4] For example, consider a perturbation of the benefit values to $\{a, V\text{-}b\}$ for some small a,b, such that the mean of the distribution remains unchanged, pV (namely, if the probability of the high value $V\text{-}b$ remains p, $b = a[p/(1\text{-}p)]$. For this reduced-variance distribution, the expected net recovery under the *greater-of* regime is $p(V\text{-}a)+(1\text{-}p)C - C = p(V\text{-}C) - pa$, which is smaller (by an amount pa) than the expected recovery under the higher-variance distribution. The smaller the variance (a higher a), the lower the expected net recovery.

2. *The* lesser-of *regime*

Under the *lesser-of* hybrid regime, party A receives the *ex-post* benefit when the realization of benefit is low, but receives only her cost when the realization of benefit is high. Thus, party A receives a recovery of 0 when the benefit is 0 and a recovery of C when the benefit is V. Under the *lesser-of* regime, party A's expected net recovery is:

$$pC + (1 - p)0 - C = -(1 - p)C,$$

which is negative, and in particular it is less than $pV - C$, the social gain from investment, for all $1 > p > 0$. The *lesser-of* regime generates no incentives to invest: whenever $0 \leq C \leq pV$, party A will not invest although the investment is socially desirable. Intuitively, the under-investment arises from the fact that the investing party internalizes the entire cost but does not get to enjoy the entire benefit.[5]

To illustrate, consider an investment of $80 that yields an expected benefit of $100. Socially, it is an efficient investment. If, however, the benefit is probabilistic, with 50% chance of $150 and 50% chance of $50, party A will *not* take it. Under the *lesser-of* regime, party A will get either $80 (when the benefit is $150) or $50 (when the benefit is $50), for an expected recovery of $65, well below the cost of the investment.

II. THE DOCTRINAL PREVALENCE OF HYBRID REGIMES

Given the apparent shortcomings of the hybrid approaches, the reader may be left wondering whether these devices are of any practical concern. Accordingly, the objective of this Section is to demonstrate the prevalent use of the hybrid approaches across a broad range of legal doctrines, and thereby to dispel any notion that hybrids are a mere esoteric phenomenon.

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[5] Here, as in the *greater-of* regime, the magnitude of the distortion is equal to the value of an option, this time a call option given to party B, to "buy" the benefit at a price of C. If the *ex-post* benefit realizes above C, party B will exercise the option and pay only C; and if the *ex-post* benefit realizes below C, party B will not exercise the option and instead will pay the benefit. The value of this option is the amount by which party A is under-compensated.

Understanding the context in which hybrid regimes operate will also help us develop, in Section III, a more general discussion of the reasons--good or bad--why hybrids are used with such surprising frequency.

A. Implied Contracts

In drafting the provisions of their contract, parties are free to determine whether the beneficiary's obligation to pay is to be based on effort (as are most contracts), or whether it is to be contingent on success. In the absence of an explicit contract between the parties, however, it is up to the law to determine the recovery for services rendered.

Normally, the absence of an explicit contract means no obligation to pay. However, the doctrine of implied contracts sometimes imposes such an obligation. A typical situation in which an implied obligation arises is when one party performs a service during negotiations over a contract. The party providing the service may do so in anticipation of striking a deal, at the encouragement of the other party, or in an attempt to convince the other party that a deal is desirable. For example, an advertising agency might develop an idea for an advertising campaign and, in bidding for the client's account, share it with the client. If negotiations eventually break down, the investing party might seek to recover its costs or the value it created for the other party

Doctrinally, courts distinguish between two types of obligations that might be imputed, labeled implied-in-fact and implied-in-law contracts. An implied-in-fact contract may be found where actions other than an express promise indicate that the beneficiary intended to pay for the service. Here, as in many other areas of contract law, the parties' expectation is determined not merely from the text of their agreement (or lack thereof), but from the context as well. An implied-in-law contract, in contrast, arises even in the absence of any reliable indication of the parties' intentions. It is based, instead, on the benefit, and is intended to strip the beneficiary of this gain if the acquisition is deemed unjust under the established principles of the law of restitution (Farnsworth 1999, pp. 499-501).

The two types of implied contracts also lead to different measures of recovery. An implied-in-fact contract, once inferred, is supplemented by courts to include a provision mimicking the fee that an express contract would have stipulated, which is usually (though not necessarily) calculated on a per-effort basis. In the advertising contract example above, it would require the client to pay the firm for the billable hours it spent on the project. In contrast, an implied-in-law obligation, once constructed, often leads to restitution of the full benefit enjoyed by the beneficiary.[6] The client would have to pay the value it actually derived from the advertising campaign, which can potentially differ from the contract fee.

Put in terms of the analysis in Section I, the implied-in-fact doctrine embodies a cost-based (or fee-based) recovery approach, whereas the implied-in-law doctrine embodies a benefit-based recovery approach. As argued in Section I, either regime, if applied consistently and in the appropriate situations, can lead to optimal pre-contractual effort.

A distortion arises, however, when the plaintiff can elect the *greater of* the two recovery measures. In particular, when courts allow a party who conferred a high benefit to seek the restitutionary implied-in-law recovery for the entire benefit, and a party who conferred a low (or zero) benefit to seek the implied-in-fact recovery for the per-effort fee, excessive recovery results. She will get the full benefit when the benefit is high, and more than the full benefit when the benefit is low, a recovery schedule that exceeds the expected benefit from her effort.

[6] In rewarding the value the benefit conferred, courts use one of two possible measures, equal either to the "net enrichment", namely, the increase in total wealth to the beneficiary, or to the "cost avoided", namely, the saving to the beneficiary in obtaining the service (Farnsworth 1999, p. 107; RESTATEMENT (SECOND) OF CONTRACTS, §371). It is only when a "net enrichment" measure is applied that the recovery under an implied-in-law claim differs from the recovery under an implied-in-fact claim.

The implied-contracts doctrine falls occasionally into this *greater-of* trap. Whenever a court is willing to recognize an implied contract, the plaintiff would often be able to satisfy the elements of both types of implied-contract claims.[7] While acknowledging the difference between the two types of claims, courts often accord plaintiffs the power to choose between them. In the casebook favorite *Hill v. Waxberg*, for example, a contractor who was negotiating a building project invested in "plans, ideas, and efforts" that benefited the landowner after negotiations broke down. In allowing a recovery, the court didactically distinguished between the two types of implied contracts and their associated recovery measures, and confirmed the plaintiff's right to choose between them.[8] Accordingly, it was suggested that, even when no actual benefit materializes, an implied-in-fact claim for the services should lie (Farnsworth, 1987, p. 232). Thus, when the benefit conferred upon the other party is low, the investing party is generally encouraged to seek a recovery of her cost or hypothetical fee, based on an implied-in-fact contract claim.[9] And when the benefit is high, the investing party is not precluded from making an implied-in-law contract claim for the full benefit conferred.

This *greater-of* approach is further facilitated by procedural rules regarding the election of remedies. Specifically, plaintiffs are permitted to offer several alternative theories of recovery and to delay their commitment to any particular remedy until the stage of trial at which it will become clear which recovery measure is higher, and even to amend the complaint if they

[7] Indeed, similar grounds give rise to implied contracts under either doctrine. These grounds often have to do with high transactions costs involved in drafting explicit contracts (Posner 1998, pp 151-2).

[8] The court noted that "the elements of either theory could be satisfied, but since counsel has declined *to choose between them*, we are not prepared to make the choice for him." 237 F. 2d 936, 939 (9th Cir. 1956) (emphasis added). *See also* Bastian v. Gafford, 563 P.2d 48 (Idaho 1977) (when an implied-in-law action fails due to the absence of actual enrichment, recovery may instead be based on an implied-in-fact claim for the standard fee).

[9] *Earhart v. William Low Company*, 600 P.2d 1344 (Cal. 1979) (in the absence of actual benefit to the defendant, the recovery of expenses incurred is allowed).

originally stated only the lower theory of recovery.[10]

B. Remedies for Breach of Contract

A similar *greater-of* approach is embodied in the choice of remedies available for breach of an explicit contract. There are two typical situations in which this election-of-remedy issue arises. The first situation involves total breach or repudiation of a contract after one party has partially performed. The aggrieved party may seek either expectation damages or restitution. That is, she can either enforce the bargain and sue for "make whole" damages, calculated in accordance with the contract price, or disaffirm the materially breached bargain—employ a legal fiction that the contract ceased to exist—and recover damages equal to the benefit conferred on the breaching party (RESTATEMENT 2D OF CONTRACTS § 373; Kull, 1994).

This is a *greater-of* hybrid regime. When the benefit the breaching party enjoys from partial performance is low, the aggrieved party would seek the standard expectation remedy, that being greater than the *ex-post* benefit. But when the benefit to the breaching party from the partial performance is high, the aggrieved party can receive more than the adjusted contract price by recovering the *ex-post* value of the partial performance.[11] Again, procedural rules enable the aggrieved party to join in the complaint a claim for restitution recovery (in quantum meruit) and a claim for expectation damages, thus postponing the election of the remedy until it becomes clear, at trial, which of the two measures is greater. This *greater-of* regime for total breach is reinforced by the way restitution damages are calculated. Under the Restatement of Contracts,

[10] Matarese v. Moore-McCormack Lines, Inc., 158 F.2d 631 (2nd Cir. 1947) (permitting amendment of the complaint from a suit based on express contract to one based on the theory of unjust enrichment); Frontier Management Co. v. Balboa Ins. Co. 658 F. Supp. 987, 994 (D. Mass. 1986) (holding that plaintiff may plead unjust enrichment merely on the possibility that its contractual claims will prove inadequate at trial).

[11] Boomer v. Muir, 24 P.2d 570, 577 (Cal. App. 1933) ("[U]pon prevention of performance the injured plaintiff may treat the contract as rescinded and recover upon a quantum meruit without regard to the contract price."); *see also* Kull (1994, pp. 1477, 1498).

the benefit to the breaching party may be measured by either the market price for furnishing a service, *or* the extent to which the beneficiary's property has been enhanced in value by the service. When the enhancement-in-value measure of benefit is low, the aggrieved party is encouraged to seek the more generous market-price measure of restitution,[12] and when the enhancement-in-value measure is high, the aggrieved party is entitled to seek this larger sum. As a leading case summarizes: "the rule has evolved that the proper measure of damages in unjust enrichment should be the greater of the two measures."[13]

A second typical situation in which the *greater-of* damage measure applies is in an action for breach of warranty of title. A buyer who purchases an asset from a seller who is not the true owner and later has to surrender the purchased asset to its true owner, can recover from the seller either the purchase price or the *ex-post* value of the asset at the time it was surrendered, whichever is greater. Thus, when the asset depreciates in value below the price paid, the buyer can recover the price. And when the asset's value increases, the buyer can recover the full value, uncapped by the contract price.[14]

C. Attorney Fees

Recovery of attorney fees is commonly governed by a hybrid regime. This Part considers three prominent examples. The first involves a trial attorney's right to recover from her client after being discharged without cause prior to the conclusion of litigation. The second example

[12] REST. 2D CONTRACTS §371 cmt. b ("[T]he reasonable value to the party from whom restitution is sought is usually greater than the addition to his wealth. If this is so, a party seeking restitution for part performance is commonly allowed the more generous measure of reasonable value. . .").

[13] Robertus v. Candee, 670 P.2d 540, 543.

[14] Menzel v. List, 246 N.E.2d 742 (N.Y. 1969); WILLISTON (1960, §1395A) (limiting damages to the purchase price "virtually confines the buyer to rescission and restitution, a remedy to which the injured buyer is undoubtedly entitled *if he so elects*, but it is a violation of general principles of contracts to deny him in an action on the contract such damages as will put him in as good a position as he would have occupied had the contract been kept").

concerns a defendant's right to seek indemnification of litigation expenses that run to the benefit of third parties. The third and final case regards a litigant's right to recover attorney fees from *opposing* parties.

1. *Discharge of an attorney-client contract*

Trial attorneys are typically compensated using one of two possible formulae. Under one approach—the billable hours contract—the attorney is paid the same fee regardless of the outcome of the litigation. This fee is calculated by multiplying the number of hours the attorney worked on the case by a pre-agreed hourly rate. The alternative approach is the contingency-fee contract, under which the attorney is paid a portion of the client's award. If the client's claim is denied, the attorney recovers nothing, but if the client's claim prevails, the attorney receives a substantial premium *vis a vis* the billable hours contract.

To protect the interests of clients, courts have traditionally held that a client has an "unfettered" right to discharge an attorney working under either type of contract. When the client exercises this right before the conclusion of litigation and dismisses her attorney without cause, the question arises as to whether and how the dismissed attorney is to be compensated for the services she has already provided the client. This situation fits well into the framework of this paper, since the benefit to the client at the time the lawyer rendered the services—before the client's case is resolved—is still probabilistic.

Consider first the law governing discharge of the attorney working under a billable-hours contract. Nearly every jurisdiction permits such an attorney to recover her fee from the client, regardless of the outcome of the litigation (Annotation, 1957, p. 616). In mimicking the contract price, the law provides here a pure cost-based recovery.

Now, contrast this with the rules governing discharge of the attorney working under a *contingency-fee* contract. Strikingly, the rules that have emerged across the states mirror the four approaches described in Section I of this paper (Annotation, 1998). Some jurisdictions apply a pure benefit-based recovery approach that simply enforces the contingency-fee agreement. As soon as the underlying litigation concludes or settles—that is, as soon as the "benefit" to the client, if any, becomes known—the dismissed attorney recovers her full contingency fee, minus any expenses not incurred by the attorney in performing the balance of the contract.[15] If the suit is ultimately successful, recovery is high; otherwise, the attorney recovers nothing.

Other jurisdictions apply a variant of a pure cost-based approach, which permits the dismissed attorney to recover, in a quantum meruit claim, the reasonable value of her services (i.e., her costs), but not the contingency fee. Neither the attorney's right to recover, nor the amount of that recovery, are affected by the outcome of the litigation.[16] In theory, a *lesser-of* regime might still emerge in these jurisdictions if the client is permitted to dismiss the attorney after the client obtains new information on the likelihood of success. Under such a scenario, when the client learns that the suit is about to succeed (or to reach a favorable settlement), the client would dismiss the original attorney and pay the attorney her costs, and when the client learns that the suit is about to fail, the client would retain the attorney and pay her the contractual contingency fee – nothing. However, courts recognize the danger of such manipulation,[17] and thus the risk that clients can strategically create a *lesser-of* regime appears relatively small.

A third set of jurisdictions applies a *greater-of* approach by permitting the dismissed

[15] Tonn v. Reuter, 95 N.W.2d 261 (Wis. 1959).

[16] *See, e.g.*, Lai Ling Cheng v. Modansky Leasing Co., Inc., 539 N.E.2d 570 (N.Y. 1989) (holding that recovery in quantum meruit may be "more or less than the amount provided in the contract").

[17] *See, e.g.*, Fracasse v. Brent, 494 P.2d 9, 14 (Cal. 1972) (holding that an attorney discharged without cause under a contingency-fee contract is normally limited to recovering the reasonable value of his services, but may recover the full contingency fee when discharge occurs "on the courthouse steps").

attorney to elect her remedy. The attorney may collect either the reasonable value of her services *or* her contingency fee minus any expense saved because of the termination.[18] Therefore, if the award the client eventually collects is high, the attorney may elect the benefit-based measure of recovery, namely, a fraction of the client's award; otherwise the attorney may elect the cost-based measure of recovery, namely, her hourly fee.

Lastly, some jurisdictions, including California, apply a *lesser-of* approach by limiting the attorney's recovery to the reasonable value of the services and then, only if the suit is ultimately successful.[19] Thus, if the client receives a high award, the attorney gets the cost-based measure of recovery (her hourly fee), whereas if the client receives no award, the attorney gets the benefit-based measure of recovery (nothing). In these jurisdictions, the attorney who is dismissed without cause will receive a lower expected recovery than under the contract arrangement, or under either pure recovery regime.

A similar issue concerning recovery by contingency fee attorneys has come to the fore in the settlement of state lawsuits against tobacco companies. The contractual arrangements between the states and their outside (i.e., private) attorneys usually entitled the attorneys to a pure benefit-based recovery measure, anywhere between 2% and 25% of the settlements. When the tobacco industry agreed to settlements involving enormous sums, the attorneys' combined fees reached billions of dollars. *Ex-post,* this translated to hourly fees reaching, in some cases, tens of thousands of dollars per hour. At that stage, lawmakers were ready to discharge the

[18] *E.g.*, *In re* Downs, 363 S.W.2d 679, 686 (Mo. 1963) (a discharged contingency fee attorney "has the election to claim a reasonable fee for the work done [...] or to wait until the claim is liquidated by judgment or settlement and then sue [...] for his contract fee").

[19] *E.g., Fracasse,* 494 P.2d at 14; *see also* Rosenberg v. Levin, 409 So.2d 1016, 1021-22 (Fl. 1982); Chambliss, Bahner & Crawford v. Luther, 531 S.W.2d 108, 113 (Tenn. Ct. App. 1975) (holding that "fees [...] should be limited to the value of the services rendered or the contract price, whichever is less").

contingency fee arrangements and override the contracts.[20] Recognizing that these fees overwhelmingly exceed standard legal hourly rates, commentators, judges, the Press, and many lawmakers called these fees excessive, exorbitant, and even unconscionable (Brinkman, 1998).

Critics of the fees are effectively advocating a *lesser-of* recovery regime. If the suits had been unsuccessful—as were most tobacco suits prior to the settlement—the plaintiffs' attorneys would have recovered no fees. But now that the states have prevailed against the tobacco companies, the attorney fees have been scrutinized relative to hourly fees, and—as many critics endorse—capped not to exceed standard (i.e., guaranteed) hourly rates. What critics overlook is the enormous risk that many of these attorneys (albeit not all) had taken at the outset of the litigation. *Ex-ante*, in light of the slim chance of victory against the tobacco industry and the projected out-of-pocket cost to be incurred by the attorneys, the negotiated contingency fees seem less excessive. Measuring in hindsight the per-hour fee that the attorneys in fact recovered overlooks this risk factor. It is equivalent to the view that the holder of a winning lottery ticket is unjustly enriched by collecting the award and that he should recover no more than the price paid for the ticket. In this *lesser-of* regime, attorneys would be less willing to undertake risky projects under contingency fee arrangements.

2. *Indemnification of litigation costs*

Another regime applying a hybrid approach to the recovery of attorney fees involves indemnification of litigation costs. A party expending litigation costs to the benefit of others may seek reimbursement from the beneficiaries, even in the absence of an express indemnification agreement. The most common situation in which such an indemnity right is recognized occurs in

[20] *See, e.g.,* 144 Cong. Rec. S6373-01, S6374 (remarks by Rep. Sessions) ("How can we violate contracts? We violate contracts all the time in this body. […] Everything about the tobacco business is being changed by this legislation. […] One of those aspects ought to be how much these fees should count for").

products liability litigation over a defective product, where a seller who has defended a suit against the buyer seeks indemnity from the product's manufacturer for any damages awarded or legal expenditures. Recovery by the seller is based on quasi-contractual principles; the manufacturer is considered the beneficiary of the seller's defense because a successful defense would bar the buyer from re-asserting the same claim against the manufacturer.

There are different approaches across jurisdictions regarding sellers' rights to recover legal expenses. Some jurisdictions allow a seller to recover reasonable legal expenses regardless of the outcome of the litigation with the buyer.[21] These jurisdictions take a distinctly cost-based approach to indemnification. If the seller expends a reasonable sum defending against the buyer's suit, the seller may recover its costs whether the benefit to the manufacturer is "low" (because the buyer prevailed) or "high" (because the seller prevailed).

Other jurisdictions allow a seller to recover its legal expenses from the manufacturer, but only—and surprisingly—when the seller *loses* in its defense against the buyer.[22] These jurisdictions follow an inverted *lesser-of* approach to indemnification. If the seller expends a reasonable sum defending against the buyer's suit, the seller may recover its costs only if the seller, and hence the manufacturer, is liable, that is, when the *ex-post* benefit of the defense to the manufacturer is low. If the *ex-post* benefit to the manufacturer is high, that is, if the seller prevails and the manufacturer thereby avoids liability for damages, the seller cannot recover its legal expenses.

This *lesser-of* approach distorts sellers' incentives to defend against product liability suits

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[21] *E.g.*, Booker v. Sears Roebuck & Co., 785 P.2d 297, 303 (Okla. 1989).

[22] This doctrine is based on the notion that the burden of indemnification lies only on a *liable* manufacturer. By succeeding in its defense against the buyer (thereby establishing also the absence of manufacturer's liability), the seller eliminates the basis for indemnification. *See, e.g.*, Merck & Co., Inc. v. Knox Glass, Inc., 328 F.Supp. 374, 376 (E.D. Pa. 1971) (noting that "[i]ndemnity arises where one is legally required to pay an obligation for which another is primarily liable").

brought by buyers. The less-than-full indemnity induces sellers to act as less-than-perfect defense agents of manufacturers. Sellers may decline to assert a defense against buyers to avoid jeopardizing their indemnification rights.

3. *Reimbursement of fees under statute*

The third application of the hybrid approach involving attorney fees arises with respect to a plaintiff's right to recover attorney fees from a defendant. The general rule of American law is that each party must bear its own litigation costs. But exceptions to the rule are found in state and federal statutes that establish a right to recover litigation expenses from a defendant in a variety of causes of action (Conte, 1993). From an economic perspective, these statutes are intended to give individuals an added incentive to prosecute violations of the law, by reducing the expected cost of pursuing claims, and to persuade attorneys to represent indigent clients, by enhancing the prospects of getting paid for their services. Since most lawsuits involve a sure cost but confer only a chance of victory and recovery, these statutes and their incentive effects are well captured by the recovery-for-chance model, even though a plaintiff clearly does not undertake litigation for the benefit of a defendant.

To recover under most fee-shifting statutes, the plaintiff must first have prevailed in the underlying litigation.[23] The recovery is then measured using the "lodestar" approach. To calculate the lodestar, the court simply multiplies the number of hours the plaintiff's attorney worked on the successful portions of the case by a reasonable hourly rate. Importantly, this hourly rate is usually the rate the attorney would charge for non-contingent work. The court may then adjust the lodestar to take into account other factors such as the plaintiff's degree of success in the litigation. However, while the court may adjust the lodestar figure downward to account

[23] A party prevails where it recovers monetary damages from its opponent or where it vindicates significant non-monetary interests in the litigation. *See* Hensley v. Eckerhart, 461 U.S. 424, 433 (1983).

for poor results obtained in litigation, it may not adjust the figure upward to account for such factors as the risk involved in the litigation.[24]

This statutory approach to recovery resembles a *lesser-of* hybrid regime. The regime takes an element of the benefit-based approach by requiring that a party prevail in order to recover anything at all. However, the regime takes a distinct element of the cost-based approach by measuring recovery on the basis of the reasonable cost of services. Accordingly, where the value of the suit turns out to be high, the prevailing party may recover only the cost of the attorney's services. Where the value of the suit turns out to be low or nominal, however, the party recovers the *ex-post* assessment of the suit's value—nothing or a reduced cost-based figure. The statutory scheme provides less-than-optimal recovery: Whenever the probability of prevailing in the suit is less than 1, the party and her attorney will be under-compensated by this regime and may thus under-invest in litigation.

D. Recovery for Precautions

Another setting in which one party might invest to the benefit of another involves accident prevention. A party who takes actions aimed at preventing a harm that might be suffered by another, or for which another party might be liable, often has a claim to recovery, even in the absence of a contract with the other party, on the basis of restitutionary principles. Recovery may be measured by either the benefit conferred, or the reasonable cost of the precautions. If the precautions eliminated an imminent risk, the benefit to the party-at-risk (or the party who is liable for the risk) is readily apparent *ex-post*. Often, however, these precautions only reduce the risk and do not eliminate it, and thus situations arise in which precautions that are cost-justified *ex-ante* provide zero measurable benefit in hindsight. This might be the case if, even after the

[24] *See, e.g.*, City of Burlington v. Dague, 112 S. Ct. 2638 (1992).

precautions are taken, the harm—which due to the precautions has become less likely to occur—nevertheless occurs. Or, it might turn out that the harm—which, without the precautions, was more likely to occur—would nevertheless not have materialized. In either case, the *ex-post* benefit from the precautions is zero.

In some situations, where the investing party is a professional performing a service that is within her occupation, the law provides a pure cost-based recovery, equal to the service provider's standard contractual fee. For instance, a doctor who treats an unconscious accident victim may recover her costs, irrespective of the actual benefit to the patient, which could be either higher (if the risk was eliminated) or lower (if the precautions failed). In other situations the law provides a pure benefit-based recovery. For instance, a salvor who comes to the aid of a sinking ship may recover a portion of the value of the salvaged cargo and vessel, but only if the efforts prove successful; this recovery schedule mirrors the "no cure, no pay" condition commonly found in salvage contracts (Schoenbaum, 2001, §16-5).

Oftentimes, however, a *lesser-of* approach applies. One situation, which was identified by Saul Levmore (1994), involves an insured party who takes precautions to reduce loss for which she is insured. Whenever the precautions go beyond the preventive steps required under the insurance agreement and reduce the likelihood of the insured-against harm, the insured party is conferring a probabilistic benefit upon the insurer. If the precaution is determined *ex-post* to have been successful in fully eliminating the harm, the insured may be able—although this is still controversial—to recover from the insurer the costs of the precaution, even if the insurance contract does not contain a "sue-and-labor" clause requiring the insurer to cover these charges.[25] If, however, the reasonable precaution fails to eliminate the harm which eventually materializes

[25] *See* Leebov v. U.S. Fidelity & Guaranty Co., 165 A.2d 82 (Pa. 1960). But see Schlosser Co., Inc. v. Ins. Co. of North America, 600 A.2d, 836 (Md. 1992) for the opposite view.

(and which becomes part of the insured's claim), the insured is usually unable to recover the cost of the precaution, as this precaution cannot be proven to have benefited the insurer (Annotation, 1970). Unless there is a provision in the insurance contract covering the insured's prevention expenses, in which case recovery is independent of the success of the prevention effort, a quasi-contractual claim to recover costs would fail in the absence of an *ex-post* benefit. Thus, when the *ex-post* value of the precaution turns out to be high, the insured recovers only its costs—that is, less than the *ex-post* value. Otherwise, when the *ex-post* value of the precaution is zero, the insured recovers nothing. This "half-step" remedy, as Levmore calls it, or *lesser-of* approach as we call it, provides inefficiently low incentives to take precaution.

E. Repairs and Improvements by Co-tenants

Property law also governs several types of investments having probabilistic benefits, including repairs and improvements made on co-owned property. While repairs and improvements are not always easily distinguished, the courts tend to treat them quite differently, potentially creating a hybrid regime to govern these investments.

Consider first the rule governing *repairs*. In many jurisdictions, a co-tenant who *repairs* property without the consent of her co-tenants may recover a portion of the cost of those repairs from her non-contributing co-tenants in an action for partition or accounting (Dukeminier and Krier 1998, pp. 358-9). These jurisdictions apply a cost-based recovery approach; if repairs are reasonable, the investing tenant recovers the cost of the repairs (the portion commensurate with the other tenant's stake in the property) regardless of whether the repairs in fact benefit her fellow tenants. For example, a mining company was able to recover one-half of the cost of repairs to a railroad track it jointly owned with another company, even though the passive tenant used the rail far less than the investing tenant and thus derived relatively little benefit from it.[26]

By contrast, the tenant who *improves* property without the consent of her co-tenants may recover the increase in value of the property attributable to those improvements, but not their cost, in an action for partition, or, in some jurisdictions, in an accounting (Dukeminier and Krier 1998, p. 360). This rule resembles a pure benefit-based recovery regime; the investing tenant recovers the full benefit, if any, of the improvements she makes. For example, a co-tenant who invested roughly $1,000 in clearing and draining land to use as pasture and crop acreage was allowed to recover a portion of the enhancement value of such improvements, potentially totaling more than $29,000.[27] The improving co-tenant may not, however, recover her costs where the improvements do not increase the value of the property.

One type of distortion arises under the *improvements* doctrine when courts limit the investing party to recovering the *lesser-of* the improvement value or its cost (Stoebuck and Whitman, 2000, p. 208). According to this approach, when the improvement value is low, the investing tenant can recover no more than the value added, which might be less than her cost; and when the improvement value is high, the tenant can recover no more than her cost, which is less than the value added.[28]

A similar *lesser-of* approach is sometimes applied under the *repairs* doctrine as well. Some courts will allow a co-tenant to recover for making repairs only if, in hindsight, the repairs actually increased the value of the land.[29] For example, courts may find a repair to be

[26] Wagner Coal Co. v. Roth Coal Co., 267 S.W. 1096 (Ky. App. 1925) (noting that the investing tenant shipped five-times more coal on the rail than did the passive tenant).

[27] Buschmeyer v. Eikermann, 378 S.W.2d 468 (Mo. 1964).

[28] Madrid v. Spears, 250 F.2d 51, 54 (10th Cir. 1957).

[29] Clifton v. Clifton, 810 S.W.2d 51, 54 (Ark. Ct. App. 1991) (re-characterizing repairs as improvements and denying recovery on basis of evidence that joint tenant's expenditures had not enhanced value of the property);

unreasonable, and hence, not reimbursable, when the repair turns out not to affect the value of the property, even though *ex-ante* the repair seemed like a good idea. As one commentator noted, "the necessity of a repair has been determined in some instances by judging the results of the mending process rather than by the nature of the repairing act" (Note, 1957).

Even more interestingly, the lack of a clear practical distinction between acts that constitute "repairs" and acts that constitute "improvements" may permit an investing tenant to create a *greater-of* regime for expenditures lying on the interface between the two categories of investments. When courts cannot easily distinguish repairs and improvements (or simply refuse to do so) a plaintiff is effectively accorded the power to choose the higher of the two measures of recovery, cost or benefit. If the benefit is low, the tenant would sue to recover her costs under the repairs doctrine; and if the benefit is high, the tenant would sue to recover the benefit under the improvements doctrine.

It is easy to imagine how such a hybrid approach might arise in practice. Courts struggle to classify some investments as either "improvements" or "repairs" across many areas of property law, oftentimes using the two terms interchangeably despite the differing legal treatment accorded each. Indeed, in a variety of cases, courts have (wittingly or unwittingly) allowed the parties to manipulate the distinction between repair and improvement to their advantage.[30] Given the lack of a clear distinction between the two types of investment and the incentive of some parties to muddle them, the hybrid regime may emerge in borderline cases.

Womach v. Sandygren, 180 P. 922, 924 (Wash. 1919) (disallowing recovery for repairs where investing tenant failed to show that the repairs enhanced the value of the property).

[30] *Compare* Gilpin v. Brooks, 115 N.E. 421 (Mass. 1917) (holding that, although mortgagee is not allowed to make permanent improvements on the property, he may finish a building if necessary to preserve its value, and the work will be found to be repairs), *with* Warwik v. Harvey, 148 A. 592 (Md. 1930) (holding that a similar completion of a building is an improvement in the context of the mistaken improver doctrine).

F. Mistaken Improvements

A related doctrine concerns recovery for *mistaken* improvement of real property. An investor might improve property she does not own when she unknowingly holds land under an invalid title, mistakes the nature of her interest, or mistakes the location of her land. When the mistake is exposed, an interesting question arises as to whether and how much the improver may recover from the true owner of the land for the improvements.

In most jurisdictions, the mistaken improver who meets certain criteria, such as acting in good faith and under the color of title, may recover from the true owner of the property (Dickinson, 1985). Recovery, however, is capped so as not to exceed the lesser of the *cost* of the investment or its value. For example, under the Restatement of Restitution (§42), the improver may recover "to the extent that the land has been increased in value by [the] improvements, or for the value of the labor and materials employed in making such improvements, *whichever is least*." Furthermore, many states have enacted betterment acts that accomplish the same result by allowing the true owner to elect the remedy for the improver.

The mistaken improver doctrine takes a *lesser-of* approach to recovery. *Ex-post,* when the improvement turns out to be valuable, the improver recovers only her costs, but when the improvement turns out to be of little or no value, the improver recovers only that nominal sum. The *lesser-of* approach could potentially distort *ex-ante* incentives. By reducing the recovery from that which the parties would have agreed upon had they contracted (namely, a recovery equal to either the cost of the investment or a portion of the benefit it creates), the Restatement's scheme dilutes incentives to invest and induces excessive caution prior to the unilateral investment in improvements.

III. WHY ARE HYBRID APPROACHES USED IN PRACTICE?

The analysis thus far has demonstrated that hybrid regimes distort incentives to invest; nonetheless, they underlie a wide variety of substantive legal doctrines. This Section explores more systematically why such regimes are used in practice. Does the broad existence of these regimes manifest the confusion of courts in distinguishing between *ex-post* (benefit-based) and *ex-ante* (cost-based) conceptions of value, or can they be justified from either an economic or alternative perspective?

In general, hybrid regimes are created in two ways. Some hybrid regimes are created intentionally by courts or legislatures in order to adjust recovery and thus serve purposes that are often unrelated to investment incentives. Part A explores such purposes and whether the hybrid recovery structure is capable of furthering them. Other hybrid regimes are created inadvertently. Parts B and C describe how problems of drawing boundaries between similar causes of action and problems of information transform what were designed as pure recovery regimes into inadvertent hybrid regimes.

A. Deliberate Adjustment of the Recovery

Courts and legislatures occasionally employ hybrid recovery schemes deliberately, to adjust the expected recovery for the investing party and thus serve other instrumental goals unrelated to investment incentives. This Section considers a variety of such goals.

1. *Provide Incentives to Contract or to Avoid Unsolicited Investment*

One goal a downward adjustment might serve is to give investors incentives to contract with beneficiaries or to avoid unsolicited investment. For example, a *lesser-of* regime, by reducing an investor's expected recovery, may give her incentives to verify title to her land before making an improvement.

While providing such incentives may be desirable policy, use of the *lesser-of* hybrid regime is a misguided way to implement it, in several respects. First, if the policy is intended to induce the investing party to contract with the beneficiary rather than make a unilateral investment, or to take more care before making a mistaken improvement, better incentives might arise if *no recovery* were allowed. Indeed, the doctrines that create restitution liability already incorporate a fault standard: the right to recover is itself conditional on the investor either taking sufficient care or not having reasonable opportunities to contract. For example, a mistaken improver must show that she acted in good faith and under color of title before making her improvements. Such conditions for the *incidence* of liability provide investors with adequate incentives to take care and to contract, rendering unnecessary additional tinkering with the *magnitude* of liability. Thus, in those cases where the investor has satisfied the "due care" requirements like the ones embodied in the mistaken improver doctrine, it is unclear what instrumental purpose, if any, a reduction of the damages award serves.

2. *Protect "Innocent" Parties*

Another stated purpose for the *lesser-of* approach is to protect "innocent" parties from burdensome liability. For example, the Restatement of Restitution asserts that forcing an "innocent" owner to pay the full value of improvements mistakenly placed on her land is harsh. An innocent beneficiary of an illiquid benefit should not be forced to liquidate her property to be able to pay for the improvements, proponents of the *lesser-of* approach assert.[31] Thus, the owner should not have to pay for the full enhancement value. Further, even if the owner could afford to pay, it seems unfair, from an *ex-post* perspective, to require an owner who received no enhancement value to compensate a mistaken investor for the costs of the failed improvement

[31] REST. RESTITUTION § 42 cmt a (acknowledging that, while the rule is "harsh to the one making the improvements by mistake . . . in many cases it would be still more harsh to require the one receiving the benefits to pay therefor").

effort. The *lesser-of* regime seems to perfectly serve this dual protective goal.

Upon careful examination, however, the *lesser-of* rule of the Restatement is more difficult to justify. In the absence of any apparent wrongdoing, it is unclear why fairness necessarily favors one innocent party over another, that is, why the owner, but not the equally "innocent" and potentially cash-strapped mistaken improver, should be protected. More fundamentally, even if some sort of reduction in liability is desirable, to protect the "autonomy" of the owner who did not solicit the improvement, the reduction achieved through the *lesser-of* regime is still ill-suited to this purpose. As the economic analysis in Section I demonstrated, the *lesser-of* regime achieves a reduction in liability equal to the option value embodied in election between the cost-based and the benefit-based values. The magnitude of this reduction depends primarily on the *variance*, or the riskiness of the investment, a factor that is independent of the reasons this reduction was deemed desirable in the first place. Thus, when the investment yields a certain—instead of a probabilistic—benefit, there is no reduction in liability although the same hardships confront the innocent landowner. Recognizing the probabilistic nature of the benefit demonstrates, therefore, that the reduction in liability attained by the *lesser-of* rule is arbitrary: it is not tailored to serve the goal motivating the reduction.

Another area in which the *lesser-of* reduction of liability is intended to ease the compensatory burden placed on the beneficiary involves recovery for breach of a contingency fee agreement. Here, courts applying the *lesser-of* approach intend to give the client greater freedom to dissolve the relationship with his current attorney and enter into a better match with a different attorney. The pure cost-based regime, according to some courts, is unfair to poor clients who cannot afford to pay the attorney's fees unless the client recovers in the suit. At the same time, the pure benefit-based regime, according to these courts, would place an undue burden on the client's right to dismiss her attorney, because the client might end up having to pay two attorneys a full contingency fee.[32] It is less often recognized, however, that while the reduced recovery accords greater freedom to the client, the added risk it places on the attorney might diminish the attorney's willingness to take on the client's case on a contingency basis (recall that billable-hours contracts are governed by different rules), or cause the attorney to raise her rates to absorb the risk, both to the client's detriment.

3. *Deter wrongdoing*

Finally, a hybrid approach may also be deliberately tailored to serve deterrent concerns. For example, fiduciary and agency doctrines entitle a principal to a *greater-of* recovery against a fiduciary or an agent who violates her duties to the principal. If the agent receives a large benefit by violating her duty of loyalty (say, if the agent expropriates funds and invests them in her own account successfully), the principal is entitled to recover the entire *ex-post* benefit. And if the agent receives little or no benefit from the violation (say, if the agent's investment failed), the principal can alternatively recover damages equal to the value taken from the principal's account (Restatement 2d of Agency §407).

This *greater-of* rule can be rationalized on the basis of deterrence theory. Since many violations of fiduciary and agency relationships go undetected, the risk of over-recovery, which normally arises under the *greater-of* regime, is not much of a factor. By applying the greater of the *ex-post* and the *ex-ante* recovery values, an increase in deterrence is achieved, countering some of the effect of imperfect detection. That is, while the expected recovery under the hybrid rule exceeds the expected value of the funds that were taken, this premium hardly measures up to the "discount" enjoyed by the wrongdoer who goes undetected.

[32] *E.g.*, *Fracasse*, 494 P.2d at 12-14.

B. Overlap of Pure Regimes

The hybrid approaches are not always adopted deliberately. A hybrid regime might also arise accidentally, where two different "pure" recovery regimes overlap. When a particular investment can lead to recovery under two different causes of action, one employing a pure cost-based recovery approach and the other employing a pure benefit-based recovery approach, a hybrid regime might *de facto* govern this investment, for two reasons. First, courts may openly defer to the investing party to elect which of the two causes of action to apply to her investment; not surprisingly, she will elect the one that gives her the greater measure of recovery. This was shown to be the case, for example, in the choice of remedies regime governing total breach of a partially performed contract.

More interestingly, courts may not be able to prevent a party from opportunistically pursuing one cause of action over another, as when the boundaries between two related causes of action are imprecise. For example, the co-tenant repairs and improvements doctrines overlap in some cases where an investment can be categorized as both a repair and an improvement. The use of a cost-based approach in recovery for repairs and a benefit-based approach in recovery for improvements may become a hybrid *greater-of* approach if the investing party can elect which of the two doctrines to apply. To the extent that courts cannot draw a bright line between what constitutes a repair versus an improvement, the investing party can effectively elect the greater of the two pure recovery measures. Likewise, a problem of imprecise boundaries exists within the implied contracts doctrine. To the extent that courts cannot draw a bright line between the grounds for implied-in-fact and implied-in-law claims—and, at least in the context of precontractual investment, such a line is difficult to draw—the investing party can claim the greater recovery measure.

Note that in the repair/improvement case, and to some extent in the implied contracts case as well, courts do not openly permit the investing party to characterize her investment so as to secure the higher recovery measure. In fact, if courts were aware of the problem, they might be driven to draw more precise boundaries between existing amorphous causes of action. Unfortunately, the type of sorting of claims that creates these *greater-of* regimes occurs "pre-trial", distant from the judge's scrutiny, when potential plaintiffs privately design their pleading strategies. In the usual case, a plaintiff pleads only one cause of action, either a pure *ex-post* or a pure *ex-ante* recovery claim. It is only across cases that a *greater-of* pattern emerges.

C. Information Problems

Finally, and perhaps most interestingly, hybrid approaches might also emerge inadvertently when courts lack the information necessary to apply a "pure" regime consistently across a class of cases. In order to apply a pure benefit-based regime, courts must be able to verify the actual benefit received. In order to apply a pure cost-based regime, courts do not need to know the actual benefit, but they do need to know the cost of the investment and the *ex-ante* distribution of benefits associated with the investment (to guarantee that the cost is reimbursed only if it was reasonable). The discussion below demonstrates that when some of this information is not readily verifiable in court, pure recovery regimes might be transformed into hybrid regimes. Formally, the doctrine employs a pure approach to measuring recovery; in practice, given information problems, it operates like a hybrid.

1. *Information Regarding the Distribution of Benefits*

To apply a cost-based recovery regime, courts need to calculate the *ex-ante* distribution of benefits. In contrast to the benefit-based regime, in which courts need only measure the actual realization of the benefit, under the cost-based regime courts need to assess whether the investment was reasonable in light of its projected benefits. In order to do that, courts have to consider the range of possible benefits that were associated with the investment and their associated likelihoods. That is, courts need to be able to measure not only the actual benefit that materialized, but also hypothetical (or counter-factual) ones. When the difficulty in estimating the prior distribution of benefits is accounted for, a pure cost-based recovery regime can be transformed inadvertently into a *lesser-of* regime.

One of the factors that could—and we believe, in fact does—interfere with a court's ability to accurately assess the distribution of benefits at the time when the costly action was taken is the hindsight bias. When a court knows the *ex-post* value of an investment, but does not have enough information to determine its *ex-ante* expected value, it may draw an inference about expected value from the value that was realized. If the actual benefit from the investment turns out to be high, it is likely to appear cost-justified, and recovery of the cost would be allowed. If, instead, the actual benefit from the investment turns out to be low or zero, the investment as a whole might seem unreasonable, and recovery of the cost would be denied. Under these conditions, a cost-based recovery regime, in which the investing party recovers her costs only if they are reasonable, may turn into a *lesser-of* regime.[33]

This hindsight bias can explain the emergence of the *lesser-of* regime in several of the areas surveyed in Section II. For example, it can explain the *lesser-of* rule that sometimes governs restitution for repairs made by co-tenants and the quasi-contractual recovery for precautions. Some courts, when evaluating the reasonableness of certain repairs, condition the right to recover repair costs on whether the repairs appear, in hindsight, to be justified. Thus, the mere fact that the repairs did not add value *ex-post* is used to justify a conclusion that they were

[33] Another possibility is that a court might mistakenly award recovery for an investment that was "unreasonable" *ex-ante*, because, by chance, it proved valuable *ex-post*.

not reasonable *ex-ante* and thereby to deny recovery of their costs.[34] Courts fail to see, in this context, that even repairs that "failed" to generate value could have been reasonable when made. Similarly, in assessing the desirability of precautions taken by an insured, courts already know whether the precautions succeeded in preventing or reducing the loss, and are susceptible to a well-documented hindsight bias (Rachlinsky, 1998). One of the effects of this bias is that when a precaution fails to reduce the loss, courts draw an inference that it was not cost-justified in the first place and refuse to award even the *ex-ante* measure of recovery. Another potential effect of this bias might occur when, in hindsight, it is clear that the loss was avoided independently of the precaution, which again might lead courts to wrongly conclude the that the precaution was unjustified *ex-ante* and deny the recovery of its cost.

This "hindsight" problem is also illustrated in the debate over the plaintiff attorneys' fees stemming from the tobacco settlement. Either an hourly fee that is not contingent or a contingency fee that is not truncated could adequately compensate the attorneys representing the states. However, conditioning the recovery on success and then limiting it to the (guaranteed) hourly fee creates a *lesser-of* regime. The rhetoric utilized by advocates of this regime suggests that they fail to consider the substantial *ex-ante* likelihood that the contingency fee attorneys could have received no recovery at all.

In theory, courts can avoid or mitigate the problems created by gaps in information by adopting the "pure" regime for which the best information is available. If it is consistently difficult for courts to assess the *ex-ante* value of any given type of investment, the courts could instead apply an *ex-post* approach to govern those investments, assuming, of course, that information about the actual benefit is relatively more obtainable.

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[34] *See, e.g.*, Clifton v. Clifton, 810 S.W.2d 51, 54 (Ark. 1991) (no recovery of cost of repair when it added no value to the property).

2. *Verifiability of the Actual Benefit*

A different type of information problem might arise if courts cannot easily verify the actual benefit. Because it is the defendant/beneficiary who usually possesses the best information regarding the benefit enjoyed, the defendant might manipulate the type of information he reveals to the court. Recognizing the plaintiff's difficulty in proving the magnitude of the benefit she conferred upon the defendant, courts might allow a plaintiff who cannot prove the magnitude of the benefit to at least recover her costs, whenever these costs appear reasonable. Namely, in asymmetric information environments, courts might be willing to award recovery based on the full *ex-post* benefit enjoyed by the defendant whenever reliable information about the actual benefit is provided, but award only some *ex-ante* measure (either cost or expected benefit) otherwise. This adjudication regime quickly transforms into a *lesser-of* regime if the defendant can selectively disclose information. The defendant would hide information about his actual benefit whenever this benefit is high, thereby limiting the plaintiff to the more moderate cost-based measure of recovery. And conversely, the defendant would reveal information about his actual benefit whenever this benefit is low, to limit the magnitude of the plaintiff's recovery to the (low) actual benefit. To the extent that discovery procedures enable the defendant to manipulate information in this way, the plaintiff is effectively governed by a *lesser-of* regime.

The limited ability of courts to verify actual benefits might also translate into a *greater-of* regime, when it is the plaintiff who can manipulate the information provided to the court. One way the plaintiff can control the informational-basis of the recovery is by affecting the *timing* of the suit. A plaintiff who, on the basis of private information, knows that the *ex-post* benefit will be low, can time her suit prior to the verifiable realization of the benefit, expecting the court, which cannot verify the actual benefit, to employ instead a cost-based recovery measure.

Conversely, a plaintiff who knows that the *ex-post* benefit will be high can await the verifiable realization of the benefit and recover the full *ex-post* value.

3. *Information about the Cost of the Investment*

Another type of information problem arises when courts cannot verify the cost of the investment. Because of the stochastic nature of the benefit, any given observable *ex-post* realization of benefit can be associated with any number of different costs of investment. This problem might be particularly acute in the context of pre-accident precautions taken by an insured party. As many of the precaution measures that the insured can take are both non-verifiable in court and non-observable to the insurer, it is less puzzling why the parties to the insurance arrangement do not contract over them and why the courts cannot apply the pure cost-based recovery rule to them. Courts must look to the verifiable benefit to ascertain, not only whether the precaution was desirable, but also whether the alleged precaution was ever taken. Thus, when the realization of the benefit is high, the inference that some unobservable precaution had been taken is more plausible than when the benefit is low. When a ship sinks, courts are less likely to believe that the insured ship-owner took the necessary, yet subsequently futile, precautions. A cost-based recovery regime might, in the presence of this Bayesian inference strategy, transform into a *lesser-of* regime.

However, the *lesser-of* regime applied in practice to precautions taken by insured parties cannot be fully explained as a by-product of this information problem. If the non-verifiability of the precaution investments were the reason for the transformation of a cost-based rule into a *lesser-of* rule, one would expect that in cases where precautions are observable and verifiable a pure cost-based regime would survive. This, however, is not the case. While many *pre-accident* precautions are indeed non-verifiable, most *post-accident* harm-reducing mitigation actions taken by the insured—which are another category of precautions—are more easily observable and verifiable, and yet are subject to the same *lesser-of* rule. For example, the actions taken by a ship's crew to avoid maritime hazards prior to an accident (e.g., safer routes, maintenance of machinery) might be non-verifiable, whereas actions taken by the crew to reduce the harm after an accident (e.g., raise a sinking vessel) are more readily verifiable. Case law, however, can hardly be partitioned according to this verifiability property of precautions; the adherence to the *lesser-of* rule and the denial of recovery for failed precautions are more robust than this conjecture would imply.

CONCLUSION

This article has identified a distortion in the structure of legal rules that deal with chance. Although the type of uncertainty examined here—uncertainty over the value of the investment—is (usually) resolved by the time the law steps in to determine the recovery, the confusion between the *ex-ante* (cost-based) and the *ex-post* (benefit-based) measures of value leads to hybrid recovery practices with their associated distortions. By identifying the generality of the problem—potentially arising any time the net external benefit of an investment is probabilistic—the analysis can be applied to any situation that exhibits this structure. The article explored some half-dozen applications of the hybrid approaches, all from seemingly unrelated areas of law, but all sharing the same analytical structure. The list is, of course, far from exhaustive. Accordingly, the usefulness of the analysis would prove greater to the extent that the trans-substantive tool offered here is found applicable within other areas of the law as well.

One possible application of the analysis is extending it to the case of probabilistic costs, rather than benefits. Some investments, say, in improving property have fairly certain benefits but involve random costs (e.g., excavating land). Here, too, in the absence of a contract the investing party may be subject to a hybrid recovery regime. For example, the law of special assessment, which taxes property owners for improvements made by the city near their property, allows the city to recover at most its costs, not to exceed the enhancement value of the affected properties.[35] According to the analysis in this paper, this *lesser-of* regime diminishes the city's incentives to make socially valuable improvements.

The analysis in this paper can be read "narrowly", as a remark on the benefit principle within the law of quasi-contract. Under this principle, the liable party has to pay only when an actual benefit is conferred upon him. The analysis in this paper provides an argument for expanding the definition of benefit to include, not only actual benefits, but also potential yet unrealized benefits. Receiving a *chance* for enrichment is valuable to the beneficiary in similar fashion that receiving a lottery ticket is beneficial. Recovery, though, has to be consistent across realizations. If the beneficiary pays only for the *ex-ante* value of the chance when the chance materializes *ex-post* into a substantial benefit, he should also pay for the value of the chance when a benefit does *not* materialize *ex-post*.

Lastly, this paper can be read more broadly, as a comment on the appropriate interface between cost-based and benefit-based liability in private law. Costly actions that are identical from an *ex-ante*, cost-based perspective, can appear dissimilar *ex-post*, once the stochastic benefit from them materializes. This appearance can lead—and as we showed, it has often led—courts to apply an inconsistent treatment of the right to recovery, bouncing in an arbitrary fashion between cost-based and benefit-based liability. While the paper does not take a position concerning the choice between the two pure methods of measuring liability, it highlights the distortion that an inconsistent choice creates.

[35] *E.g.*, McNally v. Teaneck, 379 A.2d 446 (N.J. 1977).

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