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## Protecting Reliance

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# ESSAY

## PROTECTING RELIANCE

*Victor P. Goldberg\**

*Reliance plays a central role in contract law and scholarship. One party relies on the other's promised performance, its statements, or its anticipated entry into a formal agreement. Saying that reliance is important, however, says nothing about what we should do about it. The focus of this Essay is on the many ways that parties choose to protect reliance. The relationship between what parties do and what contract doctrine cares about is tenuous at best. Contract performance takes place over time, and the nature of the parties' future obligations can be deferred to take into account changing circumstances. Reliance matters in this context since one or both of the parties might want to rely on the continuity of the arrangement; but they might also want the flexibility to adapt as new information becomes available. If one party has the discretion to react (terminating or adjusting quantity, for example), the other party can confront the decisionmaker with a price reflecting its reliance. That price need bear no relationship to the formal remedies of contract law. The Essay also considers other roles of reliance, including how it is used to determine compensation following excused performance, to trigger the irrevocability of an offer, and to validate information in a particular type of complex transaction—a corporate acquisition.*

### INTRODUCTION

Reliance-talk permeates contract law and scholarship. One party relies on the other's promised performance, its statements, or its anticipated entry into a formal agreement. Often reliance is paired with justice (or, more precisely, avoiding injustice) for defining obligations or reckoning compensation. It is the centerpiece of the Fuller-Perdue triumvirate of interests to protect.<sup>1</sup> Reliance, they argued persuasively, is tremendously important.<sup>2</sup> And many scholars were persuaded.<sup>3</sup> It is one

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1. See L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*: 1, 46 *Yale L.J.* 52, 53–56, 71–75 (1936) [hereinafter Fuller & Perdue, *Reliance 1*] (identifying restitution, reliance, and expectation interests as three principal purposes in awarding contract damages and noting restitution and expectation interests both converge with reliance interest).

2. *Id.*

of the most cited articles in contract law.<sup>4</sup> Saying that reliance is important, however, says nothing about what we should do about it. The leap from that proposition to implications for doctrine—a leap made by Fuller-Perdue and many followers—does not follow.<sup>5</sup> The Fuller-Perdue framework does nothing to resolve the Goldilocks problem: Is the protection of reliance too much, too little, or just right?

Too often court decisions or scholarship put forward arguments of this form: People want to be able to rely upon *X*, and if the law does not take that reliance into account, then something bad (inefficiency for some, injustice for others) will occur. Principles of contract doctrine can then be invoked, rejiggered, or even amended, so that the reliance is properly accounted for. The discussion, I believe, typically fails to ask the most basic questions: What do parties do and why do they do it? The focus of this Essay will be on these contract-design questions. Understanding how and why parties deal with reliance questions will provide insights into both contract doctrine and interpretation.

Contract law allows parties, within constraints, to set their own rules. It provides a set of default rules, and if the parties do not like them, they can change them. Some of the rules, however, are mandatory, and others are, to varying degrees, sticky. That stickiness is in part due to the costs of tailoring a transaction. For example, in many business-to-business (B2B) transactions, including million-dollar deals, the documentation consists of conflicting language on the back of two printed forms. Apparently in such cases the parties would rather rely on the default rule for resolving the conflicting language than spell out their obligations in a negotiated document.<sup>6</sup>

A more subtle source of stickiness is the beliefs of judges, scholars, and lawyers about the nature of contracts and contractual duties. The notion that victims of a breach of contract should be made whole is a

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3. P.S. Atiyah, Fuller and the Theory of Contract, in *Essays on Contract* 73, 73 (1986) (“The Reliance Interest in Contract Damages”[] has probably been the most influential single article in the entire history of modern contract scholarship, at any rate in the common law world.” (footnote omitted)); P. Linzer, *A Contracts Anthology* 285 (2d ed. 1989) (“The Fuller and Perdue article is probably the best-known article in the contracts literature . . .”); Todd D. Rakoff, Fuller and Perdue’s *The Reliance Interest* as a Work of Legal Scholarship, 1991 *Wis. L. Rev.* 203, 204 (“[I]ts substantive propositions are still considered worthy of debate; its themes provoke new studies of great merit; and its concepts are incorporated into the latest *Restatement of Contracts*.” (footnotes omitted)).

4. Fred R. Shapiro & Michelle Pearse, The Most-Cited Law Review Articles of All Time, 110 *Mich. L. Rev.* 1483, 1490 (2012).

5. For criticisms of the Fuller-Perdue argument for awarding reliance damages, see Richard Craswell, *Against Fuller and Perdue*, 67 *U. Chi. L. Rev.* 99, 111 (2000), and Michael B. Kelly, *The Phantom Reliance Interest in Contract Damages*, 1992 *Wis. L. Rev.* 1755, 1758.

6. On the costs and benefits of providing specific terms at the front end versus having a third party determine the content of the agreement at the back end, see Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 *Yale L.J.* 814, 822–39 (2006) [hereinafter Scott & Triantis, *Anticipating Litigation*].

powerful one that constrains the ability of parties to structure their relationship.<sup>7</sup> The Uniform Commercial Code (U.C.C.) and Restatement (Second) of Contracts are peppered with notions of good faith and prevention of injustice.<sup>8</sup> There is a vast literature on the philosophy of contract-law morality.<sup>9</sup> I do not intend to engage with it directly. I do hope that by focusing on the question of contract design, I can nudge contractual ethos and contract doctrine in a direction that is more congenial to the needs of the parties.

My concern, I must emphasize, is with the contracts of sophisticated parties. I am not concerned with consumer contracts or agreements between amateurs—for example, an uncle’s promise of cash to pay for a nephew’s car, which was featured in the debate over the adoption of section 90.<sup>10</sup> There can, of course, be some dispute over whether a particular contract falls in that category. For my purposes, the pertinent category is defined by agreements for which both parties could be expected to have access to counsel.<sup>11</sup>

Reliance is implicated in a number of doctrinal areas. Instead of starting with doctrine and working out, this Essay begins with the design problems and works backward to doctrinal considerations. The first design problem concerns the tradeoff between reliance and flexibility.

7. Scott and Triantis stress both the importance of the compensation principle in contract law and its dubious foundations. Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 *Colum. L. Rev.* 1428, 1428–29 (2004) [hereinafter Scott & Triantis, *Embedded Options*].

8. See, e.g., U.C.C. § 2-508 cmt. 2 (2012) (“[U.C.C. § 2-508(2)] seeks to avoid injustice to the seller by reason of a surprise rejection by the buyer.”); id. § 2-610 cmt. 3 (noting party may sue for damages resulting from anticipatory repudiation when “material inconvenience or injustice will result if the aggrieved party is forced to wait and receive an ultimate tender minus the part or aspect repudiated”); Restatement (Second) of Contracts § 90(1) (1981) (“A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.”); id. § 272(2) (permitting courts to “grant relief on such terms as justice requires including protection of the parties’ reliance interests”).

9. See, e.g., Charles Fried, *Contract as Promise* 14–17 (1981) (noting contract obligation is special case of general moral duty to keep promises premised on mutual trust); T.M. Scanlon, *What We Owe to Each Other* 295–309 (1998) (arguing obligations to keep promises arise from principle of fidelity); Richard Craswell, *Promises and Prices*, 45 *Suffolk U. L. Rev.* 735, 766–67 (2012) (discussing morality’s role in shaping contract law’s default rules). See generally Symposium, *Contract as Promise* at 30: *The Future of Contract Theory*, 45 *Suffolk U. L. Rev.* 601 (2012) (providing substantial commentary on whether contract law is or ought to be grounded in moral duty).

10. Gerald Griffin Reidy, Note, *Definite and Substantial Reliance: Remediating Injustice Under Section 90*, 67 *Fordham L. Rev.* 1217, 1222 (1998) (noting framers intended section 90 “for enforcing relied-upon promises in purely donative setting, rather than in commercial contexts”).

11. Included in this category is the battle of the forms, alluded to above, even though its essential feature is that the parties are not expected to involve counsel in the actual transaction.

Because contracting parties need to adapt their relationship as circumstances change, they can choose to allocate discretion to one of the parties. That discretion can be constrained to take into account the counterparty's reliance. The discretion could take the extreme form of termination or milder forms, such as granting one party the right to vary quantity. Part I considers both the "option to abandon" and quantity adjustment.

If one party relies on the other party to perform competently and the counterparty fails to do so, the consequences can be severe. If I ship a package and it fails to arrive, I, or the intended recipient, might suffer consequential damages. Since *Hadley v. Baxendale* was decided,<sup>12</sup> the aggrieved party's ability to obtain compensation for its resultant losses has been limited. Part II considers the rationale for restricting the recovery of consequential damages, with a particular emphasis on the role of reasonable reliance.

When performance of a contract is excused (by impossibility or related doctrines), the parties are left in the middle. A buyer might have already paid thousands of dollars for goods that it will not receive because the seller was excused. The seller might have spent substantial sums in reliance upon the contract before the occurrence of an event that excused performance. Must the seller disgorge the payments it has received? Should the buyer compensate the seller for expenses made in reliance upon the contract? The Restatement (Second) would have the seller disgorge but also compensate it for reliance costs to "avoid injustice."<sup>13</sup> English law yields a similar result.<sup>14</sup> This is, I suggest in Part III, a doctrine untethered by reality. Parties routinely design around the doctrine.

Reliance, coupled with the prevention of injustice, shows up in other corners of contract doctrine as well. It has been the basis for finding a promise enforceable (section 90) and an offer irrevocable (section 87(2)).<sup>15</sup> The rise of promissory estoppel and its practical significance (or lack thereof) have been chronicled elsewhere, and I have little to add to that.<sup>16</sup> The original source of the irrevocability argument is Justice

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12. (1854) 156 Eng. Rep. 145 (Ex.); 9 Ex. 341.

13. Restatement (Second) of Contracts §§ 272, 377.

14. See Law Reform (Frustrated Contracts) Act, 1943, 6 & 7 Geo. 6, c. 40, § 1 (Eng.) [hereinafter Frustrated Contracts Act] (providing seller must generally disgorge payments received but allowing seller compensation for reasonable reliance). The Frustrated Contracts Act was adopted shortly after *Fibrosa Spolka Akcyjna v. Fairbairn Lawson Combe Barbour, Ltd.*, [1943] A.C. 32 (H.L.) 49–50 (appeal taken from Eng.), where the court required the seller to return the prepayment but denied compensation to the seller for costs it might have incurred in reliance on the contract. See *infra* notes 184–193 and accompanying text.

15. Restatement (Second) of Contracts §§ 87(2), 90.

16. See, e.g., Stanley D. Henderson, Promissory Estoppel and Traditional Contract Doctrine, 78 Yale L.J. 343, 344 (1969) (examining relationship between promissory estoppel and familiar rules of contract formation); Avery Katz, When Should an Offer

Traynor's famous decision in *Drennan v. Star Paving Co.*,<sup>17</sup> which involved an offer by a subcontractor to a general contractor. The practical significance in contexts other than contracts between general contractors and subcontractors in public projects is minimal. In the few cases in which the issue has been litigated, the courts have shown little consistency in identifying the type of reliance that would trigger irrevocability.<sup>18</sup> Part IV considers both the reliance trigger and the factors affecting the need to protect the reliance of both the general contractor and the subcontractor.

In sales contracts, particularly those involving complex transactions (e.g., corporate acquisitions), information about the asset will be imperfect. Often, the most efficient producer of some types of information will be the seller. The seller wants the buyer to rely on the information. The greater the assurance, the more a buyer will be willing to pay. The seller, therefore, has an incentive to provide information, perhaps in the form of a warranty. However, the seller also wants to distinguish between information that buyers should rely on, and, of equal importance, information that buyers should not rely on. Part V explores issues concerning reliance and information: antireliance clauses, breach of warranty, and "sandbagging."

#### I. RELIANCE AND FLEXIBILITY

Contract performance takes place over time, and the nature of the parties' future obligations can be deferred to take into account changing circumstances. Reliance matters in this context since one or both of the parties might want to rely on the continuity of the arrangement while, at the same time, maintaining the flexibility to adapt as new information becomes available. If the two parties are under single ownership, the owner can determine the appropriate tradeoff between reliance and flexibility. If they are not, the coordination is done by contract, and the contract will define the tradeoff. The contract, as is often the case, might give one party the discretion to adapt to the new information, and it would convey to that party the counterparty's reliance, the cost to it of granting that discretion. In effect, one party sells discretion (or flexibil-

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Stick? The Economics of Promissory Estoppel in Preliminary Negotiations, 105 Yale L.J. 1249, 1250 (1996) (analyzing promissory estoppel doctrine as economic-regulation-shaping bargaining process); Charles L. Knapp, Reliance in the Revised Restatement: The Proliferation of Promissory Estoppel, 81 Colum. L. Rev. 52, 52-54 (1981) (discussing expansion of promissory estoppel in Restatement (Second) of Contracts and predicting future proliferation of doctrine); Juliet P. Kostritsky, The Rise and Fall of Promissory Estoppel or Is Promissory Estoppel Really as Unsuccessful as Scholars Say It Is: A New Look at the Data, 37 Wake Forest L. Rev. 531, 537-43 (2002) (surveying promissory estoppel case law and criticizing as premature announcement of doctrine's demise).

17. 333 P.2d 757 (Cal. 1958) (en banc).

18. See *infra* notes 207-229 and accompanying text (discussing courts' interpretation of reliance under *Drennan* framework).

ity) to the other. The “price” would reflect the value of flexibility to one party and the cost of providing that flexibility to the other. The price need not be explicit. As some of the illustrations below will demonstrate, the contract structure will determine an implicit price of flexibility.

The reliance-flexibility tradeoff could take the form of allowing one party to terminate the agreement—essentially giving it an option to abandon. Breach is, of course, a special case of the option to terminate. Once this is recognized, it is clear that the price of that option need bear no relationship to the traditional remedies for breach. Or the tradeoff could take the lesser form of, say, giving one party control of the quantity decision. Both of these manifestations of the tradeoff will be explored in Part I.

### A. *The Option to Abandon*

Oliver Wendell Holmes famously said that the “duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else.”<sup>19</sup> The notion that a contract is merely an option to perform or pay damages has elicited much criticism.<sup>20</sup> A common refrain in both decisions and scholarship is that parties plan for performance, not the option to terminate.<sup>21</sup> That may be true for the parties, but it is not true for their counsel. For many transactions it would amount to malpractice to ignore the possibility that one or the other party might choose to walk away from the deal. In contracts where performance is expected to take place over time, there is a tradeoff between reliance and flexibility. On the one hand, the parties want to adapt as new information becomes available. But on the other hand, if one party has relied on the continuation of the relationship, the counterparty’s adaptation to that new information might cause it considerable harm.

When circumstances change, sometimes the most efficacious response is to terminate the contract. One party might have an option to terminate while the counterparty might want to restrict that option to protect its reliance by requiring payment. The exercise price for the option to terminate need not have any relationship to the legal remedies of the U.C.C. or Restatement (Second). In the contracts literature, the notion of “efficient breach” has been controversial.<sup>22</sup> The terminology is

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19. O.W. Holmes, *The Path of the Law*, 10 Harv. L. Rev. 457, 462 (1897).

20. See, e.g., Fried, *supra* note 9, at 14–17 (arguing contract is promise that promisor has moral duty to perform).

21. See 3 Samuel Williston, *A Treatise on the Law of Contracts* § 1357 (1st ed. 1920) (“Parties generally have their minds addressed to the performance of contracts—not to their breach or the consequences which will follow a breach.”).

22. See, e.g., Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 Calif. L. Rev. 975, 997–1016 (2005) (arguing theory of efficient breach results in inefficiencies and cannot be sustained); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. Legal Stud. 1,

unfortunate. When framed as a design problem, it becomes a matter of pricing the option to terminate. The manner in which reliance affects the exercise price of the termination option varies depending on the context.

To illustrate the variety, this section will describe a number of different instances in which the price of the termination option is set. The illustrations include the venture capital contract, the illusory contract, the preliminary agreement, the breakup fee in a corporate acquisition, and the pay-or-play contract in the movie industry. Despite the fact that the reliance interest in these examples is substantial, the exercise price can be quite low. Indeed, in some instances, the price is zero. The variety of ways of pricing the termination option has implications for contract remedies. This section concludes by considering such implications.

1. *Venture Capital*. — Consider first the venture capital contract.<sup>23</sup> The venture capitalist (VC) provides funds to an entrepreneur whose project typically has a high risk of failure and, even if successful, a long period before it will yield positive returns. The VC does not commit to funding the entire project. Instead, it will phase payment, allowing it to terminate its obligation as new information on the likely success of the project becomes available. It pays for this option up front in the share price. The option to abandon is generally accompanied by a right of first refusal. If the entrepreneur finds an alternative supplier of funds, the VC would have the right to continue funding on the same terms proposed by the third party. The option to terminate—to not throw good money after bad—is valuable to the VC. But it is costly to the entrepreneur who would be sitting with an incomplete project and no viable funding source to complete it. The entrepreneur would be especially vulnerable were the VC to use the option to rewrite the deal on more favorable terms. That is, when the option to abandon is triggered, the VC could say that it would only fund the next round if the terms were altered in its favor. So, what protection of the entrepreneur's reliance would the contract exhibit? In virtually all venture capital deals the answer is that the VC would pay nothing at the time the option is exercised. All the entrepreneur has is an unenforceable understanding that if the business performs as expected, the VC will invest in another round. The entrepreneur's protection of its reliance would take two forms. First is the VC's self-interest: If the information produced has been positive, it will be in the VC's

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2 (1989) (arguing efficient breach generates large expenses rather than reduces transaction costs); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 Va. L. Rev. 947, 949–50 (1982) (noting fallacies underlying efficient-breach analysis); Joseph M. Perillo, *Misreading Oliver Wendell Holmes on Efficient Breach and Tortious Interference*, 68 Fordham L. Rev. 1085, 1090 (2000) (exploring misunderstandings of efficient breach after Holmes).

23. For a discussion of the economics of venture-capital contracting, see generally Ronald J. Gilson, *Engineering a Venture Capital Market: Lessons from the American Experience*, 55 Stan. L. Rev. 1067, 1076–92 (2003).



interest to proceed. Delay or abandonment hurts it. Second, if the VC's threat to terminate is perceived as an opportunistic attempt to renegotiate, its reputation will suffer. For present purposes, the key point is that although the entrepreneur relies on the VC's future funding, it would rarely, if ever, receive compensation if the VC were to exercise the termination option.

2. *Reliance on Illusory Promises.* — In some instances, the reliance-flexibility tradeoff can be accomplished despite the parties deliberately making their agreement legally unenforceable. That is, one party might be encouraged to make investments in reliance on the continuation of its relationship notwithstanding the fact that it would have no legal recourse were the other party to terminate. If a contract said in effect, "I will do it if I want to," it would be deemed illusory and lacking consideration. For example, the standard franchise agreement between Ford and its dealerships pre-1940 took this form. The unenforceability was not an accident of careless drafting. Ford knew what it was doing.<sup>24</sup> Ford had only promised to fill future orders if it chose to do so. In *Bushwick-Decatur Motors, Inc. v. Ford Motor Co.*, the district court described a Ford franchise agreement in detail:

The Sales Agreement, by its term Article (9)(c) was terminable at any time, at the will of either party, and does not bind defendant to sell or deliver, or plaintiff to buy, nor does it impose any liability on defendant if it terminates or refuses to make sales to the other party. The Sales Agreement was to be observed by the parties only so long as was mutually satisfactory.<sup>25</sup>

There, the court found the agreement to be illusory, despite the claimed reliance of the dealer on alleged oral statements by Ford representatives:

[T]he oral contract "in substance" provided . . . that defendant's settled policy was "Once a Ford dealer, always a Ford dealer"; that by the dealership contract "the plaintiff had become a member of the great Ford family; that the plaintiff would remain a Ford dealer as long as it wanted to;" that the Ford policy, settled for many years, "was a guarantee of this; and that the plaintiff need have no hesitation whatever in investing all available funds in the promotion of the sale and servicing of Ford products as such investments would be perfectly safe." . . . [T]he agreement was reaffirmed [numerous times and] "at all such occasions, plaintiff was encouraged to enlarge its facilities, increase its sales force and expand its business, in reliance on the assurances given by the defendant that plaintiff was 'in' as a Ford dealer as long as it wanted and should have no concern

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24. See Friedrich Kessler, *Automobile Dealer Franchises: Vertical Integration by Contract*, 66 *Yale L.J.* 1135, 1150-52 (1957) (explaining automobile companies intentionally made franchise contracts unenforceable to thwart dealer lawsuits).

25. 30 *F. Supp.* 917, 920-21 (E.D.N.Y.), *aff'd*, 116 *F.2d* 675 (2d Cir. 1940).

over the wisdom of making long term commitments and long term plans."<sup>26</sup>

Neither Chrysler nor General Motors (GM) went to the extreme of making their agreement unenforceable. However, by making the agreement terminable on very short (say, fifteen days') notice, they essentially accomplished the same thing.<sup>27</sup> Their agreements were enforceable, but only for the brief period. The auto manufacturers wanted their dealers to make investments in reliance on continuation of the relationship, and by and large dealers did so. The dealers relied on the expectation that their satisfactory performance would assure renewal of their franchise. Dealers wanted more but, absent legislative intervention, they could not get the producers to give explicit protection for their reliance.<sup>28</sup>

The GM-Fisher Body contract, subject of much academic interest,<sup>29</sup> provides another illustration. In 1919, the two entered into a ten-year agreement in which Fisher agreed to produce and GM agreed to purchase almost all of GM's closed automobile bodies.<sup>30</sup> Despite the considerable reliance by both, the agreement was unenforceable.<sup>31</sup> While GM promised to place orders for substantially all its bodies, Fisher only promised to tell GM whether it would accept the orders. It did not promise that it would fulfill them.<sup>32</sup> The reliance of each was protected in part by the consequences if either walked away. Both would have suffered significant losses since neither had an adequate alternative—the high switching costs, arguably, constrained the parties and protected the reliance of each.<sup>33</sup>

Kellogg's contract with a supplier of packaging material for its cereal provides a more current illustration of a clearly unenforceable agreement.<sup>34</sup> The contract was for three years.<sup>35</sup> The "quantity clause," such as

26. 116 F.2d at 678 (quoting Bill of Particulars).

27. See *Ellis v. Dodge Bros.*, 246 F. 764, 765 (5th Cir. 1917) (indicating agreement terminable with fifteen days' notice); *Buick Motor Co. v. Thompson*, 75 S.E. 354, 355 (Ga. 1912) (describing agreement terminable with ten days' notice).

28. Since passage of the Dealers Day in Court Act of 1956, automobile franchise agreements that were not enforceable or were terminable on short notice have been prohibited. Stewart Macaulay, *Law and the Balance of Power: The Automobile Manufacturers and Their Dealers* 96–103 (1966).

29. For a partial listing of the literature, see generally Victor P. Goldberg, *Lawyers Asleep at the Wheel? The GM-Fisher Body Contract*, 17 *Indus. & Corp. Change* 1071 (2008) [hereinafter Goldberg, *Asleep*].

30. *Id.* at 1072–73.

31. See *id.* at 1076 (discussing unenforceability of contract).

32. See *id.* at 1075 ("In the event that the FISHER COMPANY accepts the orders specified in the schedules from time to time furnished by GENERAL MOTORS, it shall proceed to make and deliver the automobile bodies called for by said schedules . . .").

33. There is some question as to whether the executives of the firms were aware of the unenforceability of their agreement. It is not clear that the arrangement was sustainable; the two firms were merged before the ten-year period expired. *Id.* at 1072.

34. Complaint Exhibit I, *Kellogg Co. v. FPC Flexible Packaging Corp.*, No. 1:11-cv-272 (W.D. Mich. Mar. 18, 2011).

it was, read as follows: "Kellogg generally encourages its employees to obtain required goods and services from suppliers who have entered into formal agreements with Kellogg, and Kellogg agrees to use reasonable efforts to *communicate the existence* of this Agreement to such employees with a general need to obtain the Products and Services within the scope of this Agreement."<sup>36</sup> Either party could terminate the Agreement with 120 days' notice.<sup>37</sup> While the agreement was, obviously, too open-ended to be enforceable for any future orders, it would have been enforceable for any orders that had already been executed. It, like the Fisher Body contract and the Ford franchise contracts, was backward-enforceable, but not forward-enforceable. Nonetheless, it likely provided sufficient assurance to encourage the supplier's reliance on continuation of its dealings with Kellogg.

3. *Preliminary Agreements.* — Parties often enter into preliminary agreements—letters of intent (LOIs), memoranda of understanding (MOUs), and so forth—prior to entering into a fully enforceable contract. With such agreements, parties need not fully commit to a project. They can defer their decision by waiting until further information is revealed about the project and about their prospective partner. Rather than negotiating an entire agreement, they can temporize with one or both parties maintaining an option to terminate. The price of that option will reflect the other party's reliance. The traditional common law rule left reliance on preliminary agreements unprotected.<sup>38</sup> In recent years, following Judge Leval's decision in *Teachers Insurance & Annuity Ass'n of America v. Tribune Co.*,<sup>39</sup> reliance has been treated as both a rationale for enforcement and a remedy. Leval stated, "Giving legal recognition to preliminary binding commitments serves a valuable function in the marketplace, particularly for relatively standardized transactions like loans. It permits borrowers and lenders to make plans in reliance upon their preliminary agreements and present market conditions."<sup>40</sup>

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35. *Id.* at 3.

36. *Id.* (emphasis added).

37. *Id.*

38. See E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 *Colum. L. Rev.* 217, 263–69 (1987) [hereinafter Farnsworth, *Precontractual Liability*] ("Courts have traditionally accorded parties the freedom to negotiate without risk of precontractual liability."); Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 *Harv. L. Rev.* 401, 412–20 (1964) (noting case law leaves parties "free to break off preliminary negotiations without being held to an accounting"). See generally Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 *Harv. L. Rev.* 661 (2007) (describing cases in which courts enforce preliminary agreements and offering model for why parties make preliminary agreements).

39. 670 F. Supp. 491 (S.D.N.Y. 1987).

40. *Id.* at 499.

He suggested that there were two types of enforceable preliminary agreements. In Type I agreements, all the terms had been settled and only the formality of a signed agreement was lacking.<sup>41</sup> These agreements would be enforced as contracts. His innovation was to recognize a lesser commitment. In Type II agreements, a number of terms remained open so the agreement could not be enforced as such.<sup>42</sup> However, because the parties had relied upon the negotiations, he wrote, there was a good faith obligation to attempt to negotiate the deal to completion. If a party breached the good faith obligation, it would be liable for damages. *Tribune* was one of a trilogy involving the Teachers Insurance and Annuity Association (TIAA).<sup>43</sup> In the other two cases, the remedy was expectation damages.<sup>44</sup> The *Tribune* trial was only on the liability issue, with damages to be determined at a subsequent proceeding.<sup>45</sup> The case settled, but it is likely that the settlement reflected the expectation damages—essentially the difference in the present value of the loan at the contract rate and the market rate. In subsequent Type II cases, most courts have restricted recovery to reliance damages, following the reasoning of Allan Farnsworth: “An award based on [the expectation interest] would give the injured party the ‘benefit of the bargain’ that was not reached. But if no agreement was reached and it cannot even be known what agreement would have been reached, there is no way to measure lost expectation.”<sup>46</sup>

If the preliminary agreement were silent on enforceability, the court would have to determine, as a matter of law, whether a good faith duty existed. Then the trier of fact would have to determine whether the party had acted in good faith and, if not, what the damages would be. Of course, the agreement could make the good faith requirement explicit, and it could also determine the consequences of termination.<sup>47</sup>

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41. *Id.* at 498.

42. *Id.*

43. *Teachers Ins. & Annuity Ass’n of Am. v. Ormesa Geothermal*, 791 F. Supp. 401 (S.D.N.Y. 1991); *Teachers Ins. & Annuity Ass’n of Am. v. Butler*, 626 F. Supp. 1229 (S.D.N.Y. 1986).

44. *Ormesa Geothermal*, 791 F. Supp. at 415; *Butler*, 626 F. Supp. at 1236.

45. *Tribune*, 670 F. Supp. at 508 (awarding judgment on merits without discussing damages).

46. 1 E. Allen Farnsworth, *Contracts* § 3.26a, at 386 (3d ed. 2004) [hereinafter *Farnsworth, Contracts*]. Professor Eisenberg argues that the remedy should be the full expectation interest, unless that is too uncertain, in which case the court should revert to reliance damages. Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, 88 *Calif. L. Rev.* 1743, 1809 (2000).

47. In *SIGA Technologies, Inc. v. PharmAthene, Inc.*, the parties agreed to “negotiate in good faith with the intention of executing a definitive License Agreement in accordance with the terms set forth in the License Agreement Term Sheet.” 67 A.3d 330, 337–38 (Del. 2013). After the value of the license increased dramatically, the licensor regretted the terms and proposed much different terms in the subsequent negotiations—more than doubling the royalty rate, for example. *Id.* at 339–40. The court held that its negotiating behavior was not in good faith and that, had it behaved in good faith, the parties would

In the leading New York case finding a Type II agreement, *Brown v. Cara*, the agreement was silent on termination,<sup>48</sup> although the subsequent negotiations suggested that the parties could easily have priced the termination option. A construction company (Brown) and property owner (Cara) entered into an MOU in which the construction company would engage in an effort to have the property rezoned.<sup>49</sup> It would also get the construction contract and have partial ownership of the project, but these terms were not spelled out.<sup>50</sup> After success in rezoning, the parties could not come to an agreement, and the property owner walked away.<sup>51</sup> The court held that this was a Type II agreement and that, if the owner's decision was not in good faith, then Cara would have to pay damages—presumably reliance damages (Brown's costs).<sup>52</sup> Since the negotiations lasted for over a year and included multiple drafts of term sheets and agreements,<sup>53</sup> it is likely that a factfinder would have concluded that Cara had negotiated in good faith.

Brown spent considerable resources in pursuit of the rezoning, relying on its expectation that it would do the construction and share in the ownership of the completed project.<sup>54</sup> Cara had the option to terminate, but the MOU did not set an option price. The decision effectively priced the option at Brown's reliance damages—expenses incurred (adjusted for the probability that a court might find the termination to be in good faith). But there were plausible alternative ways of pricing Brown's reliance. The MOU could have included a nonbinding clause, effectively pricing the option at zero.<sup>55</sup> The option price could have been based on some fraction of the out-of-pocket reliance costs. Or the option price could have made Brown's compensation contingent on the success of the deal.

One device for pricing a party's reliance is a buy-sell (or put-call) arrangement. If, after some defined milestone (perhaps following the

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have agreed to the terms in the Term Sheet. *Id.* at 347. It then awarded expectation damages—the projected stream of payments based on the terms in the Term Sheet. *Id.* at 351–52.

48. 420 F.3d 148, 155 (2d Cir. 2005). For more detail on the case, see generally Victor P. Goldberg, *Brown v. Cara*, the Type II Preliminary Agreement, and the Option to Unbundle, in *Conference on Contractual Innovation: Papers Presented* (May 3, 2012) [hereinafter Goldberg, *Option to Unbundle*] (unpublished manuscript) (separately paginated work), available at <http://web.law.columbia.edu/sites/default/files/microsites/contract-economic-organization/files/Contractual%20Innovation%20book.pdf> (on file with the *Columbia Law Review*).

49. *Brown v. Cara*, 420 F. 3d at 151.

50. *Id.*

51. *Id.* at 152.

52. *Id.* at 154–59.

53. *Id.* at 152.

54. *Id.* at 158.

55. Alternatively, the MOU could have stated that the parties would bear all of their own precontract expenses.

rezoning), either party wanted to go it alone, it could trigger a buy-sell that would give its counterpart a choice. The offeror would name a price at which it would be willing to either take full ownership of the property or sell out, and the offeree would choose. That would give both parties a piece of the upside, but would still leave them with the flexibility to adapt as they learned information about the project and about each other. In fact, in the subsequent negotiations in *Brown v. Cara*, drafts of documents included both a nonbinding clause and a buy-sell clause:

Either member (the “initiating Member”) may force the other Member to either purchase the Initiating Member’s interest or sell its interest to the Initiating Member at a price proposed by the Initiating Member at any time if there is a deadlock on an issue as to which the consent of both Members is required or after the 3d anniversary of completion of Construction.<sup>56</sup>

The case illustrates how the option to abandon in the negotiating phase can be valuable to one or both parties, that there are a wide variety of plausible means for pricing that option (including zero), and that the parties are perfectly capable of figuring out how to do so. The price would reflect the ex ante reliance concerns of the parties.

4. *Breakup Fees*. — In a corporate acquisition, there can be a temporal gap of many months between execution of the contract and its actual closing. During that period a lot can happen that might result in the buyer wanting to terminate the deal.<sup>57</sup> The terms governing the buyer’s option to terminate are the subject of extensive bargaining. The buyer is particularly concerned about the accuracy of the seller’s representations (adverse selection) and postexecution behavior (moral hazard). It also would like the ability to walk away from the deal if external forces result in a decline in the value of the seller or if it is unable to arrange financing.

However, once the contract has been executed, the seller can have a substantial reliance interest in the deal closing. The seller’s reliance has two components. First, there is the simple reliance on the agreed price. It does not want to give the buyer the option to buy at the contract price only if the market stays the same or goes up. Second, once the contract is executed, the standalone value of the seller’s business might be adversely affected. Key personnel might start looking for new jobs; investment decisions might be postponed; relations with old customers, suppliers, and bankers might be impaired; and a failure to close might send a negative signal about the viability of the company. The greater the seller’s reliance on the deal going through, the more protection (the higher the effective option price) it will try to get.

The acquisition agreement requires that all the closing conditions be met; if not, the buyer would have a zero-price option to walk away. Not

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56. Goldberg, Option to Unbundle, *supra* note 48, at 5–6.

57. Sellers also want termination rights, but I will ignore those.

every inaccuracy, however trivial, would allow the buyer to walk away; typically, the walk-right is conditioned on the inaccuracies that individually, or in the aggregate, constitute a material adverse effect (MAE).<sup>58</sup> In addition, the closing can be contingent on a broader condition: Between the exercise and closing date, there cannot have been a material adverse change (MAC).<sup>59</sup> The greater the seller's reliance, the more likely it is that the MAC will be hedged by exceptions making it more difficult for the buyer to walk.<sup>60</sup> The exceptions generally put the risk of exogenous change on the buyer, with the seller bearing the risk of endogenous change (its behavior reducing the value of the combined firm) and its inaccurate statements.

Some buyers, particularly private equity firms, include explicit breakup fees in their agreements.<sup>61</sup> If completely unconstrained, these would put the risk of a decline in value from exogenous causes entirely on the seller. Or the breakup fee could be conditional. The agreement

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58. See Mergers & Acquisitions Mkt. Trends Subcomm., Am. Bar Ass'n, 2011 Private Target Mergers & Acquisitions Deal Points Study 60–65 (2012) (discussing frequency of materiality qualifications on seller's representations and warranties in 2010 transactions).

59. In Delaware, the hurdle for proving a MAC is extremely high. See *Frontier Oil Corp. v. Holly Corp.*, No. Civ.A. 20502, 2005 WL 1039027, at \*32–\*37 (Del. Ch. Apr. 29, 2005) (employing preponderance-of-evidence standard for proving material adverse effect). The dearth of reported cases is somewhat misleading. If the existence of a MAC is clear, the case will most likely not be litigated. Diamond Foods' aborted acquisition of Pringles provides one illustration of a deal falling through because of a MAC. Steven M. Davidoff, *Diamond Foods Debacle May Crack Open a MAC*, N.Y. Times: Dealbook (Feb. 9, 2012, 11:36 AM), <http://dealbook.nytimes.com/2012/02/09/diamond-foods-debacle-may-crack-open-a-mac/> (on file with the *Columbia Law Review*).

60. In their study, Gilson and Schwartz considered the following exceptions:

(1) changes in global economic conditions; (2) changes in U.S. economic conditions; (3) changes in global stock, capital, or financial market conditions; (4) changes in U.S. stock, capital, or financial market conditions; (5) changes in the economic conditions of other regions; (6) changes in the target company's industry; (7) changes in applicable laws or regulations; (8) changes in the target company's stock price; (9) loss of customers, suppliers, or employees; (10) changes due to the agreement or the transaction itself; and (11) a miscellaneous category. The agreements also were coded for two qualifications to the explicit inclusions or exclusions of the traditional MAC definition. These qualifications would make a specified inclusion or exclusion inapplicable if the MAC either specifically affected the target company or had a materially disproportionate effect on the target company.

Ronald J. Gilson & Alan Schwartz, *Understanding MACs: Moral Hazard in Acquisitions*, 21 *J.L. Econ. & Org.* 330, 349–50 (2005).

61. E.g., *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810, 820–26 (2007) (detailing reverse breakup fee negotiations between private equity firm and acquisition target in context of failed merger); see also Gerard Pecht & Mark Oakes, *M&A Reverse Breakup Litigation*, *Securities Law360* (Feb. 25, 2008, 12:00 AM), <http://www.law360.com/articles/48141/m-a-reverse-breakup-litigation> (on file with the *Columbia Law Review*) (“Recently, many purchasers have successfully limited their exposure by capping their liability at a pre-agreed reverse termination fee. Many recent deals, especially private equity deals, expressly exclude specific performance as a remedy and provide that a reverse breakup fee is the only remedy for a jilted target.”).

in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*<sup>62</sup> provides a good illustration. Because the value of the target firm had fallen, the buyer wanted out.<sup>63</sup> The buyer's option had, in effect, three different prices. If it could prove that there had been a MAC, it could walk away at a zero price.<sup>64</sup> If the buyer used its best efforts to obtain financing but failed, it would pay a termination fee of \$325 million.<sup>65</sup> Finally, if the deal failed to close because of a "knowing and intentional breach of any covenant," damages would be uncapped.<sup>66</sup> Citing a number of bad acts by the buyer and its lawyers, the vice chancellor found that the breach of a covenant was intentional.<sup>67</sup> After losing at trial, the buyer settled for \$1 billion.<sup>68</sup>

The buyer's right to terminate is not an afterthought; it is a significant element in the deal and is often the subject of considerable negotiation. The option price—or, as *Hexion* illustrates, the option prices—would reflect the seller's reliance.

5. *Pay-or-Play*. — Next, consider a movie studio contracting with an actor to appear in a movie to be filmed in the near future (say, six months later). That was the situation in the casebook favorite featuring Shirley MacLaine's dispute with Twentieth Century Fox following the cancellation of the film project *Bloomer Girl*.<sup>69</sup> A lot can happen in the intervening period. The script might be disappointing; the genre might become less attractive; a similar film might be released; a director incompatible with the actor might sign on; a more attractive actor might become available; the actor's reputation might be tarnished in the interim; and so forth. As the primary claimant on the project's earnings, the studio has the incentive to make adaptive decisions that enhance the expected value of the project. The right to terminate the actor before filming commences would be valuable to the studio. The actor enters into the contract in reliance on the project going forward and on her being in the film. Her reliance is the opportunity cost of accepting this project and forgoing other possible offers that might come along in the intervening months. The studio's flexibility and the actor's reliance are protected by a pay-or-play clause. The studio maintains the right not to make the movie and, if it does choose to make the movie, to do so without this actor. The price of this option depends on the marketability of

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62. 965 A.2d 715 (Del. Ch. 2008).

63. See *id.* at 721 ("After receiving the seller's first quarter 2008 results, the buyer . . . began exploring options for extricating the seller from the transaction.").

64. *Id.* at 724.

65. *Id.*

66. *Id.*

67. *Id.* at 756.

68. Amy Kolz, *The Big Fall: Wachtell, Lipton Was Supremely Confident of Its Strategy in the Hexion Busted-Merger Litigation with Huntsman. So How Did It All Go So Wrong?*, *Am. Law.*, Apr. 2009, at 68, 73.

69. Victor Goldberg, *Framing Contract Law* 279–309 (2006) [hereinafter Goldberg, *Framing*].



the actor. For a major talent, the pay-or-play option would kick in upon entering into the contract and the compensation would be the so-called fixed fee.<sup>70</sup> For lesser talent, the option might not be triggered until a subsequent event—perhaps the appearance of a bona fide alternative offer for the actor. Until that point, the actor would be committed to the project, but the studio would have a free option to terminate.

The pay-or-play clause is a variation on a severance package (except the actor is not an employee). An employment agreement might give the employer the discretion to terminate the agreement at its convenience (“no cause”) and, if so, it might specify what compensation, if any, would be required. The structure of these contracts can vary in subtle ways. Consider, for example, the multiyear contracts of two coaches in major college sports programs: John Calipari at Kentucky and Rich Rodriguez, then at West Virginia.<sup>71</sup> The coach and the university both have a substantial reliance interest in the relationship. If either chooses to terminate without cause, that party must bear some consequence, but both want to retain that option. The two contracts each choose a somewhat different way to protect reliance. If Kentucky were to terminate Calipari, it would pay liquidated damages of \$3 million per year for each remaining year on the contract.<sup>72</sup> Calipari would be required to “make reasonable and diligent efforts to obtain employment.”<sup>73</sup> If he were to succeed, then the damages would be “reduced by the amount of the minimum guaranteed annual compensation package of the Coach’s new position.”<sup>74</sup> That is, he would have a duty to mitigate and there would be a partial offset. If, on the other hand, Calipari were to choose to terminate early, he would owe as liquidated damages an amount that would decrease over time—\$3 million if the termination were in the first year,

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70. Major talent typically receives a percentage of the gross offset against a fixed fee. The fee might be in the \$20 million range. If the share of the gross were 10%, the gross would have to reach \$200 million before the contingent compensation would kick in. For more detail on contingent compensation in the movie business, see *id.* at 13–42.

71. Employment Agreement Between the Univ. of Ky. and John Vincent Calipari (Mar. 31, 2009) [hereinafter Calipari Contract] (on file with the *Columbia Law Review*); Employment Agreement Between the Univ. of W. Va. and Richard Rodriguez (Dec. 21, 2002) [hereinafter Rodriguez Contract] (on file with the *Columbia Law Review*).

72. Calipari Contract, *supra* note 71, at 11. Calipari’s base salary was only \$400,000. *Id.* at 4. However, his compensation also included a broadcast endorsement payment of around \$3 million per year. *Id.* at 5. The contract included incentive payments based on the athletic and classroom performance of his team. *Id.* at 7–8. If Kentucky won the Southeastern Conference and national championships, the incentive payment would be an additional \$750,000. *Id.* at 7. If the basketball team achieved a 75% graduation rate, he would receive an additional \$50,000. *Id.* at 8. Since most of his stars were one-and-done, he seemed quite willing to sacrifice this piece of the compensation.

73. *Id.* at 12.

74. *Id.* If the new contract were structured in the same way, it appears that this would only refer to the base compensation—about \$400,000, even though the contract would likely pay out over \$3 million per year.

declining to \$500,000 in the fourth year and nothing in year five.<sup>75</sup> The Rodriguez arrangement was simpler. If either he or the school had terminated without cause, there would have been a one-time payment of \$2 million.<sup>76</sup> Rodriguez would have had to neither mitigate nor offset any earnings.<sup>77</sup>

The point of these examples is that the option to terminate the agreement can create value, and the price of that option reflects the counterparty's reliance. I say "reflects," since, as some of the preceding examples show, there can be considerable reliance but little or no compensation if the option were to be exercised.

6. *Remedies for Breach.* — If a contract does not explicitly allow for termination, what then? The default rule is that termination would amount to a breach and the promisor would be liable for damages (or specific performance). The preceding discussion of how parties protect their reliance from the possibility that the counterparty might terminate the agreement has implications for contract remedies. Importantly, these concern not only the reliance remedy, but the expectation remedy. Specifically, I will argue that in many instances the "benefit of the bargain" goes well beyond what sophisticated parties would (and in fact do) choose.

Terminating an agreement is, of course, not the only way in which a contract can be breached, and I will consider another in the next section. The starting point is that the promisor has an option to terminate with the option price being the remedy for breach. That framing has generated much criticism—indeed, hostility. Breach is immoral to some and the amorality of the option notion grates. Treating a contract breach as a transgression against another's rights, Friedmann would go beyond expectation damages on grounds that "a party is generally bound to perform his contractual promises unless he obtains a release from the promisee."<sup>78</sup> The remedy, he insists, should not be damages, but specific performance.<sup>79</sup> However, after pages of argument against allowing the promisor to walk away, Friedmann takes almost all of it back:

As a normative matter, parties in a contractual setting should be left free to define the ambit of their rights, and it is open to

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75. *Id.* at 16.

76. Rodriguez Contract, *supra* note 71, at 10.

77. *Id.* In a typical pay-or-play contract, the talent has no duty to mitigate, but he or she has to offset any earnings. That is explicit in the union contract of the Director's Guild: If the director is employed by a third party, the employer "shall be entitled to an offset of the compensation arising from such new employment for such remaining portion of the guaranteed period against the compensation remaining unpaid . . ." However, 'the Director shall have no obligation to mitigate damages arising from his or her removal . . .'" Thomas D. Selz et al., 3 Entertainment Law § 27.10, at 34 (2d ed. 2007) (quoting Director's Guild of Am., Basic Agreement § 6-105 (1993)).

78. Friedmann, *supra* note 22, at 2.

79. *Id.* at 7.

them to stipulate that the promisor will be allowed to terminate the contract subject to the payment of damages. The efficient breach theory assumes, however, that, even if they have not done so and even if they intended to confer on the promisee a broader entitlement, the law will nevertheless defeat their joint intention by granting the promisor the option to breach.<sup>80</sup>

The parties should be free, that is, to choose what, if anything, should happen if one party wants to terminate. Friedmann's entire attack is on a default rule, and he appears quite content to allow parties to contract out in any way they see fit. His argument boils down to the notion that specific performance should be the default remedy, not expectation damages. Ironically, Scott and Triantis, taking the options framework, reach the same conclusion.<sup>81</sup> Their rationale is quite different. Framing the question in terms of options makes it clear that the option price need bear no relationship to the standard damage remedies of contract law—expectation, reliance, or restitution.<sup>82</sup> Rather than privileging any of the three, Scott and Triantis recommend the “none of the above” alternative.<sup>83</sup>

I regard the Scott and Triantis proposal as a form of academic shock treatment. The expectation damages remedy is so firmly entrenched in the minds of judges, lawyers, contracts professors, and even first-year law students that a bold proposed change was necessary to get their attention. The fundamental point is that the contract law remedy is, in effect, the implied termination clause, and that it should be viewed as just another contract term from which parties are free to vary. The remedy default rule, however, is stickier than others. “Although most of contract law provides default rules from which parties are free to contract away, remedial defaults carry heavier presumptive weight than other provisions.”<sup>84</sup> Doctrinal limitations, notably the unenforceability of penalty clauses, present barriers to the proper pricing of the termination option.

The stickiness of the expectation damage remedy is, as Scott and Triantis observe, in part a historical accident,<sup>85</sup> but it also has great

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80. *Id.* at 23.

81. Scott & Triantis, *Embedded Options*, *supra* note 7, at 1486–88. Specific performance is their default rule for contracts between sophisticated businesses. *Id.* For consumer contracts, their default rule is to give the consumer a free option. *Id.* at 1488–90.

82. *Id.* at 1456–76.

83. *Id.* at 1477–86.

84. *Id.* at 1435. But there is little reason to accord greater weight to damage rules. See Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 *J. Legal Stud.* 105, 108 (1989) (“Damage rules are no different from any other terms of a contract. They should be understood solely as default provisions subject to variation by contract. The operative rules should be chosen by the parties for their own purposes, not by the law for its purposes.”).

85. Scott & Triantis, *Embedded Options*, *supra* note 7, at 1446 (“[T]he preceding inquiry into [the compensation principle’s] historical roots suggests that the elevation of

rhetorical power. If a breaching party is perceived as having wronged the promisee, then corrective justice would seem to require that, like a tort victim, the promisee should be made whole. The standard refrain is that the contract remedy should put the promisee in as good a position (financially) as if the contract had been performed. The promisee should get the benefit of its bargain. That provides an anchor for doctrinal argument and friction for moving away from the default remedies. Reframing the problem as a matter of transaction design and recognizing the reliance-flexibility tradeoff show why the benefit of the bargain remedy is too simplistic. Holmes's framing as the promisor having a choice between performing or paying damages was, in large part, a response to the notion that default rules should be derived from ethical norms rather than commercial needs. Reviving Holmes's aphorism would at least nudge the rhetoric in a more useful direction. In particular, the penalty doctrine could be softened, if not abandoned entirely. And, this Essay argues below, in some contexts awarding a seller lost profits would overprotect its reliance.<sup>86</sup>

Much scholarship, particularly economic analyses of remedies, proceeds on the implicit assumption that the parties are incapable of pricing termination themselves and that the policy options are limited to damages (expectation, reliance, restitution) or specific performance. By framing the problem as one of pricing the termination option, it is clear that in a wide variety of contexts the efficient rule (i.e., one that sophisticated parties would voluntarily choose) bears no relation to the ones featured in the lawyer's rhetoric and the economist's model. To be sure, there are classes of cases in which a default remedy of expectation damages would be efficient. I argue elsewhere that there is a strong case for protecting the contract-market differential, which I have labeled the narrow expectation interest.<sup>87</sup> But beyond that, there is little reason to believe that there would be any relationship between the option price and the default remedies of law or the remedies modeled by economists.

To illustrate the point, consider one context in which the expectation remedy does a particularly poor job, the so-called "lost-volume-seller" problem. The rule is memorialized in U.C.C. section 2-708(2), which elevates economic misunderstanding into a statutory command:

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compensation to a universally applicable norm results more from mistaken path dependence than from a sustained and systematic appreciation of the merits of the rules governing contract damages.").

86. See *infra* notes 88–106 and accompanying text (providing examples of lost profits creating overprotection).

87. Goldberg, *Framing*, *supra* note 69, at 219–24. In a study of the use of reliance damages in contracts under the U.C.C., Gibson found that courts rarely awarded reliance damages. See Michael T. Gibson, *Reliance Damages in the Law of Sales Under Article 2 of the Uniform Commercial Code*, 29 *Ariz. St. L.J.* 909, 915 (1997) ("Thus, in 467 of the cases *most likely* to produce reliance damages, only fourteen (2.9%) did so."). However, as noted below, some parties do contract to limit the remedy to reliance damages. See *infra* note 107 and accompanying text.

"If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer."<sup>88</sup> In the lost-volume cases, the contract and market price are the same, so if a buyer were to cancel an order, there would appear to be no damages. The claim is that the seller should be compensated because it would have had the additional sale and its lost "profit" would be the difference between the contract price and its "but-for" costs. For a retailer, that would be the gross margin—the retail minus wholesale price. While the retailing cases play a prominent role in the literature and pedagogy, with *Neri v. Retail Marine Co.*<sup>89</sup> being the case of choice, in practice, they are of little relevance. Since *Neri* was decided in 1972, there have been only four recorded cases involving claims by retailers against consumers. The retailer won in two cases (one for a car<sup>90</sup> and one for a boat<sup>91</sup>) and lost two (one for a boat<sup>92</sup> and one for a mobile home<sup>93</sup>).

If the buyer walked away and the dealer sold the boat at the same price, the rule focuses on whether the seller would have sold another boat.<sup>94</sup> If so, the seller has lost his "profit" (the wholesale-retail differential) on the second boat and would be entitled to a damage award of the lost profits.<sup>95</sup> The analysis gets more complicated when the seller's ability to sell the second boat is questioned. If the seller would not have been able to sell another unit, perhaps because the supply was limited (it could not get another boat from the manufacturer, perhaps because this model was so attractive), then there would be no damage.<sup>96</sup> So goes the rule. When framed as setting an option price, the remedy makes no sense.

When placing an order, the customer wants some flexibility (the option to change her mind) and the seller wants some protection of its reliance on the order. The remedy prices the option. For cars and boats, it would be in the 12% to 15% range. In effect, I agree to pay 15% of the sale price for the option to buy the boat by paying the other 85%.

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88. U.C.C. § 2-708(2) (2012).

89. 285 N.E.2d 311 (N.Y. 1972).

90. *Van Ness Motors, Inc. v. Vikram*, 535 A.2d 510 (N.J. Super. Ct. App. Div. 1987).

91. *Modern Marine, Inc. v. Balski*, No. 43411, 1981 WL 4969 (Ohio Ct. App. May 21, 1981).

92. *Lake Erie Boat Sales, Inc. v. Johnson*, 463 N.E.2d 70 (Ohio Ct. App. 1983).

93. *Schiavi Mobile Homes, Inc. v. Girona*, 463 A.2d 722 (Me. 1983).

94. U.C.C. § 2-708(2) (2012); see also *Lake Erie*, 463 N.E.2d at 72 ("[T]he controlling issue regarding . . . entitlement to lost profits is whether the [dealer] sufficiently established its status as a volume seller.").

95. See *Neri v. Retail Marine Co.*, 285 N.E.2d 311, 314 (N.Y. 1972) (noting under section 2-708, measure of damages for dealer with unlimited supply or standard-priced goods is dealer's profit on one sale).

96. *Lake Erie*, 463 N.E.2d at 72.

Leaving aside the question of whether any consumer would have any idea that she had made such a commitment, we can ask whether an informed consumer would be willing to pay such an option price. The answer almost certainly is no. The U.C.C.'s remedy overprotects the seller's reliance, which is, typically, trivial. The dealer can take into account the likelihood that a certain percentage of its orders will result in cancellations. The likelihood that a buyer will walk away is one of the risks of doing business. It is predictable; more importantly, it can be influenced by the seller's decisions. In particular, the seller can set an explicit option price—say, a nonrefundable deposit. There is no reason to believe that the option price would be equal to the lost-volume remedy. Indeed, the remedy would be perverse. If the market were weak, the option price would likely be near zero; conversely, if the market were tight, the option price would be higher. The remedy gets it backwards. When the market is tight (say the manufacturer allocates only a set number of boats to the dealer), the seller would not be able to sell an extra unit—the lost-volume remedy would be zero. When the market is slack, the U.C.C. remedy would be the full wholesale-retail margin.<sup>97</sup>

In the B2B context, there is an even greater disconnect between the remedy and its function. The aggrieved seller claims that, had there been no breach, it would have been able to produce and sell all the other units anyway; accordingly its loss would be the difference between the contract price and the costs it would have incurred had it produced the units the buyer refused to take—the “but-for” costs. Costs not associated with production of these units—research and development, advertising, marketing, most plant and equipment—would not count; they would be part of the lost profit. Lost profit, especially for high-tech products, could therefore be a significant part of the contract price—for example, in *Teradyne, Inc. v. Teladyne Industries, Inc.*, the lost profits amounted to about 75% of the contract price.<sup>98</sup> The contract created by the lost-volume remedy would have the buyer paying \$75 for the option to purchase the product for an additional \$25. Such a deal makes little business sense, especially if the seller has ample capacity to meet the needs of this buyer and others (which must be so if the seller is indeed a lost-volume seller). As in the retail context, the presumption would be that the option price would be greater if the seller faced significant output constraints—the remedy again gets it backward.

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97. For a fuller exposition of this argument, see Goldberg, Framing, *supra* note 69, at 233–42; see also Scott & Triantis, Embedded Options, *supra* note 7, at 1482–84 (arguing scholarly “focus on lost volume and selling costs is a red herring”).

98. See 676 F.2d 865, 867 (1st Cir. 1982) (“In effect, this was a finding that Teradyne had saved only \$22,638 as a result of the breach. Subtracting that amount and also the \$984 quantity discount from the original contract price of \$98,400, the master found that the lost ‘profit (including reasonable overhead)’ was \$74,778.”).

An interesting illustration is provided by *Rodriguez v. Learjet, Inc.*<sup>99</sup> The contract for a new airplane included a series of progress payments; in the event that the buyer terminated, Learjet would keep the payments already made.<sup>100</sup> The buyer terminated shortly after entering into the agreement and sued for return of its initial payment of \$250,000, asserting that the payment was an unenforceable penalty clause.<sup>101</sup> Learjet defended by arguing that it was not a penalty.<sup>102</sup> To show this, Learjet argued that it was a lost-volume seller, demonstrating that it had the capacity to sell this plane and another; it proved to the court's satisfaction that it had suffered lost profits of over \$1.8 million.<sup>103</sup> Therefore, the measly \$250,000 was not a penalty and the court enforced it.<sup>104</sup> The value of getting approval of its progress payment schedule (a schedule of option prices) apparently exceeded the one-time gain of \$1.8 million.

The case illustrates one function of the lost-volume-profit remedy: enforcing deposits. If the buyer were to sue for return of its prepayment, the seller's counterclaim for lost profits would act as a deterrent.<sup>105</sup> If doctrine recognized that the prepayment was payment for the walk-option, there would be no need for this indirect device for enforcing the option price.

So, U.C.C. section 2-708(2) is perverse. What can we do about it? One response is to interpret it narrowly; another is to enforce deposits and other termination remedies. More generally, we should view the analysis as a step in chipping away at the dominance of the notion that contract damages should be thought of as compensation for a wrongful breach rather than as a decision variable for the parties.

I do not expect contract law to abandon the benefit-of-the-bargain approach. I do hope, however, that focusing on the contract-design questions will have some effect. The lost-volume-seller problem is one example. The notion that lost profits in general should routinely be enforceable is another. The unenforceability of penalty clauses, discussed below,<sup>106</sup> is yet a third. Perhaps the analysis might nudge doctrine a bit in the right direction by requiring a high standard of proof for the lost profits on the one hand, and by facilitating the limitation of damages on the other.

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99. 946 P.2d 1010 (Kan. Ct. App. 1997).

100. *Id.* at 1012.

101. *Id.* at 1013.

102. *Id.*

103. *Id.* at 1014-15.

104. *Id.* at 1015.

105. *Neri* also was a counterclaim in response to the buyer's suit for return of a down payment. *Neri v. Retail Marine Co.*, 285 N.E.2d 311, 312 (N.Y. 1972). However, these cases appear to be an exception. Based on my own count, only around 10% of the reported cases involve a counterclaim.

106. See *infra* note 135 and accompanying text (discussing unenforceable penalty clauses).

### B. *Quantity Adjustment*

When determining the quantity in a long-term contract for the sale of goods, the parties confront a problem. Conditions on both the demand and supply side can vary over time, and they might want to adjust the quantity as new information becomes available. While Part I.A discussed an adjustment to change involving termination, this section concerns a more modest adjustment—quantity variation.

When the manufacturer, say, of automobiles enters into supply contracts, it wants the flexibility to react as new information regarding the demand for specific models becomes available. If the news is bad, the manufacturer generally maintains the right to cancel part or all of the order. For example, the standard General Motors Purchase Order Terms and Conditions says:

Buyer may change the rate of scheduled shipments or direct temporary suspension of scheduled shipments, neither of which shall entitle Seller to a modification of the price for goods or services covered by this order . . . .

. . . In addition to any other rights of Buyer to cancel or terminate this order, Buyer may at its option immediately terminate all or any part of this order, at any time and for any reason, by giving written notice to Seller.<sup>107</sup>

If GM did exercise its option to cut back its order, the contract gave the seller the equivalent of the standard reliance remedy. GM would pay for all items that had already been completed under the purchase order and the costs of work-in-progress less the value of any goods the supplier could resell to third parties. There would be no recovery for overhead and other elements of lost profits.<sup>108</sup>

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107. Am. Axle & Mfg. Holdings, Inc., Amendment No. 1 to Form S-1 Registration Statement Under the Securities Act of 1933 (Form S-1/A) (June 5, 1998) [hereinafter GM Standard Form], available at <http://www.sec.gov/Archives/edgar/data/1062231/0000889812-98-001427.txt> (on file with the *Columbia Law Review*) (including Purchase Order as exhibit D to Component Supply Agreement Between American Axle & Manufacturing, Inc. and General Motors Corp.). Other forms of the Original Equipment Manufacturers (OEMs) have similar language. Major suppliers are referred to as Tier 1 suppliers, and they, in turn, contract with Tier 2 suppliers. For example, Eberspaecher North America, Inc. is a manufacturer of exhaust systems, which it sells to OEMs. Its standard Terms and Conditions include similar language: “In addition to any other rights of Buyer to terminate the Order, Buyer may, at its option, terminate all or any part of the Order without any liability whatsoever to Seller, at any time and for any reason, by giving 30 days written notice to Seller.” Complaint and Demand for Trial by Jury Exhibit 2 at 6, *Eberspaecher N. Am., Inc. v. Nelson Global Prods., LLC*, No. 2:12-cv-11045-RHC-PJK (E.D. Mich. Mar. 8, 2012).

108. GM Standard Form, *supra* note 107, cl. 13. The costs OEMs are willing to cover vary:

While all OEMs provide some recovery to suppliers for their squandered investments, some are stingy—they pay only for finished parts, work in progress, and raw materials. Others are more generous: they will pay for a combination of other termination costs, such as suppliers’ obligations to their own



Long-term variable-quantity contracts are quite common. They are even singled out in the U.C.C., which recognizes both “full output” and “requirements” contracts.<sup>109</sup> A full output contract gives the seller discretion—if I choose to produce any of this product, you promise to take all of it. A requirements contract gives the discretion to the buyer—I will only take my requirements from you and you promise to be ready to sell to me any amount that I desire. The counterparty would be reluctant to make such an open-ended commitment, and the agreement would likely include some limitation on that discretion. For example, the buyer might agree to take all its requirements for the operation of a particular plant; or it might agree to limit the seller’s obligation to a monthly maximum. The contract will give discretion to adapt to changed circumstances to the party that values it most, and the price of that flexibility will reflect the reliance of the counterparty. The contract could constrain the discretion in a variety of ways. Unfortunately, the U.C.C. ignores any functional limitation and instead uses the amorphous standard of “good faith” to limit the discretion.

Consider a firm that, along with its primary product, produces a byproduct that has some modest commercial value but if not removed promptly will cause problems for the producer that might have to add storage space or, in the extreme, curtail production of its primary product. Examples include petroleum coke (“petcoke”), a byproduct of the coking process for refining petroleum to produce gasoline and other valuable products, and day-old bread, an inevitable byproduct of the production and sale of fresh bread. The firm could enter into a long-term contract to assure prompt removal of the byproduct. If the byproduct had no economic value, this would simply be the equivalent of a trash-removal contract; if, as in these examples, there is some economic value, the contracting problem is more interesting.<sup>110</sup>

Petcoke’s commercial value is low, less than 3% of the value of the oil.<sup>111</sup> To produce petcoke, a refinery has to add a coker, a multimillion dollar plant with no other use.<sup>112</sup> The buyer would operate a calciner,

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subcontractors and investments in capital. None of the OEMs cover suppliers’ unamortized investment in R&D and engineering—a great source of agony for suppliers who expect to cover their fixed costs only after several years of supply.

Omri Ben-Shahar & James J. White, *Boilerplate and Economic Power in Auto Manufacturing Contracts*, 104 Mich. L. Rev. 953, 959 (2006) (footnotes omitted). Toyota would compensate for “the actual cost of Supplier for all works in process.” Toyota Motor Mfg. N. Am., Inc., Terms and Conditions art. 5.8(d), at 22 (Oct. 1, 1998) [hereinafter *Toyota T&C*] (on file with the *Columbia Law Review*). “Actual cost” is not defined, but it most likely excludes overhead costs and lost profit.

109. U.C.C. § 2-306(1) (2012).

110. These illustrations, and others, are examined in more detail in Goldberg, *Framing*, supra note 69, at 101–44.

111. *Id.* at 105.

112. *Id.* at 104.

also a single-use, multimillion-dollar item.<sup>113</sup> The primary use for the calcined coke was to make anodes, which were used to produce aluminum.<sup>114</sup> There were, to simplify things a bit, two different types of contracts. In one, the refinery (seller) had very limited storage space and the buyer had the capacity to take petcoke from a number of refineries and hold it in inventory.<sup>115</sup> The seller desired the freedom to make all its decisions on the basis of the demand for gasoline and other refined products, not petcoke. Granting this flexibility was essentially costless to the buyer—there was no reliance on this particular supplier. The resultant contract was a full-output contract, which gave the seller complete discretion as to how much petcoke it would produce; the buyer promised to immediately remove the petcoke and bore all the risks of quantity fluctuation.<sup>116</sup>

The second type of contract concerned the simultaneous construction of a coker and an adjacent calciner operated by an aluminum producer.<sup>117</sup> Because petcoke was expensive to transport, the buyer's only practical source would be the output of the new coker.<sup>118</sup> To protect the buyer's reliance, the contract gave the quantity decision to the buyer.<sup>119</sup> The contract specified a maximum amount, but allowed the buyer to take less if it so chose.<sup>120</sup> The buyer's discretion was constrained to take into account the refinery's reliance. For example, one contract included a "standby" fee, which amounted to about 40% of the monthly quantity; even if the buyer took no petcoke it would have to pay.<sup>121</sup> Other contracts with the aluminum producers had similar constraints on the seller's freedom to vary quantity.<sup>122</sup>

The standby fee is one variation on a "take-or-pay" contract. In a take-or-pay contract, the buyer agrees to pay for a certain percentage of the specified quantity, regardless of whether or not it actually takes it. The price for the first, say, 20% of the product in any given month is, in effect, zero. If the value of the seller's plant is contingent on the continued purchases by the buyer, the guaranteed "take" is one way to protect the seller's reliance. The greater the reliance, other things equal, the higher the guaranteed payment will be. The seller's reliance need not, in general, be fully protected—that is, the parties can share the risk of a bad outcome by setting the sum of the guaranteed payments below the seller's costs if the buyer were to order less than the minimum; however,

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113. *Id.*

114. *Id.*

115. *Id.* at 105.

116. *Id.*

117. *Id.*

118. *Id.* at 106.

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

there can be scenarios in which the guaranteed payments would exceed the cost. That possibility has made take-or-pay clauses (or a variation such as a minimum quantity) subject to the penalty-clause doctrine. A significant case in which a court (Judge Posner, to be precise) found a minimum-quantity clause to be a penalty is *Lake River Corp. v. Carborundum Co.*<sup>123</sup> I will turn to that shortly, but first I want to discuss the leading New York case regarding a variable-quantity clause, *Feld v. Henry S. Levy & Sons, Inc.*<sup>124</sup>

Levy baked and sold rye bread and inevitably produced, as a byproduct, stale and imperfect loaves.<sup>125</sup> It decided to install an oven to convert these into breadcrumbs, which had some commercial value.<sup>126</sup> To assure prompt removal, it entered into a one-year, full-output contract with Feld.<sup>127</sup> Either party could cancel the contract on six months' notice.<sup>128</sup> To protect its reliance, Levy required that Feld obtain a "faithful performance" bond.<sup>129</sup> Because Feld had other sources of breadcrumbs, the contract put no constraints on Levy's discretion.<sup>130</sup> Things did not work out as Levy had planned and it was losing money. It tried to renegotiate the price, but Feld refused. Levy then dismantled the oven and ceased producing breadcrumbs. Since the contract required that Levy give six months' notice for termination, the dismantling should not have been viewed as a termination. Had Levy reinstalled the oven it would still have been obligated to deliver all the crumbs to Feld.<sup>131</sup> Feld sued for breach, arguing that Levy could not in good faith reduce its output to zero.<sup>132</sup>

The court of appeals held that, despite the contract language, the seller was not free to decide whether it should produce any breadcrumbs at all.<sup>133</sup> The implied duty of good faith required that it continue to produce breadcrumbs "even if there be no profit. In circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial, which, overall, is a question of fact."<sup>134</sup> The court failed to recognize that Levy was the one making an investment—the toaster oven—in reliance upon the contract. The cost to Feld of granting the discretion was zero. The court, in effect,

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123. 769 F.2d 1284, 1286–87 (7th Cir. 1985).

124. 335 N.E.2d 320 (N.Y. 1975). For more detail on this case, see Goldberg, Framing, *supra* note 69, at 117–19.

125. *Feld*, 335 N.E.2d at 321.

126. Goldberg, Framing, *supra* note 69, at 117.

127. *Feld*, 335 N.E.2d at 321.

128. *Id.*

129. Goldberg, Framing, *supra* note 69, at 117.

130. *Feld*, 335 N.E.2d at 321.

131. Goldberg, Framing, *supra* note 69, at 117–18.

132. *Id.*

133. *Id.* at 118.

134. *Feld*, 335 N.E.2d at 323.

held that Levy promised that it would be willing to lose some money—but not too much—in order to protect Feld’s nonexistent reliance. The contract priced Levy’s discretion at zero—the court trumped it for no good reason.

In *Lake River*, Judge Posner ruled that a minimum-quantity clause was an unenforceable penalty.<sup>135</sup> Lake River agreed to bag an abrasive powder produced by Carborundum.<sup>136</sup> They entered into a three-year agreement with a minimum of 22,500 tons over the life of the contract.<sup>137</sup> Lake River installed bagging equipment costing \$89,000 to be used exclusively for Carborundum.<sup>138</sup> The decision did not note one feature of the contract—Lake River promised that it would bag up to 400 tons per week; Carborundum could conceivably have asked Lake River to bag over 60,000 tons during the life of the contract.<sup>139</sup> The contract was not exclusive on either side—both were free to deal with others during the contract period.<sup>140</sup> Times were tough for Carborundum, and it only managed to deliver about 12,000 tons.<sup>141</sup> Lake River sued, claiming that it should be paid for the 10,500 tons that Carborundum had failed to deliver.<sup>142</sup> The case was framed in terms of whether the suspect clause was for liquidated damages or a penalty.<sup>143</sup> Carborundum’s defense was that it was an unenforceable penalty clause, and Judge Posner agreed.<sup>144</sup> He noted that any shortfall would have left Lake River with a greater profit than if the minimum had been reached.<sup>145</sup> If the breach had occurred on the first day, he noted, the damages would have been over five times the investment that Lake River was making in special bagging equipment.<sup>146</sup>

Instead of framing the matter in terms of liquidated damages versus penalty, it is more productive to ask why the agreement was structured in that way. Carborundum was given substantial discretion as to whether it should use Lake River’s facility and, if so, how much. The contract effectively set a fixed fee and a price for the first 22,500 tons of \$0. Lake River promised that during the three-year period, it would make available

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135. *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1290 (7th Cir. 1985); see generally Victor P. Goldberg, *Cleaning Up Lake River*, 3 Va. L. & Bus. Rev. 427 (2008) [hereinafter Goldberg, *Lake River*] (providing facts about *Lake River* not included in published opinion).

136. *Lake River*, 769 F.2d at 1286.

137. *Id.*

138. *Id.*

139. Goldberg, *Lake River*, *supra* note 135, at 439.

140. *Id.* at 440.

141. *Lake River*, 769 F.2d at 1286.

142. *Id.*

143. *Id.* at 1288.

144. *Id.* at 1290.

145. *Id.*

146. *Id.* at 1292.

capacity to bag 400 tons per week at the contract price.<sup>147</sup> The court treated Lake River's investment in the new bagging equipment as determining the outer boundary of its reliance. However, Lake River also had to have workers on hand to handle any product delivered (up to the weekly maximum); in addition, it faced the opportunity cost of holding the capacity ready for the entire period. The minimum quantity indirectly set a price for the flexibility. Did the deal overprice Carborundum's discretion? Ex post, yes. But ex ante, it is not so clear. Perhaps Carborundum did pay too much for the flexibility, but there is no reason to second-guess the consideration paid for this valuable service. At the end of the three years, Lake River had fully performed—it had remained ready, willing, and able to take 400 tons per week for the entire period. All that remained to be performed was the payment by Carborundum.

The fundamental point in all these examples is that discretion can be allocated to the party that values it most and the counterparty can protect its reliance by, in effect, charging a price for the flexibility. By failing to recognize how parties resolve the reliance-flexibility tradeoff, contract doctrine can get in the way, using concepts like good faith (*Feld*) and penalty clauses (*Lake River*) to thwart the parties' intentions. The greater the reliance, other things equal, the higher the price will be. That the price is not quoted explicitly matters not.<sup>148</sup>

## II. RELIANCE AND CONSEQUENTIAL DAMAGES

The role of reliance in a consequential damage claim is different. In a typical case, one party, *A*, relies on the successful performance by the other, *B*, but is disappointed. Perhaps *B* was negligent, as in *Hadley v. Baxendale*.<sup>149</sup> Or perhaps *B* was not at fault, but for reasons beyond its control, *B* failed to perform.<sup>150</sup> In either instance, *A* might have a claim for compensation for losses it suffered as a consequence of its reliance.

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147. Goldberg, *Lake River*, supra note 135, at 439.

148. These examples have all concerned reductions in quantity, but similar problems can arise when the seller wants to increase quantity. The contract can have a maximum (like Lake River's 400-ton weekly maximum); if the seller wants to provide more, the contract could bar it, which would give the buyer a baseline from which to negotiate a price for the increased quantity. There are a lot of alternatives. For example, in a contract between Columbia Nitrogen and Royster (a casebook staple), the buyer could ask for more if the seller had the capacity to provide it. *Columbia Nitrogen Corp. v. Royster Co.*, 451 F.2d 3, 6 n.2 (4th Cir. 1971). But it could only ask. The contract did not prevent the seller from using the capacity to sell to others, so the ability to sell to others, in effect, meant that the additional quantity could be sold at the current market price, rather than at the contract price. Goldberg, *Framing*, supra note 69, at 164–65.

149. (1854) 156 Eng. Rep. 145 (Ex.); 9 Ex. 341.

150. The recent English case that reconsidered the *Hadley* doctrine, *The Achilles*, concerned losses arising from late redelivery of a legitimate last charter, the delay being the fault of neither party. See generally Victor Goldberg, *The Achilles*: Forsaking Foreseeability, 66 *Current Legal Probs.* 107 (2013).

Contract doctrine classifies these consequential damages as expectation damages, but they are a consequence of *A*'s reliance upon *B*'s satisfactory performance. The failure to perform here, unlike in the foregoing discussion, is not normally the result of the promisor exercising an option (although, as discussed below, the failure is sometimes deliberate).

When delivery of Hadley's shaft was delayed, Hadley was forced to shut down his mill.<sup>151</sup> Hadley's claim for lost profits arising from the closure was denied.<sup>152</sup> His failure to have another shaft available was the unusual circumstance cited by Baron Alderson (and, subsequently, countless others) for rejecting Hadley's claim for the lost profits.<sup>153</sup> Baxendale controlled the likelihood of the bad event—delay—occurring. But the consequences of that bad event were, in large part, controlled by Hadley. That raises the question: To what extent could Hadley run his business in reliance upon Baxendale's performance?

Baron Alderson recognized only one thing Hadley could have done to avoid the consequences—hold an extra shaft (an input) in inventory.<sup>154</sup> But there were many other things he could have done prior to handing the shaft over to Baxendale. He could have carried a larger inventory of flour (the output), or he could have recouped the lost output by running the mill at a higher level of output after the shaft had arrived. (In effect, that entails carrying a larger inventory of productive capacity—another input.) There is no reason why Hadley had to hold his inventory of inputs or output at this one location—he could have diversified. Any of these actions would have avoided Hadley's loss of profits (or, at least, substantially reduced them).

The contract-design problem then comes down to this: Should Baxendale compensate Hadley for the losses he incurred in reliance upon satisfactory performance, or should Hadley bear the consequences so that he might be incentivized to control the costs? Some, like Professor Melvin Eisenberg, argue in favor of the former:

In most cases involving consequential damages it can be assumed that the buyer has acted prudently during the period before the contract was made, because reasons of self-regard will have led him to do so. Under Posner's argument, prudence would require every factory owner to carry the spare parts for a virtually complete factory, housed alongside his operating factory. In fact, however, calculations concerning the optimum supply of spare parts are enormously complex and must reflect the probability that parts will fail, the cost of waiting for needed spare parts that are not kept in inventory, the cost of capital employed in investing in spare parts, the cost of maintaining spare parts, and the actual or imputed rental costs for storing

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151. *Hadley*, 156 Eng. Rep. at 145; 9 Ex. at 341.

152. *Id.*

153. *Id.* at 151; 9 Ex. at 355–56.

154. *Id.*

spare parts. There is little or no reason to believe either that the mill owner in *Hadley v. Baxendale* failed to maintain an optimum supply of spare parts in the period before the crankshaft broke or that under a less demanding foreseeability standard individuals or firms would generally fail to optimize just because they might later enter into a contract.<sup>155</sup>

The evidence seems to favor the latter. Despite the fact that the U.C.C. and Restatement (Second) both allow for the recovery of consequential damages that were reasonably foreseeable,<sup>156</sup> disclaimers of consequential damages are ubiquitous.<sup>157</sup>

The reason is not terribly surprising. If a carrier like Baxendale were to be liable for the shipper's lost profits, and if it could neither price the risk nor disclaim the liability, then it would in effect be providing mandatory insurance to all its customers without the tools insurers customarily use (copayments, deductibles, monitoring, screening, etc.) to cope with the inevitable adverse selection and moral hazard. That insurance (and the extra costs of dealing with customers who make their inventory decisions in reliance on compensation from the carrier if things go awry) would be a cost of doing business that it would have to cover by charging higher rates to customers. If the costs to the shippers of self-insuring and self-protecting were less than the implicit insurance of the carriers, then the disclaimer would result in savings for shippers as a group.

Buyer forms often do allow for the recovery of consequential damages. In a battle of the forms, given the knockout rule adopted by most jurisdictions, consequential damages would be recoverable.<sup>158</sup> In negotiated contracts, my impression is that the disclaimers are common, consistent with the notion that the buyer is in the best position to protect its reliance. However, I want to note two situations in which the contract might provide some protection of the buyer's reliance.

In the previous section, I suggested that when the contract is defining the tradeoff between discretion and reliance, the hostility to the

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155. Melvin Aron Eisenberg, *The Principle of Hadley v. Baxendale*, 80 Calif. L. Rev. 563, 582 (1992) [hereinafter Eisenberg, *Principle of Hadley*].

156. U.C.C. § 2-715 (2012); Restatement (Second) of Contracts § 347 (1981). The U.C.C. does not use the term "reasonably foreseeable," but, as Professor Eisenberg notes, "the 'reason to know' standard of § 2-715(2) of the UCC lends itself naturally to the reasonably foreseeable interpretation." Eisenberg, *Principle of Hadley*, supra note 155, at 613 n.128; see also Farnsworth, *Contracts*, supra note 46, § 12.14 (discussing unforeseeability as limitation).

157. Scott and Schwartz found that clauses limiting damages to repair and replacement were common. Robert E. Scott & Alan Schwartz, *Market Damages, Efficient Contracting, and the Economic Waste Fallacy*, 108 Colum. L. Rev. 1610, 1630 (2008). In her study of internet contracts, Marotta-Wurgler found that almost every one disclaimed consequential damages. Florencia Marotta-Wurgler, *Some Realities of Online Contracting*, 19 Sup. Ct. Econ. Rev. 11, 15 (2011).

158. Not all courts adopting the knockout rule would allow recovery of consequential damages. E.g., *Dresser Indus., Inc. v. Gradall Co.*, 965 F.2d 1442, 1452 (7th Cir. 1992).

notion that one party to the contract has an option to perform or pay the consequences is misplaced.<sup>159</sup> However, the hostility to the option concept has more bite in cases involving claims for consequential damages. There is a difference between negligently shipping a shaft and willfully failing to do so. Although contract law is often characterized as a no-fault regime, courts have found devices for taking fault into account. As McCormick wrote over seventy years ago:

Would not our courts enhance the realism of the rules and make them easier for juries to accept if they gave formal approval to the tendency, written large upon the actual results of the cases, to discriminate between the liability for consequential damages of the wilful and deliberate contract-breaker on the one hand, and of the party who has failed to carry out his bargain through inability or mischance? Our rules should sanction, as our actual practice probably does, the award of consequential damages against one who deliberately and wantonly breaks faith, regardless of the foreseeability of the loss when the contract was made. We shall then have completed the process, begun piece-meal in *Hadley v. Baxendale*, of borrowing from the French Civil Code its theory of damages in contract.<sup>160</sup>

There is considerable dispute as to how to distinguish a willful breach from any other. Cancellation of an order is deliberate, but few would find it willful. Corbin was disparaging of the very notion of willfulness:

The word most commonly used to describe such breaches is “wilful.” It is seldom accompanied by any discussion of its meaning or classification of the cases that should fall within it. Its use indicates a childlike faith in the existence of a plain and obvious

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159. See *supra* Part I.A.

160. Charles T. McCormick, *The Contemplation Rule as a Limitation upon Damages for Breach of Contract*, 19 *Minn. L. Rev.* 497, 517–18 (1935); see also Ralph S. Bauer, *Consequential Damages in Contract*, 80 *U. Pa. L. Rev.* 687, 700 (1932) (“Aversion and disgust and hatred excited by a defendant’s wilful breach of contract, and pity aroused by the predicament in which another defendant is placed by his honest and unintentional breach of contract, have swayed judges, as well as juries, in the actual administration of the law.”). Fuller and Perdue note that fault is taken into account indirectly by manipulating the foreseeability doctrine. Fuller & Perdue, *Reliance 1*, *supra* note 1, at 85–86. For more recent arguments for recognizing fault and willfulness, see George M. Cohen, *The Fault Lines in Contract Damages*, 80 *Va. L. Rev.* 1225, 1226 (1994) (arguing for different measures of damages depending in part on fault); Melvin Aron Eisenberg, *The Role of Fault in Contract Law: Unconscionability, Unexpected Circumstances, Interpretation, Mistake, and Nonperformance*, 107 *Mich. L. Rev.* 1413, 1414 (2009) (“As a normative matter, fault *should* be a building block of contract law.”); Steve Thel & Peter Siegelman, *Willfulness Versus Expectation: A Promisor-Based Defense of Willful Breach Doctrine*, 107 *Mich. L. Rev.* 1517, 1518 (2009) (arguing willfulness identifies easily avoided breaches that courts rightly try to deter); Robert A. Hillman, *The Future of Fault in Contract Law* 2, 4 (Cornell Law Sch. Legal Studies Working Paper No. 12-34, 2012), available at [http://ssrn.com/abstract\\_id=2121374](http://ssrn.com/abstract_id=2121374) (on file with the *Columbia Law Review*) (noting “fault plays an important role in contract law today” and increase in “opportunities for advantage-taking suggest an even larger role for fault . . . in the future”).



line between the good and the bad, between unfortunate virtue and unforgivable sin.<sup>161</sup>

Contrast this with his enthusiastic approval of “good faith,” which surely suffers from the same flaw.<sup>162</sup> Notwithstanding the difficulties, courts do make that distinction and, more importantly, the parties themselves often do so in their contracts. Even if they disclaim liability for consequential damages, they can include a significant exception—the disclaimer will not apply if the breach were due to gross negligence or willful behavior.<sup>163</sup> They might not have any idea about what they mean by willful; rather than spelling it out, they are content to defer the definition to the ex post determination by courts.<sup>164</sup> The disposition of *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*,<sup>165</sup> discussed in Part I.A.4, provides one illustration. The Chancery Court distinguished *Hexion*’s “knowing and intentional breach of [a] covenant” and allowed for liability substantially greater than if the transaction had been terminated for an acceptable reason.<sup>166</sup>

In a *Hadley*-type scenario, a deliberate deviation by a carrier to pick up a more valuable shipment could result in liability for the shipper’s consequential damages. Of course, that can be contracted over—the seller could maintain the flexibility to deviate.<sup>167</sup> The shipper might be

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161. 12 Joseph M. Perillo, *Corbin on Contracts* § 62.2 (rev. ed. 2012). For a more recent and more measured, skeptical take on willfulness, see Richard Craswell, *When Is a Willful Breach “Willful”? The Link Between Definitions and Damages*, 107 *Mich. L. Rev.* 1501, 1501–05 (2009) (noting labels like “willfully” are not self-defining and arguing specific definition controls magnitude of damages).

162. 6 Peter Linzer, *Corbin on Contracts* § 26.9 (Joseph Perillo ed., rev. ed. 2010) [hereinafter Linzer, *Corbin*] (“Good faith is a vague and shifting concept, but so is justice. That a concept cannot be formalized into a tight matrix does not make it wrong. It makes it consistent with the way humans behave . . .”).

163. One of the standard forms of the Federation of Oils, Seeds and Fats Associations has an interesting variant on the effect of fault on damages: “If the arbitrators consider the circumstances of the default justify it they may, at their absolute discretion, award damages on a different quantity and/or award additional damages.” *Novasen SA v. Alimenta SA*, [2013] EWHC (Comm) 345, [3].

164. See Scott & Triantis, *Anticipating Litigation*, supra note 6, at 816 (providing powerful analysis of tradeoff between defining terms at front end and deferring definition to a third party—court or arbitrator—at back end).

165. 965 A.2d 715 (Del. Ch. 2008).

166. *Id.* at 724, 756–57.

167. Ocean World Lines’ Bill of Lading Terms & Conditions provides an illustration of that flexibility:

The Carrier does not undertake that the Goods will be transported from or loaded at the place of receiving or loading or will arrive at the place of discharge, destination or transshipment aboard any particular vessel or other conveyance or at any particular date or time or to meet any particular market or in time for any particular use. Scheduled or advertised departure and arrival times are only expected times and may be advanced or delayed if the Carrier or any Connecting Carrier shall find it necessary, prudent or convenient. In no event shall the Carrier be liable for consequential or other damages for delay in

content to give the carrier that option in exchange for a lower price. Suppliers in many contexts do offer interruptible service at a reduced price.

The willfulness exception can be rationalized in terms of the buyer's reliance. For innocent mistakes by the seller, the onus is on the buyer to protect itself. Buyers can make their decisions relying on the seller's "normal" behavior, even if that behavior results in a seller breach. Behavior by the seller that substantially increases the likelihood of failure, however, would be outside the buyer's reasonable expectations—buyers need not self-protect against that. However, recognizing a fault-based exception can expose the seller to juridical risk. Given the difficulty in defining willful behavior and the risk that a factfinder would define a garden-variety failure as willful, parties might be reluctant to include a willfulness exception.<sup>168</sup>

The second exception mirrors the second prong of the *Hadley* rule: damages "as may reasonably be supposed to have been in the contemplation of both parties, at the time when they made the contract, as the probable result of the breach."<sup>169</sup> It is not the mere contemplation that matters. The sellers have knowledge of the buyer's vulnerability, they know that the buyer is relying on their performance, and they accept the risk that their failure would result in substantial damages. Contracts between suppliers and automobile manufacturers make clear the buyer's intended use<sup>170</sup> and assess sellers for at least some of the costs if there is a

the scheduled departures or arrivals of the vessel or other conveyance transporting the Goods or for any other matter.

Bill of Lading Terms & Conditions, Ocean World Lines, <http://www.oceanworldlines.com/BL-terms-conditions.aspx> (on file with the *Columbia Law Review*) (last visited Mar. 24, 2014).

168. As an example of the juridical risk, consider this disclaimer by a grain elevator operator:

The elevator management, in its sole discretion, may alter the turn of vessels to be loaded [a] when, in its judgment, it is in the best interest of the elevator operations; [b] when there is urgent need to receive or load to a ship a particular grade and kind of grain; [c] to facilitate the berth conditions; or [d] whenever the elevator decides that there is nonavailability in the elevator of adequate grade, quantity, or quality of grain to be shipped or loaded on the vessel without delaying the vessel itself, or delay, prevent, or obstruct the normal elevator activity.

Romano Pagnan & F.LLI v. Miss. River Grain Elevator, Inc., 700 F.2d 149, 151 n.2 (5th Cir. 1983). The contract further states: "The elevator shall not be liable for demurrage, damages for delay or loss of dispatch time incurred by any vessel or charterer for any cause other than wilful or gross negligent acts of the elevator management." *Id.* at 151 n.3. A jury, and the court of appeals, found a fairly minor delay to be willful. *Id.* at 150.

169. *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Ex.) 151; 9 Ex. 341, 354.

170. See GM Standard Form, *supra* note 107 ("Seller acknowledges that Seller knows of Buyer's [intended use] and expressly warrants that all goods covered by this order which have been selected, designated, manufactured, or assembled by Seller based upon Buyer's stated use, will be fit and sufficient for the particular purposes intended by Buyer.").

breach of warranty (to the consumer) or a product recall. Ford's standard form, for example, says: "At its option, the Buyer may debit the Supplier for up to 50% of the Actual Recall Costs . . . if the Buyer has made a good faith determination that the Supplier is likely to be liable for some portion of the total costs . . . ." <sup>171</sup>

The multiyear supply contract between John Deere and Stanadyne makes liability for consequential damages contingent on both knowledge and fault. <sup>172</sup> The wording reverses the usual pattern of saying no liability unless the seller passes some culpability hurdle. Instead the seller would be liable unless it is without fault:

STANADYNE CORPORATION acknowledges that DEERE requires on-time delivery in order to operate its plants. The parties further acknowledge that the precise amount of damages which DEERE would sustain in the event STANADYNE CORPORATION were to fail to make timely or conforming deliveries of Parts would be difficult to determine. Therefore, the parties agree that STANADYNE CORPORATION shall be responsible for any and all damages resulting from STANADYNE CORPORATION's failure to make timely or conforming deliveries of Parts, including, but not limited to, mutually agreed upon costs DEERE incurs for the correction of Parts with quality problems and mutually agreed upon costs DEERE incurs in connection with DEERE's machining and/or assembly line downtime . . . . STANADYNE CORPORATION shall not be responsible for the above damages if such out-of-order (late) delivery or non-delivery results from a cause beyond STANADYNE CORPORATION's reasonable control without fault or negligence, provided that STANADYNE CORPORATION has informed DEERE as soon as practical of the problem . . . . <sup>173</sup>

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171. Ben-Shahar & White, *supra* note 108, at 959 n.24 (quoting Ford Motor Co., Production Purchasing Global Terms and Conditions § 23.06 (Jan. 2004)). The Toyota form goes further:

Upon the occurrence of a Recall or Products Liability Situation (Recall and Products Liability Situation are collectively referred to as a "Reimbursement Event"), where one of the potential causes for the Reimbursement Event is determined in Toyota Party's reasonable judgment to be attributable to Supplier, Supplier and Toyota party agree to negotiate in good faith to (i) reasonably allocate the cost of complying with or contesting any reimbursement event and (ii) determine TMMNA's remedies under this *Section 5.4* which may include actual, consequential and incidental damages (including, without limitation, attorneys' fees and administrative costs and expenses) arising out of, resulting from or related to any such Reimbursement Event.

Toyota T&C, *supra* note 108, cl. 5.4(a).

172. Long Term Agreement Between Deere & Co. and Stanadyne Corp. (Nov. 1, 2001), available at <http://www.sec.gov/Archives/edgar/containers/fix023/1053439/000119312507182449/dex1011.htm> (on file with the *Columbia Law Review*).

173. *Id.* cl. XV.A.

I must reiterate that these remain exceptions to the basic point. When parties design their contracts, rarely will they protect the promisee's reliance on the promisor's successful performance. The promisee's ability to control the adverse consequences usually would result in consequential damages being disclaimed.

### III. RELIANCE AND RESTITUTION WHEN PERFORMANCE IS EXCUSED

Performance of a contract could be excused under various doctrines—impossibility, impracticability, and frustration—or under the terms of the contract—force majeure or MAC. Prior to the occurrence of the event that excused performance, the parties might have incurred costs in reliance on the contract. A buyer who had made a partial payment may want restitution; a seller who had advertised an event or partially completed performance may want compensation for its reliance costs. The legal analysis of both sets of claims has been muddled by notions of fairness and justice (or, as the commentators prefer, avoiding injustice).<sup>174</sup> Thus, if performance is excused, the Restatement (Second) of Contracts says that “either party may have a claim for relief including restitution . . . . [I]f those rules . . . will not avoid injustice, the court may grant relief on such terms as justice requires including protection of the parties' reliance interests.”<sup>175</sup> Fuller and Perdue argue that the equitable resolution entailed recognition of the restitution and reliance interests: “[T]he most satisfactory solution of the difficulty may well be to relieve the promisor from his duty, at the price, not simply of returning benefits, but of making good the other party's losses through reliance on the contract.”<sup>176</sup>

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174. Much of the following discussion is based on Victor P. Goldberg, *After Frustration: Three Cheers for Chandler v. Webster*, 68 Wash. & Lee L. Rev. 1133 (2011) [hereinafter Goldberg, *After Frustration*].

175. Restatement (Second) of Contracts § 272 (1981). In England, the Law Reform (Frustrated Contracts) Act provides for restitution of money paid before the discharging event subject to a key proviso. The repayment could be offset, in whole or in part, if that party had incurred reliance expenditures if the court “considers [it] just, having regard to all the circumstances of the case.” Frustrated Contracts Act, *supra* note 14, § 1.

176. L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*: 2, 46 Yale L.J. 373, 380 (1937). The full context of their argument is as follows:

In such a field, where no technical rules serve to obstruct an insight into the purposes underlying contract law, it would seem inevitable that the cases would reveal a distinction between the three interests which have been described in this article. Such a distinction has definitely been taken in America (though apparently not in England) between the expectation and restitution interests. Where a contract has become impossible of performance, or its object is frustrated, it has been recognized that the most equitable adjustment of the situation may call for relieving the party from liability for future performance (expectation interest denied), and at the same time imposing on him a duty to return benefits received under the contract (restitution interest protected).

But in this field, where borderline cases are a normal phenomenon, it would seem that the reliance interest should also play an important role. Where

In the first Anglo-American case recognizing the impossibility defense, *Taylor v. Caldwell*, a venue was destroyed before the contracted-for event (a concert series) was to take place.<sup>177</sup> The promoter sued for his reliance costs (£58),<sup>178</sup> the costs incurred in preparation for the intended concert series.<sup>179</sup> The claim was denied on the grounds that there had been no breach; there was no focus on whether there could be compensation for reliance when performance had been excused, although a negative answer was implicit in the decision.<sup>180</sup> In the Coronation Cases, arising from the postponement of the coronation procession following King Edward's appendicitis attack, the House of Lords considered the question and left the losses where they fell.<sup>181</sup> The renter, under *Chandler v. Webster*, was responsible for any payments that had been made or were due before the procession was postponed.<sup>182</sup> There would be no restitution.<sup>183</sup>

This did not sit well with many. Contrasting the English rule with that of Scotland, the House of Lords noted "in high legal quarters a feeling both of uneasiness and of disrelish as to the English rule," which "works well enough among tricksters, gamblers and thieves."<sup>184</sup> After decades of critical comment, the House of Lords reversed itself in *Fibrosa Spolka Akcyjna v. Fairbairn Lawson Combe Barbour, Ltd.*<sup>185</sup> A British manufacturer agreed to manufacture a flax-hackling machine for a Polish buyer for delivery in three to four months. The buyer paid about a third of the contract price when the order was placed, and the manufacturer

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the court is in doubt whether the excuse should be permitted at all, the most satisfactory solution of the difficulty may well be to relieve the promisor from his duty, at the price, not simply of returning benefits, but of making good the other party's losses through reliance on the contract. In Germany, the Civil Code expressly recognizes the usefulness of the reliance interest as a means of accomplishing the most equitable allocation of the risks involved in impossibility.

Id. at 379–80 (footnotes omitted).

177. (1863) 122 Eng. Rep. 309 (K.B.) 312, 315; 3 B. & S. 826, 832, 840.

178. Victor P. Goldberg, Excuse Doctrine: The Eisenberg Uncertainty Principle, 2 J. Legal Analysis 359, 366 (2010) [hereinafter Goldberg, Excuse Doctrine]. Per capita annual income in England at the time was only around £40. Gregory Clark, Average Earnings and Retail Prices, UK, 1209–2010, at 2 (Oct. 30, 2011) (unpublished manuscript), available at <http://www.measuringworth.com/datasets/ukearnpci/earnstudynew.pdf> (on file with the *Columbia Law Review*).

179. *Taylor*, 122 Eng. Rep. at 310; 3 B. & S. at 827.

180. Id. at 315; 3 B. & S. at 840.

181. See R.G. McElroy & Glanville Williams, The Coronation Cases—I, 4 Mod. L. Rev. 241, 245 & nn.18–21 (1941) (citing, categorizing, and discussing cases).

182. [1904] 1 K.B. 493 (C.A.) at 497 (Eng.).

183. Id.

184. *Cantiare San Rocco v. Clyde Shipbuilding & Eng'g Co.*, [1924] A.C. 226 (H.L.) 258–59 (appeal taken from Scot.).

185. [1943] A.C. 32 (H.L.) 71–72 (appeal taken from Eng.). Scottish law had rejected *Chandler* earlier. It attempted to restore the precontract situation, requiring the refund of money prepaid and also compensating the seller for at least some of its reliance costs. *Cantiare San Rocco*, [1924] A.C. at 229.

started production.<sup>186</sup> Unfortunately, the Germans decided to invade Poland before the machine was finished.<sup>187</sup> The House of Lords ruled that the contract had been frustrated and then overruled *Chandler v. Webster*.<sup>188</sup> The seller would have to return the prepayment.<sup>189</sup> It did not, however, require any compensation to the seller for costs it might have incurred in reliance on the contract.<sup>190</sup> It might be unfortunate, said Lord Chancellor Simon, if the seller had relied, but, absent specific language, the reliance would not be protected:

While this result obviates the harshness with which the previous view in some instances treated the party who had made a prepayment, it cannot be regarded as dealing fairly between the parties in all cases, and must sometimes have the result of leaving the recipient who has to return the money at a grave disadvantage. He may have incurred expenses in connexion with the partial carrying out of the contract which are equivalent, or more than equivalent, to the money which he prudently stipulated should be prepaid, but which he now has to return for reasons which are no fault of his. He may have to repay the money, though he has executed almost the whole of the contractual work, which will be left on his hands.<sup>191</sup>

New legislation, he said, would be required. Parliament responded shortly thereafter by passing the Law Reform (Frustrated Contracts) Act,<sup>192</sup> which allowed for compensation for reasonable reliance. About the best thing that can be said about the Act is that it is virtually never used. Instead of leaving the parties where they were when the contract was excused (the *Chandler* rule), the Act would give the buyer restitution of any prepayment, and the seller, who incurred reliance costs, might be able to offset some or all of that if a court thought it would be just to do so. What does that standard look like? In one of the rare cases applying the Act, Lord Justice Lawton said that the law grants the trial court considerable discretion: "What is just is what the trial judge thinks is just. That being so, an appellate court is not entitled to interfere with his decision unless it is so plainly wrong that it cannot be just."<sup>193</sup>

As noted, the American rule is similar. In neither case is there any thought about why the contracts might have structured the performance and payment obligations as they had. The phasing of payment and performance is not merely a matter of whim; it is a decision variable of the parties. The contract could determine whether either party should be

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186. *Fibrosa Spolka Akcyjna*, [1943] A.C. at 34.

187. *Id.*

188. *Id.* at 40, 49, 53.

189. *Id.* at 49.

190. *Id.* at 58–59.

191. *Id.* at 49.

192. Frustrated Contracts Act, *supra* note 14.

193. *B.P. Exploration Co. (Libya) v. Hunt (No. 2)*, [1981] 1 W.L.R. 232 (C.A.) at 238 (Eng.).

compensated after performance was excused; or it could simply leave the parties as they were at the time the excusing event occurred. There are many reasons why a buyer might make some payments before a project is completed and why it might choose to make some or all of those payments nonrefundable. The payment might be for an option or compensation for a product's customization; alternatively, the payment may serve to provide working capital to the seller or to assure the seller that, after it had completed most of the performance, the buyer would not have the incentive to renegotiate (and, in doing so, take advantage of sunk costs).<sup>194</sup>

The Restatement (Second)'s illustration of the problem is instructive. A (a contractor) is working on an existing structure owned by B, but before completion of the job, the structure is destroyed by fire and the contractor is excused.

A contracts with B to shingle the roof of B's house for \$5,000, payable as the work progresses. After A has spent \$2,000 doing part of the work and has been paid \$1,800, much of the house including the roof is destroyed by fire without his fault, and the duties of performance of both A and B are discharged . . . . The work done before the fire increased the market price and the insurable value of the house by \$1,500. A is entitled to restitution of \$1,500 from B and B is entitled to restitution of \$1,800 from A . . . .

. . . [T]he fire also destroyed shingles that had cost A \$500 and that were piled near the house for the rest of the work. A is not entitled to restitution of this loss from B. The court may, however, take this loss into consideration in deciding whether to allow A restitution of \$1,500 or \$2,000.<sup>195</sup>

No reasons are given for the numbers. Why has B paid more than the benefit it had thus far "received" and less than A's costs? Why treat the shingles piled near the house differently? If one cares about reliance, then there is no reason to single these out. Why care at all about the benefit B received since after the fire there were no benefits? Why go through the effort of ascertaining the value added pre-fire and the contractor's costs (most of which would likely be labor costs)? Accidents during construction projects are hardly unexpected. One would expect parties to anticipate these problems in their contract design. And, in fact, they do. What they do is ignore both reliance and restitution.<sup>196</sup> The contract is terminated, and neither party has to compensate the other. The close link between progress payments and performance will mean that

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194. See generally Goldberg, *After Frustration*, supra note 174, at 1146 (listing reasons why buyer might prepay some, or all, of purchase price).

195. Restatement (Second) of Contracts § 377 illus. 4-5 (1981).

196. See Goldberg, *After Frustration*, supra note 174, at 1165-67 (giving real-world examples of parties contracting around Restatement (Second) rule, often through insurance requirements).

leaving the losses where they fall will generally work well. The best thing that can be said for the doctrinal solution is that it is irrelevant.<sup>197</sup>

I do not mean to suggest that, in all instances in which performance would be excused, parties would never deviate from the “leave the losses where they fall” resolution. But they would deviate as a matter of planning, not as a matter of justice.

While the language of excuse cases (and the scholarly literature) often suggests that the parties did not, or could not, have planned for the specific event, it misses the point. The King’s appendicitis (the Coronation Cases) might have been beyond their contemplation, but the possibility that the procession might have been postponed for any reason was not. In fact, there was a very active insurance market, and a number of contracts did explicitly recognize the possibility of postponement.<sup>198</sup> More generally, as Triantis has argued, specific risks can be allocated as part of a more broadly defined risk.<sup>199</sup> Planners could, if they so desired, differentiate between categories of risk when determining whether there should be some compensation for restitution or reliance. So, for example, a Rod Stewart contract distinguished between two categories of excuse.<sup>200</sup> If the performance could not be rendered because of the usual acts of God (floods, fires, riots, strikes, etc.), the performance would be rescheduled; if he were ill or incapacitated, the show would be cancelled and he would have to refund any prepayments.<sup>201</sup>

#### IV. RELIANCE AND REVOCATION

The interplay of reliance and injustice shows up in other sections of the Restatement (Second), notably in section 90(1) (making a promise absent consideration enforceable)<sup>202</sup> and section 87(2) (making an offer irrevocable).<sup>203</sup> Grant Gilmore’s prediction that promissory estoppel

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197. Because the contracts typically resolve the problem, most of the case law providing the basis for the Restatement (Second) dates back to the First World War. See *id.* at 1162–65 (discussing early-twentieth-century American case law dealing with frustration doctrine).

198. See Goldberg, *Excuse Doctrine*, *supra* note 178, at 362–66 (discussing insurance market for contract postponement in Coronation Cases).

199. George G. Triantis, *Contractual Allocations of Unknown Risks: A Critique of the Doctrine of Commercial Impracticability*, 42 *U. Toronto L.J.* 450, 464–68 (1992).

200. See Goldberg, *Excuse Doctrine*, *supra* note 178, at 368–69 (discussing force majeure clause in Rod Stewart’s contract).

201. *Id.* at 10.

202. Restatement (Second) of Contracts § 90(1) (1981) (“A promise which the promisor should reasonably expect to induce action or forbearance . . . and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.”).

203. *Id.* § 87(2) (“An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before



would swallow up the consideration doctrine has not come to pass—quite the opposite.<sup>204</sup> It remains a bit player in determining the enforceability of promises. Justice Roger Traynor's innovation—the irrevocable offer—has fared even worse. Aside from the context of subcontractor bids in public construction projects, it has had virtually no impact. My concern here is not with the impact of the decision. I have considered that elsewhere.<sup>205</sup> Rather, I want to focus on the cases within the *Drennan* ambit to illustrate how slippery the reliance concept is when courts try to implement it.

Reliance can mean different things to different people (and courts); in practice it means so many different things that it is not clear that it means anything at all.<sup>206</sup> In classic contract law, an offeror is free to revoke an offer before acceptance and a counteroffer is a rejection of an offer. Traynor's innovation was to use reliance to make the offer irrevocable. In *Drennan*, after the general contractor (GC) had been named the successful low bidder, the subcontractor ("sub") informed him that it had erred in preparing its bid (an offer), and it was therefore withdrawing it.<sup>207</sup> The GC completed the project with a new sub at a higher price and then sued the original sub for the difference.<sup>208</sup> "[T]he question," wrote Traynor, "is squarely presented: Did plaintiff's reliance make defendant's offer irrevocable?"<sup>209</sup> "Given . . . [that the GC] is bound by his own bid," Traynor stated, "it is only fair that [the GC] should have at least an opportunity to accept [the sub's] bid after the general contract has been awarded to him."<sup>210</sup> However, he added a qualification: "It bears noting that a general contractor is not free to delay acceptance after he has been awarded the general contract in the hope of getting a better price. Nor can he reopen bargaining with the subcontractor and at the same time claim a continuing right to accept the original offer."<sup>211</sup> Doing so, he suggested, would destroy reliance.<sup>212</sup>

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acceptance and which does induce such action or forbearance is binding as an option contract to the extent necessary to avoid injustice.").

204. See Grant Gilmore, *The Death of Contract* 68 (Ronald K.L. Collins ed., 1995) ("The one thing that is clear is that these two contradictory propositions cannot live comfortably together: in the end one must swallow the other up.").

205. See Victor P. Goldberg, Traynor (*Drennan*) Versus Hand (*Baird*): Much Ado About (Almost) Nothing, 3 *J. Legal Analysis* 539, 578–85 (2011) [hereinafter Goldberg, *Drennan*] (discussing limited impact of "irrevocable offer" outside public construction context).

206. Of course, in another context Justice Traynor celebrated the indeterminacy of language. *Pac. Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 643–46 (Cal. 1968).

207. *Drennan v. Star Paving Co.*, 333 P.2d 757, 758–59 (Cal. 1958) (en banc).

208. *Id.* at 759.

209. *Id.*

210. *Id.* at 760.

211. *Id.*

212. *Id.*

The GC's reliance, therefore, is a question of fact. How could the court ascertain whether the GC had in fact relied upon the sub's bid? Traynor's opinion set out the criteria. The GC could not be found to have reasonably relied if: (1) the GC should have known the bid was in error; (2) the GC proposed new terms (the counteroffer); or (3) GCs in general, or this specific GC, were known to shop the bid, and/or the GC shopped the bid in this instance.<sup>213</sup> Any of these might be enough to defeat reliance, but implementation, especially of the last two, left much to be desired.

Consider first the counteroffer. Subs usually submit their bid to a number of general contractors. In most jurisdictions, the GC must include the name of the sub it used in preparing its proposal.<sup>214</sup> After being named the winning bidder, the GC would send a written contract to that sub. If the terms of that contract were deemed a material alteration of the sub's offer, then it could be treated as a counteroffer. Since in most instances the sub's offer consisted of a single number (with no stated terms), it should not be surprising that the terms of the GC's form contract would differ. If the court found the GC's form terms materially different, it would have to conclude that the GC would no longer be relying upon the sub's offer, so the sub would be free to reject the counteroffer. That is, the offer would be revocable.

In some instances subs raised this argument in defense, and on occasion they succeeded.<sup>215</sup> The courts listed the nonconforming clauses and labeled them as either material or nonmaterial, although in most instances it is hard to tell how the court came to the conclusion that it did. For example, in one of the cases holding for the sub, the court recognized two clauses (among the seven) that made the GC's written contract a counteroffer: "[T]he sub-contract prohibited the sub-contractor from continuing to employ any person deemed by the owner, architect or contractor to be a nuisance or a detriment to the job . . . [and] the subcontract authorized the architect to discharge any workman committing a nuisance upon certain parts of the premises."<sup>216</sup> It is hard to imagine that these would be dealbreakers. Of course, the materiality of the contested terms in the cases raising the defense had nothing to do with the sub's rejection—it was simply a device for getting out of a bad deal. Nonetheless, the argument succeeded in negating reliance in almost half the cases in which the courts considered it.<sup>217</sup>

Traynor's position on the role of bid shopping in negating reliance seems clear: A GC could not "reopen bargaining with the subcontractor

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213. *Id.* at 760–61.

214. Most states require the listing of a sub if its bid exceeds a threshold. See Goldberg, *Drennan*, *supra* note 205, at 570–75 (discussing state listing statutes).

215. See *id.* at 577–80 (discussing cases where subs have succeeded).

216. *Hedden v. Lupinsky*, 176 A.2d 406, 407 (Pa. 1962).

217. Goldberg, *Drennan*, *supra* note 205, at 559.

and at the same time claim a continuing right to accept the original offer.”<sup>218</sup> If bid shopping were common in this particular market, could a GC rely on a sub’s offer? In a Minnesota case, the court noted that the sub contended “‘bid shopping’ and ‘bid chopping’ are so common to the Twin Cities area construction industry that [contractors] do not expect to be bound by prices submitted by the subcontractors . . . and that defendant was therefore not bound on its bid . . . because further and final negotiations would take place at a later time.”<sup>219</sup> However, since there was no evidence that the GC had shopped this particular bid, the court found for the GC, holding that its reliance was reasonable.<sup>220</sup> This is a really peculiar argument. In effect the court is saying that no one in this market relies on the prices quoted by subs, but that in this one case the GC did and the reliance was reasonable.

Another case added an odd twist to the reliance argument. In *Saliba-Kringlen Corp. v. Allen Engineering Co.*, the GC, claimed the court, did not rely on the offered price per se; rather, it relied on the sub’s offer setting a ceiling that would allow it to freely bargain for a better price from this sub or its competitors without having the offer lapse.<sup>221</sup> That is, the GC could shop the bid at will, so long as it ended up with a price at or below the sub’s bid. If it failed to do better, it could still hold the sub to its bid. This is hardly what Traynor had in mind. This case is an outlier, although one economic analysis of *Drennan* does treat the sub’s irrevocable offer as a cap.<sup>222</sup> The decision does, however, indicate the broad discretion that courts have in applying the ill-defined reliance standard to the question.

If the sub’s bid was treated as an irrevocable offer, the GC would have a valuable option. The value increases with the length of time and the variance of the sub’s costs (in particular, its opportunity costs). If the expected value of the option to the GC was greater than the expected cost to the sub of providing it, the parties would have an incentive to agree to make the option irrevocable for some period of time. This does not mean that the GC would have to negotiate the revocability issue with each potential sub; all that would be necessary is that the GC set out the criteria for revoking a bid in the bidding documents (and a presumption that courts would enforce the terms of the bidding documents).<sup>223</sup> The

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218. *Drennan*, 333 P.2d at 760.

219. *Constructors Supply Co. v. Bostrom Sheet Metal Works, Inc.*, 190 N.W.2d 71, 76 (Minn. 1971).

220. *Id.* at 77.

221. 92 Cal. Rptr. 799, 802–09 (Ct. App. 1971).

222. See Ofer Grosskopf & Barak Medina, *Rationalizing Drennan: On Irrevocable Offers, Bid Shopping and Binding Range*, 3 *Rev. L. & Econ.* 231, 238 (2007) (assuming GCs are free to request additional bids after winning general contract).

223. For an example of a court ignoring the GC’s requirement that bids be held open for a period, see *Fletcher-Harlee Corp. v. Pote Concrete Contractors, Inc.*, 482 F.3d 247, 249–52 (3d Cir. 2007).

*Drennan* rule really gets it backwards.<sup>224</sup> Instead of having reliance determine the level of irrevocability, the law should allow the GC to determine the level of irrevocability it needs to protect its reliance.

The reliance, according to Justice Traynor, was not symmetrical.<sup>225</sup> Subs could not claim that they relied on the GC.<sup>226</sup> Why? Because the sub typically submits a bid to a number of GCs, it therefore relies on none of them. Subs have invariably lost, although one court used the asymmetry to deny the GC's reliance claim and stated:

Allowing a cause of action based on promissory estoppel in construction bidding also creates the potential for injustice. It forces the subcontractor to be bound if the general contractor uses his bid, even though the general contractor is not obligated to award the job to that subcontractor. The general contractor is still free to shop around between the time he receives the subcontractor's bid and the time he needs the goods or services, to see if he can obtain them at a lower price.<sup>227</sup>

When preparing its bid, whether the sub relied on this GC or on all the GCs to whom it submitted its bid is really beside the point. The GC's commitment to the sub named in its bid could be spelled out in the bidding documents. Apparently GCs are reluctant to make such a commitment. As a rule, the sub does not get that protection by contract. Indeed, subs have attempted to overcome the asymmetry by group action, either through legislation or through private organizations like bid depositories.<sup>228</sup> Their efforts have only had limited success.<sup>229</sup> The relevant point is that whether or not a sub relied upon a GC says nothing about the extent to which a GC should be bound to use a sub.

#### V. RELIANCE AND INFORMATION

In complex contracts, like a corporate-acquisition contract, the parties face two significant problems. First, there is the adverse-selection problem; the buyer needs information regarding the quality of what it is buying. (If the deal were being financed in part by stock, the seller would need information regarding the quality of the buyer as well.) Second, there can be a temporal gap between execution of the contract and the closing, and a lot can happen in that period that would affect the value

224. See *supra* notes 207–218 and accompanying text (discussing *Drennan* decision).

225. *S. Cal. Acoustics Co. v. C.V. Holder, Inc.*, 456 P.2d 975, 979 (Cal. 1969) (en banc).

226. *Id.*

227. *Home Elec. Co. of Lenoir, Inc. v. Hall & Underdown Heating & Air Conditioning Co.*, 358 S.E.2d 539, 542 (N.C. Ct. App. 1987), *aff'd*, 366 S.E.2d 441 (N.C. 1988).

228. See Goldberg, *Drennan*, *supra* note 205, at 570–76 (discussing two potential remedies for disadvantaged subcontractors).

229. *Id.* at 576 (“Indeed, even with many of those restrictions in place, postbid negotiation appears to be common.”).

of the seller. Reliance is implicated in both problems. Information is costly to produce, and in many instances, the seller will be the best source of information regarding its quality. With little information, the buyer fears that it is buying a lemon and would offer a price that reflected that fear.<sup>230</sup> The seller has an incentive to provide information that would reassure the buyer; it would provide a package of representations and warranties that would fill in the details. The contract would have to specify on which of the seller's statements the buyer would rely and how that reliance would be protected.<sup>231</sup>

The acquisition document will delineate the information on which the buyer should and should not rely. Integration clauses and the parol evidence rule restrict, to some extent, the ability of courts to look outside the written agreement. While there is much hostility to the parol evidence rule amongst the professoriate, my understanding is that, especially for sophisticated parties, the courts in most jurisdictions generally respect these clauses. Professor Peter Linzer, one of the scholars hostile to the rule, reluctantly concludes in his update of *Corbin on Contracts* that courts generally respect the parol evidence rule.<sup>232</sup> Professors Schwartz and Scott, decidedly less hostile, likewise found that the rule was alive and well.<sup>233</sup> I do not want to be drawn into that debate. My concern here is with two subtopics: no-reliance clauses and remedies for breach of a warranty. A central concern in both is recognizing that litigation is expensive and imperfect. The leading New York case, *Danann Realty Corp. v. Harris*,<sup>234</sup> does not quite fit the bill. It involves a contract for purchase of a lease of a building—a simpler transaction in which it is at least plausible that the buyer was not aware of the no-reliance language.<sup>235</sup> Nonetheless, it is instructive.

The buyer in *Danann* contended that it was induced to enter into the sale by false oral representations about operating expenses and profits that it would derive from the investment.<sup>236</sup> The contract included in the merger clause a disclaimer of any representations regarding a litany of items including the operating expenses and profits, “except as herein specifically set forth [in the agreement].”<sup>237</sup> The majority held that if this

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230. George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. of Econ. 488, 488–500 (1970).

231. The discussion will be confined to the acquisition of a private company or the division of a public company to avoid the additional complication of the fiduciary duties of the seller's board.

232. 6 Linzer, *Corbin*, supra note 162, § 25.1–.4.

233. Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 Yale L.J. 926, 958–61 (2010).

234. 157 N.E.2d 597 (N.Y. 1959).

235. *Id.* at 598.

236. *Id.*

237. *Id.*

were a general and vague merger clause, it would be “ineffective to exclude parol evidence to show fraud in inducing the contract.”<sup>238</sup> But:

Here . . . plaintiff has in the plainest language announced and stipulated that it is not relying on any representations as to the very matter as to which it now claims it was defrauded. Such a specific disclaimer destroys the allegations in plaintiff’s complaint that the agreement was executed in reliance upon these contrary oral representations.<sup>239</sup>

Since the buyer should have read and understood the contract, the court continues, it “would be unrealistic to ascribe to plaintiff’s officers such incompetence that they did not understand what they read and signed.”<sup>240</sup> Implicit in this argument is the notion that the clause was tailored to this particular transaction. The dissent denies this, noting that the clause was boilerplate.<sup>241</sup> If a generic merger clause was problematic, then why should a boilerplate clause do any better? The dissent’s primary argument does not rely on the fact that the clause was a standard clause. Even if the clause had been bargained over, the buyer was entitled to its day in court because “fraud vitiates every contract and every clause in it.”<sup>242</sup>

The case is complicated a bit by the fact that the disputed clause was not bargained over. The buyer should have had legal advice, and the advisor should have had knowledge of the language. But one could at least argue that the majority’s distinction between this clause and a generic merger clause failed. The duty to read should apply equally to both or to neither. The more significant issue concerns no-reliance clauses that are specifically negotiated. The *Danann* rule has been applied to the more complex transactions in the two primary commercial jurisdictions, New York and Delaware.<sup>243</sup>

In a decision in which he recognized a no-reliance clause, Judge Posner distinguished contracts between sophisticated parties:

In the trade, no-reliance clauses are called “big boy” clauses (as in “we’re big boys and can look after ourselves”). But

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238. *Id.*

239. *Id.* at 599.

240. *Id.*

241. *Id.* at 602 (Fuld, J., dissenting).

242. *Id.* at 603.

243. For application of the rule in New York, see *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 735 (2d Cir. 1984). For its application in Delaware, see *Abry Partners V, L.P. v. F & W Acquisition, L.L.C.*, 891 A.2d 1032, 1058 & n.57 (Del. Ch. 2006). But in other jurisdictions, the *Danaan* rule has not been applied in similar contexts. See Allen Blair, *A Matter of Trust: Should No-Reliance Clauses Bar Claims for Fraudulent Inducement of Contract?*, 92 Marq. L. Rev. 423, 445–50 (2009) (explaining theoretical objections to *Danaan* rule); Kevin Davis, *Licensing Lies: Merger Clauses, the Parol Evidence Rule and Pre-Contractual Misrepresentations*, 33 Val. U. L. Rev. 485, 513–14 (1999) (discussing limited instances of enforcement of nonreliance clauses under *Danaan* rule).

if someone who is *not* a big boy—indeed is not even represented by counsel—signs a big-boy clause, there can be a problem, and this has led some courts to require, before such a clause can be enforced, an inquiry into the circumstances of its negotiation, to make sure that the signatory knew what he was doing.<sup>244</sup>

The no-reliance clause complements the parol evidence rule by defining which documents and alleged statements should not be considered by the court if a dispute were to arise. The process of negotiating the clause itself could convey valuable information, since the argument that the counterparty should not rely on *X* could immediately raise a red flag. The no-reliance clause can reduce juridical risk. If allowing certain evidence in would substantially increase litigation costs without increasing the accuracy of the verdict, enforcement of the clause would benefit both parties, *ex ante*. No-reliance clauses, if enforceable, can play a meaningful role in controlling the costs of litigation. As then-Judge Alito noted, if no-reliance clauses are not enforced,

[t]he danger is that a contracting party may accept additional compensation for a risk that it has no intention of actually bearing. This prevarication may amount to a fraud all its own . . . [T]he safer route is to leave parties that can protect themselves to their own devices, enforcing the agreement they actually fashion.<sup>245</sup>

*Abry Partners* provides an example of a contract that attempted to control litigation costs with a no-reliance clause.<sup>246</sup> It involved the \$500 million sale of a portfolio company by one private equity firm to another.<sup>247</sup> The deal—heavily negotiated by sophisticated parties—included a number of representations and warranties as well as an indemnification clause and escrow account, which limited aggregate liability for all misrepresentations or breaches to \$20 million, as the buyer's sole and exclusive remedy.<sup>248</sup> In exchange for the indemnification clause,

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244. *Extra Equipamentos E Exportação Ltda. v. Case Corp.*, 541 F.3d 719, 724 (7th Cir. 2008). The relevant clause reads:

Both parties represent and warrant that in making this Release they are relying on their own judgment, belief and knowledge and the counsel of their attorneys of choice. The parties are not relying on representations or statements made by the other party or any person representing them except for the representations and warranties expressed in this Release.

*Id.* at 730.

245. *MBIA Ins. Corp. v. Royal Indem. Co.*, 426 F.3d 204, 218 (3d Cir. 2005).

246. 891 A.2d 1032.

247. *Id.* at 1035.

248. The indemnity for misrepresentation clause read as follows:

[T]he Selling Stockholder agrees that, after the Closing Date, the Acquiror and the Company . . . shall be indemnified and held harmless by the Selling Stockholder from and against, any and all claims, demands, suits, actions, causes of actions, losses, costs, damages, liabilities and out-of-pocket expenses incurred or paid, including reasonable attorneys' fees, costs of investigation or settlement, other professionals' and experts' fees, and court or arbitration costs but

the seller gave up all the materiality qualifiers of the representations and warranties.<sup>249</sup> The contract stated: “[T]he provisions of [the indemnification clause] were specifically bargained for and reflected in the amounts payable to the Selling Stockholder . . . .”<sup>250</sup> The buyer sued and asked for rescission; it claimed that some representations were inaccurate and, had it known the truth, it would not have closed the deal.<sup>251</sup> The Delaware Chancery Court denied the seller’s motion to dismiss.<sup>252</sup> I do not want to get involved with the merits of that decision. I simply want to underscore the notion that sophisticated parties can price the buyer’s reliance on the accuracy of representations, *ex ante*.

In the absence of an indemnification clause, the buyer’s reliance on the accuracy of the representations and warranties is protected in two ways. The accuracy at the time made and at closing is usually a condition of closing. That is, if the representations were inaccurate, the buyer would have an option to abandon.

The second form of protection is a money-damage remedy for breach. The representations and warranties can survive closing for a contractually defined period of time. If after closing the buyer learned that a warranty was inaccurate, it could sue for damages. The buyer’s reliance on the accuracy is protected, in part, by monetary damages. That is simple enough. The more interesting question arises if the buyer learned before closing, but still went through with the deal. Could it close the deal and then sue for the breach? The answer in the key American jurisdictions (New York and Delaware) is yes.<sup>253</sup> Parties are, however, free to contract over it. The practice has a name—sandbagging—and it is embodied in the ABA Model Stock Purchase Agreement:

The right to indemnification [or] reimbursement, or other remedy based upon any such representation [or] warranty . . . will not be affected by . . . any Knowledge acquired at any time, whether before or after the execution and delivery of this

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specifically excluding consequential damages, lost profits, indirect damages, punitive damages and exemplary damages . . . to the extent such Damages . . . have arisen out of or . . . have resulted from, in connection with, or by virtue of the facts or circumstances (i) which constitute an *inaccuracy, misrepresentation, breach of, default in, or failure to perform any of the representations, warranties or covenants* given or made by the *Company* or the *Selling Stockholder* in this Agreement.

Id. at 1044 (emphases added in *Abry Partners*).

249. Id.

250. Id.

251. Id. at 1065.

252. Id.

253. Charles Whitehead provides evidence on the use of sandbagging clauses broken down by jurisdictions in which the default rule favors or opposes sandbagging. Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 Del. J. Corp. L. 1081 (2011). The two most prominent commercial jurisdictions—New York and Delaware—are pro-sandbagging. Id. at 1087.



Agreement or the Closing Date, with respect to the accuracy or inaccuracy of . . . such representation [or] warranty . . .<sup>254</sup>

In the absence of such a clause, some courts have held that the buyer would have to prove reliance on the misrepresentation and, if the buyer knew the truth before closing, it could not have relied. The alternative formulation notes that the buyer relied when it set the initial price; if it had known that the representation was false, the contract price would have been less. Both sides can plausibly invoke reliance in their favor. The weight of authority, and practice, is with the pro-sandbagging side.<sup>255</sup>

If the value of the target had increased prior to closing, the buyer might want to complete the deal even knowing that the representation was false. If it could not pursue its claim, it would end up with less of a bargain than if the representation were accurate or if the contract price had reflected the actual state of affairs. Two other factors argue in favor of sandbagging. First, there is a moral-hazard problem. If the value of the target has gone up, the seller could recapture some of the increased value by breaching a representation. Absent sandbagging, the buyer would have to weigh the gains from closing against the alternative of not closing and suing for the breach. Second, there is a costly litigation problem; if a buyer were to sue for breach of warranty in an anti-sandbagging jurisdiction, the seller could allege that someone at the buyer's firm had been made aware of the misrepresentation before closing, and the truth of that statement would be a fact question that likely would be enough to survive summary judgment.

### CONCLUSION

Reliance, I am sure, shows up in many other nooks and crannies of contract law. My purpose here has been twofold. First, I want to illustrate the wide range of contract questions impacted by reliance. But second, I want to emphasize that the importance of the reliance concept does not translate directly into contract doctrine. That one party relies on the continued performance of the counterparty does not suggest how, if at

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254. Mergers & Acquisitions Comm., Am. Bar Ass'n, Model Stock Purchase Agreement with Commentary 299 (2d ed. 2010). Some agreements have anti-sandbagging clauses. For example:

Buyer has no knowledge of any facts or circumstances that would serve as the basis for a claim by Buyer against Sellers based upon a breach of any of the representations and warranties of Sellers contained in this Agreement [or breach of any of Sellers' covenants or agreements to be performed by any of them at or prior to Closing]. Buyer shall be deemed to have waived in full any breach of any Sellers' representations and warranties [and any such covenants and agreements] of which Buyer has knowledge at the Closing.

Id. at 301.

255. Id. at 55–56. Whitehead looked at all corporate acquisitions in a five-year period in which the representations and warranties survived and found that very few had anti-sandbagging clauses. Whitehead, *supra* note 253, at 1092–93.

all, that reliance should be protected. Doctrine in many areas does not serve to facilitate contracting; rather it can be an obstacle that transactional lawyers must overcome. To the extent that the default rules are couched in moralistic terms (good faith, preventing injustice, etc.), the transactional lawyer's task is made more difficult.

In their Introduction, Fuller and Perdue emphasize the importance of recognizing purpose:

We are still all too willing to embrace the conceit that it is possible to manipulate legal concepts without the orientation which comes from the simple inquiry: toward what end is this activity directed? Nietzsche's observation, that the most common stupidity consists in forgetting what one is trying to do, retains a discomfoting relevance to legal science.<sup>256</sup>

They were not concerned with the purpose of the parties themselves; their focus was on damage rules that could be imposed on parties. Here, the end to which the activity is directed is the end of the *parties* (sophisticated parties, to be sure), not the doctrinalists. The parties' "end" is to balance the reliance against other factors—adaptation to change, juridical risk, allocating responsibility for controlling costs, and so forth. How, if at all, they would protect their reliance is a matter of contract design. The insights from considering the design problem should, in turn, influence the development of doctrine.

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256. Fuller & Perdue, *Reliance 1*, supra note 1, at 52.

