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## Reflections on Fuller and Perdue's *The Reliance Interest in Contract Damages*: A Positive Economic Framework

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**REFLECTIONS ON FULLER AND  
PERDUE'S *THE RELIANCE  
INTEREST IN CONTRACT  
DAMAGES: A POSITIVE ECONOMIC  
FRAMEWORK***

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Avery Katz\*

Fuller and Perdue's classic article, *The Reliance Interest in Contract Damages*,<sup>1</sup> is regarded by many contemporary contracts scholars as the single most influential law review article in the field. For those of us who teach and think about contracts from the perspective of law and economics,<sup>2</sup> the consensus would probably be close to unanimous. The article displays an approach highly congenial to an economic perspective. The connection goes beyond Fuller and Perdue's explicitly functional approach to law (which law and economics shares with other schools of thought descended from the legal realists) and beyond Fuller and Perdue's focus on commercial policy. Fuller and Perdue's analysis of the relationships among the various damage interests they identify, and of the social purposes served by their protection, reveals a sophisticated understanding of the role and limits of economic incentives in influencing the behavior of contractual parties.

Fuller and Perdue's article made two major related claims. The first claim was primarily descriptive or positive: that common-law courts deciding contracts cases had actually been attempting to protect people's reliance expenditures, notwithstanding the fact that the doctrinal focus of the cases was often elsewhere, or that courts often claimed to be protecting people's expectations. The second claim was primarily normative: that the reliance interest, rather than the expectation interest, was the appropriate object of judicial protection.

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1. Fuller & Perdue, *The Reliance Interest in Contract Damages* (pts. 1 & 2), 46 *YALE L.J.* 52, 373 (1936).

2. I will use the term "law and economics" to designate the school of thought, such that it is, that emphasizes the application of economic techniques and perspectives to the study of law. In the spirit of the modeling approach to social science, I will assume for the purposes of argument that such a categorization is useful.

It is the first claim on which this Article focuses. How was it possible for Fuller and Perdue to argue that the courts had really been protecting a different interest than everyone believed? The key to their explanation was a phenomenon they labeled as the divergence between measure and motive.<sup>3</sup> Because of the economic relationship connecting the reliance interest to the other two theories of damages they identified, it was possible for courts to use a nonreliance theory as a measure or approximation of damages, while having as their real motive the protection of reliance.

This Article will generalize the reasoning underlying this claim, and in so doing will outline a theoretical framework connecting all of the damage measures Fuller and Perdue discussed. The framework makes explicit the economic relationships among reliance, restitution, and expectation that Fuller and Perdue discussed more intuitively. It also reveals that Fuller and Perdue's analysis suggests a fourth theory of damages they did not recognize.

The relationship among the four damage principles means that any one of the four damage theories can be used, under the appropriate circumstances, as an approximate measure for the others. Thus, measure and motive can be uncoupled entirely. Whether the reliance interest is the most important or fundamental of the four interests is therefore a separate matter which I briefly discuss in the concluding section below. To the extent that the full logic of Fuller and Perdue's descriptive claim is accepted, though, their argument for the primacy of reliance may be subverted by future scholars using arguments similar to their own.

## I. CLASSIFYING DAMAGE MEASURES: THE MISSING REMEDY

The three principles of contract damages that Fuller and Perdue identified are familiar to all modern lawyers. Their definitions appear in the Second Restatement of Contracts as an introduction to the topic of damages.<sup>4</sup> They are: (1) the expectation principle, which holds that damages following breach of contract should make the plaintiff as well off as he

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3. Fuller & Perdue, *supra* note 1, at 66.

4. RESTATEMENT (SECOND) OF CONTRACTS § 344 (1981): "Purposes of remedies. Judicial remedies under the rules stated in [the Restatement of Contracts] serve to protect one or more of the following interests of a promisee: (a) his 'expectation interest,' . . . (b) his 'reliance interest,' . . . or (c) his 'restitution interest' . . . ."

would have been had the defendant performed her promise;<sup>5</sup> (2) the reliance principle, which holds that damages for breach should make the plaintiff as well off as he would have been had the promisor never made her promise; and (3) the restitution principle, which holds that damages for breach should require the defendant to return any benefit conferred on her by the plaintiff as a result of the promise. Fuller and Perdue's main thesis was that the reliance principle was central, notwithstanding appearances to the contrary.

The expectation principle was doctrinally dominant at the time Fuller and Perdue wrote and is still so today, especially for promises made in the course of commercial bargains.<sup>6</sup> For the category of donative or non-bargain promises, however, the reliance principle had gained substantial influence even by 1936 and is today predominant, due in no small part to the influence of the Fuller and Perdue analysis.<sup>7</sup> The reliance principle is also commonly used today for promises made in the course of precontractual negotiation.<sup>8</sup> Continuing (at some peril) to generalize about prevailing doctrine, the restitution theory is applied chiefly in cases involving failed bargains, or where the plaintiff's contractual claims are vitiated by lack of some element of mutual assent or proof thereof. A typical example would be an oral bargain covered by the Statute of Frauds. In many circumstances, however, a promisee entitled to expectation may be permitted to elect the restitution remedy instead, and recover "off the contract."<sup>9</sup>

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5. Throughout the essay, I adopt the convention of referring to plaintiffs as male and defendants as female.

6. For transactions covered by the Uniform Commercial Code, for instance, U.C.C. § 1-106(1) (1987) provides that "[t]he remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party had fully performed." *Cf.* U.C.C. § 1-103 (1987) (stating that principles of law and equity supplement the UCC unless displaced by particular provisions); § 2-719 (dealing with contractual modification or limitation of remedies).

7. Compare the changes in formulation of § 90 made between the First and Second *Restatements of Contracts*. The competition between the reliance and expectation principles as applied to donative promises in the 1930's is nicely illustrated by Williston's famous colloquy with the American Law Institute on the hypothetical case of Johnny and his uncle, reprinted in many contracts casebooks and discussed by Fuller & Perdue, *supra* note 1, at 64 n.14.

8. *See, e.g.,* Goodman v. Dicker, 169 F.2d 684 (D.C. Cir. 1948); Drennan v. Star Paving, 51 Cal. 2d 409, 333 P.2d 757 (1958); Hoffman v. Red Owl Stores, 26 Wis. 2d 683, 133 N.W.2d 267 (1965). For a general discussion of liability for promises made during the course of precontractual negotiation, see Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987).

9. *See, e.g.,* United States v. Algernon Blair, Inc., 479 F.2d 638 (4th Cir. 1973).

Let us develop a theoretical framework to help organize and generalize the three principles. Specifically, it is possible to classify theories of damages along two dimensions. First, one can distinguish between promisee-based and promisor-based theories of recovery. Both expectation and reliance are promisee-based in that both theories of recovery are based upon the assumption that the object of contract damages is to place the disappointed promisee at some appropriate level of welfare. I would argue that restitution is primarily promisor-based, and that it seeks to put the misbehaving promisor at some appropriate level of welfare. Fuller and Perdue cloud the issue somewhat, claiming the essence of restitution lies in a nexus between the positions of the parties:

[W]hat we have called the *restitution interest* unites two elements: (1) reliance by the promisee, (2) a resultant gain to the promisor. It may for some purposes be necessary to separate these elements. . . . Generally, however, in the cases we shall be discussing, gain by the promisor will be accompanied by a corresponding and, so far as its legal measurement is concerned, identical loss to the promisee, so that for our purposes the most workable classification is one which presupposes in the restitution interest a correlation of promisor's gain and promisee's loss.<sup>10</sup>

Though restitution and reliance overlap substantially in practice, conflating the two concepts suited Fuller and Perdue's object of explaining the law of damages with the reliance principle alone. Separating the two elements, however, will help us to generalize the Fuller and Perdue framework. In any event, the claim that courts are using a promisor-based theory when they use the word "restitution" is less important to my argument than is the claim that a focus on the promisor is the distinguishing feature of the restitution principle.

The second distinction I stress is between backward-looking and forward-looking theories of recovery. Backward-looking theories find the criterion of distributional justice at some point in the past, before the liability-creating event; forward-looking theories attempt to achieve a state of affairs that may never have existed before but that is now regarded as just, given the occurrence of the liability-creating event. Reliance is backward-look-

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10. Fuller & Perdue, *supra* note 1, at 54-55 (emphasis in original).

ing in that it seeks to return the promisee to the status quo before the promise was made, and expectation is forward-looking.<sup>11</sup>

Into which of these two classes the restitution interest falls is not immediately obvious. The ordinary-language meaning of the word and its Latin root both suggest an act of restoring to some previous condition, for whatever that is worth as a guide to legal usage. If forced to choose, I would assert without proof that most legal discussions of restitution articulate the concept in primarily backward-looking terms; the reader is invited to consult his or her own experience in this regard. Fuller and Perdue, who focus on unjust enrichment as the touchstone of restitution, clearly regard restitution as backward-looking; this is not surprising given the close connection they draw between restitution and reliance.

However one classifies the restitution interest in this taxonomy, the obvious conclusion is that there should be four theories of recovery, not just three. Each of the four theories corresponds to a choice from both the time-based and party-based classifications. Figure 1 illustrates the point. If one regards restitution as a backward-looking theory, there is no forward-looking promisor-based theory in the Fuller and Perdue scheme. Alternatively, the restitution concept can be fruitfully clarified by dividing it into backward-looking and forward-looking versions. One might facetiously call this omission the Case of the Missing Remedy.

**Figure 1**

	Promisee- based	Promisor- based
Backward- looking	Reliance	Restitution
Forward- looking	Expectation	?

11. In Fuller & Perdue's language:

In passing from compensation for change of position to compensation for loss of expectancy we pass, to use Aristotle's terms again, from the realm of corrective justice to that of distributive justice. The law no longer seeks merely to heal a disturbed status quo, but to bring into being a new situation.

Fuller & Perdue, *supra* note 1, at 56.

Admittedly, anyone who proposes a new system of classification should be prepared to demonstrate that the system is actually useful and interesting, and not just another arbitrary scheme of description. I think the taxonomy of Figure 1 is interesting because it is the one we have actually been using since Fuller and Perdue wrote their article, and perhaps before. Indeed, the distinction between expectation and reliance is probably the clearest example of the distinction between forward- and backward-looking justifications. The distinction between defendant- and plaintiff-based theories may be more familiar to modern lawyers in the context of tort law, where it tracks the distinction between deterrence and compensation, but as Fuller and Perdue admit,<sup>12</sup> it is the essence of restitution. The fact that Fuller and Perdue set up the two distinctions and yet did not notice the asymmetry caused by the lack of the fourth interest is itself enlightening. One possible explanation of the omission is that the missing remedy is itself evidence of the reliance theory's primacy, like the dog that did not bark, and that Fuller and Perdue intended that to be the case. In the schematic of Figure 1, both expectation and restitution are adjacent to the core concept of reliance, and each shares with reliance a critical feature. Although expectation is forward-looking, its focus on the promisee makes it an adequate proxy for reliance under the right circumstances; similarly, restitution's backward-looking approach often makes it an adequate substitute for reliance despite its focus on the promisor. But a forward-looking promisor-based theory would lack either connection with reliance and hence would lack justification.

Actually, the missing remedy has received, and on occasion continues to receive, consideration by some courts. One such prominent case is *Peevyhouse v. Garland Coal and Mining Co.*<sup>13</sup> In *Peevyhouse*, the defendant promised to restore plaintiffs' land to its original condition following strip-mining. Performing the promise would have cost the defendant \$29,000 and would have nominally increased the market value of the land. The court overturned a jury verdict of \$5000<sup>14</sup> and limited recovery to the difference in market value, rejecting the plaintiffs' claim to the cost of performance. The *Peevyhouse* case represents the majority rule. A minority case involving similar facts, *Groves v.*

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12. Fuller & Perdue, *supra* note 1, at 55.

13. 382 P.2d 109 (Okla. 1962).

14. *Id.* at 114. The composition of the damages was not specified in the opinion, and the award exceeded the potential market value of the land had the defendant performed.

*John Wunder Co.*,<sup>15</sup> which awarded the promisor's cost of performance of \$60,000 although the market value of the land was only \$12,000, has been widely criticized. Yet, in both cases, the plaintiffs' subjective valuation of the promise may well have exceeded the supposedly objective measure provided by market value.

It is worth noting at this point that courts and commentators might well (and sometimes do) conflate the standard expectation theory with its missing promisor-based version, just as Fuller and Perdue conflate reliance and restitution. The reason that *Peevyhouse* is widely cited and taught is because it is not always clear whether a promisee's expectation is restricted to his own gains from performance or whether he has an interest in having the promisor do what she promised. In the land-restoration cases, the courts have tended to reject the latter interest under the specter of imminent and substantial economic waste. In other cases, notably those awarding the equitable remedy of specific performance, the rhetoric of promisor-based justifications is more common.

Let me denote the missing remedy, that imposed in *Groves v. Wunder*, as "liquidated specific performance" (LSP): liquidated because it takes the form of money, and specific performance because, like specific performance it puts the promisor at the welfare level she would have enjoyed had she performed.<sup>16</sup> At least in this last sense, LSP is not punitive, notwithstanding dicta of the *Peevyhouse* court and of some commentators. Explicit recognition of LSP and of the framework of Figure 1 helps us to generalize the insights of Fuller and Perdue and to relate those insights to those of the law and economics literature.

## II. ACCOUNTING RELATIONSHIPS LINKING THE FOUR DAMAGE THEORIES

The major theoretical significance of Fuller and Perdue's article was that it clarified the relationship between the reliance principle and its competitors in a way that made the reliance principle fundamental yet still explained the expectation interest's doctrinal predominance. Fuller and Perdue's explanation,

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15. 205 Minn. 163, 286 N.W. 235 (1939).

16. Admittedly, the LSP term could be applied to the lower left-hand cell of Figure 1 with equal logic, but because the expectation term is so entrenched in that usage, I see little risk of confusion in my terminology. Another possibility would be *promisor's expectation*.



interestingly enough, depends on simple accounting identities and tracks closely the distinction between accounting and economic profit found in all economics principles textbooks.

An accounting identity is an arithmetic equation that identifies two alternative methods for dividing up a sum into its parts. To take an example from national income accounting, gross national product can be thought of either as the sum of different types of expenditures (i.e., consumption, gross investment, government spending, and net imports) or as the sum of different types of payments to factors of production (i.e., wages, interest, rent, and profits). This is because each dollar's worth of trade in the economy can be accounted for either from the point of view of the person spending the dollar or from the point of view of the person receiving the dollar. Although accounting identities are tautologies, their practical significance is that each method of calculation serves as an independent check on errors made using the other. For example, if one wanted to verify one's direct measurement of gross investment, one could add up wages, rent, interest, and profits, and then subtract the total of consumption, government spending, and net imports. Indeed, a look at the statistical tables published yearly by the Department of Commerce's Bureau of Economic Analysis will reveal a category denoted "Statistical Discrepancy." This figure, the value of which was reported in 1986 at \$5.4 billion (or 0.15% of total GNP), reflects the extent to which the alternative methods of adding up national income cannot be reconciled.<sup>17</sup>

A simple accounting of the gains and losses from an individual contract similarly reveals a number of accounting identities relating the four damage principles. Let me introduce some simple notation. We can divide amounts of value based on whether they are paid out or received by each of the parties. I will denote amounts spent by either party by the letter C, for cost, and amounts received by either party by the letter V, for value. Also, let the letters p and d in subscript denote amounts spent or received by the promisee (the mnemonic is plaintiff) and the promisor (defendant), respectively. For example, C<sub>p</sub> stands for the total amount spent by the promisee-plaintiff.

Let us also classify payments based on the point of time when they were or are to be made, with the dividing line being the

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17. See, e.g., ECONOMIC REPORT OF THE PRESIDENT 258 (1988). I am told informally that a large preliminary figure for this category provides the occasion for consternation in the halls of the Commerce Department, followed by additional staff meetings and frantic bouts of recalculation.

instant when the promisor considers whether to breach (or when the promisor actually does breach). Call the time period up until the promisor's breach decision period zero, and call the period after the breach decision period one. Subscripts 0 and 1 denote amounts spent or received in periods zero and one. For example,  $V_{p0}$  denotes the total amount received by the promisee under the contract until the moment of breach: This amount of course could be zero. The amount spent by one side may or may not be equal to the amount received by the other, although for contracts for the payment of money they will be roughly the same (excluding transaction costs). For instance, if the only activity up to the moment of breach is payment of cash by the promisee, then  $C_{p0} = V_{d0}$ . If the promisee makes additional reliance investments not benefiting the promisor, then  $C_{p0}$  will exceed  $V_{d0}$ . In general, however, the amounts spent by one party will be positively related to the amount received by the other.

**Figure 2**

$$\begin{array}{rclclcl}
 V_0 & = & V_{p0} & + & V_{d0} & C_0 & = & C_{p0} & + & C_{d0} \\
 + & & + & & + & + & & + & & + \\
 V_1 & = & V_{p1} & + & V_{d1} & C_1 & = & C_{p1} & + & C_{d1} \\
 = & & = & & = & = & & = & & = \\
 V & = & V_p & + & V_d & C & = & C_p & + & C_d
 \end{array}$$

Figure 2 summarizes the basic notation. The equations can be read both horizontally and vertically.  $V_0$  is the total amount of value received by both parties before the breach decision;  $V_1$ ,  $C_0$ , and  $C_1$  are similarly defined. Likewise,  $V_p$  is the total amount of value received by the plaintiff-promisee over both periods of time, and so on. The unsubscripted  $V$  and  $C$  are the total value and costs of the contract, summed over both periods and parties.

There is just one more bit of notation needed to begin the accounting; let  $N$  denote the net profit for any period or party—the difference between  $V$  and  $C$ . The idealized damage measures can then be identified in terms of the various components of  $V$ ,  $C$ , and  $N$ . The backward-looking measures, reliance and restitution, require us to return the party in focus back to the position before the contract. This means that the party must either return period one profits if they are positive or receive compensation in the same amount if they are negative. The forward-looking measures, expectation and LSP, require measures

based on period one profits. Finally, let us denote damages payable by  $D$ , with subscripts  $r$ ,  $n$ ,  $x$ , and  $L$  respectively denoting reliance, restitution, expectation, and LSP. Formally:

- (1) Reliance damages  $= D_r = -V_{p0} + C_{p0} = -N_{p0}$
- (2) Restitution damages  $= D_n = V_{d0} - C_{d0} = N_{d0}$
- (3) Expectation damages  $= D_x = V_{p1} - C_{p1} = N_{p1}$
- (4) LSP damages  $= D_L = -V_{d1} + C_{d1} = -N_{d1}$

These definitions are idealized, and I am not claiming that courts always apply them in practice. Note that what I call restitution includes only the net value received by the promisor before breach. This means that a promisor in breach can deduct her expenditures in partial performance as a setoff from any gross value received. There might be cases, of course, in which courts invoke restitution theory and require the promisor to pay not just  $N_{d0}$  but  $V_{d0}$ . Alternatively, a court might take seriously the doctrinal requirement that amounts in restitution actually flow from the promisee, and require the promisor to pay the lesser of  $C_{p0}$  or  $V_{d0}$ . Such decisions may put the promisor in a worse position than the one in which she started and may well be better understood on reliance grounds. This will be discussed further below.

The accounting identities relating the damage measures can be found by adding and subtracting pairs of equations (1) through (4):

- (5)  $D_x - D_r = N_{p0} + N_{p1} = N_p$
- (6)  $D_n - D_r = N_{p0} + N_{d0} = N_0$
- (7)  $D_n - D_L = N_{d0} + N_{d1} = N_d$
- (8)  $D_x - D_L = N_{p1} + N_{d1} = N_1$

The four identities expressed by equations (5) - (8) are symmetric. The difference within each pair of party-based measures, restitution-LSP for the defendant and reliance-expectation for the plaintiff, is just the combined net profits for each respective party. And similarly, the difference within each pair of time-based measures, expectation-LSP for period 1 and reliance-restitution for period 2, is the combined net profits for each respective period.

Equation (5) represents a familiar identity that Fuller and Perdue discuss at length, although obviously they do not use formal symbolic analysis in doing so. Nonetheless, the interpretation of this identity takes up much of the first half of their article. The difference between expectation and reliance damages is just the promisee's net profits from the contract—the difference between where the promisee was before the contract and where he would have been after performance.

This is how Fuller and Perdue explain their claim that courts can talk in terms of expectation while the reliance principle remains fundamental. The courts are not really applying the expectation principle but instead are applying an expectation measure as an approximation. If the promisee's net profits from the transaction are close to zero, then the approximation will be a good one. Furthermore, the expectation measure may provide in practice a better approximation to the ideal reliance interest than does the reliance measure itself:

[Expectation] offers the measure of recovery most likely to reimburse the plaintiff for the (often very numerous and very difficult to prove) individual acts and forbearances which make up his total reliance on the contract. If we take into account "gains prevented" by reliance, that is, losses involved in foregoing the opportunity to enter other contracts, the notion that the rule protecting the expectancy is adopted as the most effective means of compensating for detrimental reliance seems not at all far-fetched.<sup>18</sup>

Another way of making the same point is to say that the promisee's net profits should be understood not as *accounting profits* (the difference between the profits earned in this contract versus doing nothing at all), but as *economic profits* (the difference between the profits earned in this contract versus those available in the next best alternative project, which he would have begun but for the defendant's promise). In the jargon of economists, firms doing business in competitive markets tend over time to earn zero economic profits. This is because free entry and exit of firms and capital flows between different industries will equalize rates of accounting profit throughout the economy. In the long run, it is no better to be in one industry than in any other, unless one is lucky enough to

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18. Fuller & Perdue, *supra* note 1, at 60.

own some productive input specially suited to a particular purpose, such as rich farmland or a unique talent for hitting baseballs.<sup>19</sup> When one counts lost opportunities as a form of reliance, as Fuller and Perdue argued, the expectation measure becomes a very good approximation indeed.<sup>20</sup>

Moreover, according to Fuller and Perdue, this approach explains why expectation damages are generally not available following the breach of a gratuitous promise. Because the transaction between promisor and promisee was a gift rather than an exchange, the promisee is likely to earn substantial economic profit from it. Accepting a gift from the promisor will not generally require the promisee to forego a similar gift from another benefactor. Accordingly, using the expectation measure risks substantially overestimating the reliance interest.<sup>21</sup>

The risk of overestimation does not mean that the expectation measure should never be used in such cases, because if it is very difficult to measure actual reliance, the expectation measure may still be the best approximation. Such a situation can be illustrated by a nontraditional reading of *Hamer v. Sidway*,<sup>22</sup> in which an uncle promised his fifteen-year-old nephew a sum of \$5000 if the nephew abstained from tobacco, alcohol, gambling, and profanity until his twenty-first birthday. The court upheld the clean-living nephew's claim of the \$5000 against the uncle's executor on a bargain theory, notwithstanding a factual record indicating primarily donative intent on the uncle's part. As a result, many students come away from *Hamer v. Sidway* with the lesson that consideration is defined by the relinquishing of a le-

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19. Even in that case, the opportunity to sell the unique input to someone else means there is an implicit cost to the owner in not doing so, and that cost must be subtracted to calculate economic profit. Since prospective purchasers would be willing to pay up to the present value of the unique asset's profit stream in order to get it, long-run economic profits will still be zero if asset markets are competitive. Assets that cannot be sold, such as personal talents, can earn positive economic profits in long-run competition.

20. See Cooter & Eisenberg, *Damages for Breach of Contract*, 73 CALIF. L. REV. 1432, 1434 (1985) (arguing, inter alia, that "[u]nder certain conditions, reliance and expectation damages will be virtually identical," and that "[i]n most cases, the major variables that determine the best method for measuring expectation damages are market structure and business conduct."). Cooter and Eisenberg also develop a number of accounting formulas useful in calculating expectation damages in a number of contexts. See also the lucid discussion of formulas for calculating damages in E. FARNSWORTH, *CONTRACTS* §§ 12.9-.12 (1982).

21. See Fuller & Perdue, *supra* note 1, at 64-65 ("The suggestion that the expectation interest is adopted as a kind of surrogate for the reliance interest because of the difficulty of proving reliance can scarcely be applicable to a situation where we actually insist on proof of reliance, and indeed, reliance of a 'definite and substantial character.'").

22. 124 N.Y. 538, 27 N.E. 256 (1891).

gal right. An alternative interpretation is that there was no consideration, but the difficulty of measuring the value of the nephew's uncommon forbearance made expectation damages the best feasible way to protect his reliance interest.

On similar reasoning, equation (6) demonstrates how a restitution measure can be used to approximate the reliance interest. The difference between the two is  $N_0$ , the combined net profit of both parties before breach. If the only events preceding breach involve the payment of money or the transfer of goods in a way that does not preclude their return, combined net profit is necessarily zero, and reliance and restitution are identical in amount. More generally, if the activities of the parties prior to breach do not require substantial irretrievable outlays, the approximation will still be a good one. If, as is often the case, the promisee's reliance expenditures exceed the value received by the promisor, restitution damages will be inadequate to protect the reliance interest. Some unreflective courts faced with such cases have awarded reliance damages and called it restitution. For example, in *Vickery v. Ritchie*,<sup>23</sup> a dishonest architect tricked the parties into agreeing to the uneconomical construction of a Turkish bathhouse by changing the price written in the contract. The plaintiff spent \$33,000 building the structure; the increase in the value of the defendant's land was \$22,000; the contract price was \$23,000. The architect had skipped town. The court awarded damages of \$33,000 on a theory of quasi-contract. Such cases support the Fuller and Perdue thesis that reliance is the more fundamental interest.

One could also take advantage of equation (7) to use LSP as an approximation to restitution. The approximation will be good if  $N_D$ , the defendant's net profit from the contract, is not too large. This approach may well have motivated the Minnesota court in *Groves v. Wunder*. It may be very difficult to discover the amount by which a breaching promisor has been unjustly enriched. If we assume that the transaction was a break-even one for her *ex ante*, the promisor's expenses of completion will roughly equal her first-period profit. If the contract were a losing one (which may explain why she breached), the LSP measure exceeds the restitution interest. Nonetheless, the *Groves* court may have preferred to err on the side of overly high damages in order to ensure full disgorgement. Such an approach may seem

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23. 202 Mass. 247, 88 N.E. 835 (1909).

especially attractive when breach appears deliberate or in bad faith.<sup>24</sup>

Finally, equation (8) shows that the LSP measure can provide an approximation to the expectation interest. The difference between LSP and expectation is equal to  $N_1$ , or the combined net profit from performance. The value of  $N_1$  is important for another reason as well: it indicates whether or not the promisor's breach was efficient. If  $N_1$  is positive, it would have been socially desirable for the defendant to perform; any losses on her part would have been outweighed by the plaintiff's gains. In this case, LSP underestimates the expectation interest. Conversely, if  $N_1$  is negative, so that breach is efficient, LSP will overcompensate the promisee relative to expectation. It was apparently this risk of overcompensation that made the *Peevyhouse* court reluctant to grant LSP, because substantial economic waste means the approximation is poor. In many situations, however, the promisee's expectation is subjective and difficult to measure. Indeed, this seemed to be the case in *Peevyhouse*, where the plaintiffs explicitly bargained with the defendant for restoration of their land in circumstances where they had every reason to know that the market value of doing so was nil. If the efficiency of breach is not overwhelming, the LSP measure may be a workable alternative to attempting to value subjective expectations.

It is also possible to derive additional accounting identities by adding and subtracting pairs of equations (5) through (8). These identities suggest additional approximations to the four damage measures. The difference between LSP and reliance, for instance, is equal to  $N_0 - N_d$ , or equivalently, to  $N_p - N_1$ . Depending upon the details of the transaction, LSP could be a good approximation for reliance and could be an even better approximation than either restitution or expectation. In general, though Fuller and Perdue focus on the expectation measure as an approximation to the reliance interest, any of the four measures could be used to approximate any of the four interests more or less precisely depending on the circumstances. The accounting relationships are perfectly symmetric. A court's use of the reliance measure and even a bit of reliance rhetoric, then, does not in itself imply any rejection of the expectation, restitution, or even the LSP interests.

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24. See, e.g., *H.P. Droher & Sons v. Toushin*, 250 Minn. 490, 85 N.W.2d 273 (1957), (distinguishing *Groves* and declining to award LSP damages on the grounds that the promisor's breach had been in good faith).

A leading case that illustrates the point is *Security Stove and Manufacturing Co. v. American Railway Express Co.*<sup>25</sup> In *Security Stove*, plaintiff stove company was deprived by defendant's breach of the uncertain goodwill and promotional value of exhibiting its model stove at a trade convention. The court discussed the difficulty of measuring the expectation interest:

There is no contention that the exhibit would have been entirely valueless and whatever it might have accomplished defendant knew of the circumstances . . . . In cases of this kind the method of estimating damages should be adopted which is the most definite and certain and which best achieves the fundamental purpose of compensation.<sup>26</sup>

The plaintiff accordingly recovered its costs of preparing for and attending the convention.

Similarly, in *L. Albert and Son v. Armstrong Rubber*,<sup>27</sup> Judge Learned Hand allowed a buyer to recover reliance damages but held that the seller could deduct from the recovery any losses it could prove the buyer would have had on the contract. (In the notation of the previous section, such losses correspond to a negative value for  $N_p$  in equation (5), so that reliance minus losses equals expectation). What made the *L. Albert* case especially interesting is that Judge Hand explicitly recognized the distinction between theory and measurement, and allocated the evidentiary burdens to make the measure as precise as possible. Hand made it clear, however, that when full information is available regarding both the reliance and expectation interests, the expectation interest should be protected. Indeed, he cited Fuller and Perdue in support of that conclusion: "We will not in a suit for reimbursement of losses incurred in reliance on a contract knowingly put the plaintiff in a better position than he would have occupied had the contract been fully performed."<sup>28</sup>

A second line of cases—those awarding precontractual reliance—further illustrates the possible variations on this point. Precontractual reliance includes expenditures made by the promisee in anticipation of a bargain, either with the promisor or with someone else, but before any promise has been made. In principle, such expenditures could not have been a consequence

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25. 227 Mo. App. 175, 51 S.W.2d 572 (1932).

26. *Id.* at 184, 51 S.W.2d at 577.

27. 178 F.2d 182 (2d Cir. 1949).

28. *Id.* at 191.



of the subsequent promise and as such are not truly part of the reliance interest.<sup>29</sup> Several courts have accordingly denied recovery for such expenditures.<sup>30</sup> But others, such as the English Court of Appeals in *Anglia Television v. Reed*,<sup>31</sup> have awarded precontractual reliance on the grounds that the defendant's breach, while not inducing the plaintiff's expenditures, caused them to be wasted. This reasoning seems to assume that, were the precontractual reliance expenses not wasted, they would have produced some expectation value not otherwise measurable. If we assume that the project would have earned a normal return, the sum of postcontractual and precontractual reliance damages will help approximate the expectation. We can carry this reasoning one step further by observing that precontractual reliance could also be used to approximate postcontractual reliance through repeated applications of equation (8). Had Anglia Television not contracted with Reed, it might have contracted with another actor who would not have breached, allowing them to earn the profits from completing the film. To compensate the producer for its probable lost opportunity to contract with another actor who would not have breached, it was necessary to use the expectation profits that would have been earned by doing so. In order to approximate the expectation measure it was necessary to use precontractual reliance because such profits were too uncertain to admit of any direct calculation.

### III. CONCLUSION: CHOOSING AMONG THE FOUR DAMAGE PRINCIPLES

It should now be plain that although accounting relationships explain how courts can talk about one damage measure while "really" implementing another, they do not by themselves give us any information about which interest is the theoretically correct one. Let us suppose momentarily that we are free to ignore difficulties of measurement. Which of the four interests is most

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29. I ignore the possibility that such expenditures could reasonably have been made in reliance on some prior conduct or informal promise of the promisor during preliminary negotiation. In that case, there is no difficulty classifying precontractual reliance as true reliance, provided that the court is willing to attach liability to informal promises. See, e.g., *Goodman v. Dicker*, 169 F.2d 684 (D.C. Cir. 1948); *Hoffman v. Red Owl Stores*, 26 Wis. 2d 683, 133 N.W.2d 267 (1965).

30. See, e.g., *Chicago Coliseum Club v. Dempsey*, 265 Ill. App. 542 (1932).

31. 3 All E.R. 690 (C.A. 1971). In this case, the defendant actor's breach caused the cancellation of filming on a made-for-television movie. Calculating the profits the movie would have made would clearly have been difficult under the circumstances.

fundamental or best justified? Fuller and Perdue believed it to be the reliance interest:

It may be said that there is not only a policy in favor of preventing and undoing the harms resulting from reliance, but also a policy in favor of promoting and facilitating reliance on business agreements. As in the case of the stop-light ordinance we are interested not only in preventing collisions but in speeding traffic. Agreements can accomplish little, either for their makers or for society, unless they are made the basis for action.<sup>32</sup>

Although the importance of protecting reliance, both for utilitarian purposes and on grounds of corrective justice, may argue in favor of an expectation measure, for Fuller and Perdue such arguments were purely instrumental.

The difficulties in proving reliance and subjecting it to pecuniary measurement are such that the business man knowing, or sensing, that these obstacles stood in the way of judicial relief would hesitate to rely on a promise in any case where the legal sanction was of significance to him. To encourage reliance we must therefore dispense with its proof.<sup>33</sup>

On the other hand, it is possible to construct other normative theories of contract liability that place primary emphasis on one of the other damage interests or that find different interests to be paramount in different situations. The efficiency criterion advanced by many law and economics scholars is one such example. Much of the modern conventional wisdom of law and economics on the subject of contract remedies can be traced back to arguments suggested by Fuller and Perdue. One might expect, therefore, that the law and economics literature on contracts, with its emphasis on individual maximizing behavior and its utilitarian approach to social value, would reach similar conclusions. Yet the law and economics literature has so far declined to incorporate Fuller and Perdue's principal theme—the primacy of the reliance interest and the importance of protecting it. Instead, the problem of protecting reliance has received relatively little attention from those who have written on the economics of

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32. Fuller & Perdue, *supra* note 1, at 61.

33. *Id.* at 62.

contract remedies.<sup>34</sup> The conventional law and economics wisdom, in contrast, is that optimal contract damages protect the reliance interest only incidentally. In terms of allocative efficiency, rather, both reliance and expectation damages overprotect those who rely.<sup>35</sup> Although this is not the appropriate forum for a full explanation, a brief sketch is possible.<sup>36</sup>

The typical approach of law and economics to contract damages is to evaluate the standard damage measures on the criterion of efficiency; that is, to inquire which of the measures maximizes the sum of social benefits less social costs.<sup>37</sup> There are at least three aspects of efficiency that relate to contract damages: efficiency of performance, efficiency of reliance, and efficiency in risk bearing. In order for a damage rule to be efficient with regard to performance, it must induce the promisor to perform her promise when her cost of performance is less than or equal to the promisee's gain from performance, and to breach other-

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34. In contrast, the reliance interest has received substantial attention in the related literature on why and whether contracts should be enforced at all. One notable illustration of this latter category is Goetz & Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261 (1980); see also Posner, *Gratuitous Promises in Economics and Law*, 6 J. LEGAL STUD. 411 (1977). The gap between economic writings on contract enforcement and on remedies for breach is notable in this regard.

35. I am not going to discuss here the litany of assumptions, qualifications, and disclaimers necessary for the analysis to which I refer. That is beyond the scope of this essay. Nor do I want to defend the economic approach as a valid methodology. For a good discussion of the basic assumptions of the economic approach, see G. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 3-14 (1976); for a briefer introduction, see A. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* (1983). For clarity's sake, I note that the results I mention below proceed on the unrealistic but usefully simplifying assumptions that (1) the rules and remedies of contract law provide the primary external constraints on contracting parties' behavior, and relatedly, (2) the Coase theorem does not hold, so that bargaining and renegotiation after the making of the original contract will not suffice to induce the parties to behave efficiently. Obviously, renegotiation and other social constraints supplement the rules of contract law in protecting reliance and other economic values, and the discussion below should be understood as pertaining to situations in which other efficiency-promoting institutions fail.

36. For the standard exposition of this analysis in nontechnical form, see A. POLINSKY, *supra* note 37; R. COOTER & T. ULEN, *LAW AND ECONOMICS* 212-47 (1988). For rigorous technical expositions, see Polinsky, *Risk Sharing Through Breach of Contract Remedies*, 12 J. LEGAL STUD. 427 (1983); Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39 (1984); Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980); and Shavell, *The Design of Contracts and Remedies for Breach*, 99 Q.J. ECON. 121 (1984).

37. The performance of any legal rule, of course, depends upon individuals' reactions to it, and law and economics assumes that parties to a contract behave in such a way as to maximize their self-interests subject to the constraints imposed upon them by rules of law. Different damage rules imply different constraints and thus imply different reactions by maximizing individuals.

wise.<sup>38</sup> For a damage rule to be efficient with regard to reliance, it must induce the promisee to make reliance investments when the social value of those investments exceeds their cost, and not otherwise. Finally, for a damage rule to be efficient with regard to risk bearing, it should arrange for damages following breach to mimic the optimal insurance policy covering the risk of breach that the promisee would buy from the promisor in a perfect market.

According to standard law and economics analysis, protecting the reliance interest is not efficient with respect to either performance or reliance. Expectation damages ensure efficient performance; because the promisor must pay in damages the promisee's value of performance, she correctly trades off that value against her own cost of performance. To the extent that reliance diverges from expectation, reliance damages can induce either excessive breach or excessive performance.

Both expectation damages and reliance damages encourage inefficient overreliance. Because both rules provide full insurance against lost reliance, they give a promisee the incentive to undertake all reliance investments which earn a profit in the uncertain event of performance. This is socially inefficient, however, because there may be a significant chance that the promisor will be unable to perform (or that it will be inefficient for her to do so) and the reliance investment will be wasted. Both reliance and expectation damages make the promisee indifferent to the possibility of wasteful reliance. The efficient level of reliance occurs when a promisee undertakes all investments costing less than their discounted value, where the discount reflects the chances that performance will not turn out to be worthwhile.<sup>39</sup>

Finally, depending on the circumstances, any of the four damage theories could promote efficient risk bearing. If the promisee wishes to avoid all risk and the promisor is willing to accept risk with no compensation, expectation damages are efficient because they fully insure the promisee against losses from breach. Conversely, if the promisor receives great disutility from risk and the promisee is relatively indifferent to it, it may be efficient to

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38. Alternatively, the damage rule must induce the promisor to take precautions to ensure performance when and only when the cost of precaution is less than the expected benefit to the promisee in terms of increased benefits from performance.

39. If the promisee treats a socially risky investment as one that is guaranteed, he will overinvest in it relative to the wealth-maximizing level. Consider the behavior of a person deciding whether to build a valuable structure on a floodplain. From the social point of view, it is better that such structures be built elsewhere unless the advantage of building in this particular location is great; if the owner is fully insured, however, the most trivial locational advantage will induce him to build on the floodplain.

set damages at the promisor's expected cost of performance and to provide an appropriate adjustment in the contract price. If the two parties are equally averse to risk, it may be optimal to split the difference and agree to some intermediate level of liquidated damages.

The point is not that standard law and economics analysis reveals Fuller and Perdue to be wrong in their normative claims regarding the reliance interest.<sup>40</sup> Rather, anyone who develops a competing normative theory can use the same type of descriptive analysis to argue that the new theory is really "true." Because the distinction between measure and motive can cut in all four directions, in their tour de force Fuller and Perdue planted the seeds for their own revisionists. Whether a revisionist critique will succeed depends on the abstract force of the normative arguments mustered in its favor and on the ability of its proponents to find language in common law cases, statutes, and other legal materials that supports their theory.

I personally do not expect a fully convincing normative justification for the reliance interest, or, for that matter, any of the other interests. We are and should be moved by the perspective of both the promisor and the promisee, and the correct result in any given case will depend upon how we organize our perceptions. Similarly, both forward-looking and backward-looking perspectives have some appeal in concrete situations. In any event, unless and until such a justification is developed, it will be possible in a typical breach of contract case to make two distinct sorts of arguments regarding the damages payable. The first argument will be one of theory: which of the four theories or variations thereon best fulfills our conceptions of justice? The second argument is one of measurement: which of the four measures or variations thereon best implements our ideal theory? Both arguments are instrumental, although the second argument may seem more obviously so. Nonetheless, it is useful for both lawyers and legal scholars to make the distinction. Our dialogue will be clearer if we know whether we are arguing about means or ends.

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40. The overreliance argument of law and economics, in particular, depends upon at least two assumptions: (1) that courts are unable to recognize excessive reliance and disallow it as an item of damages, and (2) that promisees are better placed than promisors to take precautions against overreliance.