Probability and Chance in Contract Law

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In this Article, Professor Melvin Eisenberg explores the role that probability and chance play in contract law, by first developing several organizing concepts based on those elements, and then employing those concepts to examine the role of probability and chance in the areas of consideration and damages. In the area of consideration, probability and chance explain a general class of contracts, structural agreements, that contract law has understood imperfectly at best. From the perspective of a contracting actor, states of the world may be divided into those that are within the actor’s control, those that are not within the actor’s control but are predictable, and those that are a matter of chance. Some contracting behavior is intended to shift a state from the realm of chance to the realms of control or predictability. This behavior is fairly well understood by contract law. However, much contracting behavior consists of

* For David Eisenberg, UCLA ’86.
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promissory structures that are designed to increase the probability of exchange, rather than to bring a state under an actor's control or to make it predictable that the state will occur. Such promises should be enforceable, whether or not the promise is exchanged for another promise or an act. In the area of remedies, probability and chance best explain the remedies in reward and prize cases; show how the principles of uncertainty and foreseeability should be administered; and suggest that expectation damages based on lost profits should be measured by the expected value of the lost profits rather than by the amount of profits that were probably lost.

INTRODUCTION

The role of risk in the formulation of some areas of contract doctrine, primarily mistake and changed circumstances, is relatively well understood. Less well understood are the extensive roles played by probability and chance in contract law. In this Article, I develop and explore several organizing concepts in contract law that are based on those elements. I call these concepts the realm of choice, the realm of predictability, the realm of chance, agreements to increase the probability of exchange, and structural agreements. I then develop the role of these concepts in two major areas of contract law—consideration and remedies. In the course of this development, I bring to bear on these areas several elements of financial and transaction-cost economics that are related to probability and chance, including option theory, hostage theory, and expected value.

I. CONCEPTS AND TERMINOLOGY

A. The World

Probability and chance are part of a larger constellation of concepts that includes control, predictability, and states of the world or, more simply, states. Because each of these concepts can plausibly be defined in several different ways, I begin by setting out the definitions that I employ in this Article. Because I am interested in the bearing of these concepts on contract law, I generally define the concepts, for the purposes of this Article, from the perspective of a given actor who has entered or proposes to enter into a contractual arrangement.

By a state, I mean any state of the world that is defined by given actors for contractual purposes. A state can consist of action or nonaction and

can be objective or subjective. For example, refraining from acting can be a state. So can an actor's subjective satisfaction. Furthermore, contracting actors can slice states of the world thinly or thickly. For example, an injury and its consequences can be either one state or two, depending on the actors' definition.

By control, I mean the present ability of an actor to ensure almost certainly that a state will occur. For example, under this definition, I can control whether I will have a cappuccino tomorrow even though it is remotely possible that a sudden illness will take the issue out of my control. Similarly, I treat a state as predictable by an actor if the actor can predict with a high degree of certainty that the state will occur. For example, under this definition, it is predictable that human beings will see the sun rise ten years from today even though it is possible that before that time, a dark cloud will fall over the earth as a result of an unforeseen galactic event.

By probability, except as otherwise specified, I mean the personal or subjective probability that a given actor assigns to the occurrence of a state, as opposed to the objective probability that the state will occur.

By chance, I mean the possibility that a state that is neither within an actor's control nor predictable by the actor will occur. By a chance, I mean an opportunity, which has value to the actor, that such a state will occur. By the value of a chance, I mean the value that the actor assigns to such an opportunity. By an increase in the value of a chance, I mean an increase in the value of such an opportunity to the actor that results from an increase in the probability that the relevant state will occur.

Based on these concepts, the world that potential contract partners face can be divided into the realms of choice, predictability, and chance. By the realm of choice, I mean all the states that are within the control of a given actor. By the realm of predictability, I mean all the states that are not within the control of a given actor but that are predictable by the actor. By the realm of chance, I mean all the states that are neither within the control of nor predictable by a given actor.

The realms of choice, predictability, and chance are not operational categories: no legal consequences turn on whether a state or transaction is within one realm rather than another (and, in practice, these realms are to a certain extent continuous, so that a state or transaction might be in more than one). Rather, these realms constitute a conceptual apparatus that enables a better understanding of the experience that underlies contracting. This understanding, in turn, facilitates the development of legal principles that are responsive to that experience. For example, the concept of the realm of choice illuminates what it means to make a promise. A
promise is a commitment to take some future action.² By virtue of a promise, therefore, the promisor shrinks the boundaries of his realm of choice. Whatever that realm was before he made the promise, it is slightly smaller after he made the promise, because some action that he was morally free to choose before the promise is no longer an action that he is morally free to choose.

Because the realms of choice, predictability, and chance are defined from the actor's perspective, a state that is within one realm for one actor may be in another realm for another actor. For example, A's location next week may be in the realm of choice for A but in the realm of chance for B. Furthermore, an actor is often able to move a state of the world from one realm to another. For example, an actor can move a state from the realm of chance to the realm of choice if he can manage to attain control over the state, by precaution or otherwise. Thus the development of a vaccine against Illness I allows actors to move the possibility of remaining free of Illness I from the realm of chance to the realm of choice.

An actor who cannot control the occurrence of a state can shift the risk of the occurrence to another actor, who also is unable to control the occurrence of the state, by obtaining a promise that the other will bear the risk, or can shift the state from the realm of chance to the realm of choice by obtaining a promise, from an actor who can control the occurrence of the state, that the state will occur. An actor may also be able effectively to move the consequences of a state from the realm of chance to the realm of predictability by aggregating the state with a number of like states in such a way that he can predict the outcomes of the states as a class. Typically, this is possible only for actors who can deal with a large number of comparable states whose aggregate outcomes can be predicted with great precision. For example, a gambling casino can often aggregate gambles whose results are individually unpredictable into a predictable class of gambles. Similarly, an insurance company can aggregate risks whose occurrences are individually unpredictable into a predictable class of risks.

B. Contracts

From the middle of the nineteenth century until the first part of the twentieth century, contract law was dominated by a school of thought now known as classical contract law. The teachings of this school were based on the premise that contract law, like geometry, could be developed by

deduction from axiomatic rules. Like geometry, classical contract law tended to be static rather than dynamic, and binary rather than continuous. Given these characteristics, it is not surprising that classical contract law had difficulty coping with probability and chance, because rules that center on those elements tend to be dynamic rather than static, and continuous rather than binary.

From the perspective of the realms of chance and choice, most contracts fall within one of three paradigms. Two of these paradigms are well recognized in contract law. In one, an actor for whom a state is within the realm of chance obtains a commitment from another actor, for whom the state is within the realm of choice, that the state will occur. For example, IBM, which needs Pentium chips, may obtain a commitment from Intel to supply those chips. In the other well-recognized paradigm, an actor for whom a state is within the realm of chance shifts the risk of the state to another actor, for whom the state is also within the realm of chance or who has the capability of aggregating individually unpredictable states in such a way that he can predict their outcomes as a class. For example, A, who will need wheat in three months, may buy wheat futures from B, a speculator in wheat, thereby shifting to B the risk of a rise in wheat prices.

Both of these paradigms involve simple, binary shifts. In a third paradigm, which has received only limited recognition, the parties neither shift the occurrence of a state from the realm of chance to the realm of choice, nor shift the risk from one actor to another. Instead, the parties create a dynamic promissory structure to increase the probability of economic exchange.

Some promissory structures that increase the probability of economic exchange are classical bargains, in which each party makes a promise or renders an act that is exchanged as the price of the other party's promise or act. Classical bargains may be either bilateral or unilateral. In a bilateral bargain, the parties exchange a promise for a promise. In a unilateral bargain, the parties exchange a promise for an act whose performance is required as a condition to performance of the promise.

In another kind of promissory structure, one party makes a promise that increases the probability of exchange, but that promise does not require either a promise or an act in exchange. I call such promissory structures structural agreements.

Under the bargain principle, bargains between capable and informed actors are enforced according to their terms. This principle rests in large part on the premises that bargains produce gains through trade, that capable and informed actors are normally the best judges of their own utilities, and that those utilities are revealed in the terms of the parties' bargain.

Although the bargain principle is most conventionally applied to classical bargains, it applies to structural agreements as well. Structural agreements, like classical bargains, involve promises designed to promote economic exchange. The terms of structural agreements, like the terms of classical bargains, are normally bargained out. And as in the case of classical bargains, the promisor in a structural agreement makes his promise because it will serve his economic interest. Reasons comparable to those for enforcing classical bargains are therefore applicable to structural agreements: structural agreements are entered into to produce gains through trade; a capable and informed actor is normally the best judge of his own utility; and that utility is revealed in the terms of his agreement.

The concept of structural agreements, which is central to Part II of this Article, provides a direct link between transaction-cost economics and contract law doctrine. A major concern of transaction-cost economics is the manner in which various forms of governance structures can maximize the likelihood that economic transactions will be seen to completion, resulting in gains to both sides. A structural agreement is a governance structure that is designed and intended to promote the probability of gains through trade. As shown in Part II, contract law should make structural agreements enforceable to implement that design and intention. Increasingly, contract law is doing exactly that.

Against the background of the terminology and concepts developed in Part I, I now turn to the role of probability and chance in two major areas of contract law: consideration (Part II) and remedies (Part III). In Part II, I show, by using the concept of structural agreements and the tools of transaction-cost and financial economics, that requirements contracts should be enforceable even if the buyer can choose to have no requirements; that real promises given in exchange for illusory promises should be enforceable; that firm offers should be enforceable; that modifications of contracts in which only one party's rights are changed should be enforceable; and that employment contracts without a fixed duration should be enforceable, at

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least to the extent of reliance, if the relying party was not given a good faith chance. In Part III, I show that remedies in reward and prize cases can best be explained by using concepts of probability and chance; that the principle of uncertainty should be administered by probabilistic techniques; that when probabilistic methods of doing business and probable rates of breach are taken into account, the principle of Hadley v. Baxendale should be abandoned in favor of contractual allocations of loss and the principle of proximate cause; and that all expectation damages based on lost profits should be measured by the expected value of the lost profits rather than by the amount of profits that were probably lost.

II. CONSIDERATION

A. Requirements Contracts

Requirements contracts provide a good example of the difficulty that classical contract law had with promissory structures designed to increase the probability of exchange, even when those promissory structures were classical bargains.

In a requirements contract, a seller promises to supply all of the buyer's requirements of a defined commodity at a stated price over a designated period of time, and the buyer promises to purchase all of him requirements of the commodity during that time from the seller at the stated price. In the era of classical contract law, the courts often refused to enforce requirements contracts when the buyer could choose to have no requirements—because, for example, he had no established business, or was a middleman, or required the commodity only in a part of his operations, which he could easily abandon.

When the buyer may choose to have no requirements, a requirements contract is a promissory structure designed to increase the probability of exchange. By making the agreement, the seller reveals that in his view, the value of the chance that the buyer will have requirements exceeds the cost to the seller of making his commitment. Furthermore, even when the buyer may choose to have no requirements, requirements contracts are classical bargains. The seller clearly shrinks his realm of choice. So does

5. See, e.g., Pessin v. Fox Head Waukeshaw Corp., 282 N.W. 582, 585 (Wis. 1938).
the buyer. Before the buyer enters into such a contract, he is morally free to purchase the commodity from anyone he chooses. After the buyer enters into such a contract, if he requires the commodity during the contract period, he is morally obliged to purchase the commodity from the seller at the contract price. Because both parties have made real promises—have shrunk their realms of choice—and each has exchanged its promise as the price of the other's, courts that refused to enforce requirements contracts because the buyer might have no requirements violated the bargain principle.

Eventually, the problem of enforcing requirements contracts was largely, although not entirely, shouldered aside by statute. Most requirements contracts concern the sale of goods. UCC section 2-306(1) provides that in a contract for the sale of goods, a term that measures quantity by the buyer's requirements means such requirements as may occur in good faith. The official comment to that section states that a contract for requirements does not lack consideration. However, the reason given for this conclusion is not that every requirements contract is a bargain, but rather that the buyer must conduct his business in good faith and according to commercial standards of fair dealing in the trade so that his requirements will approximate a reasonably foreseeable figure—in other words, that the buyer assumes an obligation beyond the purchase of his requirements. The unwillingness of the UCC's drafters simply to recognize that all requirements contracts are enforceable bargains, even without any further obligation, has led one leading commentator to conclude that it is not clear, under the UCC, whether instances may remain in which a requirements contract is unenforceable.

B. The Illusory Promise Rule

The doctrine of mutuality presents a more important area in which consideration doctrine has failed to come to grips with promissory structures designed to increase the probability of exchange. Under the mutuality doctrine, as conventionally stated, both parties must be bound or neither is bound. This doctrine, however, needs more qualification than it sometimes receives.

First, the doctrine is inapplicable to unilateral bargains. In such bargains, the party who exchanges an act for a promise may never be bound, because he is not bound to do anything before he chooses to do the

act, and he may not be bound to do anything after he does the act. For example, suppose that A promises to pay B $50 for mowing A's lawn and makes clear that only the act of mowing the lawn, not a promise to do so, will suffice; and that B then mows the lawn. B was not bound to mow the lawn before he did so, and is not bound to A in any way after he has done so, but A is bound to B.

Second, the doctrine is not applied to bargains in which both parties have made real promises but one party is not legally bound by his promise. For example, suppose A fraudulently induces B to agree to buy Blackacre. Although B is not legally bound, he can enforce the contract, notwithstanding the doctrine of mutuality. The same result follows in many other kinds of cases, such as those in which one but not both parties has a defense under the Statute of Frauds or a defense of incapacity.

Once all the necessary qualifications to the mutuality doctrine have been made, the doctrine is, for practical purposes, largely a nom de plume for the illusory promise rule. This rule is applicable to transactions in which one party, A, makes a real promise, while the other party, B, uses an expression that seems to be a real promise—a commitment—but is not, because it does not shrink the boundaries of B's realm of choice. Under the illusory promise rule A is not bound in such a case, despite the fact that he made a real promise, on the theory that there was no consideration for his promise. As stated in Restatement Second section 77: "A promise or apparent promise is not consideration if by its terms the promisor or purported promisor reserves a choice of alternative performances unless . . . each of the alternative performances would have been consideration if it alone had been bargained for . . . ."

The Illustrations to section 77 exemplify the illusory promise rule as follows:

1. A offers to deliver to B at $2 a bushel as many bushels of wheat, not exceeding 5,000, as B may choose to order within the next 30 days. B accepts, agreeing to buy at that price as much as he shall order from A within that time. B's acceptance involves no promise by him, and is not consideration. . . .

2. A promises B to act as B's agent for three years from a future date on certain terms; B agrees that A may so act, but reserves the power to terminate the agreement at any time. B's agreement is not consideration, since it involves no promise by him.

12. Id. cmt. a, illus. 1 & 2.
Illustrations 1 and 2 are classic examples of recurring types of cases in which the illusory promise rule is applied. In one recurring case, exemplified in Illustration 1, B does not shrink the boundaries of his realm of choice because he only agrees to do whatever he may choose to do. In a second recurring case, exemplified in Illustration 2, B does not shrink the boundaries of his realm of choice because he reserves the right to choose to terminate at any time.

Nevertheless, courts that apply the illusory promise rule violate the bargain principle just as much as did courts that refused to enforce requirements contracts, and in the same way—that is, by overlooking the fact that normally, in such cases, a classical bargain has been made. It is true that in illusory promise cases, unlike requirements cases, there is no bilateral bargain, because only one party has shrunk the boundaries of his realm of choice. The fallacy of the illusory promise rule, however, is that it treats transactions involving illusory promises as if they were failed bilateral contracts, intended to involve a promise for a promise. In fact, properly understood, these transactions typically do not involve bilateral contracts. Instead, they involve either structural agreements or classical unilateral contracts designed to increase the probability of exchange.

Call the person who makes the real promise in an illusory promise transaction A, and call the person who makes the illusory promise B. In illusory promise cases, like Illustrations 1 and 2 to section 77, the promisor, A, does not make a promise to B for nothing, as a gift. He makes it for something, as a bargain. A seeks to advance his own interests by increasing the probability of exchange.

Choosing to exchange with one trading partner rather than another is not cost free. A makes his promise because he believes that B's incentives to exchange with A rather than with others would be insufficient unless the promise is made. In effect, there is a disparity of information and incentives between A and B. A has a degree of confidence in the attractiveness of his performance that he believes B does not share. A therefore makes a promise to B that is intended to change B's incentives to exchange with A so as to increase the probability of exchange. A does this by making a commitment he believes will induce B to give A a chance to show that his performance is attractive, either by sampling A's commodities or perhaps simply by giving more serious consideration to purchasing A's commodities than he otherwise would be likely to do.

The value of a chance to increase the probability of exchange is widely evidenced: book clubs give free books for the opportunity to sell future books; developers give free vacations for the opportunity to present a
sales pitch; retailers offer free prizes in promotional contests to induce customers to shop; direct sellers pay substantial amounts for mailing lists. Correspondingly, in an illusory promise transaction, if B responds to A's inducement by giving A a chance to increase the probability of exchange, the act of giving A the chance concludes a classical unilateral contract by giving A something of value in a bargained exchange for A's promise.  

Of course, in a bargain involving an illusory promise, the promisor, A, has a chance to transact with the promisee, B, even before making his promise. That is, both before and after A makes his promise, a decision by B whether to transact with A is within the realm of choice for B and within the realm of chance for A. The point, however, is that A's promise increases the probability of exchange; A makes the promise to get a chance, and if the chance is given, it concludes a unilateral contract under classical bargain analysis.

The law might go even further and enforce A's promise in an illusory promise transaction even if B has not yet given A a chance, simply on the ground that A's promise is a structural agreement. I consider that analysis below. At this point, I focus on the easier case, in which A bargains for a chance to transact and, in exchange, gets just the chance he bargained for, so that a classical unilateral bargain has been made. Almost all the reported illusory promise cases fall within this description, and any transaction that falls within this description should be enforceable under a routine application of the bargain principle.

Accordingly, the illusory promise rule is not so much wrong as irrelevant. Recall that under this rule, as formulated in Restatement Second, "[a] promise or apparent promise is not consideration if by its terms the promisor or purported promisor reserves a choice of alternative performances unless . . . each of the alternative performances would have been considered if it alone had been bargained for . . . ." That is true, but beside the point. B's "promise or apparent promise" may not conclude a bargain, but B's act of giving A a bargained-for chance does conclude a bargain.

The illusory promise rule is a creature of classical contract law. Although the rule is still on the books, it is being effectively whittled away.
under modern contract law. To begin with, the rule is inapplicable if the promisee gives any bargained-for promise at all, no matter how minimal. For example, in *Lindner v. Mid-Continent Petroleum Corp.*, 16 Lindner gave Mid-Continent a three-year lease on a filling station, with an option to renew for two further years—in all, a five-year commitment. In exchange, Mid-Continent agreed to lease the filling station, but with the right to terminate its obligations at any time on ten days’ notice—in all, a ten-day commitment. Subsequently, Lindner sought to cancel the lease on the ground that it lacked mutuality. The court held for Mid-Continent:

> [T]he requirement of mutuality does not mean that the promisor's obligation must be exactly coextensive with that of the promisee. It is enough that the duty unconditionally undertaken by each party be regarded by the law as a sufficient consideration for the other's promise...

...This is not an option by which the lessee may terminate the lease at pleasure and without notice; at the very least the lessee bound itself to pay rent for ten days.17

In *Lindner*, ten days were enough. In *Gurfein v. Werbelovsky*, 18 a nanosecond sufficed. Buyer and Seller contracted for the sale of five cases of plate glass “to be shipped within 3 months from date.”19 The contract provided that Buyer had the option to cancel the order before shipment. During the three months following the date on which the contract was made, Buyer repeatedly requested performance, but Seller never shipped. Eventually, Buyer brought suit for breach of contract. Seller argued that the agreement lacked mutuality by virtue of Buyer's right to cancel the order before shipment. The court disagreed, on the ground that Seller had “one clear opportunity to enforce the entire contract,” by shipping as soon as he received the order.20 “This is all that is necessary to constitute a legal consideration and to bring the contract into existence. If the defendant voluntarily limited his absolute opportunity of enforcing the contract to the shortest possible time, the contract may have been improvident, but it was not void for want of consideration.”21

16. 252 S.W.2d 631 (Ark. 1952).
17. *Id.* at 632; see also, e.g., Hancock Bank & Trust Co. v. Shell Oil Co., 309 N.E.2d 482 (Mass. 1974) (holding that the lease was not invalid for lack of mutuality in the case of a gas-station lessor obligated for 30 years and an oil-company lessee obligated for 90 days).
18. 118 A. 32 (Conn. 1922).
19. *Id.*
20. *Id.* at 33.
21. *Id.*
In *Laclede Gas Co. v. Amoco Oil Co.*, the court went a step further than cases like *Lindner* and *Gurfein*. In this case, the court upheld the enforcement of a promise made by a seller-promisor on the ground that although the buyer-promisee had not made any promise, it was induced to perform by the structure of the transaction, and this inducement made the seller's promise enforceable. In 1970, Amoco and Laclede entered into a master agreement concerning the sale of propane gas by Amoco to Laclede for distribution systems Laclede planned to install in new residential developments. Under the master agreement, if Laclede decided to install such a system in a given development, it could request Amoco to supply propane to the development. If Amoco decided to supply the propane, it would bind itself to do so by signing a supplemental agreement in a prescribed form. Under the terms of the supplemental agreements, Amoco was required both to install storage and vaporization facilities capable of delivering commercial propane gas to Laclede for customers in the development and to sell the propane to Laclede at a defined price. Laclede, for its part, agreed to install and operate distribution facilities for the development from the outlet of Amoco's header piping. Laclede, however, did not agree to purchase any propane from Amoco.

In 1973, Amoco declined to deliver any more propane under the supplemental agreements then in force. Laclede sued for specific performance. Amoco defended on the ground that the supplemental agreements lacked mutuality because they did not bind Laclede to purchase any propane. The court held for Laclede under “an intelligent, practical reading of the agreement.”

Once Laclede had built a distribution system that was attached to an Amoco header outlet, Laclede could not switch to a different supplier without substantially altering the supply route to its distribution system or making a substantial investment in its own storage equipment. The court stated:

As a practical matter, then, Laclede is bound to buy all the propane it distributes from Amoco in any subdivision to which the supplemental agreement applies and for which the distribution system has been established.

When analyzed in this manner, it can be seen that the contract herein is simply a so-called “requirements contract.”

Cases like *Lindner*, *Gurfein*, and *Laclede* undermine, rather than explicitly repudiate, the illusory promise doctrine. In *Harris v. Time*,

22. 522 F.2d 33 (8th Cir. 1975).
23. Id. at 38.
24. Id.
the court went the final step and explicitly held that providing a bargained-for chance that increases the probability of exchange is sufficient consideration. Joshua Gnaizda received a letter from Time. The front of the envelope contained a window, which revealed a picture of a calculator watch and the following statement: “JOSHUA A. GNAIZDA, I’LL GIVE YOU THIS VERSATILE NEW CALCULATOR WATCH FREE Just for Opening this Envelope Before Feb. 15, 1985.” After—and only after—opening the envelope, the following additional clause was revealed: “AND MAILING THIS CERTIFICATE [for a subscription to Fortune Magazine] TODAY!”

Joshua, having opened the envelope, demanded the calculator watch even without mailing the subscription certificate, based on the promise made in the envelope window. Time refused. Joshua then brought a class action against Time for breach of contract. Time argued that there was no contract because the mere act of opening the envelope was valueless and therefore did not constitute consideration. The court rejected this argument on the ground that Time had bargained for and received the chance that if Joshua opened the envelope, he would order Fortune:

> [T]he act at issue here—the opening of the envelope, with consequent exposure to Time’s sales pitch—may have been relatively insignificant to the plaintiffs, but it was of great value to Time. At a time when our homes are bombarded daily by direct mail advertisements and solicitations, the name of the game for the advertiser or solicitor is to get the recipient to open the envelope. . . . From Time’s perspective, the opening of the envelope was “valuable consideration” in every sense of that phrase.

In short, although courts continue to at least give lip service to the illusory promise rule, the trend of modern contract law is to enforce transactions involving such promises.

C. Firm Offers

An offer is often accompanied by a promise to hold the offer open for a fixed period of time. Under classical contract law, offers accompanied by
such promises were divided into two basic categories: those in which the promise had separate consideration, and those in which it did not. The former kind of offer-plus-promise was usually referred to as an option. The latter was usually referred to as a firm offer. An option was enforceable; a firm offer was not. The theory was that a promise is unenforceable without consideration, and if the promise element of a firm offer has no separate consideration, the firm offer is therefore unenforceable.

In fact, however, firm offers are promissory structures designed to increase the probability of exchange. A firm offer is made not for altruistic reasons, but for self-regarding reasons—to increase the probability of exchange. In deciding whether to accept an offer, an offeree must make an investment, in the form of deliberation and, in some cases, out-of-pocket costs. The offeree is more likely to make such an investment, or is likely to make a greater investment, if he is sure the offer will be held open while the investment is being made. The purpose of a firm offer is to induce the offeree to make such an investment so as to increase the probability of exchange. Invariably, in such cases, the enforceability issue arises only when the offeree wants to accept the offer. It can therefore fairly be presumed that the offeror has, by making his promise, induced just the consideration of his offer that he sought to induce. Indeed, it is in the interests of offerors as a class that firm offers be enforceable, because under a regime of unenforceability, offerors cannot utilize firm offers to achieve their ends. Accordingly, firm offers should be enforceable either as classical unilateral bargains, in which the promise to hold the offer open is exchanged for deliberation by the offeree, or more simply, as structural agreements designed to increase the probability of exchange.  

Like the illusory promise rule, the firm offer rule is a creature of classical contract law. Although it remains on the books and still has some bite, the rule has been heavily eroded. Under a rule that has emerged in the last forty years, a firm offer is enforceable if it is relied upon. Under a rule reflected in Restatement Second section 87(1)(a), a firm offer is enforceable if it is in writing and signed by the offeror, recites a purported (nominal) consideration, and proposes an exchange on fair terms within a reasonable time. Under UCC section 2-205, firm offers are normally

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32. See Restatement (Second) of Contracts § 87(1)(a) (1981).
enforceable when the offer concerns the sale of goods.\textsuperscript{33} Under some statutes, virtually all firm offers are enforceable.\textsuperscript{34} These exceptions significantly, although not completely, swallow the rule: the reliance exception is consistent with the rule; the other exceptions are not. The exceptions can only be explained on the ground that the classical rule is wrong because it rests on the premise that a firm offer is not part of a bargain, while, in fact, a firm offer usually involves a classical bargain and always involves a structural agreement. In this area too, therefore, modern contract law has been moving toward the enforcement of structural agreements, and the principle that such agreements should be enforceable both supports and is in turn supported by Restatement Second section 87(1)(a) and UCC section 2-205.

D. The Option Perspective

The proper analysis of firm offers, together with the teachings of financial economics, suggests another way to view structural agreements in general, and bargains involving illusory promises in particular. One teaching of financial economics is that it is often useful to analyze economic structures that are not options in form as options in substance. For example, stock in a corporation, which is usually viewed as an ownership interest, can alternatively be viewed as an option on the value of the corporation after debtors have been paid off:

Assume that Firm X has a capital structure made up of only debt and equity, and that the debt has a specified face value and is repayable on a specified date in a single lump sum. The value of the equity then equals the firm's total value minus the value of the debt. If the debt is not repaid when due, the firm will go into bankruptcy, with the result (we will assume for simplicity) that the stockholders are wiped out and the debtholders become the owners of the firm.

\textsuperscript{33} UCC section 2-205 provides:

An offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or if no time is stated for a reasonable time, but in no event may such period of irrevocability exceed three months; but any such term of assurance on a form supplied by the offeree must be separately signed by the offeror.


\textsuperscript{34} For example, section 5-1109 of the New York General Obligations Law provides: "Except as otherwise provided in section 2-205 of the Uniform Commercial Code . . . , when an offer to enter into a contract is made in a writing . . . which states that the offer is irrevocable during a [stated] period . . . , the offer [is irrevocable during that period]." N.Y. GEN. OBLIG. LAW § 5-1109 (McKinney 1989).
This arrangement can be recharacterized as an option. The stockholders can be seen as having sold an unlevered firm X to the debtholders in return for: (i) the proceeds from issuing the debt; (ii) a management contract; and (iii) most importantly, a call option to repurchase the unlevered firm by paying off the debt (face value plus interest). On the repayment date, if the firm's assets are worth more than the repayment price, the stockholders will "exercise their option" to repurchase the unlevered firm by repaying the debt. If the firm's assets are worth less than the repayment price, the equity holders won't exercise their option. They do this by defaulting on the debt.35

The option perspective illuminates structural agreements generally. It also illuminates transactions involving illusory promises in particular. In substance, in such cases, the party who makes the real promise, A, gives the party who makes the illusory promise, B, an option to acquire a given commodity at a defined price. For example, recall that in Illustration 1 to Restatement Second section 77,36 A offered to deliver to B, at $2 a bushel, as many bushels of wheat, not exceeding 5000, as B might choose to order within the next thirty days, and that B accepted, "agreeing to buy at that price as much as he shall order from A within that time."37 In substance, A gave B a thirty-day option on 5000 bushels of wheat at $2 a bushel. Similarly, in Illustration 2, A promised B that he would act as B's agent for three years on certain terms, and B accepted, reserving the power to terminate at any time.38 In substance, A gave B an option on A's services as an agent for three years on designated terms.

If, in either of these cases, B had paid A a small cash sum for the option, there would be no question that the option would be enforceable. There would also be no question of enforceability if, in Illustration 1, B had agreed to order at least ten bushels of wheat, or if, in Illustration 2, B had agreed to employ A as an agent for at least ten days. (Indeed, the latter case would be like Lindner v. Mid-Continent.39) For reasons previously discussed,40 B's act of giving A a chance that will increase the probability of exchange may be at least as valuable as, and will often be more valuable to A than, a tiny amount of cash or a tiny initial commitment.

36. See supra text accompanying note 12.
38. See id., illus. 2.
39. See supra text accompanying notes 16–21.
40. See supra text accompanying notes 10–28.
Is the chance actually valuable to A? That is not the law's concern. The law does not need to speculate about the value to A of the increased probability of exchange, because by making the bargain, A reveals that for him this value is equal to or greater than the value he puts on his own commitment.

The option perspective helps to show why structural agreements fall within the bargain principle. It also brings into focus an additional, narrower, doctrinal reason for the enforcement of transactions involving illusory promises. As the bargain theory of consideration was elaborated by the classical school, the requirement of a bargain was satisfied, even if no actual bargain had been made, if there was "nominal" consideration—that is, if the parties had utilized the form of a bargain. This doctrine was exemplified in Restatement First section 84, Illustration 1:

A wishes to make a binding promise to his son B to convey to B Blackacre, which is worth $5000. Being advised that a gratuitous promise is not binding, A writes to B an offer to sell Blackacre for $1. B accepts. B's promise to pay $1 is sufficient consideration. 41

For the most part, Restatement Second reverses the position of Restatement First on nominal consideration and instead adopts a test that requires a bargain in fact.42 However, Restatement Second section 87(1)(a), like many of the cases, makes an exception for options. Under the doctrine reflected in that section, nominal consideration—the form of a bargain—normally does make an option binding:

An offer is binding as an option contract if it... is in writing and signed by the offeror, recites a purported consideration for the making of the offer, and proposes an exchange on fair terms within a reasonable time.43

In practice, the illusory promise doctrine stated in Restatement Second section 77 is inconsistent with the rule stated in section 87(a)(1) because, in practice, almost every illusory promise case falls within the latter rule: (i) illusory promise transactions are essentially options; (ii) in such cases there is always a recital of "a purported consideration"—namely, the illusory promise; and (iii) based on the reported cases, the promise is almost invariably in writing and almost invariably proposes an exchange on fair terms within a reasonable time. Accordingly, the classical law doctrine that transactions involving illusory promises are unenforceable normally

41. Restatement (First) of Contracts § 84, illus. 1 (1933).
42. See Restatement (Second) of Contracts § 71, cmt. b, and illus. 4 & 5 (1981).
43. Id. § 87(1)(a).
violates not only the general bargain principle, but the specific rule embodied in Restatement Second section 87(a)(1).

E. The Hostage Perspective

Structural agreements always involve a promise designed to increase the probability of exchange. In some structural agreements, however, the probability of exchange is increased by more than a promise because the structure is designed to give the promisor some assurance, although not a commitment, that exchange will occur.

One such case can best be understood from the perspective of transaction-cost economics—in particular, from the perspective of a theory developed by Oliver Williamson concerning the use of hostages to support exchange.44 In certain cases, A is willing to make a promissory commitment to B even though B makes no reciprocal promissory commitment, because the parties craft a structural agreement under which B can benefit from A’s commitment only if he incurs costs whose value will be lost or greatly reduced if he does not exchange with A. Typically, those costs involve an investment by B in assets whose value is highly specific to the transaction with A. Such investments serve as a hostage for B’s continued willingness to exchange and, therefore, increase the probability of exchange.

Laclede is a good example.45 Under the structure crafted by Laclede and Amoco, Amoco promised to sell to Laclede all the propane gas required by Laclede for any given residential development, once the parties had entered into a supplemental agreement concerning the development. In contrast, Laclede did not promise to purchase any propane from Amoco. However, to obtain the benefit of the contract, Laclede had to construct distribution facilities that connected to the outlet of Amoco’s header piping. Once Laclede had constructed these distribution facilities, its investment would stand as a hostage to provide assurance that Laclede would purchase propane from Amoco for the development. The court stated:

\[
\text{If a change of suppliers could be made under the contract,}
\]

Laclede could not own and operate a separate distribution system hooked up to some other supplier’s propane storage tanks without substantially altering the supply route to its distribution system or

45. See supra text accompanying notes 22–24.
making a very substantial investment in its own storage equipment and site. As a practical matter, then, Laclede is bound to buy all the propane it distributes from Amoco in any subdivision to which the supplemental agreement applies and for which the distribution system has been established.\textsuperscript{46}

The hostage perspective also explains cases like Lindner,\textsuperscript{47} in which Lindner made a promissory commitment of five years while Mid-Continent made a promissory commitment of only ten days. On the surface, Lindner seems to have made a foolish bargain. However, the bargain is easy to explain under the hostage perspective. Mid-Continent leased Lindner's property for use as a gas station. There was a strong prospect that as the lease continued, Mid-Continent would make capital investments in the station and would develop locational good will. The investments and the locational good will, in turn, would serve as hostages that Mid-Continent would remain a tenant, because they would be sacrificed if Mid-Continent exercised its right to terminate the lease.

Of course, either Laclede or Mid-Continent could have decided at any time that they would make more profit by sacrificing their hostages than by continuing to exchange. A hostage provides assurance, but not a guarantee, of performance. Despite the hostage, Lindner was taking a chance that Mid-Continent would not terminate the lease (in fact, it did not; Lindner, not Mid-Continent, tried to terminate), just as Amoco was taking a chance that Laclede would not terminate (in fact, it did not; Amoco, not Laclede, tried to terminate). In all likelihood, the chances taken by Lindner and Amoco were sensible, but that is not the law's concern. The law's concern is whether Lindner and Amoco made bargains. They did. A bargain between businesspersons transacting on a market, who are knowledgeable about the terms of their bargain, is almost always sensible, even though the sense may not be immediately apparent to a judge. Hostage transactions are structural agreements, and a promise given as part of such an agreement should be enforceable.\textsuperscript{48}

\textsuperscript{46} Laclede Gas Co. v. Amoco Oil Co., 522 F.2d 33, 38 (8th Cir. 1975) (emphasis added).
\textsuperscript{47} See supra text accompanying notes 16–17.
\textsuperscript{48} A hostage theory of consideration has old legal roots. In ancient times, hostages were often given in settlement of blood feuds. In Germanic Europe in the Middle Ages, hostages came gradually to be used for other purposes, and eventually it became possible for a debtor to offer himself as a hostage (or surety) for his own obligation. On the Continent, this notion of self-pledge was the source of a formality that became in time a general means of making promises binding. See LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 1057 (6th ed. 1996).
F. Alignment of Interests

In hostage cases, the parties increase the probability of exchange by creating a promissory structure under which the promisee will incur costs if he does not continue to exchange. In another type of structural agreement the parties increase the probability of exchange by creating a promissory structure that aligns the interests of the parties. I call such agreements interest-aligning contracts.

Interest-aligning contracts often take the form of classical bargains in which both parties exchange commitments. Typically, the parties' interests are aligned by providing that they will share, in some designated way, the revenues that the contract produces. Sharecropping contracts are one example; publishing contracts are another. In the former, the owner of a farm and a tenant farmer share the revenues that the leased land produces. In the latter, an author and a publisher share the revenues that a book produces. The alignment of interests in these and other such contracts is not perfect. For example, when one party incurs post contract expenses to produce the revenue (the farmer or the publisher), while the other does not (the landowner or the author), the latter party will prefer that the expenses be maximized, so as to maximize revenues, while the former will prefer that expenses be incurred only to the point at which an extra dollar of expenses brings in an extra dollar of revenue to that party. Similarly, one or both of the parties to such a contract may have an incentive to cheat, by concealing revenues or in other ways. That the parties' interests are not perfectly aligned, however, should not lead us to lose sight of the fact that they are at least generally aligned.

A common technique for aligning interests is through the use of an arrangement that is an option in form or substance. Here again, corporate finance and the option perspective are useful in understanding the structural mechanics involved. One of the most important ways in which corporate executives are compensated is with stock options. Under a well-accepted theory of corporate finance, options on corporate stock have a significant present value, which depends on such factors as the current value of the corporation's stock, the exercise price of the option, the time remaining until the option expires, and the variability in the value of the underlying stock.\footnote{See Gilson & Black, supra note 35, at 238. There is a public market in put and call options. Executive stock options are somewhat harder to value than normal puts and calls because they typically carry special restrictions, but they certainly have value, which can be at least approximately determined.} Typically, the grant of an executive stock option...
involves a commitment by the corporation, but not by the executive. The corporation commits itself to issuing stock to the executive at the option price if the executive exercises the option. In contrast, the executive typically neither gives the corporation any present value in exchange for the option nor commits himself to remain in the corporation's employ for any period of time. Often the executive cannot exercise the option unless he remains in the corporation's employ for some minimum period, but in some cases the option is exercisable immediately or almost immediately under certain conditions, and the validity of such options has been upheld.50

Another example of the use of an option to align interests is presented by the contract in the famous case of Wood v. Lucy, Lady Duff-Gordon.51 Lady Lucy was in the business of creating her own designs and endorsing the designs of others. She and Wood made an agreement under which Wood had the exclusive right, subject to Lady Lucy's approval, to put her designs on sale, to place her endorsements on others' designs, and to license others to market her designs. In return, Lady Lucy would receive half of all profits and revenues derived from any contracts that Wood might make. Wood's exclusive right was to last for one year, and thereafter to run from year to year unless terminated on ninety days' notice. Despite the contract, Lady Lucy secretly placed her endorsements and withheld the resulting profits from Wood. Wood brought suit. Lady Lucy defended on the ground that her promise was not enforceable because Wood had made no promise.

The court, in an opinion by Judge Cardozo, held for Wood on the ground that Wood had made a promise—an implied promise to use reasonable efforts on Lady Lucy's behalf. Perhaps Cardozo's analysis was correct; essentially the same analysis was later embodied in the Uniform Commercial Code.52 It must be wondered, however, why Wood made no express promise to make any efforts on Lady Lucy's behalf, and whether he would, in fact, have been willing expressly to make the kind of commitment Cardozo said he had impliedly made. It was easy for Cardozo to imply such a promise without worrying much about whether he was saddling Wood with an involuntary obligation because Wood was not being forced to keep the promise that Cardozo implied. Instead, Cardozo needed to find the implied promise only to get around the mutuality rule, and thereby allow Wood to sue Lady Lucy on her express promise.

51. 118 N.E. 214 (N.Y. 1917).
52. UCC section 2-306(2) provides that: "A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale." U.C.C. § 2-306(2) (1977).
The court could have dealt with the case in a more direct way by holding that the contract was enforceable as a structural agreement. Lady Lucy probably believed that she could forgo an express commitment from Wood because the contract was structured to align Wood's incentives with hers. Here again, the option perspective comes into play. Under that perspective, Lady Lucy gave Wood an option to place her designs and endorsements. Wood, in turn, had an incentive to exercise the option by making such placements because he could make money on the contract only if such placements were made. The resulting alignment of interests may better explain Lady Lucy's motivation for entering into the contract than does the implication of a promise by Wood.

G. Employment Contracts That Are Terminable at Will

As a matter of law, employment contracts that are not for a specific duration are deemed to be terminable at will by either party. Under this rule, an employer can discharge an employee without cause at any time in the absence of an employment contract that expressly provides otherwise. Correspondingly, the employee is free to leave at any time.

Under general principles of contract interpretation, the at-will rule seems dubious. One of these principles is that when a contract is silent on an issue, the law implies a reasonable term to cover that issue. When an employment contract is silent on duration, it might therefore be assumed that the law would imply a reasonable duration. Typically, a reasonable duration, based on the parties' fair expectations, would be longer than a nanosecond.

Perhaps due to the tension between the at-will rule and general principles of interpretation, the rule has come under increasing pressure in recent years and is now subject to important exceptions. For example, federal and state statutes provide that an employee cannot be discharged on the basis of race, religion, gender, age, or disability. Even under the common law, in many or most states an employer cannot discharge an employee for a reason that violates public policy, such as retaliation against

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the employee because of his truthful testimony in an official proceeding.\textsuperscript{54}

Under other major exceptions to the at-will rule, an employee normally cannot be discharged in bad faith\textsuperscript{55} or in violation of a commitment made by the employer in an employment manual.\textsuperscript{56}

A recurring variation of the at-will case involves the following scenario: A is offered and accepts employment by B that is to begin in the future. A relies on the employment agreement—for example, by moving to B's location or by forgoing other employment opportunities. Before A begins work, B informs him that he will not be employed after all. A sues, and B defends by invoking the at-will rule.

A number of decisions have allowed an employee in A's position to recover reliance damages against B. For example, in \textit{Grouse v. Group Health Plan, Inc.},\textsuperscript{57} Grouse, who was employed as a retail pharmacist at Richter Drug, applied for employment with Group Health. After an interview, Group Health offered Grouse employment, which he accepted. That afternoon, Grouse received another offer of employment, which he declined because he had accepted Group Health's offer. Grouse then resigned from Richter Drug. Before Grouse was scheduled to begin work, Group Health told him that someone else had been employed in his place. Grouse experienced difficulty regaining full-time employment and suffered lost wages as a result. Grouse brought suit, and Group Health defended under the at-will rule.\textsuperscript{58}

The court began by holding that "[o]n these facts no contract exists because due to the bilateral power of termination [under the at-will rule] neither party is committed to performance and the promises are, therefore, illusory."\textsuperscript{59} Nevertheless, the court said, Grouse could recover under the principle of promissory estoppel:

Group Health knew that to accept its offer Grouse would have to resign his employment at Richter Drug. Grouse promptly gave notice to Richter Drug and informed Group Health that he had done so when specifically asked by Elliott. Under these circumstances it would be unjust not to hold Group Health to its promise.\textsuperscript{60}


\textsuperscript{56} See, e.g., Pine River State Bank v. Mettille, 333 N.W.2d 622 (Minn. 1983).

\textsuperscript{57} 306 N.W.2d 114 (Minn. 1981).

\textsuperscript{58} See id. at 115–16.

\textsuperscript{59} Id. at 116.

\textsuperscript{60} Id.
The court limited Grouse’s damages to reliance:

Since, as respondent [Group Health] points out, the prospective employment might have been terminated at any time, the measure of damages is not so much what he would have earned from respondent as what he lost in quitting the job he held and in declining at least one other offer of employment elsewhere.\(^6\)

Other cases have taken a comparable position on both liability and damages.\(^6\)

Grouse, and cases like it, may seem anomalous because they can be interpreted to mean that a prospective employee has a remedy if he is terminated the day before he is to begin work but not if he is terminated the day after. However, there are several ways to explain and rationalize these cases in a way that avoids such an anomaly.

One possible explanation is that the true dividing line is not whether work has begun, but whether liability and damages are based on expectation or on reliance. Under this explanation, even an employee who had begun to work could sue for reliance damages. It can be argued that the court in Grouse took this position. Group Health had argued that “recognition of a cause of action on [the facts in that case] would result in the anomalous rule that an employee who is told not to report to work the day before he is scheduled to begin has a remedy while an employee who is discharged after the first day does not.”\(^6\)

The court responded, “[w]e cannot agree since under appropriate circumstances we believe section 90 would apply even after employment has begun.”\(^6\)

A reliance-expectation explanation was more squarely adopted, in a related context, in *D & G Stout, Inc. v. Bacardi Imports, Inc.*\(^6\) General was a liquor distributor in Indiana. One of General’s major suppliers was Bacardi Imports. The relationship between General and Bacardi was terminable at will. After two of General’s other major suppliers terminated General’s franchise to distribute their products, General could not continue in business without the Bacardi account.

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\(^6\) *Grouse*, 306 N.W.2d at 116.

\(^6\) *Id.*

\(^6\) *Id.*

\(^6\) 923 F.2d 566 (7th Cir. 1991).
Another distributor, National Wine & Spirits, then offered to buy General’s business. Because it distributed the products of a Bacardi competitor, National was not interested in the Bacardi account. Bacardi, knowing that negotiations for the sale of General’s business to National were ongoing, promised General that General would continue to be Bacardi’s distributor. Based on this promise, General turned down National’s offer. One week later, however, Bacardi withdrew its account from General.

General then went back to the negotiating table with National. At this point, General’s bargaining position was considerably weakened because it could no longer continue to operate, and it had to settle for $550,000 less than National’s original offer. General then sued Bacardi to recover this shortfall, on the theory of promissory estoppel.

The Seventh Circuit, analogizing to cases like Grouse, held that the at-will nature of the relationship between General and Bacardi precluded a suit for expectation damages, but did not preclude a suit for reliance damages:

In Indiana, as in many states, an aspiring employee cannot sue for lost wages on an unfulfilled promise of at-will employment. ... Because the employer could have terminated the employee without cause at any time after the employment began, the promise of a job brings no expectation of any determinable period of employment or corresponding amount of wages.... Nevertheless, .... Indiana courts acknowledge certain damages as recoverable when the employer breaks a promise of employment, even if the employment is to be terminable at will. For example, in Eby v. York-Division, Borg-Warner, 455 N.E.2d at 627, a plaintiff who gave up a job and moved from Indiana to Florida on a promise of employment sued for recovery of preparation and moving expenses incurred on the basis of the promise. The Indiana appellate court reversed the lower court’s summary judgment for the defendant employer, holding that the plaintiff employee had stated a cause of action for promissory estoppel. ....

Our review of Indiana law thus leaves us a simple if somewhat crude question: are the damages plaintiff seeks here more like lost future wages or like moving expenses? We can better answer the question if we determine why Indiana draws this distinction. Unlike lost wages, moving expenses represent out-of-pocket losses; they involve a loss of something already possessed. It would be plausible, although not very sophisticated, to distinguish between the loss of something yet to be received and the loss of something already in
hand. But this is not precisely where Indiana draws the distinction, nor where we would draw it if it were our choice to make. Eby itself involved not only moving expenses, but wages lost at plaintiff's old job during the few days plaintiff was preparing to move. . . . Those wages were not out-of-pocket losses: plaintiff had no more received those wages than he had received wages from his promised employment.

In fact, the line Indiana draws is between expectation damages and reliance damages. In future wages, the employee has only an expectation of income, the recovery of which promissory estoppel will not support in an at-will employment setting. In wages forgone in order to prepare to move, as in moving expenses themselves, the employee gave up a presently determinate sum for the purpose of relocating. Both moving expenses and forgone wages were the hopeful employee's costs of positioning himself for his new job; moving expenses happen to be out-of-pocket losses, while forgone wages are opportunity costs. Both are reliance costs, not expectancy damages.66

An explanation of cases like Grouse that focuses on whether liability and damages are based on reliance, rather than on whether the employee has begun work, is certainly tenable. However, such an explanation is not completely satisfactory because it is not easy to see why, if "the promise of a job brings no expectation of any determinable period of employment or corresponding amount of wages,"67 the promise nevertheless justifies reliance.

A different explanation, based on the realms of choice and chance, overcomes this objection. There are two possible accounts of the understanding of a prospective employee who incurs out-of-pocket or opportunity costs in reliance on a promise of employment. Under one account, the employee understands that the employer is making no commitment of any kind, so that all of the employer's decisions concerning the course of the employment are purely within the realm of chance from the employee's perspective. The employee nevertheless incurs costs, based on the probability that employment will begin and will continue. Although this account is plausible, it seems unlikely.

The second, more likely account is that when parties agree upon a contract of employment, the employee understands that the employer is making a commitment—if not a commitment that the employee will be retained for a specific duration, at least a commitment that the employee

66. Id. at 568–69.
67. Id. at 568.
will be given a good-faith chance to satisfy the employer. Under this account, after the employee has begun work and has been given a good-faith chance, the employer is free to terminate the employment contract at will purely on the basis of his subjective dissatisfaction, barring any conflict with statute, public policy, commitments in an employee handbook, or the like. However, the employer is obliged to give the employee a good-faith chance to show that he is satisfactory. This is exactly how the court in Grouse viewed the problem:

The conclusion we reach does not imply that an employer will be liable whenever he discharges an employee whose term of employment is at will. What we do hold is that under the facts of this case [the employee] had a right to assume he would be given a good faith opportunity to perform his duties to the satisfaction of respondent once he was on the job. He was not only denied that opportunity but resigned the position he already held in reliance on the firm offer which respondent tendered him.

This explanation of cases like Grouse is consistent with most of the modern employment cases, which have tended to allow a prospective employee, but not an employee who has actually begun work, to recover damages on a reliance theory. It is also consistent with the court's statement in Grouse that "under appropriate circumstances . . . section 90 would apply even after employment has begun," because that statement probably meant only that it would be appropriate to allow an employee to recover, even after he has begun work, if he had not been given a good-faith chance.

Under such an interpretation of employment contracts with no specific duration, each party—employee as well as employer—makes a commitment to give the other a good-faith chance. Employment cases therefore differ in an important respect from illusory promise cases. In illusory promise cases, one party makes a commitment but the other does not, so that a bargained-for chance, if given, forms a unilateral contract. In contrast, in employment cases, both parties make a commitment to give each other a good-faith chance, so that there is a bilateral contract even before a chance has been given.

68. Grouse, 306 N.W.2d at 116 (emphasis added).
71. Grouse, 306 N.W.2d at 116.
There remains the question of damages. Because employment contracts are bargains, a prospective employee who is terminated before he begins work should, in principle, be awarded expectation damages based on the probability that if he had been given a good-faith chance, he would have been retained. However, the courts have tended to give reliance damages in such cases, either because they have deemed expectation damages too uncertain or because the employee's action is deemed to be founded on a reliance theory.

This brings us to another problem. In Grouse, D & G Stout, and other cases, the courts have held that reliance damages for an improperly terminated prospective employee include opportunity costs—in particular, the wages that would have been earned in lost or forgone employment. But how can those forgone wages be measured if the forgone employment would also have been at will? The answer is that even when employment is at will, employees normally are not discharged without cause except as part of economic layoffs. Therefore, if an employee had retained or taken alternative employment, he probably would have continued in that employment and is entitled to the value of that probability.

To put this differently, what the employee loses in such cases is the value of the opportunity to have retained or taken the forgone employment. That value is based on the expected tenure of the employment. It is true that the employee’s alternative employer would have had the legal power to discharge the employee at will if the alternative contract did not state a fixed duration. However, because that legal power would not necessarily or even probably have been exercised, the existence of the power does not eliminate, but simply reduces, the value of the forgone opportunity.

By way of analogy, consider the position of a haircutter, H, with a one-year contract, who is improperly discharged. H loses not only his wages under the contract, but his reasonably expected income from tips. Even though H had no legal right to tips from his customers, tips are predictable, and H’s damages therefore should include the expected value of the lost tips. This was just the result in Manubens v. Leon. If an

72. See Bower, 852 F.2d at 361; Ravelo, 658 P.2d at 883.
73. 88 L.J.K.B. 311 (1918); see also Richardson v. Mellish, 2 Bing. 229 (C.P. 1824).

It is clear that the Plaintiff could only be appointed for one voyage. . . . But though that is the case, may not parties look to that which is the practice of the East India Company, that though they renew the appointment, they renew it in the same person. If that practice be legal, may I not say, if you had appointed me for the first voyage, I should have continued for the second? You have deprived me of the profits I should have made not only on the first voyage, but on the second also. It requires no legal
improperly terminated employee has lost or forgone other employment, the expected value of that employment should be awarded, just like the expected value of H's lost tips.

H. Modifications

A central rule of classical contract law was the legal-duty rule, that a promise to perform a legal duty is not consideration. Under this rule, an agreement to make a one-way readjustment of a contract—that is, a readjustment under which only one party's rights are changed—is unenforceable. I refer to such one-way readjustments as modifications.

Modifications normally fall into one of two patterns. In one pattern, A is contractually obliged to render some performance to B, other than the payment of money, in exchange for a price, $X. The parties then agree that B will increase the price for A's performance by adding an increment, $I. After A performs, B refuses to pay the increment. Under the legal-duty rule, B is not liable for the increment that he agreed to pay.

In the second pattern, A owes $X to B, and the parties agree that B will accept $L, which is less than $X, in full satisfaction of A's debt. After A pays $L to B, B sues for $X - L, the difference between what A paid and what he originally owed. Under the legal-duty rule, A is liable for that difference.

For the most part, the two patterns raise the same issues. For ease of exposition, I discuss only cases that fall within the first pattern.

In the view of classical contract law, the legal-duty rule needed no social justification because it was a self-evident axiom. Sir Frederick Pollock, for example, said that "[i]t seems obvious that an express promise by A. to B. to do something which B. can already call on him to do can in contemplation of law produce no fresh advantage to B. or detriment to A., and therefore will not be a good consideration."

head to decide this; common sense says, you are not to be paid for consequences which might not turn up in your favour; but the Plaintiff is entitled to have a compensation for being deprived of that which almost to a certainty happens in these cases.

Id. at 239.


75. Of course, it is also possible to have a two-way readjustment, in which the rights of both parties are changed. This kind of readjustment, which does not raise a consideration problem, is also a modification in the ordinary sense of that term. In contract law, however, the term is typically used to refer to one-way readjustments, and I follow that usage here.

76. F. POLLOCK, PRINCIPLES OF CONTRACT 196 (9th ed. 1921).
Far from being obvious, however, the legal-duty rule is frequently in conflict with the bargain principle. When A explicitly states that he will perform only if a modification is made, and B agrees to the modification as the price for A's performance, the parties have made a classical bargain. It is true that when the parties agreed to the modification, A already owed the performance. However, the fact that the parties made the modification shows that B did not think the existing contract was sufficient to induce A's performance, and that a new incentive was required to increase the probability that A would perform. If B agrees to the modification in exchange for some act or promise of A, the modification is a bargain, has consideration, and should be enforceable—subject only to the standard defenses that can be raised against any otherwise enforceable bargain, like fraud or duress.

The legal-duty rule cannot be rationalized on axiomatic grounds: no rule can be rationalized on such grounds, least of all the legal-duty rule, which frequently violates the more basic bargain principle. In modern times, therefore, attempts have been made to justify the legal-duty rule on social grounds. The conventional justification—advanced, for example, in Restatement Second—is based on the premise that modifications are commonly made under duress. But that premise alone, even if true, is not sufficient to justify the legal-duty rule. Because duress is always a defense to a contract, a modification that is made under duress would be unenforceable even in the absence of the legal-duty rule. Accordingly, the duress justification must rest on one of two additional predicates—either that: (i) the proportion of modifications made under duress is so high that it would be a waste of judicial resources to determine whether a particular modification was not made under duress; or (ii) duress should be conclusively presumed because it is too difficult for a court to determine whether duress was actually present in any given case. Neither of these predicates is well founded.

First, whether a modification was made under duress is not especially difficult to determine. The relevant issues are whether A had a good-faith reason for requesting the modification, and whether B lacked practicable freedom to resist A's request. Courts can easily deal with these issues directly. Indeed, they frequently do so, both under the legal-duty rule and in cases in which a party invokes the doctrine of economic duress to recover all or part of a payment he has already made.

77. See Restatement (Second) of Contracts § 73 cmt. a (1981).


Second, there is nothing to show that an extremely high proportion of modifications are made under duress, or even that modifications are commonly made under duress. In fact, the opposite is more likely to be true. To begin with, most modifications do not seem to arise out of a desire by A to grab more of the contract surplus simply because a shift in bargaining power has allowed him to make such a grab. Instead, most modifications seem to arise because a state of the world looks significantly different than it was expected to look when the contract was made, either because one or both parties were under a misapprehension at the outset, or because the world unfolded in a different way than the parties expected.

Of course, even though A's request for a modification may be motivated by a misapprehension or changed circumstances, B may agree only because he is under duress. Indeed, Aivazian, Penny, and Trebilock ask, in an elegant article on the modification problem,

> Why would any party to a contract agree, by way of modification, to pay more or accept less than originally contracted for, without an appropriate *quid pro quo* (consideration), unless the other party had obtained bargaining power in the course of the relationship that he did not possess at the time of the contract formation and that he now seeks to exploit?  

The syntax of this question strongly implies that, in the authors' view, the answer to the question is self-evident—that rarely, if ever, would a contracting party agree to a modification except under duress. In fact, however, modifications commonly appear to be made in the absence of duress. For example, in many cases A requests a modification but does not threaten breach, and in other cases there is nothing to indicate that A's performance could not have been practicably replaced. But why would B ever agree to a modification if A had not obtained more bargaining power in the course of the relationship than he had at the time the contract was made and improperly used that power for exploitive purposes?

There are two answers to this question. The first answer centers on concepts of fair dealing. Modifications typically are motivated by misapprehensions or changed circumstances. In some situations, a misapprehension or changed circumstance may provide a complete defense to

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81. See, e.g., Angel, 322 A.2d at 630.

82. See B.J. Reiter, *Courts, Consideration, and Common Sense*, 27 U. TORONTO L.J. 439, 466 (1977) ("[T]he opportunity for over-reaching requires virtually irreversible reliance on the pre-existing duty, present in only a small handful of the many situations in which modification promises are made.")
performance by A, under the doctrines governing mistake and impossibility (using that term to include commercial impracticability and frustration). If one of those doctrines is applicable, there will be no legal-duty-rule problem, because if A agrees to render a contracted-for performance despite the fact that he has a legal defense, he is agreeing to do something that he is not legally obliged to do.

However, the doctrines of mistake and impossibility have a very narrow ambit, because if the doctrines were unduly encompassing, legitimate expectations might be improperly upset by judicial action. Given the narrow ambit of these doctrines, it will often be the case that B may be willing to modify a contract because he believes that, even though the misapprehension or changed circumstance does not rise to the level of a legal defense, as a matter of fair dealing a readjustment should be made to reflect the original purpose of the contractual enterprise or of the equities as they now stand in light of the parties' original tacit assumptions. This is especially likely when, even under the modification, the gains to be made by B under the contract will equal or exceed the gains B originally expected.

There is reason to believe that modifications motivated by fair dealing are extremely common. As B.J. Reiter has stated:

> [T]he basic assumption that a businessman will insist upon the strict fulfillment of his legal rights however dramatically circumstances have changed for the other party and that only pressure will force him to yield to suggestions that he ought to help absorb unforeseen and onerous changes suffered by his obligee, reflects an unrealistic and unduly pernicious view of modern business ethics. 83

There is also a deeper, perhaps more common, reason why B might accede to A's request for a modification even if A does not have newly acquired market power: reciprocity, or the hope of reciprocity. 84 A modification that appears to be one sided if examined in isolation may be reciprocal when account is taken of the dynamic ebb and flow of the contractual stream in which the modification is located. For example, B may agree to a modification that favors A for the purpose of reciprocating for past modifications—of either the same or other contracts—that favored B. Or, B may agree to a modification that favors A because he believes his agreement will increase the probability that A will consent to future modifications in B's favor when B is in A's shoes, under either the same or other contracts. In such cases, a modification is a special kind of a structural

83. Id. at 465.
84. See id. at 465–66; Wessman, supra note 30, at 746–47.
agreement, made to increase the probability of future exchange—that is, future reciprocity.

Of course, under an enforceability regime a contracting party who agrees to a modification in the expectation of reciprocity takes the risk that when his turn comes, his contracting partner will not agree to a modification that other contracting parties would have believed appropriate. That is, the prospect that the other party will agree to future modifications is within the realm of chance. However, contracting parties may be willing to take that chance when they believe that the other party will probably agree to appropriate modifications in the future because he will want to deal fairly, will want to develop a reputation for dealing fairly, or will want to increase the likelihood of reciprocal modifications in his favor.

The fair-dealing and reciprocity reasons for agreeing to modifications reinforce one another. For example, if B agrees to a modification now because A agreed to a modification in the past, B's action can be described as based either on fair-dealing or reciprocity. Indeed, reciprocity itself is a fair-dealing concept. The important point is not whether B's agreement to any given modification is motivated by fairness or self-seeking. Rather, the important point is that in many and perhaps most modifications, B is motivated by one or both of these factors rather than by A's duress.

As discussed above, many modifications are classical bargains, in which the parties make reciprocal promises—A to perform, B to pay. In some modifications, however, A does not make an express promise. For example, in a scenario that seems to be common, A asks B for a modification without threatening breach. Because A has not threatened breach, B, in agreeing to the modification, may choose not extract a promise from A. This kind of modification is an even more appealing candidate for enforceability than one in which A does make a promise, just because it involves no threat of breach. The ground of enforceability is that the parties have made a structural agreement that is designed to increase the probability of exchange under the existing contract, under future contracts between the parties, or both.

It has been suggested, however, by Aivazian, Trebilock, and Penny, that a regime under which modifications are enforceable would be based only on static considerations, while the legal-duty rule (or, more precisely, a rule under which modifications are presumptively unenforceable) would reflect dynamic considerations:

The nature of the apparent analytical paradox presented by contract modifications can be stated briefly. . . . If most modification situations occur in a context in which one party seeks to exploit bargaining power he has obtained during the course of the relation-
ship] .... then it might be argued that the law should attempt to discourage extortionary, coercive, opportunistic or monopolistic behavior by refusing to enforce most modifications, perhaps by means of a presumption of invalidity .... On the other hand, especially in commercial contexts where most litigated modification cases seem to arise, it might be argued that parties would typically not enter into modifications unless they both felt better off as a result relative to the position that would or might have been obtained without a modification. Hence, the law should respect the parties' assessment of what course of action best advances their joint welfare and enforce modifications, that is, apply a presumption of validity ....

... The paradox described above is the product of a tension between two competing sets of efficiency considerations, which in some cases require difficult trade-offs .... Static efficiency considerations will generally require that contract modifications be enforced on the grounds that the immediate contracting parties perceive mutual gains from recontracting that cannot, at the time modification is proposed, be realized as fully by any alternative strategy. On the other hand, dynamic efficiency considerations focus on the long-run incentives for contracting parties at large .... In the modification context, these dynamic efficiency considerations adopt an ex ante perspective, rather than the ex post perspective implicit in the static efficiency considerations. Adopting the former perspective, rules that impose no constraints on recontracting may increase the over-all costs of contracting by creating incentives for opportunistic behaviour in cases where "holdup" possibilities arise during contract performance .... Thus, what is in the best interests of two particular contracting parties ex post contract formation when a modification is proposed and what is in the interests ex ante of contracting parties generally in terms of legally ordained incentives and constraints that minimize the over-all costs of contracting may lead to divergent policy perspectives. 85

In fact, however, the matter is the other way around: it is the legal-duty rule that is based on a static view of contract. The rule conceives of modifications as individual events that occur in isolation, rather than as ripples in a stream of reciprocity. The rule also ignores the virtues of ongoing cooperation and accommodation between contracting parties. Finally, the rule conceives of contracts as static transactions whose terms are fully determined at the moment of contract formation, and inhibits

85. Aivazian et al., supra note 80, at 174–75.
both the evolution of a contract and dynamic reciprocity between contacting parties.

In contrast, an enforceability regime is based on a dynamic view of contract. An enforceability regime recognizes that a modification is likely not to be an isolated event, but instead is likely to be a part of an ongoing stream of modifications and contracts between the parties. An enforceability regime also takes account of the value of ongoing cooperation and accommodation between contracting parties. Finally, an enforceability regime conceives of a contract as an evolving process, rather than a static event, and encourages the dynamic evolution of contracts as circumstances unfold.

There is another dynamic aspect to an enforceability regime. Most modifications are made as private-ordering responses to unexpected states of the world. The power of contracting parties to engage in such private ordering ex post may make parties more willing to enter into contracts ex ante. Indeed, even a party who feels no moral need to deal fairly may agree to an appropriate modification because he wants to develop or maintain a reputation for fair dealing, so that others will be more ready to contract with him. Accordingly, knowledge that modifications will be enforced is likely to make actors more willing to enter into contracts.

Given the disadvantages of the legal-duty rule when compared with an enforceability regime, it is to be expected that modern contract law would move from the former to the latter. That is just what has been occurring. Although the legal-duty rule still has some bite, even courts that believe themselves obliged to follow the rule characterize it as "technical," regard it with "disfavor," and find it to be supported by "neither rhyme nor reason." The rule has been riddled with inconsistent exceptions, repudiated by judicial decisions in several

88. See, e.g., Morrison Flying Serv. v. Deming Nat'l Bank, 404 F.2d 856 (10th Cir. 1968) (holding that the legal-duty rule is not applicable when there is a preexisting contractual duty owed to a third person); Schwartzreich v. Bauman-Basch, Inc., 131 N.E. 887 (N.Y. 1921) (holding that the legal-duty rule is not applicable when the prior contract is mutually rescinded when the new contract is made); Cohen v. Sabin, 307 A.2d 845 (Pa. 1973) (ruling that the payment of part of an unliquidated obligation that is admittedly due is consideration for the surrender of the balance of the claim); Angel v. Murray, 322 A.2d 630 (R.I. 1974) (holding that the legal-duty rule is inapplicable if the new contract is fair and equitable in light of circumstances not anticipated when the old contract was made).
states, and repudiated as to written modifications by statutes in several major jurisdictions. More generally, the UCC explicitly provides that modifications of contracts for the sale of goods are enforceable, provided they are made in good faith. More generally still, Restatement Second section 89 provides that a modification of a contract that has not been fully performed on either side is binding "if the modification is fair and equitable in view of circumstances not anticipated by the parties when the contract was made." The Illustrations make clear that this rule includes modifications based on misapprehensions as well as changed circumstances.

III. REMEDIES

In the area of consideration, classical contract law took insufficient account of probability and chance, but those elements figure implicitly in the transformation of classical contract law into modern contract law. In this Part, which deals with remedies, I explore the role of probability and chance in prizes and rewards, the principle of certainty, and the principle of Hadley v. Baxendale.

A. Prizes and Rewards

Prizes and rewards may be either freely bestowed for achievement or claimed as due by virtue of an offer. Examples in the former category include the Nobel and Pulitzer Prizes. Examples in the latter category include prizes in contests and rewards for the return of lost or stolen property, for information, or for the capture of criminals.

Freely bestowed prizes and rewards normally raise no issues of contract law. Accordingly, in this Article I use the terms prize and reward restrictively, to mean either an offer of a prize or reward, or the prize or reward claimed under such an offer, depending on the context. So defined, prizes and rewards have an important structural similarity: they are offers to pay for the performance of an act, normally by a member of the public, and therefore constitute prototypical unilateral contracts. Indeed, Karl

89. See Dreyfus & Co. v. Roberts, 87 S.W. 641 (Ark. 1905); Clayton v. Clark, 21 So. 565 (Miss. 1897); Frye v. Hubbell, 68 A. 325 (N.H. 1907).
90. See CAL. CIV. CODE §§ 1524, 1541, 1697 (West 1954); MICH. COMP. LAWS ANN. § 566.1 (West 1967); N.Y. GEN. OBLIG. LAW § 5-1103 (McKinney 1964).
93. See id. illus. 1–5.
Llewellyn, somewhat precipitously, viewed prizes and rewards as virtually the only true unilateral contracts. 94

Although prizes and rewards are similar in important respects—and, indeed often overlap, especially when the offeree is called upon to exercise skill—there are differences between prizes and rewards taken as classes. These differences cannot easily be captured in a definition, as evidenced by the first definition of *prize* in the *Random House Dictionary*: “a reward for victory or superiority.” 95 Nevertheless, the terms prize and reward carry somewhat different connotations: *Prize* connotes competition; *reward* connotes compensation. So, for example, prize offers, unlike reward offers, are frequently restricted to those members of the public who have first qualified for a contest, or qualified as a finalist in a contest by paying money, doing a specified act, or jumping through a specified hoop.

At least in form, prizes and rewards are mirror images of illusory promise cases. In illusory promise cases, A makes a commitment to B as an incentive to B to give A a chance. In prizes and rewards, A makes a commitment to B as an incentive to B to take a chance—that is, to take the chance that his efforts or expenditures will not be wasted, but instead will yield the fruit of the prize or reward.

Rewards seldom, if ever, present a consideration problem, because to claim a reward the offeree normally must perform a designated act that has actual or imputed value to the offeror. Similarly, in contests in which contestants must pay money or perform some designated act other than merely registering to enter the contest, the promise of a prize is normally enforceable without regard to the objective value of the claimant’s act. For example, in *Simmons v. United States*, 96 American Brewery sponsored a well-publicized annual American Beer Fishing Derby. Under the Derby rules, the brewery tagged one of the millions of rockfish in the Chesapeake Bay, and named it Diamond Jim III. Anyone who caught the fish and presented it to the brewery, together with the tag and an affidavit that the fish was caught on hook and line, would be entitled to a cash prize of $25,000. Simmons caught Diamond Jim about six weeks after it was tagged, and


96. 308 F.2d 160 (4th Cir. 1962)
soon thereafter received the cash prize. Simmons knew about the contest, but as an experienced fisherman he also knew that his chances of landing the tagged fish were minuscule, and he did not have Diamond Jim in mind when he set out to go fishing. The court held (in a tax context) that the brewery was legally obliged to award the prize to Simmons once he had caught the fish:

It is not fatal to his claim . . . that [Simmons] did not go fishing for the express purpose of catching one of the prize fish. So long as the outstanding offer was known to him, a person may accept an offer for a unilateral contract by rendering performance, even if he does so primarily for reasons unrelated to the offer. 97

Similarly, in Cobaugh v. Klick-Lewis, Inc., 98 Cobaugh, while playing in a golf tournament, unexpectedly found a new Chevrolet Beretta at the ninth tee together with signs that proclaimed: “HOLE-IN-ONE Wins this 1988 Chevrolet Beretta GT Courtesy of KLIK-LEWIS Buick Chevy Pontiac $49.00 OVER FACTORY INVOICE in Palmyra.” 99 Cobaugh shot a hole-in-one and claimed the prize. The court held that there was consideration:

In order to win the car, Cobaugh was required to perform an act which he was under no legal duty to perform. The car was to be given in exchange for the feat of making a hole-in-one. This was adequate consideration to support the contract. 100

Courts have had more difficulty with contests in which the offerees are not required either to pay money or to perform a designated act other than registering to enter the contest. The leading examples of such contests are promotional games that do not require a purchase, such as magazine-clearinghouse sweepstakes or free scratch-off games that can be picked

97. Id. at 165.
99. Id. at 1249.
100. Id. at 1250; see also Champagne Chrysler-Plymouth, Inc. v. Giles, 388 So. 2d 1343 (Fla. Dist. Ct. App. 1980); Schreiner v. Weil Furniture Co., 68 So. 2d 149 (La. Ct. App. 1953); Las Vegas Hacienda, Inc. v. Gibson, 359 P.2d 85 (Nev. 1961); Grove v. Charbonneau Buick-Pontiac, Inc., 240 N.W.2d 853 (N.D. 1976). But see Fernandez v. Faha, 144 F. Supp. 630 (S.D. Fla. 1956) (holding that a prize at a baseball-game drawing was a gift because the winning contestant would have attended the game even if the prize had not been offered). Usually in this kind of case the promoter of the contest does not deny that the offer is enforceable, but instead argues that some condition was not satisfied, that there was a mistake of some sort, that there was a problem of interpretation, see, e.g., Grove, 240 N.W.2d at 862, or that the contest was illegal under the gambling laws, see, e.g., Chenard v. Marcel Motors, 387 A.2d 596 (Me. 1978). In Cobaugh, Klick-Lewis had offered the car as a prize for a charity golf tournament two days earlier and had neglected to remove the car and the posted signs prior to Cobaugh's hole-in-one. Cobaugh, 561 A.2d at 1250.
up at retail locations. Some courts have held that the prizes in such games are unenforceable for lack of consideration.\textsuperscript{101} In fact, however, these prizes should be enforceable because promotional games are structural agreements. Although promotional games are the mirror image of illusory promise cases in form, in substance they are mutual bargains for a chance: The contestant enters the contest for the chance of winning, while the promoter stages the game to increase the probability of transacting. Under the structure of these games, contestants must sample the promoter's wares, either by coming to a store to play an in-store game or by reading through direct-mail advertising to find a contest entry form. The greater the volume of customers or readers, the greater the probability of transacting.\textsuperscript{102}

Although prizes and rewards do not raise significant consideration issues, they do raise two difficult damages issues: What measure of damages should be utilized if a prize or reward is not forthcoming, and how to deal with the wrongful denial of a chance to win a contest.

1. Measure of Damages

As Llewellyn pointed out, “[t]ypically, the recompense promised [in a prize or reward case] is vastly greater than the worth of the offeree's time and skill measured on a pure \textit{per diem} and out of pocket basis.”\textsuperscript{103} Llewellyn might have added that, especially in the case of prizes, the recompense is often vastly greater than the market value of the benefit the offeree confers upon the promoter, as evidenced by Simmons and Cobaugh. Under these circumstances, what, if anything, justifies measuring the offeree's damages by his expectation (the amount of the reward or prize), as opposed to either the value of the time, skill, and out-of-pocket costs expended by the offeree, or the market value of the benefit the offeree conferred on the promoter?

One possible answer is that prizes and rewards are bargains, and a breach of a bargain promise leads to expectation damages. However, when the functional reasons for expectation damages are examined, this answer is not convincing. Although expectation damages are often conceived to be compensatory, as Lon Fuller trenchantly observed, such damages “com-


\textsuperscript{102} See Wessman, supra note 94, at 635.

\textsuperscript{103} Llewellyn, supra note 94, at 806.
pensate' the plaintiff by giving him something he never had. This seems on the face of things a queer kind of 'compensation."

In fact, the best explanation for the expectation measure is not that it is compensatory, but rather that it provides the right kind of incentives to contracting parties and, therefore, is the measure that contracting parties probably would have adopted if they had addressed the issue of damages.

One important dimension of a damages measure concerns its incentive effect on the rate of performance—that is, on deliberate decisions to breach, either to take advantage of a newly presented alternative performance that is more profitable or to avoid higher-than-expected costs. Contracts create joint value. Incentives for performance are efficient if they compel a party to balance the gains he will reap from breach against the lost joint value. The expectation measure places on the breaching party the loss of the other party's share of the contract's joint value, and thereby sweeps that loss into each party's self-interested calculus in a decision whether to perform or to breach. In contrast, if liability was not based on expectation damages, the value of a contracted-for performance to one party would not enter into the other's purely self-interested calculation whether to perform or breach.

This analysis can be restated in terms of externalities. If a party who breaches is liable for the other party's loss of his share of the joint value created by the contract, then in determining whether to perform or breach, he will internalize not only his own gains from breach but also the other party's losses.

Another important dimension of a damage measure concerns its incentive effect on the rate of precaution. In some cases in which unexpected costs motivate breach, those costs could have been forestalled if appropriate precautions had been taken. For example, suppose S agrees to construct a yacht for B, to be delivered in six months. S may stock all the raw materials he needs for the yacht immediately after signing the contract, so that he will not be caught short if the supply of raw materials tightens up. Similarly, S may make contracts with skilled workers, rather than hiring the workers on at-will basis, so that he is not caught short if the labor market tightens up. But precaution is expensive. S could reduce his inventory costs by buying raw materials for B's yacht on a just-on-time basis. He could reduce his labor costs by keeping his labor supply flexible. From an efficiency standpoint, the cost of precaution must be balanced against the resulting benefit—a reduction in the probability of breach and a conse-

quent enhancement of the likelihood that the value of the contract will be realized.

The expectation measure provides an incentive for the efficient rate of precaution, for the same reason that it provides an incentive for the efficient rate of performance. An incentive for precaution is efficient if it induces each party to balance the cost of precaution against the cost of failing to take precaution, including the risk to the other party of losing his share of the contract's joint value. In the absence of liability for expectation damages, that risk would not enter into a purely self-interested calculation, and the incentive for precaution would therefore be inadequate. The expectation measure causes each party to internalize the cost of failure to take adequate precaution and therefore creates an incentive for efficient precaution against breach.

Both of these explanations for expectation damages, however, seem thin when applied to prizes and rewards. Normally, no damages at all can be assessed against the offeree, because he has not made a promise. As to the offeror, normally his only duty in such cases is to pay money. Although in theory one who offers a prize or reward might want to breach because he finds some more attractive use for his money, or because unexpected circumstances make payment of the money unusually costly, in practice neither explanation seems realistic in this context. Similarly, the experience reflected in the case law suggests that breach of reward or contest offers seldom results from a lack of sufficient precaution, but instead is normally the product of either a deliberate decision to breach or some sort of transient mechanical mistake that occurred despite the fact that reasonable precautions had been taken. Therefore, neither the rate of performance nor the rate of precaution is likely to be an issue in prize and reward cases. Accordingly, the reasons for awarding expectation damages in such cases seem to lie elsewhere—in particular, in the role of probability in prizes and rewards.

Begin with prizes in contests. Although a contest prize is often all out of proportion to the contest winner's time, trouble, and out-of-pocket costs, it is usually not disproportionate to the contest winner's investment if the investment is viewed on a probabilistic basis. Any given contestant usually has only a very small probability of winning the prize—often, an infinitesimal probability. To induce people to enter a contest, the prize must be sufficient to make the contestant's investment worthwhile, given the low probability. Accordingly, when the investment of an offeree in a contest is adjusted for the probability that the investment will yield a return, it is typically not disproportionate to the prize.
Similar considerations apply in determining the benefit derived by the promoter. Although the benefit a promoter gets from the contest winner is typically only an infinitesimal fraction of the contestant's prize, the promoter will set the amount of the prize at no more than the benefit he expects to derive by running the contest. Accordingly, while the overwhelming proportion of that benefit will flow from persons other than the contest winner, requiring payment of the prize will not result in a net loss to the promoter, at least as he calculated costs and benefits ex ante. Furthermore, because the benefit of the contest to the promoter depends upon the contestants' belief that the winner will be paid in full, it is in the interest of promoters as a class that contest offers be enforceable in full.

Now consider rewards. In asking what motivates a person, \( O \), to offer a reward, it is useful to consider \( O \)'s alternatives. Suppose \( O \) wants to achieve result \( R \). \( O \) could attempt to achieve that result through a bilateral contract with some person, \( T \). For example, if result \( R \) is the production of certain information, \( O \) could make a contract concerning \( R \) with a detective agency. Often, however, it will be uncertain whether result \( R \) can actually be achieved—for example, whether, in the hypothetical, the information can actually be found or developed. Therefore, if \( O \) seeks to achieve result \( R \) through a bilateral contract with \( T \), typically \( T \) would not be willing to promise to produce result \( R \), but instead would only be willing to promise to use certain efforts to attain that end. Because \( O \) is paying \( T \) for efforts, not results, \( O \) will probably contract to pay \( T \) on the basis of the market rate for the services of persons like \( T \) on a time basis, rather than on the basis of the value of result \( R \) to \( O \). The advantages of such a contract are that it assures \( O \) that someone he regards as reliable will expend efforts to achieve his end, and that the amount that \( O \) pays may be considerably less than the value he places on result \( R \). The disadvantage is that \( O \) will normally be required to pay \( T \) for his efforts even if the efforts are not successful.

In contrast, if \( O \) makes a reward offer, he is not assured that any efforts will be expended, but he will only be obliged to pay if result \( R \) is achieved.\(^{105} \) Partly for that reason, and partly because \( O \) will not know

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\(^{105}\) Sam Broderick Sokol, my editor at UCLA Law Review, points out another reason why \( O \) may prefer an offer of a reward over a bilateral contract. If reward-offerees have perfect information and are risk neutral, then each reward-offeree will make an investment of effort and money equal to the value of the reward multiplied by the probability that the offeree will succeed. Given these conditions, the summed probabilities of success of all the reward-offerees who act on the reward should be 1, and the summed value of the effort and money invested by all the reward-offerees should be no more than the reward. However, if reward-offerees view the reward
what amount is required to provide unknown members of the public with a sufficient incentive to achieve result $R$, $O$ may offer a reward whose amount approaches the value he places on result $R$. Therefore, the amount of the reward will be no more than the benefit to the offeror. Accordingly, measuring damages by the amount of the reward can be explained on an unjust enrichment or benefit-conferred theory: We know, from the fact that a reward was offered, that by performing the requested act the claimant conferred a benefit on the offeror. We know, from the amount of the reward, the minimum value that the offeror places on that benefit. Having received a benefit in the amount of that value, the reward-offeror should pay that amount to the claimant who has conferred the benefit.

Moreover, enforcing rewards to their full extent is in the interests of reward offerors as a class, just as enforcing prizes according to their terms is in the interest of contest-promoters as a class. It is true that ex post—that is, after a reward offeror gets what he wants—it may be in the offeror’s narrow self-interest to argue that a successful claimant should be compensated only for costs. However, ex ante—that is, before the requested act has been performed—the picture is much different. The amount of a reward may be disproportionate to the claimant’s costs, but because the reward-offeree is normally compensated only if his efforts bear fruit, his costs may be wasted. In effect, a reward-offeree, like a prize-contestant, bets his investment of time and trouble.\textsuperscript{106} To induce him to make that bet, the reward must be high enough so that the reward, multiplied by the probability of gaining the reward, exceeds the offeree’s investment. If rewards were enforced only to the extent of the successful claimant’s costs, claimants would be stiffed on their bets and reward offerors would be unable to make binding offers in the amount they believed necessary to achieve the results they desire.

2. Lost Chances

A second difficult damages issue arises when a person who has properly qualified for a contest is wrongfully disqualified before the contest is completed, and it cannot be determined whether the contestant would have won a prize if he had not been disqualified. Call the promoter of the

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\textsuperscript{106} See Llewellyn, \textit{supra} note 94, at 806.
contest, the contestant C. In such a case, P's breach has clearly caused a loss to C. Before P acted wrongfully, C had a chance to win the contest; after P acted wrongfully, C did not. As a result of P's wrongful act, C has lost an asset—the chance—and P should be liable for the value of that asset. By way of analogy, suppose that N steals a lottery ticket owned by C. N should be liable to C for the value of the ticket. Similarly, if O is the promoter of a lottery and wrongfully refuses to include C's lottery ticket in the drawing, O should be liable to C for the value of the ticket, and if P is the promoter of a contest and wrongfully disqualifies contestant C, P should be liable to C for the value of C's chance.

The leading case is Chaplin v. Hicks, decided by the English Court of Appeals in 1911. Hicks, a well-known actor and theater manager, ran a contest for actresses. The prizes were theatrical engagements. The rules of the contest were as follows: Contestants would send photographs of themselves to Hicks, who would divide England into ten districts and would publish, in a newspaper in each district, photographs of the candidates he had selected. Newspaper readers would then vote for the contestants they considered to be the most beautiful. Hicks would thereafter interview fifty finalists, consisting of the five candidates in each district with the highest votes. From these fifty finalists, Hicks would select twelve winning actresses who would receive the theatrical engagements.

Chaplin became one of the fifty finalists, but Hicks did not give her an interview. Chaplin then brought an action against Hicks for the loss of her chance of being selected as one of the twelve winners. At trial, she was awarded damages of £100. The court of appeal affirmed. Lord Justice Moulton stated:

Is expulsion from a limited class of competitors an injury? To my mind there can be only one answer to that question; it is an injury and may be a very substantial one. Therefore the plaintiff starts with an unchallengeable case of injury, and the damages given in respect of it should be equivalent to the loss.

... Is there any such rule as that, where the result of a contract depends on the volition of an independent party, the law shuts its eyes to the wrong and says that there are no damages? Such a rule, if

107. 2 K.B. 786 (C.A. 1911).
108. See id. at 786–88. The rules of the contest had been changed after the initial applications had been made due to an unexpectedly heavy volume of applications, but the plaintiff agreed to the changes. See id. at 787.
109. See id. at 788.
it existed, would work great wrong. Let us take the case of a man under a contract of service to serve as a second-class clerk for five years at a salary of 200£ a year, which expressly provides that, at the end of that period, out of every five second-class clerks two first-class clerks will be chosen at a salary of 500£ a year. If such a clause is embodied in the contract, it is clear that a person thinking of applying for the position would reckon that he would have the advantage of being one of five persons from whom the two first-class clerks must be chosen, and that might be a very substantial portion of the consideration for his appointment. If, after he has taken the post and worked under the contract of service, the employers repudiate the obligation, is he to have no remedy? He has sustained a very real loss, and there can be no possible reason why the law should not leave it to the jury to estimate the value of that of which he has been deprived. Where by contract a man has a right to belong to a limited class of competitors, he is possessed of something of value, and it is the duty of the jury to estimate the pecuniary value of that advantage if it is taken from him.110

Similarly, in the United States, it is now an accepted principle of contract law that recovery will be allowed where a plaintiff has been deprived of an opportunity or chance to gain an award or profit even where damages are uncertain. This alternative theory of recovery was established under the English Common Law. Recovery was based not on the value of the contract; instead the value of the plaintiff's opportunity or chance of success at the time of the breach became the basis for the award.111

This rule is reflected in Restatement Second section 346(3):

If a breach is of a promise conditioned on a fortuitous event and it is uncertain whether the event would have occurred had there been no breach, the injured party may recover damages based on the value of the conditional right at the time of breach.112

110. Id. at 795–96; see also Howe v. Teefy (1927) 27 N.S.W. St. R. 301 (chance to make profits from betting on and touting a racehorse); Hawrysh v. St. John's Sportsmen's Club, [1993] D.L.R. 45 (Manitoba Q.B.) (loss of a chance for competing for a prize in a bowling competition); Sanders v. Parry, 2 All E.R. 803 (1967) (chance to retain a client's business); Macrae v. Clarke, 1 L.R.-C.P. 403 (1866) (chance to get payment of a debt from a debtor imprisoned for the debt); Hampton & Sons, Ltd. v. George, 3 All E.R. 627 (K.B. 1939) (chance to make a commission on the sale of a hotel); Schilling v. Kidd Garrett Ltd, [1977] 1 N.Z.L.R. 243 (C.A.) (chance to retain a franchise to sell power saws).


Comment d to this section states:

d. Fortuitous event as condition. In the case of a promise conditioned on a fortuitous event . . . , a breach that occurs before the happening of the fortuitous event may make it impossible to determine whether the event would have occurred had there been no breach. It would be unfair to the party in breach to award damages on the assumption that the event would have occurred, but equally unfair to the injured party to deny recovery of damages on the ground of uncertainty . . . . Under the rule stated in Subsection (3) [the injured party] has the alternative remedy of damages based on the value of his conditional contract right at the time of breach, or what may be described as the value of his "chance of winning." The value of that right must itself be proved with reasonable certainty, as it may be if there is a market for such rights or if there is a suitable basis for determining the probability of the occurrence of the event.113

Moulton's opinion in Chaplin v. Hicks did not state with precision how the value of a contestant's chance should be measured. The best approach is to use market value. In cases, like lottery tickets, in which there is an established market for the chance, market value should be measured by the market price. When there is no established market, market value should be based on the price that a willing buyer would pay to a willing seller.114 This approach was implied in the opinion of Lord Justice Vaughan Williams, concurring in Chaplin v. Hicks:

It is true that no market can be said to exist. None of the fifty competitors could have gone into the market and sold her right; her right was a personal right and incapable of transfer. But a jury might well take the view that such a right, if it could have been transferred, would have been of such a value that every one would recognize that a good price could be obtained for it.115

Typically, in the absence of a market price, what a willing buyer would pay a willing seller will be based on the expected value of the chance. So, for example, in Van Gulic v. Resource Development Council for Alaska,116 a promoter had staged a lottery. Under the lottery rules, the contestants' tickets were to be drawn one by one from a bin. The last ticket drawn would win the grand prize of $10,000. When only three tickets, owned by A, B, and C, remained in the bin, the lottery operators mis-

113. Id. cmt. d.
115. 2 K.B. at 793 (Williams, L.J., concurring).
takenly, and in breach of the contest rules, both drew the tickets owned by B and C simultaneously and overlooked that A's ticket was still in the bin.\textsuperscript{117} The operators then compounded their breach by wrongfully drawing all the lottery tickets all over again.

If the operators had drawn only B's ticket or only C's ticket, as they should have done, the last two tickets would have either been those of A and B or A and C, so that at the time of the breach, A had a 50\% chance of winning $10,000.\textsuperscript{118} A brought suit, and the court gave him the choice of $5,000 in damages, based on the expected value of his chance at the time of the breach, or participation in a re-drawing involving only his ticket and one other.\textsuperscript{119}

Similarly, Illustration 5 to Restatement Second section 348(3) states:

A offers a $100,000 prize to the owner whose horse wins a race at A's track. B accepts by entering his horse and paying the registration fee. When the race is run, A wrongfully prevents B's horse from taking part. Although B cannot prove that his horse would have won the race, he can prove that it was considered to have one chance in four of winning because one fourth of the money bet on the race was bet on his horse. B has a right to damages of $25,000 based on the value of the conditional right to the prize.\textsuperscript{120}

Of course, the expected value of some chances are difficult to evaluate. I will discuss the methodology for dealing with such cases in the next section.

B. Certainty

It is a well-established principle of contract law that damages must be proved with reasonable certainty.\textsuperscript{121} Damages that fail this test are said to be “speculative.” Many or most kinds of contract damages do not implicate

\begin{itemize}
\item\textsuperscript{117} See id. at 1071–72.
\item\textsuperscript{118} See id. at 1072.
\item\textsuperscript{119} See id. at 1073; see also Mange v. Unicorn Press, Inc., 129 F. Supp. 727, 730 (S.D.N.Y. 1955) (stating, in a case involving a lost chance to win a puzzle contest, that “there appears to be a liberal trend towards allowing . . . the jury to determine the value of the chance of which plaintiff was deprived”); Wachtel v. National Alfalfa Journal Co., 176 N.W. 801 (Iowa 1920) (lost chance to win a magazine contest); Hall v. Nassau Consumers’ Ice Co., 183 N.E. 903 (N.Y. 1933) (lost chance of payment of a bond); Kansas City Mex. & Orient Ry. Co. v. Bell, 197 S.W. 322 (Tex. Civ. App. 1917) (lost chance of prize at a livestock show). But see Phillips v. Pantages Theatre Co., 300 P. 1048 (Wash. 1931) (no recovery for lost chance in a “movie contest for beginners”); Collatz v. Fox Wis. Amusement Corp., 300 N.W. 162 (Wis. 1941) (no recovery for lost chance in question-and-answer contest).
\item\textsuperscript{120} \textit{Restatement (Second) of Contracts} § 348(3) cmt. b, illus. 5 (1979).
\item\textsuperscript{121} See, e.g., id. § 352.
\end{itemize}
this principle because they are highly certain. This is normally true, for example, of damages that turn on the cost of cover or on the market value of a breached performance that has a readily ascertainable market price. In practice, therefore, the certainty principle is usually associated with damages based on lost profits.

The meaning of the certainty principle lies as much or more in its application as in its formulation, because the principle leaves open the degree of certainty that is required. Under classical contract law, the degree of certainty required was typically set at a high level, and with little or no sensitivity to conceptions of probability. The classical approach has been carried over in some modern cases and is exemplified in two decisions of the New York Court of Appeals, Freund v. Washington Square Press, Inc. and Kenford Co. v. Erie County.

In Freund v. Washington Square Press, Inc., the plaintiff, an author and college teacher, entered into a contract with a publisher. Under the contract, the plaintiff granted the publisher the exclusive right to publish and sell the plaintiff's book on modern drama. The publisher, in turn, agreed to pay the plaintiff royalties based on specified percentages of actual sales, and an advance of $2,000. The plaintiff wrote the book and delivered it to the publisher, who in turn paid the plaintiff the $2,000 advance. The publisher, however, never published the book, because after the contract was made, the publisher stopped publishing in hardbound.

The plaintiff brought suit, and the trial court awarded him damages of $10,000 based on the cost of publication. The court of appeals held that the plaintiff was entitled only to nominal damages of six cents, because the plaintiff's "expectancy interest in the royalties—the profit he stood to gain from sale of the published book—while theoretically compensable, was speculative." The plaintiff, the court said, had "provided no stable foundation for a reasonable estimate of royalties he would have earned had defendant not breached its promise to publish."

In Kenford Co. v. County of Erie, Erie County entered into a contract with Kenford and its affiliate, Dome Stadium. Under the contract,

123. See id. at 419-20.
124. See id. at 420.
125. Id. at 421.
126. Id.
Kenford agreed to convey 178 acres of land to the county for construction of a domed stadium. The county agreed to construct the stadium and to lease it to Dome for forty years or, if the parties could not agree upon the terms of a lease, to enter into a twenty-year agreement, on terms stated in an appendix to the contract, under which Dome would manage the stadium. Under the management agreement, the county would receive a stated percentage of gross revenues from stadium operations.

The stadium was never constructed because the county breached the contract after it became apparent that the cost of construction had been significantly underestimated: The county had passed a $50 million bond resolution to finance the stadium, but when the bids came in, they totaled $70 million. The county concluded that going forward with the stadium would result in a loss rather than a profit, and therefore abandoned the project, eventually reconveying the land to Kenford.

Dome sued the county for breach, and summary judgment was entered against the county on the issue of liability. In the ensuing damages trial, Dome presented statistical projections of the profits it would have made under the management agreement and was awarded a verdict for $25.6 million for these lost profits.

The New York Appellate Division set aside the jury's verdict. A line of federal cases interpreting New York law had held that lost profits for a new venture could be awarded if there was a rational basis for calculating the profits. The appellate division accepted the rational basis test, but held that Dome's statistical projections involved too many variables to provide a rational basis upon which lost profits could be calculated. The court of appeals affirmed the appellate division's decision, but specifically rejected the rational basis test—presumably because even under the court of appeals' own description, Dome's probabilistic evidence did provide a rational basis for calculating damages:

[T]he procedure for computing damages selected by [Dome] was in accord with contemporary economic theory and was presented through the testimony of recognized experts. . . . [Dome's] economic analysis employed historical data, obtained from the operation of other domed stadiums and related facilities throughout the country, which was then applied to the results of a comprehensive study of

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128. This line of cases originated with Perma Research & Development Co. v. Singer, 542 F.2d 111 (2d Cir. 1976).
the marketing prospects for the proposed facility in the Buffalo area. The quantity of proof is massive and, unquestionably, represents business and industry's most advanced and sophisticated method for predicting the probable results of contemplated projects.129

It might be thought that massive proof that "unquestionably ... represents ... [the] most advanced and sophisticated method for predicting the probable results of" a business project would have sufficed. The court of appeals, however, did not share that view:

[D]espite the massive quantity of expert proof submitted by [Dome], the ultimate conclusions are still projections, and as employed in the present day commercial world, subject to adjustment and modification. We of course recognize that any projection cannot be absolute, nor is there any such requirement, but it is axiomatic that the degree of certainty is dependent upon known or unknown factors which form the basis of the ultimate conclusion. Here, the foundations upon which the economic model was created undermine the certainty of the projections. [Dome] assumed that the facility was completed, available for use and successfully operated by it for 20 years, providing professional sporting events and other forms of entertainment, as well as hosting meetings, conventions and related commercial gatherings. At the time of the breach, there was only one other facility in this country to use as a basis of comparison, the Astrodome in Houston. Quite simply, the multitude of assumptions required to establish projections of profitability over the life of this contract require speculation and conjecture, making it beyond the capability of even the most sophisticated procedures to satisfy the legal requirements of proof with reasonable certainty.

The economic facts of life, the whim of the general public and the fickle nature of popular support for professional athletic endeavors must be given great weight in attempting to ascertain damages 20 years in the future.131

In its rejection of a probabilistic analysis, the classical law approach to the certainty principle reflects the binary nature of classical contract law. Indeed, this approach is often referred to as the all-or-nothing rule:132 A premise of the approach is that there is some level of likelihood such that if

130. Id. at 236.
131. Id. at 262–63.
the injured party's proof of his total claim is just above that level, his damages are "reasonably certain" and he is awarded all of his damages, but if his proof is just below the level, his damages are "speculative" and he is awarded nothing. The required level of likelihood, in turn, seems to be that the promisee's claimed damages be more likely than not.

This approach, however, is dramatically out of touch with the reality of probability. There are few cases in which damages for lost profits should be completely denied on the basis of uncertainty. In almost every case in which uncertainty is raised as a problem, damages should be awarded under one of several alternative measures, which I develop in the balance of this section. For ease of exposition, I will call the breaching party the promisor and the injured party the promisee.

Assume for a moment that the level of likelihood that should be used in applying the certainty principle is whether the promisee's claimed damages are more likely than not. Even under that assumption, the relevant issue should not be whether the promisee's total claimed damages are more likely than not, but whether some claimed damages are more likely than not. At a minimum, therefore, a promisee should be entitled to recover that portion of his claimed damages that is more likely than not. I call this approach the baseline measure. This measure is extremely conservative in the sense that it accepts the two central elements of the classical school approach—all or nothing, and a requirement of more likely than not—but refines that approach by applying these elements to segments of damages rather than to damages as a whole.

For example, in Freund, although total book sales might not have been determinable at an amount that was more likely than not, there must have been some amount of book sales, and therefore some amount of royalties, that was more likely than not. (Indeed, the publisher would almost certainly have made projections showing some likely minimum amount of sales before it decided to publish the author's book.) Thus, suppose that the total possible sales of the author's book was stratified into 100-book segments, beginning from the first sale, so that the segments consisted of 1–100, 101–200, and so on. Suppose further that there was a 99% likelihood that the first 100 books would be sold, a 95% likelihood that the next 100 books would be sold, and so forth, and that not until segment 701–800 did the likelihood of a segment dip below 50%. In that event, under the baseline measure, the author should recover royalties for at least 700 books, even though total sales were unpredictable.

Of course, the record in Freund does not show how the baseline measure would have applied to the facts, but that is only because the court of
appeals reversed the award of damages without remanding for a new trial on that issue. It is hard to imagine, however, that the author could not have established some damages under the baseline measure by showing the minimum sales of comparable books to libraries, theatrical bookstores, and general bookstores.

The baseline measure, while more accurate than the classical all-or-nothing approach, is less accurate than other alternatives because it rests on the unduly conservative elements of the classical approach. Accordingly, I will now consider a series of alternative, more realistic approaches.

One well-established approach to deal with uncertainty is to allow the promisee to recover the costs he incurred in a venture that failed because of the breach. Although damages measured in this way are often referred to as reliance damages, the courts have allowed the promisee to recover not only costs incurred in reliance on the contract, but also costs incurred before the parties entered into the contract. I therefore call this approach the \textit{incurred-costs measure} rather than the reliance measure.

For example, in \textit{Security Stove & Manufacturing Co. v. American Railways Express Co.},\textsuperscript{133} Security Stove, who manufactured a special kind of furnace, wanted to exhibit the furnace at a booth it had rented at a trade show. American Railways agreed to deliver the furnace to the show in time for the exhibition, but failed to do so. The court held that although Security Stove's expectation damages were too speculative, it could recover its costs, including the cost of a booth it had rented before the contract had been made.

Similarly, in \textit{Anglia Television Ltd. v. Reed},\textsuperscript{134} Anglia wanted to make a television film entitled "The Man in the Wood," which would portray an American man married to an English woman. Before Anglia selected the leading man, it arranged for a location for the film; employed a director, a designer, and a stage manager; and involved itself in much other expense. For the leading man, Anglia required a strong actor capable of holding the film together. It eventually decided upon Robert Reed, "an American with a very high reputation as an actor," and the parties agreed over the phone that Reed would come to England and star in the film for a fee of £1,050 and expenses.\textsuperscript{135}

Because of a mix-up in his bookings, Reed later repudiated the contract. Anglia tried to find a substitute but could not do so and subsequently abandoned the film. It then sued Reed for its out-of-pocket expenses on

\textsuperscript{133} 51 S.W.2d 572 (Mo. Ct. App. 1932).
\textsuperscript{134} 3 All E.R. 690 (C.A. 1971)
\textsuperscript{135} See id. at 691.
the film, £2,750, including almost £1,900 incurred before the contract was made. The court held that Anglia was entitled to recover all of its expenses. Lord Denning said:

[It is plain that, when Mr. Reed entered into this contract, he must have known perfectly well that much expenditure had already been incurred on director's fees and the like. He must have contemplated—or, at any rate, it is reasonably to be imputed to him—that if he broke his contract, all that expenditure would be wasted, whether or not it was incurred before or after the contract. He must pay damages for all the expenditure so wasted and thrown away.

... It is true that, if the defendant had never entered into the contract, he would not be liable, and the expenditure would have been incurred by the plaintiff without redress; but, the defendant having made his contract and broken it, it does not lie in his mouth to say he is not liable, when it was because of his breach that the expenditure has been wasted.

A principal rationale for allowing the promisee to recover costs incurred before the parties entered into the contract is that the promisee's costs serve as a surrogate for expectation damages, because normally the promisee must have confidently expected to recover at least the amount of those costs. As stated in Beefy Trail, Inc. v. Beefy King International, Inc.: Essentially, the rationale [for granting reliance damages in a bargain context] is this: Normally, had the contract's performance not been prevented by the defendant, and the contract had been a profitable one for the plaintiff, the plaintiff would have recovered over the life of the contract a gain, sufficient not only to fully reimburse him for his expenditures, but also to yield an excess which would be the profit. Since the amount of the gross receipts (i.e., the gain) cannot be determined with the requisite degree of certainty, the amount of the profit cannot be determined and therefore cannot be allowed in the recovery. But the amount of the gain which would have reimbursed plaintiff for the expenditures incurred in preparation and part performance can be determined by and to the extent of these expenditures, and therefore this amount can be allowed in the recovery.

136. See id.
137. Id.
139. Id. at 859.
Consistent with that rationale, if the promisee uses the incurred-costs measure, the promisor is allowed to show that the promisee's revenues would actually not have covered its costs, so that the promisee would have incurred a loss on the contract.  

Frequently, the incurred-costs measure of damages is not a sufficient way to deal with the problem of uncertainty, either because breach occurs before the promisee has incurred a significant portion of his anticipated costs, or because the promisee's costs were very low in relation to the promisee's anticipated revenues or were very difficult to measure. Freund is an example: the author probably had little or no out-of-pocket costs; his opportunity costs, if any, would be difficult to determine; and, in any event, the author might have anticipated revenues far in excess of those costs.

In some such cases, however, there is another way to use costs as a surrogate for expectation damages. Recall that many contracts create a promissory structure that aligns the interests of the parties. Perhaps the most common way to achieve such an alignment is by giving each party a share of projected contract revenues. This was the case, for example, in Wood v. Lucy, in which Wood and Lady Lucy were to share 50-50 in revenues that Wood produced through the placement of Lady Lucy's name and designs. It was also the case in Freund, as it is in almost all publishing contracts. The publisher and author were to share the revenues from sales of the author's book by allocating a certain share of the gross revenues to the author in the form of royalties, and the balance of the revenues to the publisher.

In such cases, instead of using the promisee's incurred costs, as in Security Stove and Reed, courts can often derive the promisee's minimum expected gains by use of the costs that the promisor expected to incur as of the time the contract was made. Just as a promisee normally would not incur costs unless it confidently believed it would reap a return in excess of those costs, so a promisor would normally not enter into a contract unless it confidently believed, as of that time, that its revenues would exceed its expected costs. Because the promisee's gains in an interest-aligning contract depend on contract revenues, and because minimum expected contract revenues will be shown by the promisor's expected costs, often the promisee's minimum expected gains can be easily derived from those expected costs. I call this approach the expected-cost measure.

141. The basis of the approach in this section was suggested to me by Ed Anderson, a student in my Seminar on Contract Theory.
For example, in Freund, the trial court found that the cost of publishing the author's book was $10,000. Presumably, therefore, the publisher would not have entered into the contract unless it expected to reap revenues of at least that amount plus royalties and the cost of distribution. Thus, the expected minimum contract revenues could easily be derived from the publisher's expected costs, and the author's minimum expected royalties could easily be derived from the expected minimum contract revenues.

Similarly, in Kenford, the county must have confidently expected, as of the time the contract was made, that the contract would generate sufficient revenues to pay off the $50 million in bonds that the county expected to issue. Dome's share of those revenues under the management agreement should have been easy to calculate. Therefore, only Dome's expenses would need to be determined to compute Dome's expected minimum gains.

In 1993, seven years after the decision in Kenford, the New York Court of Appeals itself approved the use of a promisor's projections—although of gross revenues, rather than costs—as the basis of measuring the promisee's damages, in Ashland Management Inc. v. Janien. Ashland Management was a successful investment advisory company, which managed over one billion dollars in client funds. As part of its investment strategy, Ashland relied on a computerized mathematical stock selection model, known as Alpha, to analyze selected financial information and make an initial determination of which stocks should be bought and sold. In 1985, Ashland and Janien entered into a contract for Janien to develop a second investment model, Eta, to be used by Ashland. Paragraph C(12) of the contract projected the minimum sums expected under Eta-model management for each year between 1988 and 1992. Paragraph C(21) provided that if "for any reason" Janien left Ashland's employment, he was entitled to a royalty of the higher of $50,000 or 15% of gross annual revenues of accounts using the Eta model or any derivative of that model. Thereafter, Ashland terminated Janien's employment. The trial court held that Janien was entitled to damages for lost profits based on the projections set forth in paragraph C(12). The court of appeals affirmed:

Ashland itself had enough confidence in its ability to perform to predict minimum amounts of funding which Eta would attract. It

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143. See id. at 1008.
144. See id. at 1009.
145. See id.
agreed to compensate Janien on that basis. Based on this evidence, the court properly relied on the projections of paragraph C(12) and the provisions of paragraph C(21) to hold that defendant had met his burden of proving his lost profits with reasonable certainty. 146

It might be thought that the promisor's expected costs are not a sufficiently certain prediction of the actual costs he would have incurred if the contract had been performed. However, the actual costs that the promisor would have incurred are irrelevant for these purposes. In interest-aligning contracts in which the parties share the contract revenues, the issue in determining the promisee's expected minimum gains is not what the promisor's actual costs would have been, but what his expected costs were. Once we know that, we know that the promisor so confidently believed that a minimum amount of revenues was sufficiently certain that he was willing to put his money on the line. If that expected minimum was sufficiently certain for the promisor to be willing to put his own money on the line, it should be sufficiently certain for the courts.

Similarly, the validity of the expected-costs measure in an aligned-interest contract is not negated by the fact that the promisor decided to breach. Often, the promisor decides to breach not because expected minimum contract revenues change, but because expected costs change after the time the contract is made, or for some other reason entirely. In Freund, for example, the publisher breached simply because it stopped publishing in hardbound. In Kenford, the county breached because it decided that its actual costs would be higher than the costs it expected at the time the contract was made, and that those higher costs would not be covered by its share of expected contract revenues. However, that did not mean that the county's projection of expected contract revenues, from which the promisee's minimum expectation would be derived, was incorrect.

More generally, in interest-aligning contracts that involve royalties or comparable arrangements, typically the contract revenues are produced by the post-contract costs of only one party. For example, in contracts between publishers and authors, as in Freund, once the book is completed, the author has no remaining costs, so that his share of contract revenues (the royalties) are pure profit. In contrast, the publisher will only make a profit if its share of contract revenues exceeds the costs of publication, royalties, distribution, and so forth. Call the party who will have no post-contract costs A, and the party who will have such costs B. It is easy to see that an unexpected increase in costs may lead B to breach even though

146. Id. at 1012.
minimum expected contract revenues, and therefore A's minimum expected gains, remain as originally projected.

Just as under the incurred-costs measure the promisor is allowed to show that the promisee's revenues would actually not have covered its costs, so too, under the expected-costs measure the promisor should be allowed to show that the promisee's share of contract revenues would actually have been less than the amount derived on the basis of the promisor's original projected costs.

Although the baseline measure, the incurred-costs measure, and the expected-costs measure are more accurate than the all-or-nothing measure of classical contract law, they fall short as measures of expectation damages, partly because they are based on minimum expected profits rather than on fairly expected profits. Furthermore, these measures and the classical approach share a theoretical flaw: under all these measures, damages (whether or not sufficiently certain) are conceived of as the promisee's lost profits. The damages the promisee suffers, however, are not his lost profits as such, but the loss of the value of an asset that consists of the promisee's right to earn profits under the contract. Correspondingly, the promisee's damages should be measured by the value of that asset at the time of breach. I call this approach the market-value measure.

We have already seen such a principle in operation—it is essentially the principle used to measure damages in loss-of-a-chance cases. Indeed, it can now be seen that almost all cases that raise problems of uncertainty essentially involve the loss of a chance—that is, the chance to make profits. To put this differently, a claim for the loss of profits is normally only a special case of a claim for the loss of a chance. Just as in the general case the claimant's damages should be measured by the market value of the chance at the time of breach, so too in the special case the claimant's damages should be measured by the market value of the right to lost profits at the time of breach. Under the market-value measure, the promisee should recover the amount that a willing buyer would have paid a willing seller for a pre-breach assignment of the promisee's right to earn profits under the contract.

The problem raised by the market-value measure is how to measure the market value of a risky asset—the promisee's right to earn returns under the contract—when, as in Kenford, there is no actual market in which like assets are freely traded. Here, once again, financial economics is relevant because it provides a well-established methodology, the Capital Asset Pricing Model (CAPM), for determining the value of assets whose value is based on prospective returns.
To apply CAPM, the expected cash flow of an income-producing asset is first calculated by determining the various possible cash flows that the asset may yield, multiplying each cash flow by its probability, and summing the result. The value of the asset is then determined by discounting the expected cash flow by a rate generated under a formula that essentially adds: (1) the time value of money, measured by the interest rate for risk-free investments, such as treasury bonds; and (2) the rate for the risk of unanticipated events whose impact is marketwide (known as market or systematic risk) multiplied by the risk of unanticipated events that affect only the kind of asset in question, which is known as the beta of the asset. So, for example, in deciding whether to invest in a movie theater, an investor applying CAPM would first calculate the theater's expected cash flow, and would then calculate the appropriate discount rate to apply to the expected cash flow by plugging into the CAPM formula the time value of money, the rate of risk for the stock market (with certain adjustments), and the beta of stock of corporations engaged in the movie-theater business. As the methodology of financial economics shows, therefore, riskiness of returns does not prevent the valuation of an income-producing asset—it could not; virtually all such assets are risky. Instead, the uncertainty is impounded into the value of the assets, first in weighing the cash flows the asset may produce, and then in determining the discount rate.

A contract is a special type of income-producing asset. Its value should be determined in the same way as the value of any other such asset. Thus, if in Kenford there was a 40% probability of a $10 million cash flow to Dome over the twenty-year term of the management agreement, a 30% probability of a $30 million cash flow, and a 30% probability of a $40 million cash flow, the expected cash flow to Dome would be $25 million. Damages would be calculated by applying a discount rate, calculated under CAPM, to that expected cash flow. I call this kind of computation the expected-value measure, although it is important to bear in mind that this measure is simply a special way of imputing market value in the


\[
E(R_i) = R_f + (E(R_M) - R_f) \times \beta_i
\]

where \(E(R_i)\) is the expected return on the investment or asset; \(R_f\) is the pure time value of money; \(E(R_M)\) is the market premium per unit of risk, and \(\beta_i\) is the beta for the asset.

absence of an established market. A court that believes profits under a contract to be uncertain should therefore not disregard the profits, but instead should either assign very low probabilities to very unlikely cash flows, increase the discount rate applied to the expected cash flow by utilizing a relatively high beta, or both.

Essentially, the classical contract law approach to uncertainty, reflected in Freud and Kenford, lags a generation behind financial economics in its refusal to employ the methodology of that discipline and its substitution of an approach to valuation that is today employed only by courts, who are the least knowledgeable decision makers in this area. There is a striking resemblance, in this respect, between the classical contract law approach and the law governing the valuation of dissenting shareholders' stock in appraisal proceedings under corporate law. The corporate statutes provide that a shareholder who dissents from certain types of corporate actions is entitled to the "value" or "fair value" of his stock. Until the mid-1980s, the value of stock in appraisal proceedings was established under the so-called Delaware block method. This method requires the court to weight earnings value, market value, and asset value, all calculated in stylized ways. Valuation under this method often had little contact with current financial economics. For example, in Francis I. DuPont & Co. v. Universal City Studios, Inc.,\(^1\) the corporation's "earnings value" was derived by capitalizing its mean earnings for the five preceding years. The shareholders argued that earnings value should have been determined by capitalizing current earnings. Testimony was presented that the accepted practice among security analysts was to capitalize current earnings, and to take the earnings trend into account in selecting the multiplier used for capitalization. The court stated that the shareholders' argument

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\text{was not persuasive even if [the] testimony as to the accepted practice among security analysts for capitalizing earnings is conceded to be correct. Whatever that practice may currently be, the policy of Delaware law is that averaging earnings over the five years immediately preceding the merger should be the rule and not the exception.}\]

\(^{150}\)

In 1983, however, in Weinberger v. UOP,\(^1\) the Delaware Supreme Court overturned the traditional Delaware block method of valuation, stating: "We believe that a more liberal approach must include proof

\(^{149}\) 312 A.2d 344 (Del. Ch. 1973), aff'd, 334 A.2d 216 (Del. 1975).

\(^{150}\) Id. at 348-49 (emphasis added).

\(^{151}\) 457 A.2d 701 (Del. 1983).
of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court."\textsuperscript{152} Around the same time, the New York statute was amended to provide that in fixing the fair value of shares for these purposes, the court shall consider "the concepts and methods then customary in the relevant securities and financial markets for determining fair value of a corporation engaging in a similar transaction under comparable circumstances."\textsuperscript{153} The ALI's Principles of Corporate Governance adopts the same position.\textsuperscript{154}

There has been a comparable evolution in the area of uncertainty in contract law. Some courts simply finesse the certainty principle by invoking one of two counterprinciples: (1) that the certainty principle applies only to the fact of damage, not to the amount of damages;\textsuperscript{155} or (2) that the wrongdoer should bear the risk of uncertainty that his own conduct has created.\textsuperscript{156} Both of these counterprinciples are inconsistent with the certainty principle as administered under the classical contract law approach. Because the counterprinciples can be invoked in almost any case, they serve to illustrate the radical instability of that approach. As John Calamari and Joseph Perillo observe, "what is clear is that there is no universal application of the rule of certainty, and that, within a given jurisdiction, case authority which applied a stringent test often exists along with other cases which, in express terms or, in effect, hold that certainty is not a requirement."\textsuperscript{157} Such instability is the hallmark of an unsound rule.\textsuperscript{158}

Many courts have explicitly broken away from the binary, static, economically uninformed approach taken by classical contract law to the problem of uncertainty. Some courts have accepted the kinds of projections that Kenford rejected. For example, in Independent Mechanical Contractors, Inc. v. Gordon T. Burke & Sons,\textsuperscript{159} the plaintiff's evidence on lost profits consisted of the expert testimony of an economics professor experienced in evaluating future profits, who used a standard methodology to
project the plaintiff's lost profits from 1980 through 1985. The court approved a verdict based on this evidence:

[W]e are not persuaded that the projection of lost profits in this case constituted speculative proof of lost profits. . . .

. . . Proof of lost profits is not speculative as a matter of law simply because all conceivable factors have not been assessed. A degree of uncertainty is inherent in any projection of future profits; the essential issue is whether the evidence on lost profits provides enough information under the circumstances to permit the fact finder to reach a reasonably certain determination of the amount of gains prevented.160

Other courts have even more specifically accepted the concept that probabilistic evidence sufficed to establish contract damages. For example, in Locke v. United States,161 Locke owned a typewriter repair company in San Diego. He was awarded a federal contract for the repair, maintenance, and reconditioning of manual typewriters in the San Diego area for a one-year period. Similar contracts were awarded to three other repair companies. Locke and the three other repair companies were listed in a Federal Supply Schedule. The government had its own repair facilities, but agencies that used a contractor to make typewriter repairs were required to choose a contractor listed in the schedule, although they were free to choose any contractor in the schedule.162

In the middle of the contract year, the government improperly terminated Locke's contract and his name was stricken from the schedule.163 The court held that although the government was free to enlarge its own repair facilities to satisfy its needs, which would have left nothing to be awarded under the contract, Locke was entitled to compensation for the value of his chance:

[The facts as alleged show that the Government did have some service requirements beyond its own capacity. . . . Plaintiff's chance of obtaining some of these awards, by being in the schedule and competing with the other contractors, had value in a business sense. The Government by its breach deprived plaintiff of this value. . . .

. . . We are here concerned with the value of a chance for obtaining business and profits. . . . Here it appears that the plaintiff [had] a

160. Id. at 491.
161. 283 F.2d 521 (Cl. Ct. 1960).
162. See id. at 522–23.
163. See id. at 523.
chance of obtaining at least one-fourth of the total typewriter-repair business let by the government. . . . We believe that where the value of a chance for profit is not outweighed by a countervailing risk of loss, and where it is fairly measurable by calculable odds and by evidence bearing specifically on the probabilities that the court should [attempt] to value that lost opportunity.164

Similarly, in *Rombola v. Cosindas*,165 Rombola agreed to train, maintain, and race Cosindas's horse, Margy Sampson, for the period November 8, 1962 through December 1, 1963. Rombola was to pay all expenses and receive 75% of all gross purses, and Cosindas was to receive the remaining 25%. In the winter of 1962, Rombola maintained and trained Margy Sampson at his stable and in the following spring and summer he raced her twenty-five times.

In fall 1963, Rombola entered Margy Sampson in six stake races (races in which horses run against others in their own class, according to the amount of money they have won) to be held at a Suffolk Downs meet ending December 1. Before the meet began, Cosindas took possession of Margy Sampson and thereby deprived Rombola of his right to race her. The horse was not raced again until after December 1.166 Rombola sued Cosindas for lost profits, and the trial judge directed a verdict for Cosindas.167 The Massachusetts Supreme Judicial Court reversed, holding that Margy Sampson's racing history established Rombola's damages with sufficient certainty:

In the year of the contract, of the twenty-five races in which the horse was entered by Rombola, she had won ten and shared in the purse money in a total of twenty races, earning, in all, purses approximating $12,000. In the year following the expiration of Rombola's contract with Cosindas, the horse raced twenty-nine times and won money in an amount almost completely consistent percentage-wise with the money won during the period of the contract. . . .

. . . We think . . . that Rombola would be entitled to show substantial damages on the theory of loss of prospective profits. . . . [Margy Sampson] had already proved her ability both prior to and while under Rombola's management and training, over an extended period of time, against many competitors and under vary-

164. *Id.* at 524–25.
166. *See id.* at 921.
167. *See id.*
ing track conditions. Her consistent performance in the year subsequent to the breach negates any basis for an inference of a diminution in ability or in earning capacity at the time of the Suffolk Downs meet. While it is possible that no profits would have been realized if Margy Sampson had participated in the scheduled stake races, that possibility is inherent in any business venture.  

Even more striking is Contemporary Mission, Inc. v. Famous Music Corp. Famous Music had agreed to pay royalties to Contemporary Mission in return for the master tape recording of a religious rock opera called Virgin and the exclusive right to manufacture and sell records made from the master. The agreement required Famous Music to release at least four separate single records from Virgin. Under the doctrine of Wood v. Lucy, Famous had an obligation to use reasonable efforts to promote Virgin on a nationwide basis.

Famous Music breached the contract by failing to promote the singles. Prior to the breach, one of the singles from Virgin had reached number 80 on the Hot Soul record charts. After the breach, it reached number 61. At the trial, Contemporary offered a statistical analysis of every song that had reached number 61 during 1974. This analysis showed that of the 324 songs that had reached number 61, 76% reached the top 40, 65% reached the top 20, 34% reached the top 10, 21% reached the top 5, and 10% reached number 1. Contemporary Mission also was prepared to offer the testimony of an expert witness who could have converted these measures of success into projected sales figures and lost royalties. The trial judge excluded all this evidence under Freund on the ground that it was speculative. The Second Circuit held that the evidence should have been admitted:

This is not a case in which the plaintiff sought to prove hypothetical profits from the sale of a hypothetical record at a hypothetical price in a hypothetical market. . . . [T]he record was real, the price was fixed, the market was buying and the record's success, while modest, was increasing. Even after the promotional efforts ended, [and] the record was withdrawn from the marketplace, it was carried, as a result of its own momentum, to an additional 10,000 sales and to a rise from approximately number 80 on the "Hot Soul Singles" chart

168. Id. at 922.
169. 557 F.2d 918 (2d Cir. 1977).
170. See id. at 921.
171. See 118 N.E. 214 (N.Y. 1917).
172. See Famous Music Corp., 557 F.2d at 927–28.
173. See id. at 927.
of Billboard magazine to number 61. It cannot be gainsaid that if someone had continued to promote it, and if it had not been withdrawn from the market, it would have sold more records than it actually did. Thus, it is certain that Contemporary suffered some damage in the form of lost royalties.

I now return to the baseline measure. Recall that under that measure, as applied to a case like Freund, potential sales would be divided into 100-book segments, the probability of each segment would be determinable, and the author would recover damages equal to 100% of royalties on each segment that had more than a 50% probability, but no damages on any segments that had less than a 50% probability. This measure therefore reflects the approach of classical contract law in two respects: (1) it requires that damages, or more accurately any segment of damages, be more likely than not; and (2) it applies to each segment on an all-or-nothing basis. As applied to Freund, the expected-value measure would differ from the baseline measure and classical contract law in both respects. On the one hand, even segments that had a probability of less than 50% would be factored into the expected value of the contract at the time of breach, rather than being disregarded. On the other hand, segments that had a probability of more than 50% would be factored into expected value on a weighted basis, rather than at a 100% level.

In addition to serving as a measure of damages, the concept of the expected value of a contract at the time of breach brings out a basic ambiguity in the standard theory of expectation damages, because probable lost profits may substantially diverge from the expected value of lost profits. For example, suppose that the promisee shows a 51% probability of $100,000 in profits if the contract had been performed. Under standard expectation damages theory, the promisee would recover $100,000. Under the expected-value measure, however, the promisee would recover only $51,000. In such cases, the promisee's recovery should be measured by

174. Id.; see also Lexington Prods. Ltd. v. B.D. Communications, Inc., 677 F.2d 251 (2d Cir. 1982). Lexington licensed B.D. to market its toothbrush and associated dental liquid. B.D. agreed to purchase 200,000 brushes a year for the life of the contract, to pay royalties on each brush sold, and to spend at least $500,000 on promotion each year for the life of the contract. The contract remained in effect for two years, but B.D. invested only $104,038 in marketing and sold only 60,843 brushes. See id. at 252. At the trial, Lexington offered to prove damages by dividing the number of toothbrushes sold into the amount of marketing dollars expended and using that ratio to show how many toothbrushes would have been sold if $1 million had been spent on marketing. The trial court rejected this theory and awarded only nominal damages. See id. at 253. The Second Circuit reversed on the ground that Lexington's theory provided an acceptable degree of certainty. See id. at 253–54.

175. See Schaefer, supra note 114.
the expected value. Under such an approach, probability would be central to the entire area of damages, not simply to the areas considered in this Article.

C. The Principle of *Hadley v. Baxendale* 176

In the famous case of *Hadley v. Baxendale*,177 Exchequer Chamber held that a party injured by a breach of contract can recover only those damages that either should "reasonably be considered . . . [as] arising naturally, i.e., according to the usual course of things" from the breach or might "reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach."178

The two branches of the court's holding have come to be known as the first and second rules of *Hadley v. Baxendale*.

On the basis of the two rules of *Hadley v. Baxendale*, contract law has conventionally distinguished between general or direct damages, on the one hand, and special or consequential damages, on the other. General or direct damages are the damages that flow from a given type of breach without regard to the buyer's particular circumstances. General damages are never barred by the principle of *Hadley v. Baxendale* because by their very definition such damages should "reasonably be considered . . . [as] arising naturally, i.e., according to the usual course of things from the breach."

Special or consequential damages are damages above and beyond general damages that flow from a breach as a result of the injured party's particular circumstances. The standard conceptualization of the second rule of *Hadley v. Baxendale* is that consequential damages can be recovered only if, at the time the contract was made, the breaching party had reason to foresee, at some designated level of probability, that the consequential damages were the likely result of breach. Under this conceptualization, the first rule is simply a special case of the second: If damages arise "naturally, i.e., according to the usual course of things" from breach, then the breaching party should foresee that the damages will result. Accordingly, I refer to this conceptualization of the second rule as the principle of *Hadley v. Baxendale*, or, more simply, the Hadley principle.

This principle is normally applied only in cases involving a breach by a seller, because usually a buyer's obligation is only to pay money, and a

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178. Id. at 151.
simple failure to pay money rarely implicates consequential damages. For ease of exposition, therefore, I refer to the breaching party as the seller and the injured party as the buyer. Furthermore, the principle typically does not come into play in contracts for the sale of differentiated commodities, such as office buildings or custom-tailored database software, because in such cases the precontract parley—specifications, quotations, preliminary discussions, and negotiations—normally puts the seller on notice of the buyer's special circumstances. Indeed, because of the specialized nature of markets for differentiated commodities, a seller of such commodities is likely to know or have reason to know of the buyer's special circumstances even if the commodity is not specifically tailored to the buyer's special needs. In contrast, homogeneous commodities, such as wheat, personal computers, or consumer goods, are characteristically sold in more anonymous markets, and often without the kind of precontract parley or specialized market information that typically puts a seller of differentiated commodities on notice of the buyer's special circumstances. Accordingly, in the balance of this section, I will focus on contracts for the sale of homogeneous commodities.

The Hadley principle is a default rule. It applies only if the parties have not addressed liability in some other way, and therefore can be contracted around. In the absence of the Hadley principle, the default rule would be the principle of proximate cause. Historically, the Hadley principle and the principle of proximate cause differed in two critical respects. The first difference concerned probability—more specifically, the probability that the buyer would incur a given kind of loss on the basis of the information known to the seller. Unlike the area of consideration, in which the role of probability is masked, probability therefore plays a very explicit role under the Hadley principle. However, it is not enough to say that a legal rule requires a showing of probability. There must also be at least a rough formulation of the level of probability that the rule requires. In the case of the Hadley principle, for example, one approach would be to require, as a condition to the seller's liability, that the probability of the consequential damages was more than marginal, or not insignificant. More demanding approaches would be to require that the consequential damages be more likely than not, or even highly likely.

179. See, e.g., U.C.C. § 2-714 (1990) (stating that damages for breach of warranty are governed by the principle of proximate cause); GRANT GILMORE & CHARLES L. BLACK, JR., THE LAW OF ADJIRALTY 76 (2d ed. 1975) (noting that marine insurance covers losses "proximately caused" by the peril insured against and claimed under).
As traditionally applied, the Hadley principle required damages to be foreseeable at the more-likely-than-not or highly-likely levels, while proximate cause may not have been understood to include a foreseeability component. Under modern law, however, the two principles have been converging in this respect. On the one hand, the ascendant conception of proximate cause is that it is normally applied on the basis of the risks that were foreseeable at the time of the wrong. On the other hand, the level of probability at which consequential damages must be foreseen under the Hadley principle has been steadily eroding. For example, in Koufos v. C. Czarnikow, Ltd.,180 decided by the House of Lords, the Law Lords' opinions approved such tests as "liable to result," "real danger," and "serious possibility." All of these formulations require a level of probability that is much less demanding than the traditional more-likely-than-not or highly-likely requirement.

A second difference between the principle of Hadley v. Baxendale and proximate cause is that application of the Hadley principle is normally based on the information the seller has at the time of contract formation, while application of the principle of proximate cause normally depends on the circumstances that exist at the time of the wrong. Over the years, a series of rationales have been made to justify this aspect of the Hadley principle. The most convincing rationale begins as follows: A seller has a choice of the terms under which he will enter into a contract and the precautions he will take to ensure that he will be able to perform the contract. In making these choices, the seller can take account of information concerning the damages that might result from his breach. For example, if a seller knows that a particular buyer will probably incur consequential damages, the seller might charge the buyer a greater price, take greater-than-normal precautions to ensure his own performance, or both. Therefore, a buyer should be required to transmit information concerning his special circumstances to the seller, so that the seller can adjust his price and precautions accordingly.

This part of the rationale does not justify the principle of Hadley v. Baxendale. As pointed out above, sellers of differentiated commodities normally do not need the Hadley principle because they will usually have the relevant information regardless. Sellers of homogeneous commodities

can normally deal with the problem through probabilistic methods. Such sellers typically sell in high volumes and develop an extensive claims experience. This experience allows these sellers to construct a probability distribution of potential claims. Therefore, although such sellers might not know whether, in the event of breach, any individual buyer will likely incur supranormal damages, they will often know that given percentages of their buyers will almost certainly incur various amounts of supranormal damages. Accordingly, high-volume sellers of homogeneous commodities can reliably price and plan for supranormal damages, even in the absence of information transmitted under the incentive of the Hadley principle, by setting an equilibrium price and level of precaution that takes into account, on a weighted basis, all potential damages from breach. To put the matter differently, high-volume sellers of homogeneous commodities, like insurance companies and casinos, can shift the outcomes of breach from the world of chance to the world of predictability, in which outcomes taken in the aggregate are predictable to the seller although they may remain in the world of chance as to individual buyers.

Furthermore, high-volume sellers of homogeneous commodities are unlikely to take special precautions even when they know that a buyer presents a high risk of supranormal damages. The critical issue here is the probable rate of breach. Suppose that a seller breaches only one out of every 500 contracts, and that only a small portion of the seller's breached contracts result in consequential damages. Such a seller is highly unlikely to incur the expense of setting up separate facilities and processes just to deal with the occasional supranormal-damages buyer. For example, high-volume carriers, such as airlines, express-mail handlers, and household movers, routinely limit their liability for loss unless the seller pays a special premium. Therefore these carriers know precisely which shipments will involve supranormal damages. However, casual empirical research indicates that (as is to be expected) such carriers normally take no greater precautions in transporting high-value shipments, for the loss of which they have specifically agreed to pay supranormal damages, than for transporting shipments as to which their liability is limited.182

An argument against an equilibrium-pricing regime is that under such a regime, normal-damages buyers will inefficiently subsidize supranormaldamages buyers because the higher cost of selling to the latter will be

182. Telephone Interviews by Daniel A. Saunders with Jim Hanon, Director of Underwriting for United Van Lines; Trudy Atkinson, Customer Service Agent for Federal Express; Tina McGuire of Emery Air Freight; Alice Rogers of American Airlines; and representatives of Airborne, Pan Am, United, and TWA.
reflected in higher prices charged to the former. The Hadley principle, however, is a clumsy and ineffective tool to deal with this problem. A seller who wants to make use of information transmitted to it under the Hadley principle normally would have to incur costs, first for retransmitting the buyer's information from the seller's frontline employees to its risk managers, and then for evaluating and acting on the information. If a seller deals in high volumes, and the probable rate of breach is low (which seems typical), the cost to the seller of processing and utilizing such information would almost invariably exceed the expected value of utilizing such information, because if breach seldom occurs, almost all of the costs will be wasted. Observation suggests that sellers of homogenous commodities typically do not adopt such strategies.

More importantly, sellers do not need the Hadley principle to avoid the problem of cross-buyer subsidization. Instead, sellers can, and routinely do, avoid this problem contractually, either by limiting their liability outright or by giving buyers a menu of lower prices and lower liability or higher prices and greater liability.

As shown by modern business and contracting practice, therefore, the principle of Hadley v. Baxendale is not required to achieve efficient pricing or efficient precaution. Both can be achieved, even without that principle, by probabilistic methods of doing business and by contracting around the default rule of proximate cause. Accordingly, the issue is whether the principle of proximate cause or the Hadley principle is the better default rule. Under the Hadley principle, the burden is on buyers to communicate information about their special circumstances. Under the principle of proximate cause, the burden is on sellers to limit damages. A default rule that puts the burden on sellers to limit damages is preferable to a default rule that puts the burden on buyers to disclose their special circumstances. Sellers, as a class, are more sophisticated than buyers and are in a much better position than buyers to determine how to most efficiently couple price and liability choices. Furthermore, many buyers—particularly, but not exclusively, consumers—do not know the Hadley principle. Such buyers will often fail to communicate information about their special circumstances because communication will seem unreasonable, partly because the buyers realize that the information will be disregarded by the frontline salespeople and clerks with whom they deal. In contrast, under a proximate cause default rule, buyers do not have to know the law because the seller's contract will delineate the seller's basic liability and the buyer's alternative price and liability choices.
Finally, in most cases, the transaction costs of contracting around a proximate cause default rule will be much lower than the transaction costs of contracting around the principle of Hadley v. Baxendale. To contract around the Hadley principle, the buyer must first determine what information he needs to communicate—what is special about his circumstances—and then must communicate the information effectively. To contract around a proximate cause default rule, the seller ordinarily needs to make a one-time investment in determining his optimal levels of price and liability, and the buyer need only choose or reject either the basic level or one of the seller’s alternatives.

Adoption of a proximate cause default rule, without more, would leave one problem. A covert reason for the principle of Hadley v. Baxendale may be to limit damages that would be highly disproportionate to the seller’s potential profit on the transaction in question or on the relevant class of transactions.\(^\text{183}\) In contrast, a combination of a proximate cause default rule, contractual limitations on liability, and probabilistic methods of doing business may not suffice in cases—which are probably relatively few in number—in which the buyer’s damages would be highly disproportionate to the seller’s potential profit and the seller is too unsophisticated to limit its liability by contract and too small to use probabilistic methods of doing business. However, that problem should be addressed directly by a rule limiting disproportionate damages, rather than indirectly by the principle of Hadley v. Baxendale. Just such a rule seems to be emerging, as evidenced in Restatement Second section 351(3), which provides that a court “may limit damages for foreseeable loss by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.”\(^\text{184}\) The principle of section 351(3) would be especially apt when, to modify slightly a test that James Gordley has suggested, the buyer knows that the seller is abnormally vulnerable but fails to disclose that vulnerability.\(^\text{185}\) This may be true, for example, when the buyer knows that the seller is a relatively small firm that is unable sufficiently to aggregate risks, insufficiently sophisticated to bargain for a contractual allocation of loss, or both, or knows that the


seller’s damages would be significant in proportion to the seller’s net worth and that the seller probably does not understand the risk it runs.

CONCLUSION

Probability and chance have a pervasive impact on contract law. This Article has discussed the role of these elements in two of the most important areas of that body of law, consideration and remedies. The discussion is illustrative, not exhaustive. For example, the doctrines of mistake and changed circumstances, properly formulated, turn on what risks a contract concerns. In the area of performance, the probability of future performance plays an important role in determining whether there has been an anticipatory breach, and a critical role in determining whether a party is entitled to insist on assurance that performance will be forthcoming.

It is not surprising that probability and chance figure so heavily in contracts. After all, contracting activity is commonly motivated by those elements. However, much of classical contract law either masked the role of these elements or got that role wrong because an expansive treatment of probability and chance was inconsistent with the static and binary character of that school of law. Modern contract law, in contrast, has been evolving to take account of probability and chance. In the area of consideration, structural agreements have been accorded increasing legislative and judicial recognition. In the area of remedies, the courts have, generally speaking, ratcheted down the required level of probability in applying both the certainty principle and the principle of *Hadley v. Baxendale*. What remains is to convert the often-implicit recognition of the role of probability and chance in contract law into explicit doctrine.