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THE NEGLIGENCE-OPPORTUNISM TRADEOFF IN CONTRACT LAW

*George M. Cohen**

In this Article, Professor Cohen discusses the relationship between two traditions of contract analysis developed in the Law and Economics literature: one which focuses on assigning the "sunk" costs of contract breach to the "least cost avoider," and one which would assign these costs to whichever of the contracting parties most likely acted opportunistically. The Article begins with a thorough description of these two analytical strands, and uses them to critique the classic "efficient breach" scenario.

Professor Cohen posits a fault-based economic theory of contract analysis that combines the "least cost avoider" and "opportunism" analytical strands. He focuses his discussion on scenarios where these two analytical strands suggest differing outcomes to the question of which party to a contract ought to absorb the "sunk" costs associated with its breach. He argues that these scenarios present a tradeoff between deterring negligent and opportunistic behavior in the marketplace: The Negligence-Opportunism Tradeoff. This tradeoff is analogous to the classic tension between individual freedom and society's interest in market regulation. Professor Cohen resolves this tension by arguing that the law should place a presumptive priority on curbing potentially opportunistic behavior, at the expense of permitting—or at least not preventing—potentially negligent behavior. He argues that to give priority to deterring negligence over deterring opportunism—which many Law and Economics scholars implicitly advocate—perversely rewards deceitful

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behavior while punishing often unobservant action, and cracks the foundation of trust necessary for efficient contracting to occur.

INTRODUCTION

Over the past two decades, Law and Economics scholars have developed two different analytical approaches to contract law without examining the relationship between them: The first approach, based on the idea of the "least-cost-avoider" developed in tort law, aims to deter "negligent" contracting behavior by punishing a contracting party who fails to take cost-justified precautions. The second approach aims to deter "opportunistic" contracting behavior by punishing a contracting party who affirmatively acts contrary to some contractual expectation or social norm.¹ Typically, scholars focus on one approach or the other in their work. Rarely do scholars combine the

1. Professors Goetz and Scott first recognized a version of this dichotomy in 1983 when they wrote that Law and Economics scholarship in the contracts area "has developed from two distinct and largely unrelated analytic traditions." Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 968 n.5 (1983) [hereinafter *Mitigation Principle*]. They identified these traditions as the "bargain model" and the "transaction cost" approaches. Bargain model theorists "have constructed models of contracting behavior under conditions of low transaction costs to examine the influence of different legal rules in environments where parties are able to allocate all relevant risks at the time of contracting." *Id.* In contrast, transaction cost theorists "have focused on methods of reducing transaction costs in complex contractual relationships. They assume that uncertainty and complexity often prevent parties from accurately allocating all relevant risks at the time of contracting. This scholarship thus examines the strategies parties devise to encourage subsequent cooperation in such relational contracts." *Id.* Other scholars have recognized the dichotomy identified by Goetz and Scott. See Jay M. Feinman, *Contract After the Fall*, 39 STAN. L. REV. 1537, 1539 n.11 (1987) (reviewing HUGH COLLINS, *THE LAW OF CONTRACT* (1986)); Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661, 670 n.35 (1989); Ian R. Macneil, *Relational Contract: What We Do and Do Not Know*, 1985 WIS. L. REV. 483, 495-96; see also Jason S. Johnston, *Law, Economics, and Post-Realist Explanation*, 24 LAW & SOC'Y REV. 1217 (1990) (distinguishing the "model of precautions" from "transaction cost economics").

If by "distinct and largely unrelated," Goetz and Scott meant that these traditions must necessarily be so, this conclusion seems highly questionable. The distinctions between the traditions that they identify are based on different assumptions about transaction costs and court competence in the two approaches and different objects of study. The bargain model assumes low transaction costs and focuses on court rules. The transaction costs model assumes high transaction costs and focuses on private contracting devices. But there is no necessary connection between the assumptions in these models. In particular, models of the influence of different legal rules under conditions of high transaction costs would seem to be crucial to an economic analysis of contract law. In distinguishing between the two traditions, I find more significant the type of behavior which the law seeks to deter or encourage, not assumptions about transaction costs and relative institutional competence.

two approaches.² Never have scholars combined them in any systematic way.

This paper will develop a general fault-based economic theory of contract law that combines the least-cost-avoider and opportunism approaches. In many cases, these approaches point toward the same outcome, but often they conflict and present what I call the negligence-opportunism tradeoff: the legal rule must favor the deterrence of one type of behavior over the other. The negligence-opportunism tradeoff captures to a large degree the fundamental tension in contract law largely ignored by economists but traditionally recognized by lawyers: the tension between individual freedom of contract and social regulation of the marketplace.³ In resolving this tradeoff, I argue on efficiency grounds that the law should place a presumptive priority on deterring potentially opportunistic behavior over deterring potentially negligent behavior. To give priority to deterring negligence over deterring opportunism—which many economists often implicitly advocate—perversely rewards deceitful sleaziness while often punishing hapless incompetence, and cracks the foundation of trust necessary for

2. Goetz and Scott, as well as other scholars, have started to link the two traditions. See VICTOR P. GOLDBERG, *READINGS IN THE ECONOMICS OF CONTRACT LAW* (1989); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (4th ed. 1992); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87 (1989); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 *CAL. L. REV.* 261 (1985) [hereinafter *Limits of Expanded Choice*]; *Mitigation Principle*, *supra* note 1; cf. Robert Coote, *The Cost of Coase*, 11 *J. LEGAL STUD.* 1 (1982) [hereinafter *Cost of Coase*] (contrasting the “Coase Theorem” with the “Hobbes Theorem”). Professor Goldberg’s book in particular has greatly influenced my thinking about the problems discussed in this paper.

3. See, e.g., Robert Braucher, *Freedom of Contract and the Second Restatement*, 78 *YALE L.J.* 598, 599 (1969) (arguing that the Second Restatement “makes clearer the tension that exists between the doctrines of freedom of contract and elemental fairness of the transaction”); Harry W. Jones, *The Jurisprudence of Contracts*, 44 *U. CIN. L. REV.* 43, 54 (1975) (“conflicts . . . arise often and inevitably between freedom of contract as a political value and social interest and, on the other side, the public interest in commercial fairness and socially advantageous economic arrangements”); Friedrich Kessler, *Contract as a Principle of Order*, in *CONTRACTS* 1-17 (Friedrich Kessler et al. eds., 3d ed. 1986); Roscoe Pound, *Liberty of Contract*, 18 *YALE L.J.* 454, 482 (1909) (arguing that constitutional decisions striking down social legislation as violative of freedom of contract are wrong because they ignore the fact that “there never has been at common law any such freedom of contract as they postulate. From the time that promises not under seal have been enforced at all, equity has interfered with contracts in the interests of weak, necessitous, or unfortunate promisors”). For more recent revisions of the tension, see Melvin A. Eisenberg, *The Responsive Model of Contract Law*, 36 *STAN. L. REV.* 1107 (1984) (identifying the “objective-subjective spectrum” and the “standardized-individualized spectrum”) and Joel Levin & Banks McDowell, *The Balance Theory of Contracts: Seeking Justice in Voluntary Obligations*, 29 *MCGILL L.J.* 24 (1983) (developing a model that balances “voluntariness” and “fairness”).

efficient contracting behavior to occur.

My broader thesis is that focusing on this tradeoff leads to a revision of traditional thinking about contract law. Traditional contract law is organized from a litigator's perspective: Was a valid contract formed?; Was it breached?; Is there any excuse?; What remedies are available? Doctrines have been carved out based on this schema: offer and acceptance, consideration, conditions, mistake, impossibility, and damages. But the traditional approach often blinds us to the underlying economic relationships and doctrinal similarities. An economic approach to contract can illuminate these relationships and similarities. Courts and scholars should shift attention away from their obsession with what kinds of promises the law should enforce. Instead, the economic approach I advocate suggests that what matters more are the parties' reasons for making and breaking their contracts. Formulating contract doctrine along these lines will lead us to create and enforce contract law that is more efficient—and more just.⁴

I. THE TWO TRADITIONS OF ECONOMIC ANALYSIS OF CONTRACT LAW

A. *The Least-Cost-Avoider Tradition*

One approach Law and Economics scholars have used to analyze contract law focuses on deterring negligent contracting behavior by advocating legal rules that encourage cost-effective precautions.⁵ This approach is largely a transplant from the economic analysis of accident law,⁶ one of the common law areas first subjected to scrutiny

4. I do not intend to take a position here on the debate about whether justice and efficiency are equivalent. See, e.g., POSNER, *supra* note 2, at 27. To a large extent, the debate may be a semantic one. My point here is that increasing emphasis on deterring opportunism is consistent with both efficiency as traditionally defined by Law and Economics scholars and justice as understood by more traditional scholars. That is, in this instance at least the two goals need not conflict. See F.H. Buckley, *Three Theories of Substantive Fairness*, 19 HOFSTRA L. REV. 33, 65-66 (1990) (noting that promoting fairness is often efficient and that in such cases "greater fairness may be accompanied by greater wealth").

5. The best statement of this approach is Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985) [hereinafter *Model of Precaution*]. Cooter defines a "precaution" broadly as "any action that reduces harm." *Id.* at 3. Early examples of this approach include Anthony T. Kronman, *Mistake, Disclosure, Information and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) and Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977).

6. "Accidents" in this tradition are defined as "harmful outcomes that neither injurers nor victims wished to occur . . ." STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* 1 (1987).

by the new Law and Economics scholarship.⁷ The central theme of these writings is that the law establishes default entitlement settings that tend to put the burden of various risks on the party best able to take actions to prevent, mitigate, or insure against these risks: the least-cost-avoider.⁸ Current Law and Economics scholarship in the contracts area continues to follow this tradition.⁹

The least-cost-avoider tradition is best understood by thinking first about the paradigmatic tort situation from which it arose: a car accident that injures a pedestrian.¹⁰ The accident creates a sunk (irretrievable) loss, the risk of which the law must assign. Economic analysts have defined legal rules as "efficient" if they create incentives for future parties similarly situated to minimize joint costs (or equivalently to maximize joint wealth).¹¹ The parties can take various precautions to reduce the probability of the accident or the magnitude of the harm. Ex ante (before the accident), the parties can purchase safety equipment, drive or walk more carefully, or substitute other safer activities for driving or walking.¹² Risk averse parties can

7. See Guido Calabresi, *The Decision for Accidents: An Approach to Nonfault Allocation of Costs*, 78 HARV. L. REV. 713 (1965); Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961).

8. See GUIDO CALABRESI, *THE COSTS OF ACCIDENTS* 135 (1970) [hereinafter *COSTS OF ACCIDENTS*]. Later writings in the accident law area have recognized that often efficiency requires providing incentives for *both* parties to take precautions, because one party's precautions would not eliminate the expected residual accident costs and the second party's precautions would further reduce these costs. In such a case, there is no one least-cost-avoider. See SHAVELL, *supra* note 6, at 17-18. The least-cost-avoider approach has therefore come to be viewed as a special case involving either "unilateral care," in which only one party can take precautions, or "alternative care," in which precautions by both parties are merely duplicative. See POSNER, *supra* note 2, at 170 (distinguishing alternative care cases from joint care cases). But see Stephen G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost-Avoider*, 78 Va. L. Rev. 1271 (1992) (defending the least-cost-avoider concept in tort law analysis). Nevertheless, in contract law, this special case is significant for reasons discussed below. See *infra* note 23. I will therefore preserve the "least-cost-avoider" terminology here, as other economic scholars of contract have done. See, e.g., GOLDBERG, *supra* note 2, at 51-73.

9. See, e.g., Robert Cooter, *Symposium on Causation in the Law of Torts: Torts as the Union of Liberty and Efficiency; An Essay on Causation*, 63 CHI.-KENT L. REV. 523, 532 (1987); Richard E. Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More Into the Void*, 67 B.U. L. REV. 9, 47 (1987); John T. Vangel, *A Complicity-Docctrine Approach to Section 10(b) Aiding and Abetting Civil Damages Actions*, 89 COLUM. L. REV. 180, 190 (1989).

10. See *COSTS OF ACCIDENTS*, *supra* note 8, at 148-49.

11. See, e.g., POSNER, *supra* note 2 at 13-16. Minimizing joint costs and maximizing joint wealth are equivalent if "costs" are defined to include opportunity costs, as well as the direct costs of accidents and precautions.

12. This last form of precaution is often neglected under traditional negligence standards. Economists term this omission and the distorted incentives it creates the "activity level

insure and thus reduce the costs associated with uncertainty. Ex post (after the accident), the parties may be able to mitigate losses by acting quickly to seek medical help, for example. Efficient legal rules minimize the sum of all precaution costs and the residual expected accident costs.

In formulating efficient legal rules, economists usually start with the simplest model and then add complexities. Coase posited the simplest possible model, in which transaction costs are zero, and concluded that in such a situation all legal rules are efficient because future parties will bargain around costly legal default settings.¹³ In the car accident example, however, transaction costs are great. Future parties would not bargain before the accident to assign this risk because it would be impossible for the driver and the pedestrian before the accident to identify each other and then get together and negotiate some kind of mutually beneficial arrangement. Thus, an economically-minded court can "mimic the market" by choosing default rules that encourage both parties to take optimal precautions.

The least-cost-avoider approach is a rule of thumb for choosing such efficient legal rules. Under this approach, the court must evaluate which party was in a better position to take the optimal precautions.¹⁴ The court then assigns the loss to this party to provide an incentive for a similarly situated party to take those precautions in the future.¹⁵

Law and Economics scholars have transplanted this approach to contract law. Instead of an "accident" we now have a "regret contingency"¹⁶ for which the contracting parties did not provide; that is, the contract has a "gap."¹⁷ The contingency can be, for example, a

problem." See A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 131-32 (2d ed. 1989).

13. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2-8 (1960).

14. See COSTS OF ACCIDENTS, *supra* note 8, at 155 (explaining that "the search for the cheapest cost avoider of accident costs is the search for that activity which has most readily available a substitute activity that is substantially safer"). Calabresi's analysis of finding the least-cost-avoider is substantially more complex than this, but this notion captures the essence of the theory.

15. *Id.* at 73-75.

16. See Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1273 (1980) [hereinafter *Enforcing Promises*] (defining regret contingency as the occurrence of a condition that would motivate breach if breach were a cost-less option to the promisor).

17. Economists sometimes postulate an ideal "complete contingent claims contract," which dictates what the parties agree to do in every possible situation. Under such a contract, which is one of the great "assumed can openers" of Law and Economics, there is no need to

change in market price, the appearance of an unforeseen opportunity, a mistake, or a fire.¹⁸ Again, both parties can take various precautions: the promisor can provide backup performance or monitor its actions more carefully; the promisee can temper its reliance; both parties can insure,¹⁹ condition the promise, mitigate, or contract less.²⁰ Finally, as in the car accident case, the court may assign the loss associated with this contingency efficiently by asking which party could have best prevented or reduced the loss by taking cost-effective precautions.²¹ From this perspective, economic scholars have identified an essential economic unity between torts and contracts.²²

worry about regret contingencies.

18. *See, e.g.,* *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887) (parties contracted for the purchase and sale of a cow believed to be unable to breed. When the seller discovered that the cow was with calf he attempted to void the contract based on the legal doctrine of mistake); *Taylor v. Caldwell*, 122 Eng. Rep. 309 (K.B. 1863) (Taylor contracted to use Caldwell's music hall for a series of performances when one week prior to the first performance the Hall was destroyed by fire); U.C.C. § 2-615 cmt. 4 (1990) ("But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which . . . causes a marked increase in cost . . . is within the contemplation of this section.").

19. Posner and Rosenfield use the term "superior risk bearer" to capture the notion that insurance, as well as preventive action, is a precaution. *See* Posner & Rosenfield, *supra* note 5, at 90.

20. Though some scholars seem to think that we never want to deter promise-making, *see, e.g.,* W. David Slawson, *The Role of Reliance in Contract Damages*, 76 CORNELL L. REV. 197, 218 (1990) ("As a rule, promising is not wrongful conduct. We do not want to deter promising."), one way to interpret many contract doctrines is that they are designed to deter (or at least reduce) promise-making. Some doctrines deter promise-making by denying enforcement. These include the doctrines of illegality, fraud, duress, unconscionability, and capacity. *See, e.g.,* Buckley, *supra* note 4, at 50 ("Where bargains are vitiated by fraud, duress or incapacity, the level of contracting is assumed to be excessive."). Less obviously, perhaps, other doctrines deter promise-making by *granting* enforcement. These include the objective theory of contracts (deters joke and other unintended promises), promissory estoppel and the material benefit rule (deters—perhaps unintentionally—certain gratuitous promises), and the doctrine of unilateral mistake (deters accidental promises). The use of contract enforcement to deter or reduce promise-making is analogous to the use of strict liability in torts to deter or reduce "ultrahazardous" activities. *See, e.g.,* WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* 111-20 (1987).

21. Goetz and Scott refer to this idea as allocating risks to the party who has the "comparative advantage in risk-bearing." *Mitigation Principle, supra* note 1, at 971 n.11. For an example of an application of this approach, *see Enforcing Promises, supra* note 16, at 1305-09 (advocating enforcement of nonreciprocal promises if extralegal sanctions are not effective to induce optimal precautions by promisors and if performance is relatively certain).

22. *See Model of Precaution, supra* note 5. Cooter's point is somewhat different than the focus of this paper. He argues that in joint care cases, the law must solve what he calls the "paradox of compensation." *Id.* at 2-5. The paradox is that for both parties to have incentives to take optimal precautions, they must both bear the full cost of harm at the margin, but strict liability and no liability rules both provide insufficient incentives for one

But in their zealous quest for unity, which is one of the hallmarks and prime benefits of Law and Economics, economic scholars have failed to emphasize key differences between tort accidents and contract breaches. This makes exclusive reliance on the least-cost-avoider concept more misleading in contract cases than in unintentional tort cases.²³ What these differences all have in common is the danger of opportunistic behavior.

Unlike accident law, contract law must somehow take account of the consensual interaction of two parties—the contract. In the least-cost-avoider tradition, a contract is more than an agreement on specified terms; it is another form of precaution. Contract law provides a set of “defaults,” which the parties can override in their contract.²⁴

party to take precautions. *Id.* at 3-4. According to Cooter, the tort law solution to the paradox is to use fault rules rather than strict liability; the contract law solution is to impose strict liability for breaches, but to make damages invariant to the promisee's reliance. *Id.* at 5-19.

I disagree with Cooter's assertion that fault rules are not important in contract law. *See id.* at 31-32. For example, courts do look at the reasonableness of the promisee's reliance in deciding whether to enforce promises in the absence of consideration. *See, e.g.,* *Quake Constr. v. American Airlines*, 565 N.E.2d 990, 1004 (Ill. 1990); *RESTATEMENT (SECOND) OF CONTRACTS* § 90 cmt. b (1981) (stating that the reasonableness of the promisee's reliance bears on the requirement that relied-upon promises should be enforced only if enforcement avoids injustice). Fault rules are also important in contract excuse doctrines, such as mistake. But I agree with Cooter's general point that the paradox exists and that the law addresses it in several different ways. *See Model of Precaution, supra* note 5.

23. The least-cost-avoider concept is, in one important sense, more helpful in contract law than in tort law. One can distinguish two types of precautions: those that reduce the probability of a regret contingency, and those that reduce the magnitude of harm that occurs. In tort accidents, as noted above, application of the least-cost-avoider concept is problematic because both parties must be given incentives to take precautions often that reduce the probability of harm. *See supra* notes 5-14 and accompanying text. Contract contingencies, on the other hand, often require that only one party take each type of precaution. Contract regret contingencies are often not events whose probability the parties can cheaply control by taking ex ante precautions. The best example is a change in market price. But those contingencies that the parties can control by taking precautions are often either problems of alternative care, such as “mistakes,” or problems of unilateral precaution, such as unsatisfactory performance or delay. Precautions against excessive damages—tempered reliance ex ante and mitigation ex post—also typically involve either alternative care or unilateral precaution. Although the “least-cost-avoider” (the party best able to take probability-reducing precautions) may not be the same party as the “least-cost-mitigator” (the party best able to take loss-reducing precautions), within each category of precaution the use of the least-cost-avoider label makes sense. Moreover, as Cooter notes, courts can provide incentives for both parties by using the least-cost-avoider determination to manipulate liability rules and the least-cost-mitigator determination to manipulate damage rules. *See Model of Precaution, supra* note 5, at 32 & n.70. It is no wonder then, that contract scholars continue to use the term though it has fallen into disfavor in the tort area.

24. *See generally* Ayres & Gertner, *supra* note 2 (discussing the concept of default); Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH.

Failure to override the relevant default where it is relatively cheap to do so can be viewed as an inefficient failure to take "contract-based precautions."²⁵

To take one example that has recently received much attention in the Law and Economics literature,²⁶ if the default rule states that foreseeable consequential damages are recoverable, the promisor can put in a clause that excludes consequential damages. On the other hand, if the default rule does not allow consequential damages unless specifically contracted for, the promisee can contract for them and put in a clause to that effect. If the default is known,²⁷ then the party who suffers a loss under that default and fails to take contract-based precautions to protect itself can be deemed the least-cost-avoider.²⁸

But the least-cost-avoider analysis is not so simple. In many contract disputes the question is what the default should be. If transaction costs are low,²⁹ then the Coase Theorem suggests that from an efficiency perspective, the default rule chosen does not matter unless either party has a comparative advantage in taking contract-based precautions.³⁰ Absent such a comparative advantage, the low

L. REV. 489 (1989) (same); *Limits of Expanded Choice*, *supra* note 2 (same).

25. Goetz and Scott refer to the conditioning of promises in this way as taking "quality precautions," which they differentiate from taking "quantity precautions," or making fewer promises. *Enforcing Promises*, *supra* note 16, at 1274. Because the term "quality precautions" does not capture the fact that these precautions cannot be taken in typical tort cases (excluding product liability), I prefer the term in the text.

26. See, e.g., Ayres & Gertner, *supra* note 2, at 101-04; Lucian A. Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of Hadley v. Baxendale*, 7 J.L. ECON. & ORG. 284 (1991); Melvin A. Eisenberg, *The Principle of Hadley v. Baxendale*, 80 CAL. L. REV. 563 (1992); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989); Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990).

27. The prevailing default, of course, is *Hadley v. Baxendale*, 9 Ex. 341, 156 Eng. Rep. 145 (1854).

28. Courts have often used this type of argument to support the results they reach. See, e.g., *Stees v. Leonard*, 20 Minn. 448, 451 (1874) (holding a builder to its contract despite unforeseen soil difficulties on the ground that "the hardship is attributable, not to the law, but to the contractor himself, who has improvidently assumed an absolute, when he might have undertaken only a qualified liability"). If, however, the probability of a particular contingency is very low, it might not be cost-effective for either party to draft an appropriate clause. See POSNER, *supra* note 2, at 92-93.

29. Economic scholars tend to think of transaction costs in the contract context, unlike the tort accident context, as being low because the parties are already in a bargaining relationship.

30. In certain situations one party may in fact have a comparative advantage in taking contract-based precautions. For example, a repeat contractor with an in-house legal staff might have lower precaution costs than a one-shot, individual contractor.

transaction cost scenario seems to render irrelevant the traditional least-cost-avoider function of setting defaults.³¹ Economic scholars have recognized, however, that there are transaction costs involved in contracting around a default setting. Therefore, they have argued that efficiency-minded courts should set the default in accordance with the preferences of a majority of contracting parties.³²

This majoritarian approach to default setting resurrects the idea of placing risk on the least-cost-avoider, in the sense of the party in a better position to take precautions itself. But it also contemplates placing risk on "idiosyncratic" parties, who have private information about their unusual circumstances. These parties are also deemed least-cost-avoiders, not necessarily because they can reduce or insure against risk themselves, but because they can take contract-based precautions; that is, they can reveal their private information to the other party so that the *other* party will be able to take precautions or insure optimally. The least-cost-avoider tradition has generally assumed that contract-based precautions are no different than other precautions.

But two important recent articles by Professor Johnston and Professors Ayres and Gertner recognize that contract-based precautions are meaningfully different from other precautions, though they reach different conclusions about how defaults should be set.³³ Both articles rely on the insight that when precautions depend on information revelation, courts must take into account the fact that parties may not truthfully reveal all relevant information for strategic reasons.³⁴ Put

31. Professor Levmore has argued for similar reasons that the least-cost-avoider approach is not so helpful in analyzing the law of restitution. See Saul Levmore, *Explaining Restitution*, 71 VA. L. REV. 65, 72-74 (1985). In my view, Levmore is overly skeptical about the usefulness of the least-cost-avoider approach in this area because he ignores the possibility of deeming as least-cost-avoider the party with the "last clear chance" to avoid the problem. However, his general conclusion that the least-cost-avoider approach alone is not sufficient to explain restitution law is consistent with the thesis of this article.

32. See, e.g., *Mitigation Principle*, supra note 1, at 971. Johnston calls this idea the Coasean Contractual Theory. See Johnston, supra note 26, at 623-26. Ayres and Gertner refer to the majoritarian rule as an "untailored default," which they distinguish from a "tailored default," or one that is based on the preferences of the parties to a particular contract. Ayres & Gertner, supra note 2, at 91. It seems to me that what differentiates a tailored default from an untailored default is not that the untailored default is a majoritarian rule and the tailored default is not, but simply that an untailored default takes into account fewer circumstances. That is, it is more like a "rule" than a "standard," to use the more familiar jargon.

33. See Ayres & Gertner, supra note 2, at 91, 97-100; Johnston, supra note 26, at 616-19.

34. See Ayres & Gertner, supra note 2, at 94; Johnston, supra note 26, at 616-17.

another way, the failure to take contract-based precautions, unlike the failure to take many precautions against accidents, may not be an act we would normally call "negligent," but an act we would normally call "intentional." Whatever implications this fact has for the analysis,³⁵ it at least casts doubt on the straightforward application of the least-cost-avoider concept to contract-based precautions.³⁶

A second, related way that the existence of the contract complicates the least-cost-avoider analysis involves not the setting of the default, but the determination of whether the parties have overridden the default.³⁷ The problem is that it is not always so certain whether the parties have agreed and to what they have agreed. Ironically then, contracts not only decrease, but also increase transaction costs, because a party to whom the contract assigned a particular risk may later deny that obligation.³⁸ One could simply apply the least-cost-avoider approach and argue that we should encourage the party in the best position to clarify and specify the agreement to do so, and to some extent the law does this.³⁹ But this solution ignores the possi-

35. Ayres and Gertner argue that if contract-based precautions are more important than other precautions, we might want courts to choose not majoritarian defaults, but rather "penalty defaults," which are deliberately set at what the parties would not want in order to encourage information disclosure. See Ayres & Gertner, *supra* note 2, at 91, 97-100; see also Johnston, *supra* note 26, at 620-23 (referring to this approach as the "information-forcing paradigm"). They use this idea to argue in favor of a restrictive interpretation of the *Hadley* rule to force high value shippers to reveal (rather than strategically withhold) their private information to carriers. Ayres & Gertner, *supra* note 2, at 101-04.

Johnston argues in favor of a broad reading of the *Hadley* rule, which he claims the courts have in fact adopted on the ground that given strategic incentives, high value shippers would be less likely to contract around a narrow default than low value shippers would be to contract around an expansive default. In particular, under a narrow default, high value shippers would be reluctant to reveal their value because they would then be subject to a higher price. Moreover, carriers would be reluctant to reveal the likelihood of nonperformance for fear of losing the contract or being forced to lower their price. See Johnston, *supra* note 26, at 616-17.

36. Johnston in fact differentiates "precautions" from "revealing information" and chides Judge Posner's discussion of *Hadley*, see POSNER, *supra* note 2, at 126-28, for a "nifty bit of rhetoric" in lumping the two together under the "avoidability principle because this label suggests the only case in which the principle is clearly efficient." See Johnston, *supra* note 26, at 621 n.23. I think Posner's argument may be based more on his overly broad interpretation of the least-cost-avoider paradigm (the avoidability principle) than on strategic rhetoric. But I agree with Johnston's bigger point, which is that the prospect of strategic behavior makes information revelation different from other precautions.

37. See Ayres & Gertner, *supra* note 2, at 119-27.

38. See *Mitigation Principle*, *supra* note 1, at 977-84.

39. See, e.g., RESTATEMENT (SECOND) OF CONTRACTS § 206 (1981) (directing courts to interpret writings against the drafter). Ayres and Gertner refer to this rule as another example of a penalty default. Ayres & Gertner, *supra* note 2, at 105 n.80.

bility—discussed below—that acting according to the parties’ mutual understanding of the agreement could also be viewed as a “precaution.”⁴⁰

The problem is exacerbated by the fact that in contracts, many precautions occur *ex post*.⁴¹ The least-cost-avoider approach assumes there is no special problem posed by sequential decision making. This approach makes some sense in tort cases because there is usually only one relevant time for precaution-taking decisions by both parties: before the accident. *Ex post* mitigation is often limited to seeking medical attention, though sometimes decision making by the relevant parties may be sequential, as in “last clear chance” cases.⁴² In contract cases, by contrast, *ex post* mitigation and sometimes even complete avoidance of the loss are often possible.⁴³ Moreover, there may not be any “real” loss at all. Law and Economics scholars analyzing contract remedies have often focused solely on the *ex post* incentives of the party contemplating breach and ignored or downplayed *ex ante* precautions.⁴⁴ But the problems of information withholding and obligation denial are particularly acute *ex post*. Therefore, *ex post* precautions may be meaningfully different from *ex ante* precautions in a way not captured by the least-cost-avoider approach.

These problems—withholding information in negotiations, denying contractual obligations, and claiming nonexistent losses—all point to a significant type of behavior not present in the paradigmatic tort case: the problem of opportunism. Because of the potential for opportunistic behavior, the least-cost-avoider approach provides an incomplete explanation of and justification for contract doctrine.

40. See *infra* notes 128-34 and accompanying text.

41. Note that in contract cases, “*ex ante*” could refer either to the time before the contract is entered into or the time before the regret contingency arises. I will adopt the latter meaning, which coincides with the common-sense distinction between (*ex ante*) precaution and (*ex post*) mitigation, and captures the idea that a regret contingency can occur before a formal contract is entered into.

42. See generally Donald Wittman, *Optimal Pricing of Sequential Inputs: Last Clear Chance, Mitigation of Damages, and Related Doctrines in the Law*, 10 J. LEGAL STUD. 65 (1981) (arguing that marginal cost liability is the “optimal method” of pricing sequential inputs because efficient choices are dictated by the internalization of all costs).

43. See *Mitigation Principle*, *supra* note 1, at 1005-11.

44. See Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 630, 646-50 (1988) (noting that the theory of efficient breach focuses primarily on the question of the least cost *ex post* mitigator of the loss resulting from breach).

B. *The Opportunism Tradition*

Beginning in the mid-1970s, but predominantly during the 1980s, a second economic approach to contract law began to develop. This approach has traveled under several different names—relational contracting, transaction cost theory, new institutional economics—and has not been propounded solely by writers sympathetic to economics (at least Chicago-style economics). The approach is also less unified than the least-cost-avoider tradition. In my opinion, however, the distinguishing feature common to all variants of this approach and the feature that highlights the difference between this approach and the least-cost-avoider approach is the focus on the need to deter opportunistic, as opposed to negligent, contracting behavior.⁴⁵

As they do with the least-cost-avoider concept, Law and Economics scholars generally use a paradigmatic case to describe opportunism. Consider a contract to build a house. If construction precedes payment, then before payment but after full or partial construction, the buyer can force the builder to renegotiate the price or other term by threatening to withhold payment even though no other circumstances change. Such behavior by the buyer is deemed opportunistic.⁴⁶

Economists agree more on examples of opportunistic behavior than on definitions of it, though the term has achieved general acceptance.⁴⁷ Posner and Goldberg, for example, define opportunistic be-

45. Professor Cooter has termed the "Hobbes Theorem" the view that the "role of law is to minimize the inefficiency that results when bargaining fails, by restricting the threats which the parties can make against each other." *Cost of Coase*, *supra* note 2, at 18-19. This is similar to what I term the opportunism tradition, though Cooter seems to limit the application of the Hobbes Theorem to blatant forms of coercion.

46. See POSNER, *supra* note 2, at 89; Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, in GOLDBERG, *supra* note 2, at 17.

47. Judge Posner did not use the term in the second edition of his treatise. By the time he wrote the third edition, the deterrence of opportunism had become "the fundamental function of contract law (and recognized as such at least since Hobbes's day)." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 81 (3d ed. 1986); see also *Wisconsin Knife Works v. National Metal Crafters*, 781 F.2d 1280, 1285 (7th Cir. 1986) (Posner, J.) (holding that because the performance of the parties to a contract is typically not simultaneous, one party may find himself at the mercy of the other unless the law of contracts protects him. Indeed the most important thing which that law does is to facilitate exchanges that are not simultaneous by preventing either party from taking advantage of the vulnerabilities to which sequential performance may give rise.). Recent treatises on contracts do not make use of the term. See JOHN D. CALAMARI & JOSEPH M. PERILLO, *CONTRACTS* (3d ed. 1987); E. ALLAN FARNSWORTH, *CONTRACTS* (2d ed. 1990); JOHN E. MURRAY, *MURRAY ON CONTRACTS* (3d ed. 1990). But some non-economic scholars have begun to incorporate the term into their

havior simply as taking advantage of the other party's vulnerability.⁴⁸ Williamson's well-known definition evokes conventional morality: opportunism is "self interest seeking with guile."⁴⁹ Others, notably Goetz and Scott, and Muris, connect opportunism to the parties' agreement by defining it as an attempted redistribution of an already allocated contractual pie.⁵⁰

Each of these definitions captures part, but only part, of the types of behavior economists generally characterize as opportunistic, and thereby limits unnecessarily the application of the concept. The Posner and Goldberg definition focuses on the conditions under which opportunism is likely to occur. Contracting parties are "vulnerable" in two senses. First, they cannot foresee all possible problems that can arise, and therefore cannot write complete contingent claims contracts; that is, they are subject to bounded rationality.⁵¹ Bounded rationality

work. See, e.g., MELVIN A. EISENBERG, *THE NATURE OF THE COMMON LAW* 28 (1988); Randy E. Barnett & Mary E. Becker, *Beyond Reliance: Promissory Estoppel, Contract Formalities, and Misrepresentations*, 15 HOFSTRA L. REV. 443, 461 n.88, 468 n.125 (1987); Clayton P. Gillette, *Commercial Rationality and the Duty to Adjust Long-Term Contracts*, 69 MINN. L. REV. 521, 554 & n.107, 556, 562 (1985); Robert A. Hillman, *Contract Modification and "Self-Help Specific Performance": A Response to Professor Narasimhan*, 75 CORNELL L. REV. 62 (1989); Richard E. Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193, 204 (1982). The term is not without its critics. See Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 3-4 (1989).

48. GOLDBERG, *supra* note 2, at 17; POSNER, *supra* note 2, at 89 & 117.

49. OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47 (1985) [hereinafter *ECONOMIC INSTITUTIONS*]. Williamson has repeated this definition for many years. See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* 26 (1975); Oliver E. Williamson et al., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250, 258-59 (1975). Williamson intends to distinguish opportunistic behavior from the kind of self-interested behavior usually assumed in economics. He is fond of citing a quotation from economist Peter Diamond that "standard economic models treat 'individuals as playing a game with fixed rules which they obey. They do not buy more than they can pay for, they do not embezzle funds, they do not rob banks.'" *ECONOMIC INSTITUTIONS*, *supra*, at 49 n.7, 65 (citing Peter Diamond, *Political and Economic Evaluation of Social Effects and Externalities: Comment*, in *FRONTIERS OF QUANTITATIVE ECONOMICS* 31 (Michael D. Intriligator ed., 1971)). The normative principle embedded in this distinction is that we do not want people to engage in individualistic cost-benefit calculations with respect to every decision they make.

50. Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1139 n.118 (1981) [hereinafter *Relational Contracts*]; Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521 (1981). Muris's precise definition is that opportunism occurs "when a performing party behaves contrary to the other party's understanding of their contract, but not necessarily contrary to the agreement's explicit terms, leading to a transfer of wealth from the other party to the performer." *Id.* (emphasis added). It is not clear why the performing party's action would be opportunistic unless it was contrary to the *shared* understanding of the contract.

51. See *ECONOMIC INSTITUTIONS*, *supra* note 49, at 45.

makes one party vulnerable not only to unanticipated future events, but also to unanticipated opportunistic behavior by the other party.⁵²

Second, contracting parties perform their contractual obligations sequentially rather than simultaneously. Many of the investments they make in the contract are “sunk,” or nonrecoverable investments that have few or significantly inferior alternative uses.⁵³ When a contracting party makes sunk investments in transaction-specific assets, that party is at the mercy of the other party because the vulnerable party has nowhere else to turn. Even if before committing itself the investing party had many contracting options available, the sunk investments effect a “fundamental transformation”⁵⁴ from a “thick” or competitive market *ex ante* to a “thin” market or bilateral monopoly *ex post*.⁵⁵ Sunk investments make opportunism more profitable, and therefore more likely.

The Posner-Goldberg definition misses several important features of conduct generally recognized as opportunism, however. It describes one form of opportunism—“*ex post*” opportunism—but ignores “*ex ante*” opportunism, which includes fraud and adverse selection.⁵⁶ An opportunistic party may intend to mislead or deceive the other party from the beginning of the relationship, before the other party has invested in it. Thus, the “fundamental transformation” resulting from sunk investments in transaction-specific assets, though facilitative of

52. Williamson refers to uncertainty created by potential opportunism as “behavioral uncertainty,” and argues that such uncertainty is pervasive because “[t]he capacity for novelty in the human [especially legal!] mind is rich beyond imagination.” *Id.* at 58. *But cf.* HAROLD C. HAVIGHURST, *THE NATURE OF PRIVATE CONTRACT* 70 (1961) (stating that “furtive breach of a promise is seldom possible”). Despite Professor Havighurst’s initial skepticism, he later argues that “an evil contract breaker can frequently hide behind a trumped-up defense,” *id.* at 75, and that “[f]raudulent lawsuits are common.” *Id.* at 115.

53. *ECONOMIC INSTITUTIONS*, *supra* note 49, at 53-56. Williamson calls this condition “asset specificity.” Williamson’s precise definition is that “asset specificity refers to durable investments that are undertaken in support of particular transactions, the opportunity cost of which investments is much lower in best alternative uses or by alternative users should the original transaction be prematurely terminated” *Id.* at 55.

54. *Id.* at 61-63.

55. See David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CAL. L. REV. 1, 14 n.40 (1990) (defining “thick” and “thin” markets).

56. See *ECONOMIC INSTITUTIONS*, *supra* note 49, at 47-48. Not all economists view adverse selection as a problem of opportunism; many view it simply as a problem of asymmetric information. But I agree with Williamson that absent opportunism, contracting parties could simply solve the problem of adverse selection by requiring honest disclosure. *Id.* at 48. In fact, the literature on default rules and strategic information disclosure, see *supra* notes 34-35 and accompanying text, is simply an application of the adverse selection problem; see also *infra* notes 116-18 and accompanying text (discussing opportunism and moral hazard).

opportunism, is not necessary for it. Including *ex ante* fraud and *ex post* bad faith under the same umbrella term, opportunism also highlights the behavioral similarities of the temporally distinct conduct.⁵⁷

In addition, the "taking advantage of the other party's vulnerability" definition is unclear about what "taking advantage" means. It may mean only blatant behavior—behavior with no plausible justification—such as the house buyer's forcing the vulnerable builder to modify its terms after construction, but before payment, for no reason other than to get more money.⁵⁸ But focusing on this type of extortionate behavior obscures the fact that opportunism is often more subtle, that is, difficult to detect or easily masked as legitimate conduct.⁵⁹ The buyer often does not simply decide to become evil and take advantage of the builder. There is usually some "regret contingency,"⁶⁰ such as finding another builder who will build a better house for less or a change in market price. An opportunistic party can exaggerate or misrepresent the extent of the contingency, especially when that party has an asymmetric information advantage with respect to that contingency.⁶¹ Moreover, there may be some clause in the contract or rule of contract law that allows the buyer to escape the contract, even though that clause or rule was intended to handle a different situation.⁶² In summary, the Posner-Goldberg definition fo-

57. One need not accept that *ex ante* and *ex post* opportunism are equivalent (one could view *ex ante* opportunism as more reprehensible) to agree that the two types of opportunism share important features and that failure to recognize these similarities could lead to an unwarranted underemphasis on deterring opportunism relative to determining negligence.

58. Posner at times seems to limit opportunism to cases in which no plausible economic justification is offered by the promisor. See POSNER, *supra* note 2, at 97-98 (contrasting Alaska Packers' Ass'n v. Domenico, 117 F. 99 (9th Cir. 1902) with Goebel v. Linn, 11 N.W. 284 (Mich. 1882)); *Id.* at 117 ("A pays B in advance for goods and instead of delivering them B uses the money in another venture.").

59. See Muris, *supra* note 50, at 525; POSNER, *supra* note 2, at 91 ("But it is not always obvious when a party is behaving opportunistically."). Williamson also distinguishes "blatant opportunism," which includes lying, cheating, and stealing, from "subtle opportunism," which includes "the incomplete or distorted disclosure of information, especially . . . calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse." ECONOMIC INSTITUTIONS, *supra* note 49, at 47.

60. See *supra* note 16.

61. See *id.* at 80; *Limits of Expanded Choice*, *supra* note 2, at 311 ("Even if an agreement were perfectly communicative between the parties initially, one of the parties may dispute its meaning as a *strategic response* to a now disfavored arrangement.") (emphasis added).

62. In Williamson's words, there may be "opportunistic efforts to take advantage of (rely on) the letter of the contract when the spirit of the exchange is emasculated." ECONOMIC INSTITUTIONS, *supra* note 49, at 62.

Posner gives the example of a contract in which A hires B to paint his portrait "to

cuses too much on blatant and ex post opportunism and too little on subtle and ex ante opportunism.

The other two definitions of opportunism, posited by Goetz and Scott, Muris, and Williamson, include subtle opportunism but differ on the source of the standard against which contractual behavior is measured.⁶³ Both definitions view opportunism as inefficient in the sense that ex ante, both parties would presumably agree not to allow it; that is, opportunistic behavior is not joint maximizing.⁶⁴ But the Goetz and Scott, and Muris definitions hypothesize that the parties would agree not to allow opportunism because the behavior is contrary to the purposes of the agreement, which again excludes ex ante opportunism. On the other hand, the Williamson definition hypothesizes that the parties would agree not to allow opportunism because it violates moral standards, or in economic terms is not long-term maximizing behavior.⁶⁵ Behavior that violates contractual understandings and behavior that violates societal norms would both seem to be opportunistic. I therefore offer an alternatively broad definition of opportunism: any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms,⁶⁶ or conventional morality.⁶⁷

A's satisfaction." He argues that if B paints a portrait that others admire but A rejects without giving "any reason," then A acts in bad faith, that is, opportunistically. On the other hand, if A is in fact dissatisfied with the portrait, but the dissatisfaction is "unreasonable" in the eyes of others, then A has not acted opportunistically. See POSNER, *supra* note 2, at 91-92. Posner does not say how he would characterize a case in which A is in fact satisfied with the quality of the portrait but claims he is dissatisfied with some other aspect of B's performance because A wants to get out of the contract for other reasons. In my view, this is a case of subtle opportunism in which A relies on the "letter" of the contract, which does not expressly limit A's dissatisfaction to the quality of the portrait, yet violates the "spirit" of the contract and thereby "takes advantage" of B's vulnerability. It may be difficult to tell that this is what A is doing and we might hesitate to punish A because of this difficulty, but that is different from saying that A is not acting opportunistically.

63. See generally Muris, *supra* note 50, at 532-34.

64. Posner would agree. See POSNER, *supra* note 2, at 91 (stating that it is "reasonable to assume that if the parties had thought about the possibility of bad faith they would have forbidden it expressly").

65. See ECONOMIC INSTITUTIONS, *supra* note 49, at 45-57.

66. I have in mind here such standards of behavior as U.C.C. § 1-205(2) (1990) (trade usage); *id.* § 1-205(1) (course of dealing); *id.* § 2-208 (course of performance); as well as negotiating conventions, *id.* § 3-104(1) (defining negotiable instrument).

67. In using the term "conventional morality," I hope to, in the words of James Boyd White, "keep alive the recognition that not everything can be said in economic terms, that there are other languages, other cultures, with which it must have a relation, and to which it should on many occasions submit." James B. White, *Economics and Law: Two Cultures in Tension*, 54 TENN. L. REV. 161, 198 (1986). By conventional morality, I mean principles to

My purpose in adopting such a broad definition is not merely to quibble with the definitions others have advanced, but to argue that opportunism does and should play a much broader role in understanding and developing contract doctrine from an economic perspective than the legal economists have so far recognized. While Law and Economics scholars have boldly applied the least-cost-avoider concept to analyze and critique contract doctrine, they have been far more timid in their claims for the role of contract doctrine in deterring opportunism.

First, though it may seem self-evident to lawyers that legal rules can be used to deter opportunistic behavior, and though some Law and Economics scholars have taken this view,⁶⁸ Williamson and other sympathizers of the "transaction cost" school have their doubts.⁶⁹ Williamson in particular rejects the "legal centralism tradition," which assumes that "efficacious rules of law regarding contract disputes are in place and are applied by the courts in an informed, sophisticated, and low-cost way."⁷⁰ Although Williamson understands that "court ordering" is an important governing institution,⁷¹ and although his

which we are strongly committed—however much we may violate them or be tempted to violate them in practice. These principles include prohibitions on lying, stealing, and cheating. Of course, contract law incorporates these principles through its obligation of good faith. *See* U.C.C. § 1-203 (1990); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). But "good faith" carries much doctrinal baggage which limits its general application. The term also lumps together negligence and opportunism concerns. *See* U.C.C. § 2-103(1)(b) (1990) (defining good faith for merchants as "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade").

Morality has not escaped the attention of economists. *See, e.g.*, KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 26-27 (1974). In fact, the famous "Prisoners' Dilemma" from game theory can be used to explain the economic rationale for developing moral principles. In this sense, opportunism can be viewed as a form of "noncooperative" behavior resulting from excessive pursuit of self-interest. *See* AMARTYA SEN, *CHOICE, WELFARE AND MEASUREMENT* 62-64, 66-68 (1982).

68. *See* Muris, *supra* note 50, at 522; *see also* Ayres & Gertner, *supra* note 2, at 94 ("By changing the default rules of the game, lawmakers can importantly reduce the opportunities for this rent-seeking, strategic behavior.").

69. *See* Anthony T. Kronman, *Contract Law and the State of Nature*, 1 J.L. ECON. & ORG. 5, 29 (1985) (noting the limits of legal, as opposed to private, mechanisms for deterring opportunism and suggesting that "where the marginal cost of increasing transactional security by strengthening the parties' legal remedies exceeds the marginal benefit of doing so, the law will leave the task of further enhancing their security to the parties themselves").

70. ECONOMIC INSTITUTIONS, *supra* note 49, at 20. The term "legal centralism" comes from Marc Galanter, *Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law*, 19 J. LEGAL PLURALISM 1, 1 (1981).

71. Williamson recognizes, for example, that private ordering always operates in the "shadow of the law." ECONOMIC INSTITUTIONS, *supra* note 49, at 168 & n.4. The phrase comes from Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law:*

main concern is examining private institutions that combat opportunism, to the extent he is suggesting that severe ineffectiveness of court ordering is inherent in courts, I disagree.

Contracting parties cannot solve all problems of opportunism on their own; thus, legal rules matter.⁷² Courts concerned with promoting efficiency can become more effective by incorporating explicitly the goal of deterring opportunism into contract doctrine. Although opportunistic behavior may be difficult to detect—it is often difficult for courts to discern what the reasonable contractual expectations of the parties are—as courts incorporate opportunism concerns into contract doctrine, they will elicit more relevant facts and become better able to detect opportunism. Furthermore, even imperfectly informed courts can identify types of behavior that are *potentially* opportunistic as well as situations in which opportunism is more likely to occur. These courts can develop rebuttable presumptions of opportunistic behavior.⁷³ Thus, courts can become more informed, sophisticated, and efficient in deterring opportunism.⁷⁴

A second way that Law and Economics scholars limit the role of contract doctrine in deterring opportunism is by tending to view the problem of opportunistic behavior as present only in certain classes of contracts, namely long-term or other “relational” contracts.⁷⁵ But the danger of opportunism lurks in many adjudicated contracts cases. It is true that if perfect substitute markets are available, opportunism does not pose much of a problem, but these cases are typically not litigat-

The Case of Divorce, 88 YALE L.J. 950 (1979), but the idea is not new. See HAVIGHURST, *supra* note 52 at 10 (“[T]he reliability of direct observation is limited by the consideration that when the public force does in truth lurk in the background, it is hard to tell the extent to which it is having an effect upon the contracting parties.”). Moreover, in his concluding chapter, Williamson acknowledges that “if private ordering and court ordering can be used in combination rather than separately, then the study of contract will benefit from an effort to identify the *mix* of private and public structures that best serve the purposes of the parties.” ECONOMIC INSTITUTIONS, *supra* note 49, at 399.

72. See Muris, *supra* note 50, at 527-28. In the language of traditional Law and Economics, the transaction costs of contracting around legal default settings are high. See Ayres & Gertner, *supra* note 2, at 89, 92-93, 111.

73. See Muris, *supra* note 50, at 530. In fact, all legal rules contain factual presumptions and behavioral hypotheses. One could even describe common law adjudication as the process of revising such presumptions and hypotheses in light of experience and evolving social norms.

74. I develop this point further below. See *infra* notes 173-86 and accompanying text.

75. Goetz and Scott sometimes seem to suggest this limitation, as does Goldberg. See GOLDBERG, *supra* note 2, at 16-17. But see *id.* at 1. My position is closer to that of Macneil, who finds relational concerns in most contracts. See Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691 (1974).

ed.⁷⁶ I do not dispute that long-term contracts are unique in certain respects;⁷⁷ in particular, I do not mean to argue that the legal rules governing long-term contracts should be the same as those governing other types of contracts. Rather, my point is merely that many of the insights into opportunistic behavior first gained in studying these contracts could just as easily be applied to all contracts.

A third limitation that some scholars tend to put on using contract doctrine to deter opportunism is the tendency to confine concern with opportunism to so-called "performance" or "enforcement" questions, but not to "formation."⁷⁸ Limiting the study of opportunism to performance cases results from defining opportunism in terms of the agreement; if there is no agreement, there can be no behavior contrary to the other party's understanding of the agreement. But this understanding of formation issues is somewhat naive. In many formation cases, there is an agreement, at least in the common sense understanding of the term, and the question is whether the court will ignore the agreement because some formation rule was not satisfied.⁷⁹

76. See GOLDBERG, *supra* note 2, at 1 (stating that "most of the interesting, and difficult, questions of contract law disappear in a world of discrete transactions"). As Professors Levin and McDowell eloquently put it:

When alternate goods or services are easily available on a ready market, the disincentives to bring suit are great. It is when the market is not working, or when agreement is questionable or the contract price is of disputed value, that suit is brought. The law is concerned with unusual situations, those arising when things have gone wrong. Theories based on models of institutional strength are of little help when the institution relied upon is crumbling.

Levin & McDowell, *supra* note 3, at 58. In light of this statement, the aphorism "hard cases make bad law," see, e.g., *United States v. Clark*, 96 U.S. 37, 49 (1878) (Harlan, J., dissenting), makes little sense. The aphorism should be "easy cases make no law."

77. For example, parties in relational contracts may leave certain terms deliberately indeterminate, to be worked out or resolved judicially as problems arise. See *Limits of Expanded Choice*, *supra* note 2, at 317-20.

78. Muris seems to suggest that opportunism occurs only after the contract is formed: "the problem occurs after the contract is formed; it is not a problem of precontractual monopoly." Muris, *supra* note 50, at 523. But this statement may be merely an expression of the idea that precontractual monopoly is not necessary for opportunism rather than a statement that precontractual opportunism cannot occur.

Recent traditional writers focusing on "good faith," whose work parallels the opportunism approach, also seem to find meaningful the distinction between formation and performance and enforcement questions. See Eric G. Anderson, *Good Faith in the Enforcement of Contracts*, 73 IOWA L. REV. 299, 326 n.102 (1988); Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 372 n.17 (1980).

79. Of course, the converse situation can also arise. That is, there are cases in which there is no agreement, yet the promisee tries to argue that there is because some formation rule is satisfied. See, e.g., Michael W. Miller, *When the "Junker" Calls, This Man Is Ready*

Moreover, even if there is no formal agreement, opportunistic behavior can still occur at the negotiation stage, because the crucial point (for ex post opportunism) is when one party makes sunk investments in transaction-specific assets, not the magical moment when the contract comes into being.⁸⁰

C. *The Traditions and Efficient Breach*

Those familiar with the economic analysis of contract law may have noticed a glaring omission from the previous discussion: the theory of efficient breach. Because this theory has become almost synonymous with the economic analysis of contract law—as well as the primary foil for its detractors—I will offer a critique of the efficient breach theory. My goal is to show that the efficient breach theory alone does not provide a viable economic theory of contract law, and that the two traditions I have discussed provide a superior approach.

The idea of efficient breach is very simple—deceptively⁸¹ so. According to the theory, the purpose of contract remedies is to encourage (or permit, to make the idea more palatable) a promisor not to perform, but rather, to breach and pay damages whenever circumstances change after the contract is entered into so that breach and payment of damages leaves the promisor better off and the promisee no worse off than if performance occurred.⁸¹ That is, contract remedies should encourage (allow) the promisor to breach when breach is Pareto superior to performance.⁸²

As with the least-cost-avoider and opportunism traditions, economists posit a paradigmatic efficient breach situation to explain and

for Revenge, WALL ST. J., June 24, 1991, at A1 (describing attempts by recipient of telemarketing calls to use the unilateral contract device to bind telemarketers to promises to pay the recipient a fee simply by making the call). I am grateful to Harry Flechtner for this example.

80. See generally E. Allan Farnsworth, *Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations*, 87 COLUM. L. REV. 217 (1987) (arguing that existing contract doctrines are adequate to protect the parties to failed negotiations where there is no formal offer and acceptance). *Hoffman v. Red Owl Stores*, 133 N.W.2d 267 (Wis. 1965), is the prime example. For recent examinations of formation issues by Law and Economics scholars that incorporate opportunism considerations, see Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215 (1990); G. Richard Shell, *Opportunism and Trust in the Negotiation of Commercial Contracts: Toward a New Cause of Action*, 44 VAND. L. REV. 221 (1991).

81. See FARNSWORTH, *supra* note 47, § 12.3, at 846-47.

82. See Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 343 (1984).

defend the concept. I will discuss the example provided by Professor Ulen,⁸³ though all are similar. Suppose a homeowner promises to sell her house to a buyer for \$100,000. The buyer values the house at \$115,000 and therefore enjoys a "consumer surplus" of \$15,000. Before the transfer of the house is completed, a second buyer offers the homeowner \$125,000 for the house. The efficient breach theory holds that "if . . . efficiency is our goal, contract law should specify a remedy for breach that will lead to ownership of the house by the person who values it most, and should attempt to reach this result at the lowest possible resource cost."⁸⁴ Expectation damages (\$15,000) provide the correct incentives for efficient breach, because whenever the second buyer values the house more than the first buyer, the homeowner will breach and pay the expectation damages.

Although the efficient breach theory can be (and has been) attacked from many different directions,⁸⁵ the criticism I want to stress is that the theory assumes that the sole fact that the house is worth more to the second buyer is *sufficient* to entitle the homeowner to breach and pay expectation damages.⁸⁶ But this is simply not correct, either from a positive or normative perspective. In the example given, we do not know enough about the *purpose* of the contract and the *reasons* for the appearance of the second buyer—*why* the breach occurred—to be able to answer meaningfully the question of which remedy is most efficient. To see this point, let us consider several alternative additional facts.

First, suppose after contracting with the first buyer, the homeowner actively went out looking for another buyer willing to pay more for the house. Or suppose that the first buyer, after contracting with the homeowner, told the homeowner that she wanted to resell the house after doing some touch-up work and had lined up another potential buyer for \$115,000 but was still looking for a better resale price. Then realizing the resale value of the house for the first time, the homeowner found the second buyer. In these cases, the homeowner's breach could be characterized as opportunistic. The homeowner may be acting contrary to the *ex ante* expectations of the

83. *See id.* at 344-45.

84. *Id.* at 345.

85. *See generally* Craswell, *supra* note 44; Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980) (criticizing the efficient breach theory); Friedmann, *supra* note 47; Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947 (1982).

86. *See* Ulen, *supra* note 82, at 345.

parties that once the deal was struck the first buyer was entitled to any resale profits. That is, if a contract means anything, it means that if one party wants to find a better deal, she should do it before committing herself to the other party. In this case, the contract remedy should deter the homeowner from breaching in order to sell to a second buyer, *no matter what the value* the second buyer places on the house.⁸⁷ Specific performance, restitution damages, or lost profits under a liberal reading of *Hadley* would accomplish this goal, as would "market" damages if the breach occurred because of a change in the market price.⁸⁸

Second, suppose that the homeowner neglected to read the contract carefully upon signing, but soon thereafter discovered objectionable terms and then sought to sell the house to a second buyer.⁸⁹ In this case, it is possible that the breaching homeowner was the least-cost-avoider, but was not acting opportunistically. If so, reliance damages would arguably give the right incentive for future homeowners to take cost-effective precautions.⁹⁰

One can also construct scenarios in which the first buyer would

87. This example is similar to the "efficient theft" critique that others have leveled against the efficient breach theory. If the only efficiency concern is whether the resource ends up in the hands of the person who values it most, without regard to how it gets there, then theft would be economically justified whenever the thief places a high enough value on the resource. Law and Economics scholars have recognized this problem at least since Calabresi and Melamed. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1124-27 (1972). The problem with the efficient theft critique is that it can go too far. For example, Professor Friedmann seems to suggest that *any* breach of contract is essentially a theft regardless of the reason for the breach. See Friedmann, *supra* note 47, at 4-8. As I stated in the text, in my view the reason for nonperformance is crucial to deciding both whether there is a breach and what remedy should be applied.

88. Market damages are based on the difference between the contract price and the price on the market at the time of breach or repudiation. "If the buyer is the injured party, the market will often have risen, and the contract price is subtracted from the market price If the seller is the injured party the market will often have fallen, and the market price at which the seller could have resold is subtracted from the contract price." FARNSWORTH, *supra* note 47, § 12.12, at 902-03.

89. See *Laughlin v. Stephenson*, 525 S.W.2d 308 (Tex. Civ. App. 1975) (denying specific performance in a similar situation).

90. If the homeowner can characterize her action as a "unilateral mistake," the law may allow her to withdraw from the contract upon payment of reliance damages. See 3 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 612, at 700-02 (1960). It is not obvious why the result should be different if there is no "mistake," but simply negligent promissory activity on the part of the homeowner. *But see* Slawson, *supra* note 20, at 218-19 (arguing that in mistake cases the wrong is the mistake rather than the breach and so these cases alone merit reliance damages).

be the opportunistic party or the least-cost-avoider. For example, the first buyer might have known of the existence of the second buyer and kept that fact from the homeowner through deceit or misrepresentation. Alternatively, the first buyer might have intentionally or negligently led the homeowner into thinking that the agreement allowed the homeowner to continue searching for another buyer for a limited period of time to secure the deal. In these cases, a court might conclude that there was no breach at all. Perhaps even more important, the potential for opportunistic behavior on the part of the first buyer may be the most compelling justification for not allowing greater remedies than expectation damages, including specific performance, liquidated damages, and punitive damages. The greater the remedy, the greater the temptation for the first buyer to make a mountain out of molehill in order to reap the large windfall.⁹¹

The point is that one cannot provide an intelligible answer to the question of which contract remedy—or any other contract doctrine—is most efficient without examining the parties' purposes in contracting and their reasons for not performing.⁹² Contract remedies, like other contract rules, should be designed primarily to encourage contracting parties to take cost-effective precautions and to refrain from opportunistic behavior, and therefore to improve contracting practice and *reduce* the costs associated with breach.⁹³ The efficient breach theory, by contrast, views breach as a kind of unavoidable accident. The second buyer magically drops down from the sky. Perhaps some contract cases can be usefully analyzed this way, but in my view, most

91. See, e.g., Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 Wis. L. REV. 351. This is just another example of this moral hazard problem discussed below. See *infra* notes 117-19 and accompanying text.

An additional explanation for restrictions on more powerful remedies than expectation damages is that these remedies result in excessive precautions by the promisor, including quantitative precautions (making fewer promises). This explanation is the one stressed by Goetz and Scott. See *Limits of Expanded Choice*, *supra* note 2, at 317-20; *Mitigation Principle*, *supra* note 1, at 1001-03; *Relational Contracts*, *supra* note 50, at 1089-91.

92. Professor Slawson has recently made a similar argument in defending the expectation measure of damages. He states that the "compensation principle . . . requires that one identify the conduct that ought to be deterred . . ." Slawson, *supra* note 20, at 217. But he does not differentiate between negligence and opportunism. Instead, he views the only relevant "conduct" to be deterred as nonperformance of promises. "The wrong in a contract case is the failure to perform the promise. This failure to perform is the conduct we seek to deter or punish by imposing liability." *Id.* I disagree that nonperformance is *the* wrong to be deterred. There may be several "wrongs" to be deterred, of different weight. In my view, the fact of nonperformance of a promise by itself does not define the relevant "wrong" that ought to be deterred.

93. See Craswell, *supra* note 44, at 646-49 & n.43.

litigated contract disputes involve behavior that can be characterized as negligent, opportunistic, or both.⁹⁴ Put another way, in all contract disputes we can articulate alternative courses of conduct that we want similarly situated parties to take in the future to avoid a similar dispute. Even if the contingencies giving rise to the disputes are not preventable, contract law can encourage the parties to take contract-based precautions.⁹⁵

The efficient breach theory is not so much wrong on its own terms as it is irrelevant to most contract cases and doctrines. But economists cannot be entirely to blame for the efficient breach theory. Traditional contract doctrine and scholarship continue to preach the dogma that contract is a field of strict liability for breach; the reason for the breach generally does not matter in determining the remedy.⁹⁶ If economic theory can contribute anything to the development

94. That is not to say the characterization is easy. See Levmore, *supra* note 31, at 73-74 (either party could be acting opportunistically). But that does not mean we should eschew the attempt. *But see* POSNER, *supra* note 2, at 118 (arguing that most breaches are not opportunistic but are either "efficient" or "involuntary").

95. Perhaps another example of this critique will make the point even clearer. Consider the "valued form contract" for property insurance, that is, a contract that specifies a particular value of the property insured. Suppose some contingency arises and the property is destroyed. The insurance company would prefer not to pay anything; it "regrets" the contract. Suppose further that it turns out for some reason that the value of the property to the insured is less than the amount the insurance company has promised to pay. Should the insurance company have the right to limit payment to the actual loss (including a refund of any excess premium paid)? The efficient breach theory would suggest that it does, because the loss to the insurance company from performance exceeds the loss to the insured from nonperformance. But the law does not allow the insurance company to be excused or to pay only actual damages in this case "if it appears that the overvaluation was not intentional or made with an intent to deceive . . ." 4A JOHN A. APPLEMAN & JEAN APPLEMAN, *INSURANCE LAW AND PRACTICE* § 2602 (1969). Such a rule makes sense only if one looks at the reason for nonperformance. In many cases the insurance company is the least-cost-avoider because it can best take precautions (such as more careful inspection of the property and clearer policies) in order to prevent this problem from occurring in the future. See, e.g., *Gamel v. Continental Ins. Co.*, 463 S.W.2d 590, 594-95 (Mo. Ct. App. 1971).

96. See, e.g., *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540, 544 (1903) (Holmes, J.); E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1146-47 (1970). Consider, for example, the famous exchange between Williston and Coudert in the debate over § 90. See *Debate on Section 88 (Later Section 90) of the Restatement of Contracts*, reprinted in *A CONTRACTS ANTHOLOGY* 222-32 (Peter Linzer ed., 1989). The two disagreed over the measure of damages in a case where the reason for enforcing the promise was the promisee's reliance rather than a bargain. Nowhere in the debate did anyone raise the question of *why* the promise was made and *why* it was broken. The same problem plagues the famous "Brooklyn Bridge" hypothetical: nowhere does anyone raise the question of *why* A offered B \$100 to walk across the Brooklyn Bridge or *why* A revoked that offer when B had walked halfway across. See I. Maurice Wormser, *The True Conception of Unilateral Contracts*, 26 YALE L.J. 136, 138-39 (1916), retracted in I. Maurice

of contract doctrine, it is the debunking of this myth—not its perpetuation. Law and Economics scholars should therefore focus less on the efficient breach theory and more on creating a general theory that combines the least-cost-avoider and opportunism traditions.

II. AN EXPANDED ECONOMIC THEORY OF CONTRACT LAW

A. *The Traditions Compared*

The two traditions of economic analysis of contract law outlined in the previous sections are not recent developments. Yet it is puzzling that Law and Economics scholars have largely worked in one tradition or the other without attempting to compare or combine them.⁹⁷ There are at least two possible explanations for this omission. One explanation is that the traditions are truly “distinct and largely unrelated,” as Goetz and Scott have said.⁹⁸ Economists may view the tension between the two traditions as simply a version of the efficiency-equity (or similar economic-noneconomic) tradeoff, which economists feel competent to identify but powerless to expound upon in their role as economists.⁹⁹ More strongly, in the jargon of Critical Legal Studies scholars, there may be a “fundamental contradiction” between the two traditions—they cannot live comfortably to-

Wormser, Book Review, 3 J. LEGAL EDUC. 145, 146 (1950).

Even Judge Posner seems to accept at face value the idea that contract damages are based largely on strict liability. See POSNER, *supra* note 2, at 180. Posner then attempts to justify the greater use of strict liability in contract than in tort by arguing first, that market insurance is more important in tort cases, and second, that the promisor in contract cases is ordinarily the least-cost-avoider, whereas in tort cases we cannot ordinarily assume that the tortfeasor is the least-cost-avoider. The first argument ignores the possibility of “contract-based precautions,” see *supra* notes 24-44 and accompanying text, and recognized by Posner. See POSNER, *supra* note 2, at 102-09. The second argument ignores the importance of opportunism in contract cases, which is odd given Posner’s reliance on problems of opportunism and bilateral monopoly to explain many contract doctrines.

97. See *supra* note 2 and accompanying text.

98. See *Mitigation Principle*, *supra* note 1, at 968 n.5.

99. This aversion seems to be symptomatic of much Law and Economics scholarship, see, e.g., Jeffrey L. Harrison, *Trends and Traces: A Preliminary Evaluation of Economic Analysis in Contract Law*, 1988 ANN. SURV. AM. L. 73, 100-04 (1989), which is somewhat perplexing because some of the most innovative and powerful work in economics has involved the study of just such tradeoffs. See, e.g., ARROW, *supra* note 67, at 27 (explaining that “at any moment an individual is necessarily faced with a conflict between his individual desires and the demands of society”); ECONOMIC INSTITUTIONS, *supra* note 49; ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970); CHARLES E. LINDBLOM, POLITICS AND MARKETS (1977); ARTHUR M. OKUN, EQUALITY AND EFFICIENCY: THE BIG TRADEOFF (1975).

gether.¹⁰⁰ The alternative explanation is that the traditions are really indistinguishable on some fundamental level, and so there is no need to “combine” them. I argue in this section that both of these polar positions are incorrect. In my view, the two traditions are distinct: opportunistic behavior is more costly. But the traditions are not so divergent that they cannot be combined into a more unified approach that recognizes and accommodates the potential tradeoff between the goal of deterring opportunism and the goal of deterring negligence. I attempt such a combination in the next section.

The view that the least-cost-avoider and opportunism traditions are distinct and contradictory finds support in the close relationship between these two economic traditions and the two most prominent philosophical paradigms within contract law: freedom of contract and social regulation. The least-cost-avoider tradition strongly parallels the traditional idea of “freedom of contract.” The freedom of contract paradigm champions individualism. It views contracting parties as independent, self-reliant people, who consent to strict enforcement of all contractual terms agreed upon and no enforcement of terms not agreed upon.¹⁰¹ The necessary, though not often articulated, corollary of the freedom of contract paradigm is that it attributes contractual breakdowns to incompetence—the failure of one of the parties to act responsibly. If only this party had investigated, inspected, read, written, clarified, or insured, she would not be in the mess she is now in. Moreover, the assumption underlying this view is that it would have been relatively easy for the remiss contracting party to have taken these actions. Therefore, we should preserve her autonomy and encourage her (and others similarly situated) to be more responsible by putting the burden of liability on her. Expressed this way, freedom of contract echoes the least-cost-avoider tradition, with its emphasis on putting liability on the party in the best position to take precautions.

On the other hand, the opportunism tradition aligns more closely with the paradigm of contract law as a means of social control that fosters community ideals rather than individualism. The theme of this paradigm, which we might generically term “social regulation,” encompasses the ideas in contract law that contracting parties are inter-

100. See MARK KELMAN, *A GUIDE TO CRITICAL LEGAL STUDIES* 16-17 (1987). The term comes from Duncan Kennedy, *The Structure of Blackstone's Commentaries*, 28 *BUFF. L. REV.* 205, 211-13 (1979).

101. See, e.g., Kessler, *supra* note 3, at 3-6.

dependent, vulnerable people, who necessarily operate within a social system of widely shared norms and expectations. Under this paradigm, contractual breakdowns arise from the wrongful behavior—the violation of social norms—of one of the parties. What the parties in fact expected and did is more important in this view than what they might have done differently. Because it is difficult for someone to guard against the wrongful behavior of another, we should protect the victim by putting liability on the wrongdoer. This view parallels the opportunism tradition which focuses on deterring wrongful behavior.

Although drawing these parallels between economic perspectives and traditional paradigms highlights the distinction between the least-cost-avoider and opportunism approaches, it overlooks the strong similarities between the two approaches. These similarities suggest an alternative explanation for the failure to distinguish and combine the two traditions: economists find no meaningful difference between them.

For example, though it may appear that the two traditions view the purpose of contract law differently, this difference is largely illusory. The least-cost-avoider tradition seems to view law as a means to create desirable incentives for future behavior (deterrence),¹⁰² while the opportunism tradition seems to be more concerned with doing justice between the parties in this case (equity).¹⁰³ But this distinction between a “next case perspective” and a “this case perspective,” of which Law and Economics scholars¹⁰⁴ and practicing lawyers¹⁰⁵

102. See COSTS OF ACCIDENTS, *supra* note 8, at 26-27; Lewis A. Kornhauser, *The New Economic Analysis of Law: Legal Rules and Incentives*, in LAW AND ECONOMICS 27, 27-55 (Nicholas Mercuro ed., 1989).

103. *But see* Muris, *supra* note 50, at 526-27 (detailing four ways by which potential victims can reduce opportunism).

104. See, e.g., ROBERT E. SCOTT & DOUGLAS L. LESLIE, CONTRACT LAW AND THEORY 15 (1988) (noting a distinction between a “redistributive function” and a “behavior modification function” of contract law). This distinction may derive from the fact that lawyers and economists use the term “equity” differently. When economists speak of “equity” they usually refer to the distribution of income, whether in society at large or between two parties to a dispute. A decision based on equity, to an economist, is based solely on the respective economic positions of the parties, regardless of their conduct. To a lawyer, by contrast, equity most often refers either to how the parties behave toward each other (fairly or unfairly) or to a relaxing of seemingly inflexible legal rules in order to prevent some injustice. See, e.g., P.S. Atiyah, Book Review, 95 HARV. L. REV. 509, 524-25 (1981) (“Courts may rely on egalitarian values not in order to redistribute wealth between plaintiff and defendant, but to insist, for instance, that the defendant should treat this plaintiff in the same way he has treated other contracting parties.”); cf. Calabresi & Melamed, *supra* note 87, at 1093-1105 (broadly defining distributional concerns and “other justice reasons” as alternative goals to efficiency in the setting of entitlements). If one views equity this way, the “conflict” between

seem to be particularly fond, does not really differentiate the two traditions. The two traditions can both comfortably fit within the "next case perspective" of the economic approach to law. If the purpose of contract law is to develop legal rules that minimize transaction costs (or equivalently maximize the joint profits) of the contracting parties by creating incentives for future parties to engage in efficient contracting behavior, then negligence and opportunism can both be viewed as costly types of behavior that reduce the joint profits of the parties and therefore should be deterred.¹⁰⁶ Making opportunistic parties liable should deter future opportunistic behavior at least as much as (and perhaps more than) making negligent parties liable deters future negligent behavior.¹⁰⁷

Similarly, it may seem that the two traditions focus on different time frames. The least-cost-avoider tradition seems to take more of an *ex ante* perspective: the relevant time for decision-making by the parties is the time of contracting, when the parties can take precautions. In contrast, the opportunism tradition seems to take more of an *ex post* perspective: the relevant time of decision is after the parties have made sunk investments in the contractual relationship and the regret contingency has occurred, when the parties are most vulnerable to opportunistic behavior. It is true that the least-cost-avoider ap-

equity and efficiency becomes less apparent, unless efficiency, for some reason, usually requires strict adherence to legal rules. *Cf. id.* at 1090 n.4 (arguing that the reliance by the state on morality is efficient).

105. Consider the following statement from perhaps the opinion most beloved by Law and Economics scholars, *Boomer v. Atlantic Cement Co.*, 257 N.E.2d 870 (N.Y. 1970):

A court performs its essential function when it decides the rights of parties before it. Its decision of private controversies may sometimes greatly affect public issues. Large questions of law are often resolved by the manner in which private litigation is decided. But this is normally an incident to the court's main function to settle controversy. It is a rare exercise of judicial power to use a decision in private litigation as a purposeful mechanism to achieve direct public objectives greatly beyond the rights and interests before the court.

Id. at 871. Of course, the court then goes on to exercise judicial power in just such a way.

106. Both traditions may also be viewed as being concerned with the behavior of the parties in this case. Both traditions measure conduct against some external standard—the reasonable person in the least-cost-avoider tradition, and the agreed upon obligations or moral constraints in the opportunism tradition—to determine whether liability should be imposed. The important point is that the usefulness of the distinction is far from apparent.

107. It could be—and often is—argued that attempts to deter opportunistic behavior in the future are misguided because such rules will have unintended and costly consequences. This may be true, but this observation alone does not distinguish attempts to deter negligent behavior, which may also have unintended and costly consequences. Moreover, the observation ignores the fact that failing to deter opportunistic behavior may also have unintended and costly consequences.

proach developed in tort law, in which high *ex ante* transaction costs are the biggest problem, while the opportunism approach developed in contract law, in which high *ex post* transaction costs are the biggest problem.¹⁰⁸ But as I argued in the previous section, there is no necessary connection between negligence and *ex ante* behavior, or between opportunism and *ex post* behavior. Both negligent and opportunistic contracting behavior can occur at any time during the contracting process. Failure to mitigate can be viewed as *ex post* negligence, while fraud, misrepresentation, or incomplete disclosure can be viewed as *ex ante* opportunism.

Nor does it seem at first glance to be a meaningful difference that the least-cost-avoider tradition focuses on acts of omission—failure to take cost-effective precautions—while the opportunism tradition focuses on acts of commission—affirmative wrongdoing. On the one hand, contracting parties can take various precautions to protect against not only regret contingencies, but also opportunistic behavior. Although the opportunistic party can simply refrain from opportunistic behavior, the victim of opportunism can also protect herself through such devices as security deposits, progress payments, collateral, hostage-giving, and background checks.¹⁰⁹ We could easily deem the party who could take precautions more cheaply the “least-cost-avoider of opportunistic behavior.”¹¹⁰ On the other hand, negligently engaging in an activity without taking proper precautionary measures could be viewed as an affirmative (intentional) improper action, especially if the activity is repeated over time in the face of a known danger. At least in cases of gross negligence, a party expecting to be bailed out by the law could be characterized as opportunistic.¹¹¹

108. In fact, the key difference between contracts and torts may not be, as some economists have asserted, that contracts involve situations of low transaction costs and torts involve situations of high transaction costs. Compare POSNER, *supra* note 2, at 95 (contracts occur in a setting of low transaction costs) with *id.* at 164 (transaction costs in accidents are high). Rather it is that torts generally involve high *ex ante* transaction costs, while contracts generally involve high *ex post* transaction costs. As a result, the problem of opportunism is not usually seen as essential to tort law (at least unintentional torts) though it pervades contract law.

109. See ECONOMIC INSTITUTIONS, *supra* note 49, at 33-34; GOLDBERG, *supra* note 2, at 18-19; Kronman, *supra* note 69, at 9-24.

110. Victor Goldberg has suggested that in some cases we might want to impose a “duty not to be too vulnerable” and therefore not compensate a victim of opportunism in order to encourage precaution-taking. GOLDBERG, *supra* note 2, at 71. I take issue with this position in the next section.

111. This blurring of the distinction between opportunism and negligence often occurs in

Economists do not always recognize the similarities between negligent and opportunistic behavior, however. For example, economists are often quick to point out that market forces tend to diminish the threat of opportunism. In a competitive market, a firm that gets a reputation for opportunism will not keep its customers and suppliers for very long.¹¹² But the same could be said about negligent contracting behavior. Incompetent firms would not seem to have any better chance of holding onto their customers or suppliers than sleazy firms. In fact, in some cases the brand of incompetence might be worse. The business world often seems to admire undetected and successful sleazy behavior; not so, incompetence.¹¹³

Economists also emphasize the ability of parties to contract around legal rules as a justification for nonintervention to remedy opportunistic behavior. This argument typically appears in discussions of unconscionable contract terms. But once the focus shifts from the harshness of the term or the poverty of the bargainer—substantive unconscionability—to the *conduct* of exploiting an unexpected term—procedural unconscionability¹¹⁴—it is no longer clear why a

the area of product liability, which explains in terms of the theory presented here the usual characterization of this area of law as lying "on the border" between contract and tort.

112. The so-called reputation effect argument has been recognized at least since the time of Plato when Socrates made the point while defending himself at his trial. See Plato, *The Apology*, reprinted in *THE LAST DAYS OF SOCRATES* 43, 55-56 (Hugh Tredennick ed., 1969).

113. In a recent article, two Harvard Business School professors argue that reputation is not a very effective deterrent of opportunistic behavior. See Amar Bhide & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay*, HARV. BUS. REV., Sept.-Oct., 1990, at 121. They argue (in my view convincingly) that reputation often fails as a mechanism for enforcing trust. First, the benefits of doing business with powerful opportunistic parties are too great to pass up. *Id.* at 123. Second, "cognitive inertia" often leads business people to search for reasons to trust and ignore conflicting evidence. *Id.* at 124. Third, it is often difficult to know with sufficient certainty that the other side has been opportunistic in the past. *Id.* at 125. And finally, business people believe that a leopard can change its spots.

Nevertheless, the authors argue that most business people are honest most of the time because their personal morality leads them to be that way. Moreover, to the extent that opportunism does exist, the authors argue that we should not worry about it because to punish opportunism too frequently and too harshly diminishes the value of honesty, dampens entrepreneurial risk taking, and hinders efficient adjustment to changed circumstances. I find the assertion that most business people are not opportunistic implausible in the context of litigation. I also find the "best of all possible worlds" mentality disturbing. Surely one of the purposes of law is to encourage us to do better, to move us toward a better society, not simply to let us shrug our shoulders at the wrongdoers of the world. See Robert M. Cover, *The Supreme Court, 1982 Term—Foreword: Nomos and Narrative*, 97 HARV. L. REV. 4, 9 (1983) ("Law may be viewed as a system of tension or a bridge linking a concept of a reality to an imagined alternative . . .").

114. See Arthur A. Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 487 (1967).

party held liable for opportunistic behavior would be any more likely to contract explicitly for the right to be opportunistic than a party held liable for negligent behavior would be to contract for the right to be negligent.

As these examples show, the similarities between the two traditions can explain, only in part, the failure of economists to explore the relationship between them. The failure seems to stem as much from a tendency among economists to underestimate the importance of opportunistic behavior. Professor Williamson has repeatedly noted this tendency.¹¹⁵ Another example of this tendency that Professor Williamson discusses is the use of the term "moral hazard." Economists often define moral hazard as the decreased incentive of an insured party to take precautions,¹¹⁶ which comports with the least-cost-avoider approach. Economists use the concept of moral hazard, so defined, to argue for example that strict liability in tort, which fully insures a victim, is inefficient, absent a contributory negligence defense or its equivalent, because it decreases the incentive for the victim to take precautions.¹¹⁷ In contract law, moral hazard can help explain why reliance and consequential damages, which fully insure the promisee, are often inefficient: they decrease the incentive of a promisee to take precautions against breach by tempering reliance. But moral hazard can also be viewed more broadly to include an ex post fabrication of losses or coverage: if one is insured against a particular kind of loss, one has the incentive to define any loss suffered to fall within the coverage of the insurance policy and to exaggerate the extent of loss.¹¹⁸

115. See, e.g. ECONOMIC INSTITUTIONS, *supra* note 49, at 65 (arguing that "[t]he study of contract doctrine . . . still relies . . . almost entirely on assumptions of differential risk aversion, concerns over the hazards of opportunism having been suppressed").

116. See, e.g., POLINSKY, *supra* note 12, at 54; Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 531, 535 (1968) (defining moral hazard as the tendency of insurance to increase usage of care by lowering the cost of care, and distinguishing "outright fraud" and "moral perfidy"); cf. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 65-66 (1988) (distinguishing the "extreme example" of an insured's incentive to burn his home from the "more realistic example" of an insured's failure to take precautions against his car being stolen).

117. See COOTER & ULEN, *supra* note 116, at 65-66.

118. See ECONOMIC INSTITUTIONS, *supra* note 49, at 51 n.8 (explaining his reluctance to use the term "moral hazard" because it "does not ordinarily elicit sensitivity to the full set of *ex ante* and *ex post* efforts to lie, cheat, steal, mislead, disguise, obfuscate, feign, distort, and confuse"). Kenneth Arrow has also stressed a broader notion of moral hazard. See ARROW, *supra* note 67, at 36 (including arson as a type of moral hazard response to fire insurance); Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV.

Although both forms of activity could be viewed as moral hazard, Williamson suggests that the two types of behavior—inadvertent and intentional—are meaningfully different.¹¹⁹ The question is how. The simple (perhaps overly simplistic) economic answer is that “opportunistic” is a label we place on a category of activity that we believe imposes relatively higher “social costs” than the category of activity we label “negligent.”¹²⁰

Opportunistic behavior produces no social benefits; instead of adding to the net wealth of society it merely redistributes wealth from one party to another.¹²¹ Because opportunistic behavior, like criminal activity, violates social norms, any private gains to the opportunistic party must be excluded from the social calculus.¹²² Investments

537, 538 (1968).

119. Moral philosophers would agree. See, e.g., SISSELA BOK, *LYING: MORAL CHOICE IN PUBLIC AND PRIVATE LIFE* 8 (1978) (“We must single out, therefore, from the countless ways in which we blunder misinformed through life, that which is done with the *intention to mislead*; and from the countless partial stabs at truth, those which are intended to be truthful.”).

120. Economists distinguish “social costs” from “private costs.” Each type of cost is an opportunity cost, that is, a “benefit foregone by employing a resource in a way that denies its use to someone else,” POSNER, *supra* note 2, at 6. A private cost is a benefit foregone by an individual resource user. A social cost is a benefit foregone by society from the use of a resource. A resource owner in deciding whether and how to use a resource may consider only private costs, that is the best alternative use to which *she* may put the resource. She may not consider the social costs, that is the alternative uses to which *others* may put the resource. See RICHARD G. LIPSEY & PETER O. STEINER, *ECONOMICS* 255 (4th ed. 1975). Law and Economics is largely about the role of the law in transforming social costs—such as accidents, pollution, breaches, and crimes—into private costs. In fact, the Coase Theorem is nothing more than an argument that in a world of zero transaction costs, many social costs become private costs even without legal intervention once one recognizes that potential “bribes” from a non-entitlement-holder can be viewed as foregone resources.

121. That is not to say that all redistribution of wealth is undesirable, even among individuals, but merely that there is no reason to presume that a redistribution by one individual solely to enrich himself at the expense of another is likely to achieve any social goal.

122. See Jeff L. Lewin & William N. Trumbull, *The Social Value of Crime?*, 10 INT’L REV. L. & ECON. 271 (1990):

[T]he total exclusion of criminal gains would appear to be mandated by prevailing social norms. If one accepts the premise that welfare economics must rest on an ethical foundation beyond pure utilitarianism, we believe that there exists a broad consensus in support of the proposition that criminal gains should not be counted in welfare economics. The term “criminal” represents an implicit societal judgment that the conduct has no social value.

Id. at 280 (footnote omitted). The same could be said about opportunistic contractual behavior. See COOTER & ULEN, *supra* note 116, at 252 n.2 (discussing coercion and duress in contract law and stating that “widely held community norms” require “ignoring the possibility that the threat-maker derives utility simply from the act of making a threat or of bullying others”).

in opportunistic behavior and in taking precautions against such behavior can therefore be viewed as "deadweight losses," that is, decreases in society's total wealth.¹²³

In contrast, negligence can be viewed as an unintended and inevitable byproduct of potentially productive activity.¹²⁴ To borrow from the antitrust field, negligent behavior is usually "ancillary" to some desirable behavior, while opportunism is "naked" coercion.¹²⁵ The costs of negligent behavior must therefore be offset against this wealth-producing potential, while there is no such offset against the costs of opportunistic behavior.¹²⁶ As a result, the relative social cost (foregone social benefit) of negligent activity is likely to be smaller than the social cost of opportunistic behavior.¹²⁷

Put another way, the social costs of avoiding opportunistic behavior are lower than the social costs of avoiding negligent behavior. Thus, as between an opportunistic and a negligent party, the opportunistic party is always the least-cost-avoider.¹²⁸ The social (though not private) cost of precaution against opportunism is zero. An opportunistic party can simply refrain from opportunistic behavior, usually

123. Judge Posner in his treatise describes coercive transfers as those that occur in situations of low transaction costs, and do not lead to value-maximizing exchanges. See POSNER, *supra* note 2, at 109-10 (fraud), 113 (duress), 208 (intentional torts), 231-32 (common law crimes); see also COOTER & ULEN, *supra* note 116, at 252 (defining coerced exchange as a "trade extracted under the threat to destroy existing value"). In my view, all opportunistic behavior, not merely these more blatant forms of coercion, can usefully be described this way. It is not clear whether or how Posner differentiates "coercive" from "opportunistic" behavior.

124. By "unintended" I mean with some probability less than "substantial certainty," to use traditional torts jargon. See W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 8, at 36 (5th ed. 1984). By "inevitable" I mean that the probability is greater than zero so that if the activity is repeated over time an accident will occur.

125. See *United States v. Addyston Pipe & Steel Co.*, 85 F. 271, 283 (6th Cir. 1898) (Taft, J.), *aff'd*, 175 U.S. 211 (1899). The fact that opportunism may be "subtle," that is, difficult to detect, does not make it any less "naked" than price fixing that is difficult to detect.

126. Note again that "oppressive" contract terms, unless they are also unexpected, are not "opportunistic" and do in many cases have ancillary benefits such as reduced costs due to standardization.

127. Negligent activity is therefore more similar to activity we label "pollution" or "competition" than activity we label "crime"; that is, it represents activity for which we are willing to weigh the benefits to the "wrongdoer" against the costs to the "victim."

128. See POSNER, *supra* note 2, at 112 (fraud is unlawful even if the buyer could unmask the lie at very low cost), 173 (a landowner is not liable for negligent injuries to trespassers because the accident could have been prevented at lower cost by the trespasser by not trespassing), 210 (contributory negligence is not a defense to an intentional tort because the cost of avoidance is lower to the injurer). Recall that the least-cost-avoider concept is justifiable in these "alternative care" cases. See *supra* note 23.

at no loss in social wealth, by substituting market transactions that effect the same transfer of resources. We prefer that people use the market when that is feasible: they should buy cars rather than steal them; they should bargain explicitly for desired contract terms rather than sneak them in.¹²⁹ The market assures that bargains transfer resources from lower to higher-valued uses.¹³⁰

The availability of cheap alternatives explains in part why we tend to care more about deterring opportunistic behavior itself than about encouraging victims to take precautions against opportunism. The law has always recognized this priority, at least implicitly, in its development of "equity" jurisprudence.¹³¹ In particular, the negligence of the victim does not usually result in liability for victims of fraud, trespass, intentional tort, or crime.¹³²

In contrast, the social costs of precautions against negligence are always positive and may be quite high.¹³³ In the extreme case, the cost of eliminating negligent behavior may be the elimination of the accompanying productive activity.¹³⁴ Activity we label negligence,

129. Professors Haddock, McChesney, and Spiegel refer to conduct that forgoes consensual exchange in favor of socially costly takings as "contractual bypass," which they argue justifies punitive sanctions. See Haddock et al., *supra* note 55, at 18, 27, 32, 50.

130. See COOTER & ULEN, *supra* note 116, at 254-55.

131. See Roscoe Pound, Note, *Liberty of Contract*, 18 YALE L.J. 454 (1909):

It has been said that the common law will not help a fool. But equity exists to help and protect him. It is because there are fools to be defrauded and imposed upon, and unfortunates to meet with accidents and careless to make mistakes, that we have courts of equity.

Id. at 483.

132. An unfortunate and manifestly unjust exception to this principle is the law governing rape. See generally Susan Estrich, *Rape*, 95 YALE L.J. 1087, 1094 (1986) (arguing that "in striking contrast to [other common law crimes] . . . courts . . . have focused almost incidentally on the defendant—and almost entirely on the victim"), 1162 (arguing that "notions of male entitlement and female contributory fault . . . are at the core of the common law tradition"). For example, "the conclusion that no force is present may emerge as a judgment not that the man did not act unreasonably, but as a judgment that the woman victim did." *Id.* at 1112. In contrast to rape, for other crimes such as false pretenses, carelessness of the victim is no defense. See *id.* at 1119 & n.91. In rape law, "the definition of nonconsent requires victims of rape, unlike victims of any other crime, to demonstrate their 'wishes' through physical resistance." *Id.* at 1122. Professor Estrich notes at several points the lapses in precautions for which courts and juries have faulted women: "hitchhiking, dating, and talking to men at parties," *id.* at 1173; agreeing to "drinks, rides or dates, or fail[ing] to react strongly enough to sexual suggestions and overtures," *id.* at 1178 n.318.

133. See generally COSTS OF ACCIDENTS, *supra* note 8, at 198-226 (discussing the costs associated with reducing accidents).

134. Of course, at a certain point, the costs of precaution become so high relative to the expected losses associated with the regret contingency that we would cease to label the failure to take precautions "negligence." While such "unavoidable accidents" may be common

moreover, often occurs in situations of high transaction costs in which substitute market transactions are not cheap alternatives, or at least are not deliberately bypassed.¹³⁵

There is another crucial sense in which opportunism is more costly behavior than negligence. Opportunistic behavior imposes higher costs on third parties—has greater spillover effects—than does negligent behavior. Sissela Bok's warning about the contagious harms of lying applies equally to other forms of opportunistic contracting behavior:

These practices clearly do not affect only isolated individuals. The veneer of social trust is often thin. As lies spread—by imitation, or in retaliation, or to forestall suspected deception—trust is damaged. Yet trust is a social good to be protected just as much as the air we breathe and the water we drink. When it is damaged, the community as a whole suffers; and when it is destroyed, societies falter and collapse.¹³⁶

Economists too have recognized that trust is an extremely valuable and vulnerable resource, which the market alone cannot be counted on to supply.¹³⁷ Trust is essentially a conscious decision not to take precautions or other preemptive action in the face of potential opportunism because of a belief that such opportunism will not in fact occur. If opportunism does occur, and goes unpunished or minimally punished, contracting parties will adjust their beliefs about the likelihood of opportunism in the future; trust will diminish, parties will spend more resources on various precautionary and insurance devices, and will invest more in engaging in opportunistic behavior, whether because it is now cheaper or viewed as more acceptable. By damaging trust beyond the existing transaction, therefore, opportunistic behavior imposes large social costs.¹³⁸

in contracts cases, I have my doubts, and am therefore focusing on what is at least an important class of cases in which we want at least one of the parties to alter her future behavior because she can do so at relatively low cost.

135. An example that arises in contracts cases is a mistaken bid submitted at the last minute.

136. BOK, *supra* note 119, at 26.

137. See ARROW, *supra* note 67, at 23; POSNER, *supra* note 2, at 261-62.

138. Cooter and Ulen make essentially the same argument to show that criminal sanctions, rather than simply compensatory damages, are economically desirable if a driver intentionally runs down a victim:

If there were no criminal prosecution, fear of being intentionally hit by drivers might spread among pedestrians. The spread of fear among pedestrians is a loss of peace and security, and because those are public goods, it is appropriate that the

Although unpunished negligent behavior in one context may also result in third party effects—that is, lead to more carelessness or increased defensive precautions in general—this result is less likely for several reasons. First, even if negligent behavior is punished, people do not “trust” others to be careful to the same degree that people trust others to be honorable, because people realize that even if others are generally careful, some negligence is inevitable.¹³⁹ Thus, a failure to punish negligence in a particular case would lead to fewer *additional* precautions than a failure to punish opportunism. Second, an individual is more likely to be hurt by his own carelessness than by his own opportunistic behavior, and thus may have private incentives to take at least self-protecting precautions even if negligence is legally tolerated. Finally, even though the fear of increased carelessness in others will engender more precaution-taking to prevent falling victim to this carelessness, these precautions by potential victims, unlike precautions against opportunism, may in fact be efficient.

Differentiating negligence from opportunism on the basis of the relative social costs associated with each activity is helpful. Nevertheless, we should not feel too comfortable with this somewhat pat distinction, as we should not with any legal category. In certain cases, the private costs of avoiding opportunistic behavior for an individual contractor may be so high that we want to “count” the benefits the individual receives from that behavior in deciding whether and how much to punish it. For example, we might want to treat a poor thief stealing necessities differently from other thieves.¹⁴⁰ On the other hand, the opportunity costs of foregoing negligent behavior might be extremely low (action we label “gross” negligence, for example). But we should not be overly pessimistic either. Categories can be useful if we maintain a healthy skepticism toward them and remember the reasons for creating them. The point I have tried to stress here is that the negligence and opportunism traditions are neither incompatible nor

state should take an interest in punishing those who spread fear and insecurity. COOTER & ULEN, *supra* note 116, at 512. It is somewhat surprising that Cooter and Ulen do not make the same point about trust in their chapter on contract law.

139. See POSNER, *supra* note 2, at 175 (noting that everyone is occasionally negligent because the cost of reducing to zero the probability of negligent behavior is too high). The admonition of “drive defensively” is perhaps the best example of this phenomenon.

140. The Law and Economics literature has struggled mightily with the question of whether and when the benefits to a wrongdoer should “count” in the social calculus. See generally Lewin & Trumbull, *supra* note 122.

identical; thus, combining them is neither impossible nor inconsequential.

B. The Traditions Combined

In combining the least-cost-avoider and opportunism traditions, we may delineate three classes of cases. In two of the classes the traditions do not conflict, and so there is no problem combining them. In the third class, the traditions do conflict and present what I term the negligence-opportunism tradeoff. For this class of cases, I advocate giving a presumptive priority to deterring opportunism.

1. Cases Involving Only Negligence or Opportunism

The first class of cases includes those that present problems predominantly of negligence or opportunism, but not both.¹⁴¹ For example, in deciding which party should bear the loss associated with a mistaken transmission, identifying the least-cost-avoider—who could have taken precautions most cheaply—may be much more important than trying to identify opportunistic behavior. If a mistake or misunderstanding is truly an “accident,” it could be that neither party is behaving opportunistically.¹⁴² On the other hand, if the issue is whether or not a quantity variation in an output or requirements contract was made in “good faith,” articulating precautions the parties could have taken *ex ante* may be less useful than isolating the parties’ reasonable expectations and identifying which party is acting contrary to those expectations *ex post*. There may be precautions that could be taken in such a case—insurance or more detailed provisions, for example—but these precautions may be exceedingly costly or it may not be obvious which party is in a better position to take them. If a class of cases involving only negligence or opportunism exists (and I am somewhat skeptical), then there is certainly no difficulty in

141. Another possible category is contract disputes involving neither opportunism nor negligence. These “unavoidable accident” cases are in my view rare, or at least economically uninteresting because if they really exist, then any outcome in the case would have no effect on future contracting behavior. One may view cases in which the defense of impracticability or one of its variants is successfully invoked as examples of this class, but even here there are precautionary measures (such as insuring) that we want to encourage parties to take. I will therefore not pursue this class further.

142. In addition, absent the potential for opportunistic behavior, one could argue that damages should be limited to “reliance” damages. That is, the case should be treated as a “tort” case rather than as a “contract” case. This is not because the case is not “really” a contract case, but because there is no need to deter the behavior that is the primary concern of contract doctrine—opportunism.

combining the two approaches, because one of the two approaches predominates and the other can be safely ignored. I will not stop to debate whether or not this set of cases is empty, because even if it is not, it poses no threat to a unified theory.

2. Cases in Which the Least-Cost-Avoider and the Most-Likely-Opportunist Are the Same Party

A second class of cases also poses no threat to a unified theory, but unlike the first class, it generates some useful insights. These are cases in which the least-cost-avoider and the most-likely-opportunist are one and the same. In such cases, the two traditions are complementary rather than contradictory, and therefore there is again no need to choose between them. This class of cases serves as a counterexample to the Critical Legal Studies assertion of a "fundamental contradiction" to the extent that the assertion is that a contradiction must necessarily exist in every case. It also supports the view that there are such things as "easy cases," if by such a term we mean cases in which identifiable values or purposes that often conflict do not do so.¹⁴³

As an example of this class of cases, consider the objective theory of contracts. This theory maintains that courts should determine contractual intent based on the objective "manifestations" of the parties rather than what they were subjectively thinking at the time.¹⁴⁴ Such a theory can be justified under either the least-cost-avoider or the opportunism traditions. Under the least-cost-avoider tradition, we want to encourage parties who seek to override "normal" expectations to take precautions in clarifying intent. We also want to discourage negligent promissory activity.¹⁴⁵ Therefore, we put liability on the idiosyncratic party or the party who acts as if she intends

143. See Lon L. Fuller, *Positivism and Fidelity to Law—A Reply to Professor Hart*, 71 HARV. L. REV. 630 (1958). Professor Fuller endorses a similar explanation of "easy cases" as those in which several possible purposes of a legal rule are satisfied by interpreting the rule in a particular way: "If the rule excluding vehicles from parks seems easy to apply in some cases, I submit this is because . . . whether the rule be intended to preserve quiet in the park, or to save carefree strollers from injury, we know, 'without thinking,' that a noisy automobile must be excluded." *Id.* at 663; cf. Ronald Dworkin, *Hard Cases*, 88 HARV. L. REV. 1057, 1060 (1975) (defining hard cases as those for which "no settled rule dictates a decision either way").

144. See THE ECONOMICS OF CONTRACT LAW 4-5 (Anthony T. Kronman & Richard A. Posner eds., 1979).

145. Some have viewed this as the only legitimate justification for the objective theory. See, e.g., Clarke B. Whittier, *The Restatement of Contracts and Mutual Assent*, 17 CAL. L. REV. 441, 443 (1929).

to contract even if she does not really want to. Less obviously, perhaps, the opportunism tradition, which aims to deter contracting behavior that runs counter to the parties' expectations or conventional morality, also supports the objective theory.¹⁴⁶ We do not allow a party to deny contractual obligation on the ground that she did not subjectively intend to bind herself, not only because she might have been negligent or idiosyncratic, but also because the chances are good that such a person is lying.¹⁴⁷ Put another way, under a subjective theory of contractual intent, the potential for opportunistic behavior is great.¹⁴⁸

The idea that the objective theory can be justified under either of the two traditions may not seem all that illuminating.¹⁴⁹ But the interesting insight one can glean from combining the two traditions is that the justification for the objective theory is strongest when the two traditions converge in suggesting that liability be placed on the

146. Law and Economics scholars tend to justify the objective theory with reference to some variant of the least-cost-avoider theory. Curiously, they tend to omit any reference to the potential for opportunism or bad faith on the part of the promisor. See SCOTT & LESLIE, *supra* note 104, at 26-28; THE ECONOMICS OF LAW, *supra* note 144, at 5.

147. The party denying subjective intent may be engaging in either ex ante opportunism—she never intended to go through with the promise—or ex post opportunism—she originally did intend to go through with the promise, but now finds it convenient not to do so.

148. Judge Hand's famous explanation of the objective theory in *Hotchkiss v. National City Bank of New York*, 200 F. 287 (S.D.N.Y. 1911), is not necessarily inconsistent with this view. Hand stated:

A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. A contract is an obligation attached by the mere force of law to certain acts of the parties, usually words, which ordinarily accompany and represent a known intent. If, however, it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes upon them, he would still be held, unless there were some mutual mistake, or something else of the sort.

Id. at 293. Hand's statement might simply mean that in the absence of any opportunism, there is still a justification for the objective theory, based on the least-cost-avoider idea of putting the burden on the idiosyncratic bargainer to clarify intent. Such a case would fall within the first class previously discussed. The real question is not what would happen if twenty bishops proved that either party truthfully believed his own interpretation, but rather what would happen if the bishops proved that either party knew what the other's expectation was and was lying now in denying this understanding. If Hand would still hold such testimony irrelevant, his position is inconsistent with the theory advanced in the text.

149. It might be more illuminating in other areas of the law, such as procedure. Consider the rule that prohibits a defendant from proving at trial a defense not pleaded. See FLEMING JAMES, JR. & GEOFFREY C. HAZARD, JR., CIVIL PROCEDURE § 4.7 (3d ed. 1985). Such a rule might be justified not only to deter negligence on the part of the defendant, but also because of the potential opportunism involved in making such a claim at such a late date.

party asserting a subjective intent different from her objective manifestations. The cases in which the least-cost-avoider or the more-probable-opportunist is not the promisor denying objectively manifested contractual intent, are precisely those cases in which the objective theory has come under the greatest criticism. For example, suppose both parties share an unusual understanding of a contractual term even though such an understanding is "objectively" unreasonable. In this case, the party relying on the "objective" manifestation would be the opportunistic party and perhaps the least-cost-avoider as well, because at least within that contractual relationship she was the idiosyncratic party who should have signaled a different meaning. Thus, although there may be good reasons for disregarding subjective intent to enter into a contract, subjective intent should always be relevant to the question of why a party wants to get out of a contract.

A second example of a contract doctrine that is most defensible when the two traditions converge is the general rule that unilateral mistake is less likely to be excused than mutual mistake.¹⁵⁰ The traditional Law and Economics defense of this rule, given by Kronman, relies on the least-cost-avoider tradition.¹⁵¹ If the mistake is unilateral, it is likely that the mistaken party is the least cost information gatherer.¹⁵² The inference is weaker if the mistake is mutual. But the unilateral mistake doctrine also makes sense under the opportunism approach because if the mistake is unilateral, it is more likely that the party claiming mistake was not really mistaken at all but is simply trying to rewrite the contract. In contrast, if both parties are mistaken about the same fact, the mistake is in some sense objectively verified; it is less likely the mistaken party is making up the mistake to get out of a bad deal. The distinction between unilateral and mutual mistake becomes more controversial when it appears the non-mistaken party was acting opportunistically.

The insights gained from the complementary use of the two traditions need not only be used to support existing contract doctrines, but can also be used to critique them. A good example is *Peevyhouse*

150. See Kronman, *supra* note 5, at 5 ("[I]t is still 'black letter law' that a promisor whose mistake is not shared by the other party is less likely to be relieved of his duty to perform than a promisor whose mistake happens to be mutual.").

151. *Id.* at 5-8.

152. The mistaken party is not always the least-cost-avoider; the presumption is rebuttable. The Restatement does provide for excuse for unilateral mistake if "the other party . . . had reason to know of the mistake . . . or where his fault caused the mistake." RESTATEMENT (SECOND) OF CONTRACTS § 153 cmt. a (1981).

v. *Garland Coal & Mining Co.*¹⁵³ In that case, a mining company promised to restore a farmer's land to its prior condition—apparently at the farmer's insistence—in return for being allowed to strip-mine the land. The mining company breached the promise and the Supreme Court of Oklahoma awarded damages based only on the diminution in value of the land rather than on the cost of completion. Although the case has been frequently discussed and criticized, the point here is that the critique is strongest if one believes—as I happen to—that the mining company was both the least-cost-avoider and the most-likely-opportunist. The farmer apparently (according to the facts presented by the dissent) took the precaution of making his idiosyncratic preferences regarding his land known at the outset;¹⁵⁴ it is not clear what other precautions the farmer could have taken.¹⁵⁵ On the other hand, it seems that the mining company might not have made an adequate inquiry into the feasibility and cost of going through with its promise, and therefore could easily be viewed as the more negligent party. Moreover, if the mining company found out about the cost of restoration in the middle of the contract, it may have negligently failed to mitigate the damages to the farmer.

As for opportunism, while the farmer might have been exaggerating the value of his farm *ex post* and simply might have been looking for a windfall damage award, the fact that the farmer insisted on restoration at the beginning and the fact that the farm might have been a business, as well as a residence, supports the view that the farmer was not behaving opportunistically.¹⁵⁶ In contrast, it is plau-

153. 382 P.2d 109 (Okla. 1962), *cert. denied*, 375 U.S. 906 (1963).

154. *Peevyhouse*, 382 P.2d at 115-16.

155. *Id.*; Ayres & Gertner, *supra* note 2, at 121-23.

156. On this point, *Peevyhouse* can be usefully contrasted (as it often is) with *Groves v. John Wunder Co.*, 286 N.W. 235 (Minn. 1939), another case involving a breach of a promise to restore land. In that case, the likelihood of opportunistic behavior by the landowner was greater: there was no reason to think there was any subjective value over and above the commercial value of the land; the landowner had not specifically insisted on the restoration clause but may have simply been interested in shifting the risk of falling land values due to the Depression; and apparently the landowner never did the restoration work, but simply pocketed the money. See JOHN P. DAWSON ET AL., *CASES AND COMMENT ON CONTRACTS* 17-18 (4th ed. 1982).

One might be able to infer opportunism on the part of the plaintiffs in both cases from the fact that they sought damages rather than specific performance. See POSNER, *supra* note 2, at 109, 120; cf. Albert L. Nichols & Richard J. Zeckhauser, *Targeting Transfers through Restrictions on Recipients*, 72 AM. ECON. REV. PAPERS & PROC. 372, 374-76 (1982) (arguing that in-kind transfers—which are analogous to specific performance—are sometimes preferable to cash transfers because individuals may lie about their qualifications to get cash but will not be willing to incur the costs associated with in-kind transfers). But according to

sible that the mining company from the beginning never had any intention of going through with its promise, though some have questioned this possibility.¹⁵⁷ But if, as I have argued, the notion of opportunistic behavior should be extended beyond simple ex ante fraud, the likelihood that the mining company was behaving opportunistically ex post is even stronger. If at any point during performance the mining company had discovered the true cost of restoration, its incentive might have been not to tell the farmer immediately, but to continue mining and postpone the bad news until the mining company had reaped its full benefit. Perhaps the mining company thought that by running up the cost of restoration, it could later be in a better position to convince a court to be sympathetic to its (self-imposed) predicament, though this strategy might be a risky one.

3. The Negligence-Opportunism Tradeoff

It should be apparent that the most interesting and difficult class of cases involves a conflict between the two traditions. When it appears that one contracting party is the least-cost-avoider and the other is the most-probable-opportunist, the court must choose between deterring negligence and deterring opportunism.¹⁵⁸ It cannot do both si-

Professor Judith Maute, who has done extensive research into the background of the *Peevyhouse* case, one more innocent explanation of why the *Peevyhouses* did not seek specific performance was that their lawyer was predominantly a tort lawyer used to working on a contingency fee. Judith L. Maute, *Peevyhouse v. Gardard Coal Co. Revisited: The Ballad of Willie and Lucille* (forthcoming) (This decision by the lawyer might not have been innocent, however; in fact, the lawyer may have been acting opportunistically toward his clients).

157. See LON L. FULLER & MELVIN A. EISENBERG, *BASIC CONTRACT LAW* 218-19 (5th ed. 1990) (quoting unpublished materials of Richard Danzig).

158. Goetz and Scott note a similar tradeoff in their article on mitigation rules, but there is an important difference. They argue that in cases involving mitigation, an unconditional right of specific performance would reduce "evasion costs" (opportunistic behavior by the promisor), but increase the cost of "autonomous readjustment" (the costs arising from the fact that the promisee may be the least-cost-mitigator). Thus, the need to deter opportunism (evasion) must be balanced against the need to foster efficient mitigation (readjustment), or deter negligent failures to mitigate. See *Mitigation Principle*, *supra* note 1, at 978. The difference between their approach and mine is that they focus on balancing the opportunism of a particular party (the promisor) against the negligence of the other party (the promisee), while I prefer to talk about balancing opportunism and negligence in general, recognizing that either party may be opportunistic or negligent. The significance of this difference is that in my view, specific performance is an inadequate solution not only because it may lead to inefficient mitigation by the promisee, but also because it may lead to opportunism by the promisee. Goetz and Scott do address the problem of promisee opportunism later in their article, see *id.* at 982-83, but they do not explicitly address the same tradeoff I analyze in the text.

multaneously in a single case of this type.¹⁵⁹ The question is how to handle these cases, the so-called “hard cases.”

Professor Goldberg has termed a version of this conflict the “Boomer problem,”¹⁶⁰ after the famous case of *Boomer v. Atlantic Cement Co.*¹⁶¹ In that case, residents sued a cement factory alleging that pollution from the factory was a nuisance. Although the court found a nuisance, it did not award the plaintiffs an injunction (the typical relief), but limited their remedy to damages.¹⁶² Law and Economics scholars typically defend this decision because of the potential for opportunistic behavior by the residents—holding out for large payments for the entitlement to pollute—that an injunction would create.¹⁶³ Goldberg argues that the damage remedy is also flawed because it may fail to give the correct ex ante incentives to future firms considering whether to build factories: they might fail to take cost-justified “precautions” such as investigating alternative low-cost locations or negotiating with residents before building the plant.¹⁶⁴ Thus, we have a conflict between potentially opportunistic parties—the residents—and an arguably negligent but possibly opportunistic party—the factory.¹⁶⁵ Goldberg does not offer a definitive resolution of the conflict, though he does suggest that “the likelihood that an injunction would be granted to Boomer might be greater if Atlantic simply built first and asked questions later [i.e. was opportunistic] rather than making a good-faith, but erroneous, projection of the magnitude of the pollution problem [i.e. was negligent].”¹⁶⁶ I will try to elaborate on Goldberg’s insight—the reason the conflict

159. In the neat world of economic modeling, both would be deterred in the long run. As in tort cases, punishing the least-cost-avoider would lead all future similarly situated parties to take cost-justified precautions and avoid liability, so the contributorily negligent (here opportunistic) party would also have an incentive to take cost-justified precautions to minimize the losses he would have to bear. See *Model of Precaution*, *supra* note 5, at 5-11.

160. Victor P. Goldberg, *Relational Exchange, Contract Law, and the Boomer Problem*, in GOLDBERG, *supra* note 2, at 69-71, 126-27.

161. 257 N.E.2d 870 (N.Y. 1970).

162. *Id.* at 875.

163. Goldberg, *supra* note 160, at 69.

164. *Id.* at 70.

165. Economists argue that the damage remedy leads to efficient ex ante incentives if courts accurately measure damages; if courts underestimate damages, too many factories will be built. See, e.g., POLINSKY, *supra* note 12, at 23. But efficient ex ante incentives also require that the factory have perfect knowledge of the actual damages and the court’s remedy. Underestimation by the factory of its expected losses could also lead to too many factories being built.

166. Goldberg, *supra* note 160, at 71.

occurs matters—in the remainder of this section.

To analyze the tradeoff between negligence and opportunism, we must first return to the goal of the economic approach to law, which is to minimize joint costs. I have already argued that opportunism is more costly behavior than negligence. Therefore, deterring opportunism must take priority over deterring negligence; when one party is the least-cost-avoider and the other is the most-probable-opportunist, the latter should lose. But, as is often the case in law, matters are not so simple.

In particular, we must consider that sometime annoying, sometime convenient, *deus ex machina* in Law and Economics—administrative costs. If the court system is institutionally better equipped to detect and deter negligent behavior than opportunistic behavior, then perhaps opportunism should be downplayed in contract doctrine, except in its more blatant varieties. Both Williamson¹⁶⁷ and Posner,¹⁶⁸ as well as traditional contract doctrine, can be read as implicitly supporting this view. I want to argue here that this view is wrong. Placing a priority on deterring opportunism, and making that priority more explicit would in fact reduce administrative costs in many cases.

One possible argument against giving priority to deterring opportunism is that opportunistic behavior is often difficult to detect.¹⁶⁹ Courts may not be able to determine with any certainty the parties' expectations, contractual norms, or conventional morality; moreover, opportunistic parties have every incentive to hide their indiscretions or concoct post hoc justifications for this conduct. It is true that opportunistic behavior is often subtle, and that it often appears in cases that either party (or both) could be acting opportunistically. Of course, if a court cannot decide who the most-probable-opportunist is, but it can decide who the least-cost-avoider is, it would make sense for the court to place the liability on the least-cost-avoider because it is more certain of that judgment. But there are also cases in which either party (or both) could be characterized as negligent, while one party is more likely opportunistic. In such a case, a court should place liability on the opportunistic party.¹⁷⁰ Punishing the behavior of which the

167. See, e.g., Williamson et al., *supra* note 49, at 258-59 (1975).

168. "The law of contracts . . . enforces only a limited subset of promises; many morally objectionable breaches of promise give rise to no cause of action. This is because the reach of the law is limited by the costs of administering it." POSNER, *supra* note 2, at 262.

169. See *supra* note 59 and accompanying text.

170. Goetz and Scott use such an argument to defend the common law rule that a

court is more certain could even be viewed as a variation on the first class of cases already discussed.¹⁷¹

One might assert that uncertainty about the most-probable-opportunist is more likely than uncertainty about the least-cost-avoider. But this problem may be due simply to a lack of adequate (though easily discoverable) information about the contracting parties' purposes, expectations, and actions. If so, one would expect that if the focus of the inquiry shifts to identifying opportunistic behavior, the information presented to courts will improve.¹⁷² In particular, if the courts in interpreting *any* contract doctrine begin to pay more attention to the parties' purposes in contracting, the commercial context of the deal, and the reasons for nonperformance, opportunistic behavior should become more apparent.¹⁷³ At the very least, courts are no worse equipped to collect this kind of data than they are to measure the precaution costs, expected accident costs, and activity levels required under the least-cost-avoider tradition.

Even if opportunism is difficult to detect in some cases, courts can begin to identify situations in which the potential for opportunism is great, and a rebuttable presumption that opportunism has occurred is warranted.¹⁷⁴ For example, disputes involving a seller attempting to justify nonperformance in the face of a market price increase, or a buyer attempting to justify nonperformance in the face of a market

plaintiff need not mitigate so long as the defendant has not clearly and definitively repudiated the contract. If there is a competitive market for substitutes, Goetz and Scott argue that neither party is the least-cost-mitigator—either one can cover on the market. So the main concern is to deter opportunism by the promisor, who may send ambiguous signals in the hope of preserving the contract if the market turns favorable and absolving herself of mitigation responsibility should the market turn unfavorable. See *Mitigation Principle*, *supra* note 1, at 989-90.

171. Another example is *Raffles v. Wichelhaus*, 159 Eng. Rep. 375 (1864), the famous case of the two ships named "Peerless." There was no indication that either party was in a better position to have known of the existence of the other ship. But there was a great likelihood that the buyer was acting opportunistically in seeking to get out of the deal.

172. See *supra* notes 72-74 and accompanying text.

173. Another source of information about opportunism could be surveys of people in various industries about what they view as the norms of behavior in that industry and what would constitute unethical behavior. Professor Sen has argued for increased use of such data by economists in determining preferences. See SEN, *supra* note 67, at 9, 71-72. Courts deciding contract disputes could allow such surveys to be introduced into evidence as "usages of trade," see U.C.C. § 1-205(2) (1990), and "good faith," see *id.* § 2-103(1)(b). Alternatively, courts could allow testimony by industry participants about "acceptable" behavior.

174. Cooter frames the issue as a balance between the Hobbes Theorem and the Coase Theorem, that is between pessimism and optimism about the potential bargaining solutions. See *Cost of Coase*, *supra* note 2, at 19.

price decrease, should (and often do) alert judicial neurons to the likelihood of opportunistic behavior and should presumptively cast doubt on alternative explanations for the nonperformance. More generally, the presumption in favor of opportunistic behavior should be stronger as the private benefits of such behavior increase and the private costs decrease.

For instance, the greater the absolute level of the promisee's sunk specific investments, the greater the potential private benefits of opportunistic behavior to the promisor and the more likely the promisor is behaving opportunistically. More importantly, the greater the *relative* difference between the promisee's sunk specific investments and the promisor's sunk specific investments—the more vulnerable the promisee is relative to the promisor—the more likely the promisor will act opportunistically. The extreme case of this disparity is the paradigmatic opportunism case discussed earlier:¹⁷⁵ the promisee has completely performed and is therefore completely vulnerable, while the promisor has done nothing and has nothing at risk.¹⁷⁶ On the other hand, if the promisor has suffered what Michael Wachter and I have elsewhere termed a “sunk cost loss,”¹⁷⁷ that is a loss of specific assets resulting from some regret contingency, the inference of promisor opportunism as opposed to reasonable adjustment is weaker (though not necessarily absent).¹⁷⁸ The link between sunk investments and the potential for opportunism is the feature that has led many scholars to identify concerns about opportunism with long-term or relational contracts, which I have discussed previously.¹⁷⁹

In addition, the private costs of opportunistic behavior are lower—and opportunistic behavior is therefore more likely—in situations where extralegal enforcement mechanisms are weaker.¹⁸⁰ The private

175. See *supra* note 46 and accompanying text.

176. A sunk investment need not be a physical investment, however. A contractual commitment itself is a form of sunk investment because it represents a commitment to forego certain other opportunities. See Burton, *supra* note 78, at 375-76.

177. See Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure, and Relocation*, 136 U. PA. L. REV. 1349, 1378-79 (1988).

178. This idea underlies some of the impossibility cases in which the party seeking excuse has suffered some loss. For example, a farmer whose crops are destroyed by disease will generally be excused from a contract for crops specified to come from a particular location. See U.C.C. § 2-615 cmt. 9 (1990).

179. See *supra* note 75 and accompanying text.

180. See David Charney, *Nonlegal Sanction in Commercial Relationships*, 104 HARV. L. REV. 373 (1990).

costs associated with developing a reputation as an opportunist might, for example, deter opportunism regardless of the legal treatment.¹⁸¹ Moreover, the market for substitute performances might be sufficiently "thick" ex post that any attempt to behave opportunistically will simply result in the other party going elsewhere.¹⁸² Or contracting parties might use such self-help enforcement devices as deposits or bonds to deter opportunism.¹⁸³ But in many cases, these private enforcement mechanisms will be relatively ineffective. Information about reputation might be very costly to collect and transmit, especially if the victim of opportunistic behavior is not a repeat player in the promisor's market.¹⁸⁴ The substitute market will often be "thin," especially as performance becomes more specialized. And private contracting devices to curb opportunism might be too costly or too manipulable. Because of uncertainty and complexity, contracting parties often use vague and incomplete contract terms, thus making it possible for their contracting partners to be opportunistic.¹⁸⁵ Moreover, even if the parties can anticipate some potential opportunism in advance, "behavioral uncertainty" prevents parties from foreseeing all the ways the contract can potentially be used to allow one party to escape from her expected responsibilities.¹⁸⁶

As courts begin lowering the potential private benefits and increasing the private costs of investing in opportunistic behavior (by increasing the likelihood that such behavior will be detected and punished), economic theory predicts that the amount of such behavior will decrease. The efficacy of court regulation of opportunism will depend not only on the available information, but also on the responsiveness of contracting parties to the legal rules created. To deter undesirable behavior, legal rules must be known to the parties. Contracting parties are more likely to know about rules punishing or forgiving opportunism—and what it takes to comply with those rules—than about rules punishing or forgiving negligence. Not only

181. See, e.g., Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. PAPERS & PROC. 356, 358-59, 361 (1980).

182. See Muris, *supra* note 50, at 522-23.

183. See *supra* note 109 and accompanying text.

184. Klein recognizes this problem in the franchise context. He notes that although a franchisor's interest in the value of its brand name will often deter franchisor opportunism, "this protective mechanism is limited by the relative importance of new franchise sales compared to the continuing franchising operation, that is, by the 'maturity' of the franchise chain." Klein, *supra* note 181, at 360.

185. See *Mitigation Principle*, *supra* note 1, at 968 n.5.

186. See *ECONOMIC INSTITUTIONS*, *supra* note 49, at 58-59.

are rules concerning opportunism more likely to coincide with a layperson's sense of justice and injustice, but because opportunistic behavior is engaged in deliberately and often *ex post*, it is more likely that a person contemplating such behavior will be able to consult with legal counsel beforehand.¹⁸⁷ It is likely, therefore, that rules regulating opportunism will have a greater deterrent effect than rules regulating negligence.¹⁸⁸ One possible exception is contract disputes involving a negligent contracting party, who is a "repeat player" in the market, and an individual making a "one-shot transaction," who acts opportunistically. In such a case, there is an argument for deterring the negligent party, because deterrence is likely to be effective and the failure to deter the opportunistic individual may have relatively small consequences.¹⁸⁹

It is of course possible that fashioning contract rules as incentives to deter opportunism will have the exact opposite effect. If opportunism becomes more prominent in contract doctrine, parties may respond simply by becoming more opportunistic, for example, by investing even more in obfuscating their purposes and actions. One may doubt the likely cost-effectiveness of such a strategy. But it is also important to recognize that legal rules do not affect only individuals' self-interest motivations. If contract law deems opportunistic behavior unlawful, then at least some people who would other-

187. Cf. Richard Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 282 (1975) (arguing that a modern rationale for the *Hadley* rule might focus on its effect on a seller at the time of deciding whether or not to breach, and not at the time of contracting, because a seller will more likely consult a lawyer at the latter time, and therefore will more likely be affected by the legal rule).

188. Some scholars have expressed skepticism about the deterrent effect of negligence law in tort. See Stephen D. Sugarman, *Doing Away With Tort Law*, 73 CAL. L. REV. 555, 560 (1985).

189. A variation on this argument could be used to criticize the good faith exception to the exclusionary rule under the Fourth Amendment. Courts face a conflict between the desire to punish "opportunistic" criminals and to deter "negligent" police officers that is similar to the conflict within contract law. Deterrence of negligent police behavior through application of the exclusionary rule might be more effective than deterrence of negligent contracting behavior because the police are repeat players who are likely to be aware of the legal requirements. On the other hand, criminals may also be repeat players. Of course, there are other important economic reasons why we might be more likely to punish negligent police behavior over opportunistic criminal behavior in the criminal context than in the contractual context; in particular the spillover costs of failing to deter police misconduct may be substantial. See generally Myron W. Orfield, Jr., Comment, *The Exclusionary Rule and Deterrence: An Empirical Study of Chicago Narcotics Officers*, 54 U. CHI. L. REV. 1016, 1054 (1987) (noting that police officers who knowingly conduct illegal searches will not be deterred by education and, therefore, need to be deterred by subjection to punishment).

wise act opportunistically will refrain from such behavior. This is not because opportunistic behavior is now more costly to them, but because it is now legally defined as "wrongful" behavior.¹⁹⁰ That is, law can change people's "social preferences," or sense of "social responsibility" or "commitment," which influence behavior as much as the pursuit of personal welfare does.¹⁹¹ The combination of self-interest and social responsibility should lead to a reduction in opportunistic behavior and a corresponding increase in trust among contracting parties.

In sum, in most cases, the administrative costs of discovering and deterring opportunistic behavior are not so high as to disturb my initial assertion that opportunism should generally take priority over negligence in contract cases in which the two goals conflict.

III. THE THEORY APPLIED

To make the points in the previous section more concrete, I will apply the insights from the expanded, fault-based theory of contract law to analyze two cases in seemingly unrelated areas of contract law: substantial performance and the statute of frauds. The goal here is a modest one: to show that the combined negligence-opportunism model is a useful tool both for explaining and criticizing a wide variety of contract doctrines, and for suggesting new avenues for research and reform.

A. *Jacob & Youngs v. Kent*

Perhaps the case that best epitomizes the negligence-opportunism tradeoff in contract law is the famous case of *Jacob & Youngs, Inc. v. Kent*.¹⁹² Jacob & Youngs built a "country residence" for Kent, a successful New York lawyer,¹⁹³ for \$77,000, of which Kent paid all but around \$3500. One of the contract specifications provided: "All wrought-iron pipe must be well galvanized, lap welded pipe of the grade known as 'standard pipe' of Reading manufacture." Nine months after the house was completed, Kent learned that some of the pipe used was not Reading pipe, but wrought iron pipe made by other manufacturers, including Cohoes. Kent then ordered the pipe

190. See generally TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990).

191. See SEN, *supra* note 67, at 65-70, 91-97.

192. 129 N.E. 889 (N.Y. 1921).

193. This fact does not appear in the opinion, but is mentioned in RICHARD DANZIG, *THE CAPABILITY PROBLEM IN CONTRACT LAW* 120 (1978).

replaced, even though much of it was already encased within the walls of the house. Jacob & Youngs refused to replace the pipe, Kent refused to make the final payment, and Jacob & Youngs sued. The New York Court of Appeals, speaking through Judge Cardozo, allowed Jacob & Youngs to recover the full remaining payment, despite its acknowledged breach. Cardozo's reasoning—in different terminology, of course—is essentially that the builder was merely negligent in breaching while the homeowner was potentially opportunistic in insisting on the letter of the contract; therefore, the homeowner lost. Cardozo's approach is fully consonant with the model outlined here.

After stating the facts, Cardozo begins the opinion by stressing that “the omission of the prescribed brand of pipe was neither fraudulent nor willful. It was the result of the oversight and inattention of the [builder's] subcontractor Even the [homeowner's] architect, though he inspected the pipe upon arrival, failed to notice the discrepancy.”¹⁹⁴ Cardozo's starting point is one of this article's main themes: the reason the breach occurs matters. Despite Cardozo's hint of contributory negligence by the homeowner through his architect, Cardozo's conclusion (in the terms developed here) is that the contractor was the *ex ante* least-cost-avoider of the regret contingency, but was not acting opportunistically. Although the contractor's superintendent had reminded the subcontractor's foreman about the Reading pipe specification at the time of the first delivery of pipe, and had examined this first delivery to see that it was Reading pipe,¹⁹⁵ the contractor could have taken further precautions regarding subsequent deliveries, such as monitoring more closely the subcontractor's employee responsible for ordering the pipe, inspecting the pipe upon arrival more carefully, and seeking prior approval of the homeowner for making substitutions.¹⁹⁶

194. *Jacob & Youngs*, 129 N.E. at 890.

195. *Id.* at 892 (McLaughlin, J., dissenting).

196. One could argue that the contractor was not negligent in the sense that the homeowner suffered no damages from the substitution and therefore no precautions were necessary. In my view, however, the negligence label makes sense for several reasons. First, *ex ante* the precautions were arguably cost-effective because the cost of precautions was relatively low and there was some probability—however slight—that the homeowner had a special preference for Reading pipe and would suffer large damages if a different brand were substituted. Put another way, even if there are no actual losses *ex post*, we might prefer the contractor next time around to be more careful, even if only by using different contract language or by checking with the homeowner before making substitutions. Imposing liability on the contractor would thus make contract law more like *ex ante* regulation (e.g., fining a driver for not wearing a seat belt); it would also make contract liability “strict” in the sense that actual loss

On the other hand, there was no evidence that the contractor knew of a special reason the homeowner had for wanting Reading pipe and ignored his wishes for the sake of convenience. Nor was there evidence that the contractor was substituting non-Reading pipe for the purpose of cutting corners and taking advantage of either the homeowner's relative lack of knowledge about pipes or a court's potential hesitation to apply the contract strictly, or for any other "guileful" purpose. Cardozo found instead that the installed pipe was "the same in quality, in appearance, in market value, and in cost as the brand stated in the contract."¹⁹⁷ In Cardozo's view, this fact differentiated the case from *Schultze v. Goodstein*,¹⁹⁸ in which the court found that the contractor had "willfully and intentionally used inferior and less expensive ['earthen' 1½ inch pipe] in the place of [the iron 2 inch pipe] agreed upon."¹⁹⁹ Although the dissent in *Jacob & Youngs* concluded that the contractor's failure to perform "was either intentional or due to gross neglect which . . . amounted to the same thing,"²⁰⁰ it offered no evidence in support of this interpretation other than the fact that Reading pipe comprised only 1000 feet out of the 2000 to 2500 feet of pipe required. It is difficult to see how the mere quantity of the deviation—regardless of the quality—supports an inference of opportunism on the part of the contractor.²⁰¹

need not be proved rather than in the tort sense that actual loss must always be compensated. Second, the contractor should have known that the potential for homeowner opportunism could have resulted in losses to the contractor from tearing out the nonconforming pipe and replacing it with Reading had the court interpreted the contract strictly and ruled in Kent's favor. In this sense, too, the contractor was negligent: it could easily have avoided the whole dispute and its attendant costs, including administrative costs.

197. *Id.* at 890.

198. 73 N.E. 21 (N.Y. 1905).

199. *Id.* at 23. It is true that in upholding the exclusion of expert testimony by a plumber, the *Schultze* court also says, more broadly: "When the owner stipulated for iron pipe, he had the right to iron pipe, regardless of whether some other kind, according to the opinion of the contractor or of experts, would do as well." *Id.*; *Jacob & Youngs*, 129 N.E. at 892 (McLaughlin, J., dissenting). But this statement does not detract from the fact that the evidence in *Schultze* suggested a material difference (in fact, the homeowner had counter-claimed for repair costs), and therefore potential opportunistic behavior (skimping) by the contractor. Moreover, there was apparently no plausible story that the contractor did not know of the deviation, as there was in *Jacob & Youngs*.

200. *Jacob & Youngs*, 129 N.E. at 892 (McLaughlin, J., dissenting).

201. If the quality deviation per foot is close to zero, then 1000 times zero is still zero. Perhaps the mere quantity could make a difference if it tended to suggest that the contractor must have known of the substitution; that is, if so much non-Reading pipe was being used, the contractor at some point would have noticed, and so its claim that the substitution was inadvertent is implausible. I do not think that is what the dissent means, but in any event I

In contrast, the facts do support a fairly strong inference that the homeowner was acting opportunistically *ex post* in insisting on carrying out the letter of the contract. In fact, the case bears a striking resemblance to the paradigmatic opportunism case discussed earlier.²⁰² The contractor was in a relatively vulnerable position, having completed its performance before payment was made. Although the contractor had protected itself against homeowner opportunism to some degree by insisting on progress payments, the final payment outstanding was still a sizeable sum by 1921 standards. Nor were the extralegal enforcement mechanisms sufficient to check any potential homeowner opportunism. The homeowner was a one-shot contractor; thus, developing a reputation as an opportunist would not likely hurt him in the marketplace.²⁰³ Moreover, the market for substitute performance was not thick, because the contractor had (literally) “sunk” specific assets into the project, thereby effecting a “fundamental transformation”: tearing out the old embedded pipe would have been very costly. Cardozo recognized this problem, distinguishing between cases in which “the thing upon which labor has been expended is incapable of surrender” and those in which “the subject-matter, if defective, is in shape to be returned.”²⁰⁴

Finally, the chances that the homeowner had any real interest in Reading pipe as opposed to the pipe that was supplied were very slight. Cardozo starts from the proposition that just as the reason for the promisor’s nonperformance matters, so does the promisee’s reason for proposing the relevant contractual provision.²⁰⁵ But he notes that

do not think it is a reasonable presumption in this case. The contractor had already checked once that Reading pipe was being used, and probably saw no reason to check again. And absent careful checking, the substitution would not easily have been noticed.

202. See *supra* notes 46 & 176 and accompanying text.

203. Reputation would have a much greater effect on Jacob & Youngs, a repeat player in a market that often uses word of mouth recommendations. And Kent, an influential lawyer, was more likely to have an influence on Jacob & Youngs’ business by badmouthing it than the typical homeowner. These facts further support putting liability on Kent, because Jacob & Youngs would be deterred from future negligent behavior even absent legal sanction.

204. *Jacob & Youngs*, 129 N.E. at 890-91. In his statement of the facts, Cardozo stressed that the pipe “was then encased within the walls except in a few places where it had to be exposed. Obedience to the order meant more than the substitution of other pipe. It meant the demolition at great expense of substantial parts of the completed structure.” *Id.* at 890. The dissent argued that Jacob & Youngs had not proved this expense. *Id.* at 892 (McLaughlin, J., dissenting).

205. In Cardozo’s words, “We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence.” *Id.* at 891.

"[i]ntention not otherwise revealed may be presumed to hold in contemplation the reasonable and probable. If something else is in view, it must not be left to implication."²⁰⁶ The "reasonable and probable" purpose of requiring Reading pipe was to guarantee pipe of a certain functional quality, rather than to guarantee a particular brand.²⁰⁷ This purpose was satisfied.²⁰⁸ If this had been a case involving "fields of art" as opposed to products "of mere utility,"²⁰⁹ there might have been some subjective, stylistic purpose that was not satisfied by the substitute performance.²¹⁰ But this was not the case with pipe. Nor was it likely that the homeowner had any special interest in the Reading company, such as a family or personal connection.²¹¹ If the homeowner had such an interest, he (or the personal connection)

206. *Id.* It is crucial to note that for Cardozo (and me), "revealed preference" does not mean the same thing that it does to an economist. To an economist, preferences are "revealed" solely by choices made in the market and are not to be questioned. In discussing *Jacob & Youngs*, an economist might therefore argue (as the dissent does) that Kent had revealed his preference for Reading pipe by specifying it. To Cardozo—and the rest of us who do not live in the bizarre world imagined by neoclassical economists—one's actions are not synonymous with one's preferences. See SEN, *supra* note 67, at 1-10.

207. This interpretation is supported by one of the specifications, which is quoted in DANZIG, *supra* note 193, at 111: "Where any particular brand of manufactured article is specified, it is to be considered as a standard. Contractors desiring to use another shall first make application in writing to the Architect stating the difference in cost and obtain their written approval of the change." Although *Jacob & Youngs* did not comply with this specification in full, it does suggest what the parties' intentions were.

208. *Cf.* *Spence v. Ham*, 57 N.E. 412 (N.Y. 1900). In this case, relied on by both Cardozo and the dissent, the court denied the contractor's claim of substantial performance. But although some commentators claim that this case stands for "a very restricted doctrine of substantial performance, under which only very trivial omissions could be excused," Levin & McDowell, *supra* note 3, at 68, this interpretation seems overly cramped. In fact, the case is reasonably distinguishable from *Jacob & Youngs*. The *Spence* court concluded that the contractor's "failure to have girders of certain length and properly placed, and the failure to place wooden partition on a brick wall in basement, . . . were structural defects, which affected the solidity of the building, and tended to defeat the object of the contract." *Spence*, 57 N.E. at 414 (emphasis added).

209. *Jacob & Youngs*, 129 N.E. at 891.

210. For example, "[i]f the owner prefers a plain and simple Doric column, and has so provided in the agreement, the contractor has no right to put in its place the more costly and elegant Corinthian." *Id.* at 893 (McLaughlin, J., dissenting) (quoting *Smith v. Brady*, 17 N.Y. 173, 186 (1858)).

211. In subsequent research on the case, Richard Danzig found no evidence of any professional or financial connection between Kent and the Reading Company. See DANZIG, *supra* note 193, at 120. Although the possibility of such a connection is mentioned as at least a hypothetical variation on *Jacob & Youngs* by many commentators, I have not been able to find any appellate case that involves an idiosyncratic contracting party with some undisclosed reason for wanting a particular brand of some product who refuses to perform when another equivalent brand is substituted and replacement is difficult.

would likely have been more aggressive about monitoring, he would have ordered the pipe himself, or—as the idiosyncratic party—would have used “apt and certain words” to make his meaning clearer.²¹² Thus, the likelihood was strong that the homeowner was acting opportunistically, insisting on Reading pipe even though he did not really care what brand of pipe he got, so long as it was “wrought iron pipe.”²¹³

That is not to say that the homeowner was blatantly opportunistic—extortionate. He probably did not just happen to notice the discrepancy and decide that money in his pocket is always better than money in the contractor's pocket; rather he most likely was unhappy with some other aspect of Jacob & Youngs' work and used the Reading pipe specification as a means of expressing this dissatisfaction.²¹⁴ If the contractor had breached any other part of the agreement, however, the homeowner could have either refused to make the final payment or litigated on that ground.²¹⁵ Absent such a claim or any evidence of damage, however, there is nothing to lend any validity to the homeowner's gripes. The homeowner's potential opportunism was subtle, but it was opportunism nonetheless. The dissent, however, shows no concern at all with the homeowner's motive: “What his reason was for requiring this kind of pipe is of no impor-

212. *Jacob & Youngs*, 129 N.E. at 891. Kent was “idiosyncratic” in the sense that a “typical” homeowner would not have cared which brand of pipe was used as long as the quality was the same. Knowing this, Kent could have added language such as, “No other brand of pipe will be considered acceptable.” Such language would be, of course, superfluous where “fields of art” or substitutes of inferior quality are concerned, but in this case, Cardozo was suggesting that a stronger signal must be sent than simply naming “Reading.” On the other hand, one must use caution in making this type of argument—essentially that Kent was the least-cost-avoider with respect to clarifying the contract terms—because Jacob & Youngs could also fairly easily have stipulated in the contract that Reading pipe is required and no steel pipe may be substituted. If Kent is viewed as the least-cost-avoider, the negligence-opportunism tradeoff dissolves and the case becomes an “easy” Type 2 case like *Peevyhouse*. See *supra* part II.B.2.

213. According to Professor Danzig, the brand name Reading was probably specified to insure that wrought iron pipe was used as opposed to steel pipe, which was thought to be inferior in durability and maintenance. See DANZIG, *supra* note 193, at 121. In particular, “it was the normal trade practice to assure wrought iron pipe quality by naming a manufacturer. In contemporary trade bulletins put out by . . . Reading, prospective buyers were cautioned that some steel pipe manufacturers used iron pipe and often sold under misleading names like ‘wrought pipe.’” *Id.* at 122.

214. See *id.* at 123.

215. Evidently, Jacob & Youngs admitted in its complaint that “minor details” remained to be completed and that Kent would not be obligated to make the final payment until these defaults were cured. See *id.* at 124. Jacob & Youngs apparently made no objection to this perfectly reasonable use of self-help by Kent.

tance. He wanted that and was entitled to it. It may have been a mere whim on his part, but even so, he had a right to this kind of pipe."²¹⁶ But as Cardozo's intuition and the analysis of this paper shows, the homeowner's insistence on only Reading pipe may have been much more objectionable than a "mere whim."

Jacob & Youngs thus presents a classic case of the negligence-opportunism tradeoff.²¹⁷ The court had to choose between deterring the contractor's negligence in allowing nonconforming pipe to be used, and the homeowner's potential opportunism in insisting on strict performance when he had no real interest in it. This choice parallels Professor Goldberg's "Boomer problem": the court could either award the injunction and deter the factory's negligence in choosing an unsuitable location, or award damages and deter the potential opportunism of the residents who could hold out for high sums and force the plant to close. In both cases, the court opted for deterring ex post opportunism by denying injunctive relief to the homeowner and the residents.²¹⁸

Jacob & Youngs has not met with universal approval, however. Professor Alan Schwartz, an influential Law and Economics scholar, has recently criticized the case on the ground that the "result seemed precluded by the contract, which . . . gave [the homeowner] the power to choose between the cost of completion and diminution in value damage measures, but the court reserved this power for itself."²¹⁹

216. *Jacob & Youngs*, 129 N.E. at 892 (McLaughlin, J., dissenting).

217. Professors Levin and McDowell characterize *Jacob & Youngs* as supporting their theory that contract law reflects a balance between voluntariness and fairness. They argue that the scope of voluntarily assumed contractual obligations is determined by fairness: only if "the parties [would] have agreed to the performance if they had possessed the foresight to see that a deviation might occur," would the terms be strictly enforced. Levin & McDowell, *supra* note 3, at 70. Although there are important similarities between this theory and mine, they are not identical.

218. Goldberg, *supra* note 160, at 69.

219. Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 406 (1990). The clause that Professor Schwartz refers to is the following:

Any work furnished by the Contractor, the material or workmanship of which is defective or which is not fully in accordance with the drawings and specifications, in every respect, will be rejected and is to be immediately torn down, removed and remade or replaced in accordance with the drawings and specifications, whenever discovered The Owner will have the option at all times to allow the defective or improper work to stand and to receive from the Contractor a sum of money equivalent to the difference in value of the work as performed and as herein specified.

SCOTT & LESLIE, *supra* note 104, at 78. The clause is not mentioned at all in the *Jacob &*

This argument comes at the end of a carefully argued and provocative article, whose main thesis is that "parties will choose appropriate remedies when left to their own devices,"²²⁰ and that therefore "courts should enforce all liquidated damage and specific performance clauses."²²¹ *Jacob & Youngs*, as well as other cases refusing to enforce contract remedy terms strictly, are guilty of what Schwartz refers to as "court centeredness," which "holds that courts should ensure that performance under a fair reading of a contract's terms would not contradict the parties' 'deeper' intentions and fairness."²²² Throwing down the gauntlet, Schwartz concludes his article by asking "whether defenders of court centeredness can show how their commitment to it is reconcilable with Contract Law's parallel commitment to party autonomy. Absent this showing, one of these foundational commitments must be abandoned."²²³

It is difficult to imagine a position more at odds with the thesis of this article, and so I will attempt to take up Professor Schwartz's challenge. The purpose of the *Jacob & Youngs* contract clause cited by Schwartz was apparently to squelch any temptation by the contractor to substitute inferior components and to protect the homeowner against any deviations that might cause damage that would be difficult to measure. If this purpose would in fact be served by enforcing the contract strictly in this case, there could be little objection. The problem is that there is a chance—in my view, a strong probability—that this purpose would not be served by enforcing the clause, because the contractor breached unintentionally, the homeowner acted opportunistically, and there were no damages.

Schwartz is aware of the dangers of *ex post* promisee opportunism, but he seeks to minimize these dangers primarily by invoking

Youngs opinion, though in a brief *per curiam* opinion denying the defendant's motion for reargument, the court stated that it:

did not overlook the specification which provides that defective work shall be replaced. The promise to replace, like the promise to install, is to be viewed, not as a condition, but as independent and collateral, when the defect is trivial and innocent. The law does not nullify the covenant, but restricts the remedy to damages.

Jacob & Youngs v. Kent, 130 N.E. 933, 933 (N.Y. 1921).

220. Schwartz, *supra* note 219, at 407.

221. *Id.* at 405.

222. *Id.* at 406. This seems somewhat similar to Galanter's concept of "legal centralism." See *supra* note 70 and accompanying text.

223. *Id.* at 407. This last statement resembles the "fundamental contradiction" position—that the negligence and opportunism traditions cannot be usefully combined—which I considered and rejected earlier. See *supra* note 100 and accompanying text.

arguments that we have discussed previously. Although he disperses these arguments throughout the article, and does not specifically apply them to *Jacob & Youngs*, he clearly intends his analysis to have broader application than the specific doctrines he critiques.²²⁴ First, Schwartz argues that ex post opportunism rarely occurs, because various extralegal sanctions sufficiently deter it: thick substitute markets render opportunistic threats empty;²²⁵ parties contemplating opportunistic behavior fear developing bad reputations;²²⁶ and contracting parties use "bonding mechanisms" to make opportunism unprofitable.²²⁷ But effective as these mechanisms are in deterring opportunism generally, it requires no small leap to conclude that they are so effective at deterring opportunism that courts need not worry about it ever occurring.²²⁸ And we have already seen how, at least in *Jacob & Youngs*, these mechanisms would not have successfully deterred an opportunistic homeowner.

Second, Schwartz argues that even if opportunism can occur, courts cannot distinguish opportunism from legitimate behavior.²²⁹ I have already addressed the issue of administrative cost in general. In

224. *Id.* at 391 n.45 (arguing that the argument can be extended to cost of completion damages). Presumably, Schwartz would agree with the conclusion of this article (though not necessarily the reasoning) that the *Peevyhouse* case was wrongly decided.

225. *Id.* at 388-89.

226. *Id.* at 393 (inducing breach can create reputational losses).

227. *Id.* at 392 n.48.

228. Schwartz at one point seems to take the extreme position that opportunism is unlikely to exist, even if it is feasible. He argues with respect to contracting for specific performance that "exploitation could occur only when a promisee who contracted for the right for specific relief later discovered that such relief was unnecessary but chose to demand it to extort a large payment." *Id.* at 388-89. Although this seems to describe *Jacob & Youngs*, Schwartz abruptly concludes: "This apparently would seldom happen." *Id.* at 389. This statement precedes what Schwartz evidently considers to be a separate argument, namely that opportunism is not feasible in any event because effective substitutes usually exist. Schwartz then cites two pieces of evidence in support of his conclusion that promisee opportunism is rare: (1) specific performance is seldom sought in jurisdictions where it is easier to get; and (2) specific relief is almost never denied on the ground that the promisee had an adequate alternative remedy. *See id.* The first piece of evidence might be explained by the fact that the jurisdictions with more liberal specific performance laws police ex post promisee opportunism through other doctrines. The second piece of evidence seems to say nothing about the potential for opportunism, because, as Schwartz earlier states and later recognizes, *see id.* at 396 n.54 (noting that a case for punitive damages can be made in thin markets), opportunism can occur only where there is no adequate alternative remedy.

229. *See id.* at 387 ("Courts . . . cannot easily know when a clause is supracompensatory."). This concern with the difficulties courts face in trying to recognize opportunism is also expressed by Danzig, who refers to these difficulties as "capability problems." *See DANZIG, supra* note 193, at 127-28.

Jacob & Youngs, there did not seem to be anything particularly complex about the contract. True, the purpose of the Reading pipe requirement, the reason for the breach, and Kent's motive were all difficult factual questions, but courts constantly deal with those types of questions. Courts certainly make mistakes, but even in the cases that Schwartz critiques, it does not seem that it would be so difficult to explain the purposes of the contract clauses at issue, especially when these clauses were most likely drafted with the help of lawyers.²³⁰ Apparently, though Schwartz fears court centeredness, what he preaches is court impotence.

Third, Schwartz seems to suggest that even if opportunism can occur, and courts can recognize it, deterring negligence should take priority over deterring opportunism. He states that "the willingness of courts to attempt to rescue parties from bad deals reduces the parties' incentives to write good contracts originally."²³¹ There are two problems with this statement. It assumes that there is such a thing as a "good" contract that will deter all opportunistic behavior; but there is no such contract because there is no limit to opportunism.²³² Schwartz's statement also assumes that it is always efficient for parties to write better contracts. However, this ignores the transaction costs of writing such contracts and the opportunity costs of leaving opportunism undeterred. An advocate of an increased role of the

230. See Schwartz, *supra* note 219, at 384-86 (criticizing two cases striking down liquidated damage clauses as unlawful penalties). Schwartz attributes court error in one opinion written by Judge Posner to his failure to recognize the liquidated damage provision as an efficient take-or-pay clause. According to Schwartz, "Judge Posner's difficulty probably stemmed from the fact that he had made no study of liquidated damage clauses generally and neither party mentioned take-or-pay clauses during the case. That courts and lawyers seldom are industry experts is the reason why courts generally do not review contract clauses." *Id.* at 386 n.33. Without discussing the merits of Posner's decision, I find it somewhat surprising that a firm's lawyers, who probably helped draft the provision at issue, could not explain in simple terms to a highly intelligent judge what the parties were attempting to accomplish by using a particular contract clause. It is common for lawyers to offer testimony about the intended meaning of contract terms they helped to draft. See, e.g., *Lamborn v. Dittmer*, 873 F.2d 522 (2d Cir. 1989); *United Food & Commercial Workers Health & Welfare Fund v. Darwin Lynch Adm'rs, Inc.*, 781 F. Supp 1067, 1069-71 (M.D. Pa. 1991). At least in such cases, one cannot claim that the reason for a particular preference is not knowable. This is not a situation like the "business judgment rule" in corporate law, under which courts decline to second-guess management decisions because they lack the expertise. Shoddy lawyering should be condemned for what it is.

231. Schwartz, *supra* note 219, at 370.

232. See ECONOMIC INSTITUTIONS, *supra* note 49, at 58, 66; cf. SEN, *supra* note 67, at 65 (noting that although it is sometimes possible for the players in a prisoner's dilemma game to contract against opportunistic behavior—confession—"such a contract may be difficult to devise and conceivably impossible to enforce under certain circumstances.").

courts in deterring opportunism could flip Schwartz's statement and argue that the unwillingness of the courts to rescue parties from bad deals increases transaction costs by forcing parties to write substantially more detailed contracts to cover more remote contingencies, and to invest in other costly self-protection devices, thereby reducing the level of trust in the other side and poisoning the relationship from the outset²³³—all in the hopeless quest to eliminate opportunism. Thus, rules that direct courts to ignore the parties' "deeper intentions" may lead to costly court error just as much as rules that advocate excessive "intervention."

Finally, Schwartz argues that other contract doctrines—good faith²³⁴ and unconscionability²³⁵—can handle any problem of opportunism that may arise. Shunting off the problem onto other doctrines does not resolve it, however. Schwartz gives no hint of how these other doctrines would handle opportunistic behavior, though one suspects that Schwartz would restrict the application of these doctrines to fraudulent or other blatant abuses.²³⁶ In sum, *Jacob & Youngs* provides an excellent example of how one can be simultaneously committed to "court centeredness" and "party autonomy"; it successfully navigates the negligence-opportunism tradeoff.

B. *Barrett Builders v. Miller*

A seemingly unrelated area of contract law into which the negligence-opportunism tradeoff can offer insight is the statute of frauds, which in its various guises denies enforcement to certain categories of contracts not put into writing. An interesting recent case that starkly presents the tradeoff and nicely parallels *Jacob & Youngs* is *Barrett Builders v. Miller*,²³⁷ written by Chief Justice Peters of the Connecticut Supreme Court, formerly a professor of Contracts at Yale. The particular version of the statute of frauds at issue in *Barrett Builders* and the three companion cases decided the same day²³⁸ is contained

233. Cf. Schwartz, *supra* note 219, at 397 (arguing that parties would not typically bargain to shift attorneys' fees because "a party that requests a legal fee clause may be taken to signal that it would rather sue than work disputes out privately. This is a bad signal to send"). Prenuptial agreements are another example of this problem.

234. See *id.* at 371 n.5, 393.

235. See *id.* at 384 n.26, 386 n.34.

236. Cf. *id.* at 396 n.54 (noting as "thoughtful" an article suggesting that punitive damages would be appropriate in cases of "outrageous producer behavior").

237. 576 A.2d 455 (Conn. 1990).

238. *A. Secondino & Son, Inc. v. LoRicco*, 576 A.2d 464 (Conn. 1990) (Peters, C.J.);

in Connecticut's Home Improvement Act.²³⁹

The facts of *Barrett Builders* are straightforward. Barrett Builders and Rhoda Miller entered into a signed written agreement for the acquisition and installation of kitchen cabinets, a counter top, "underlayment" for the floor, and a door, as well as for the repairing, refinishing, and painting of the ceiling in Miller's home.²⁴⁰ The writing did not specify any particular style, size, or brand of cabinet. The price was \$9783 to be paid in three equal installments: a down payment, a payment upon installation of the cabinets, and a final payment upon completion of the job.²⁴¹ Miller made the down payment and Barrett Builders started working. After Barrett Builders installed the cabinets, Miller issued a check for the second installment, but later stopped payment, claiming "that the cabinets installed by [Barrett] were inferior to the samples provided at the time of the contract negotiation."²⁴² Miller alleged that she was supposed to get "solid core" cabinets, but instead got "hollow core" cabinets.²⁴³ Barrett sued for the amount of the last two installments, claiming that by the time Miller stopped payment, it had substantially completed the required work. Miller responded that the written agreement did not satisfy the requirements of the Connecticut statute and so the contract was unenforceable. The Connecticut Supreme Court agreed.

The particular issue addressed by the *Barrett Builders* court was whether a home improvement contractor that has not satisfied the Home Improvement Act statute of frauds can nevertheless recover on a theory of quasi-contract, unjust enrichment, or restitution for the value of the work performed. Several years earlier in *Caulkins v.*

Liljedahl Bros. v. Grigsby, 576 A.2d 149 (Conn. 1990) (Peters, C.J.); Sidney v. DeVries, 575 A.2d 228 (Conn. 1990) (per curiam).

239. CONN. GEN. STAT. ANN. § 20-429(a) (West 1988). This section states:

No home improvement contract shall be valid or enforceable against an owner unless it: (1) is in writing, (2) is signed by the owner and the contractor, (3) contains the entire agreement between the owner and the contractor, (4) contains the date of the transaction, (5) contains the name and address of the contractor, (6) contains a notice of the owner's cancellation rights in accordance with the provisions of chapter 740, (7) contains a starting date and completion date, and (8) is entered into by a registered salesman or registered contractor. Each change in the terms and conditions of a contract shall be in writing and shall be signed by the owner and contractor.

Id.

240. See *Barrett Builders*, 576 A.2d at 456 n.2.

241. *Id.*

242. *Id.* at 457.

243. *Id.* at 459-60.

Petrillo,²⁴⁴ the court had held that it would not recognize an exception to the Home Improvement Act statute of frauds for contractors that had fully performed. *Barrett Builders* extended this holding to deny an exception based on restitution.

The parallels between *Barrett Builders* and *Jacob & Youngs* are apparent. In both cases there was a dispute between a homeowner and a contractor over the quality of the work done after the contractor performed, but before the homeowner paid. In both cases, the contractor claimed to have performed substantially. In both cases the contractor used progress payments to protect itself against excessive vulnerability, but was still in a relatively vulnerable position at the time of the suit. There are of course important factual differences, which will be discussed below. Yet it is crucial to recognize at the outset that in the eyes of traditional contract doctrine, these two cases are completely different. The economic analysis, however, is largely the same—with some slight adjustments.

To examine the *Barrett Builders* holding in terms of the model presented here, it will be helpful to first consider the economics of the “traditional” statute of frauds and its exceptions. The statute of frauds is one of the few areas of contract law that is explicit in its attempt to deter opportunism. The statute’s primary purpose is to prevent plaintiff promisees from asserting false contractual claims against defendant promisors.²⁴⁵ A writing, then, is just another “safeguard” against opportunism: like arbitration, it can be viewed as a kind of “specialized governance structure to which to refer and resolve disputes.”²⁴⁶ But the absence of a writing does not always imply opportunism by the plaintiff promisee. Therefore, courts have created exceptions to the statute for cases in which other evidence suggests the plaintiff is not falsely asserting an agreement. These exceptions include partial and full performance, restitution, and reliance.²⁴⁷

One way courts tend to show that the promisee is not opportunistic is to argue that it is actually the defendant promisor who is the most-likely-opportunist. Courts, therefore, sometimes ground exceptions to the statute of frauds in the perceived opportunism of the

244. 513 A.2d 43 (Conn. 1986).

245. See, e.g., FARNSWORTH, *supra* note 47, § 6.1, at 394.

246. ECONOMIC INSTITUTIONS, *supra* note 49, at 34. I can think of no other safeguards against opportunism in private contracting that are mandatory, however.

247. See FARNSWORTH, *supra* note 47, at § 6.9, at 440-44, § 6.11, at 450-53, § 6.12, at 453-60.

defendant promisor, though this idea is usually (unartfully) phrased as "using the statute [of frauds] to accomplish a fraud."²⁴⁸ The "fraud" accomplished by the defendant promisor via the statute of frauds is not the typical *ex ante* variety of fraud,²⁴⁹ but rather stems from the defendant's *ex post* desire to escape from promissory obligations that have become costly. The defendant promisor seeking to use the statute of frauds defense acts opportunistically when the "real reason" for the rupture of the deal is not a dispute over the existence or terms of an agreement that have not been put in writing.²⁵⁰ If the reason for the rupture of the deal lies elsewhere, the plaintiff promisee cannot be acting opportunistically in asserting that an agreement existed, and denying enforcement of this agreement based on the statute of frauds would not serve its purpose of deterring promisee opportunism.²⁵¹

Deterring opportunism is not the only purpose of the statute of frauds, however. The statute of frauds also aims to deter negligent behavior. Putting a contract in writing is often a relatively cheap precaution against disputes,²⁵² whether the cause of the underlying

248. Michael Braunstein, *Remedy, Reason, and the Statute of Frauds: A Critical Economic Analysis*, 1989 UTAH L. REV. 383, 384-85 (brackets in original) (explaining one reason courts have created exceptions to the statute is to prevent the statute from being used as a shield for fraud and to prevent economic waste). The *Barrett Builders* dissent relies on this rationale to argue in favor of recognizing an exception for restitution:

The statute of frauds was never intended to be used to permit one relying on it to enrich himself at the expense of another or to aid in defrauding such other person. To permit a party to an oral contract to accept the benefits of such contract and then invoke the statute to avoid payment would be using the statute to perpetrate a fraud.

Barrett Builders, 576 A.2d at 462 (Shea, J., dissenting) (quoting 73 AM. JUR. 2D *Statute of Frauds* § 537 (1974)).

249. See 2 CORBIN, *supra* note 90, § 429, at 469-72 ("Such a result [using the statute of frauds to avoid a contractual obligation], if permitted to exist, is indeed a horrid injustice, as the community at large conceives of justice; but it is not the fraud of the statute of frauds, or the fraud that is a tort." 2 *id.* § 429, at 471.). The baggage that apparently accompanies the word "fraud" supports the use of the more generic term "opportunism" that I have argued for here.

250. Cf. *Barrett Builders*, 576 A.2d at 463 (Shea, J., dissenting) (referring to "forfeitures enriching the homeowners regardless of the merits of the disputes or the value of the work performed").

251. Professor Braunstein's criticism of this rationale for exceptions to the statute of frauds seems to miss the point. He argues that the statute of frauds is not designed to prevent denial of a true agreement by the promisor, but only assertion of a false agreement by the promisee. See Braunstein, *supra* note 248, at 404-05 & n.78. But allowing a promisor to deny a true oral agreement would not further the purpose of the statute of frauds; it would instead turn the statute into what laymen would call a "technicality" or "loophole."

252. I avoid the use of the now widely accepted term "evidentiary function" here. See Lon F. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941); Joseph M. Perillo,

dispute is opportunism by the plaintiff promisee or some other reason.²⁵³ By denying enforcement of oral agreements, the statute of frauds encourages contracting parties to put their agreements in writing.²⁵⁴ But just as the absence of a writing does not necessarily indicate that the plaintiff promisee is opportunistic, neither does it necessarily indicate that she is the least-cost-avoider. First, it may be relatively costly to create a writing for some transactions, because, for example, time is at a premium.²⁵⁵ Moreover, in some contexts, insisting on a writing may be a sign of lack of trust in the other party's word, and could actually foment rather than prevent disputes.²⁵⁶ Second, the promisor might be the least-cost-avoider or at least an equal-cost-avoider. Often either party could just as easily have put the agreement into writing. If, however, the absence of a writing does suggest that the plaintiff promisee is the least-cost-avoider, but it nevertheless appears that the defendant promisor is the most-likely-opportunist, the court faces the negligence-opportunism tradeoff.

With this background in mind, we may now return to *Barrett Builders*. The court could have made one of three possible choices: declined to recognize a restitution exception in all cases regardless of the facts; recognized a restitution exception and found that on the

The Statute of Frauds in the Light of the Functions and Dysfunctions of Form, 43 *FORDHAM L. REV.* 39, 64-69 (1974). The evidentiary function could be applied to either opportunistic or negligent behavior. I want to keep separate the deterrence of these two behaviors, however.

253. The underlying breach by the promisor need not be opportunistic. As Professor Braunstein argues, however, strict enforcement of the statute of frauds will often lead to inefficient breaches which may be opportunistic, and as I argued above, even "efficient" breaches are sometimes opportunistic. My approach differs from Professor Braunstein's in that he argues for the abolition of the statute of frauds to allow expectation damages to provide the correct incentives for efficient breach, while I find the efficient breach theory inadequate. Moreover, Professor Braunstein's efficient breach argument seems to ignore the administrative cost savings the statute of frauds is supposed to bring about, and therefore sidesteps the negligence-opportunism tradeoff that I find crucial to statute of frauds and other contract cases. See Braunstein, *supra* note 248, at 395-403.

254. In the terminology of Ayres & Gertner, the statute of frauds operates as a "penalty default." See generally Ayres & Gertner, *supra* note 2.

255. This may hold true for certain commercial transactions, such as last minute subcontractor bids. It does not hold true for the typical home improvement transaction. We might therefore expect to see stricter enforcement of the statute of frauds in this area. Cf. *THE ECONOMICS OF LAW*, *supra* note 144, at 64-65 (asserting that enforcement of the statute of frauds may be stricter in real estate transactions because time is not usually of the essence).

256. See, e.g., *Shepard v. Purvine*, 248 P.2d 352, 362 (1952) (explaining that "to have insisted upon a deed would have been embarrassing; in effect, it would have been expressing a doubt as to their friend's integrity"). The existence of the statute of frauds, however, mitigates this social norm by making it acceptable to insist on a writing.

facts of the case such an exception was not satisfied; or recognized the exception and found that it was satisfied. The court chose the first option. The theory presented here, by contrast, would advocate that a restitution exception should be recognized, and that depending on the facts of the case, the exception could be satisfied.

Recognizing contractor opportunism as the main evil the legislature sought to remedy through the Home Improvement Act statute of frauds, Chief Justice Peters states that:

if recovery is permitted despite the fact that the underlying home improvement contract is invalid, a contractor could unilaterally expand the scope of the project beyond the contemplation of the invalid agreement, without the homeowner's consent, and recover for the unwanted work The remedial purpose of [the statute] would be placed in even greater jeopardy if a contractor could recover by merely demonstrating that services had been rendered, without even alleging that there was some sort of agreement for the work.²⁵⁷

These assertions, which are unobjectionable, say nothing more than *if* the contractor acts opportunistically by doing unwanted work and thereby taking advantage of the homeowner, it should not recover. The assertions also correctly imply that the legislature could make a determination that contractor opportunism may occur frequently,²⁵⁸ and could therefore establish a presumption that in the absence of a writing, contractor opportunism has occurred. However, Chief Justice Peters makes the presumption irrebuttable. What if the facts suggest that contractor opportunism did not cause the problem?²⁵⁹

257. *Barrett Builders*, 576 A.2d at 459. This is not the first argument that the court makes. Chief Justice Peters starts off by asserting that the case is governed by *Caulkins* because there is no meaningful difference between an exception based on partial or full performance and one based on restitution. *See id.* at 457-58. Although the dissent takes issue with this assertion, *see id.* at 461 & n.1 (Shea, J., dissenting), it seems reasonable (at least from an economic perspective), and so I will concentrate on the part of the opinion that, in the alternative, reexamines *Caulkins*. In the interest of keeping the discussion to a manageable length, I will also not discuss the doctrinal disagreement between the majority and the dissent concerning the applicability of several lines of cases. *Compare id.* at 458-59, *with id.* at 462-63 (Shea, J., dissenting).

258. *See id.* at 460 n.4 (taking judicial notice of a New York Times article reporting a large number of consumer complaints against home improvement contractors).

259. Peters later asserts "that the objective of the Home Improvement Act is not only to protect homeowners from substandard work, but also to ensure that homeowners are able to make an informed choice on a decision that has potentially significant financial consequences." *Id.* at 460. The same argument applies here: the legislature may establish a statutory presumption that a contractor who does not use a writing will unduly pressure or mislead the homeowner at the outset. But the absence of a writing does not always indicate that such

Peters implicitly recognizes the opportunism-negligence tradeoff when she acknowledges that the court's "decision may lead to a harsh result where a contractor in good faith but in ignorance of the law performs valuable home improvements without complying with" the statute.²⁶⁰ But she claims that "this deficiency in the statute [is not] within our power to remedy."²⁶¹ Peters's explanations of the court's impotence, however, are unpersuasive. She makes three points that are all accurate as far as they go, but irrelevant to the question of why the opportunism-negligence tradeoff should be resolved in favor of the homeowner in all cases.

Peters first states that "the legislature is entitled . . . to impose the burden of compliance with the statute on the professional, the contractor, rather than on the nonprofessional, the consumer."²⁶² This statement is significant and defensible: unlike the case with other statutes of frauds, the absence of a writing in a home improvement situation probably does mean that the contractor was the least-cost-avoider. The contractor, as the professional, repeat performer in the market, is generally in a better position than the one-shot homeowner to create a meaningful writing at lower cost.²⁶³ But this conclusion has nothing to do with how to resolve the negligence-opportunism tradeoff. The absence of a writing may mean that the contractor is *at least* negligent, but if the contractor is *no more than* negligent, and the homeowner is acting opportunistically, the statutory presumption should yield.

Peters next concludes that "the legislature could legitimately view

contractor opportunism has occurred. In fact, a writing itself may be used to confuse homeowners and deprive them of an "informed choice." 3 CORBIN, *supra* note 90, § 559, at 271 n.20; 6A *id.* § 1376, at 20-21; 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.26, at 478-90 (1990).

260. *Barrett Builders*, 576 A.2d at 460. Of course, the dissent states the danger more forcefully:

The issue presently before us . . . is . . . whether a contractor who, out of ignorance or carelessness, has not reduced his oral agreement to writing or otherwise has failed to conform to [the statute], must forfeit the entire value of the services and materials he has furnished to a homeowner without any recompense.

Id. at 461 (Shea, J., dissenting).

261. *Id.* at 460.

262. *Id.*

263. Even this presumption is not always true. In *A. Secondino & Son, Inc. v. LoRiccio*, 576 A.2d 464 (Conn. 1990), one of the companion cases to *Barrett Builders*, the contractor was "principally engaged in commercial work," including work for the defendant, "an experienced lawyer," who specifically requested the contractor to do work on his home. *Id.* at 466. In that situation, the defendant was arguably the least-cost-avoider, as the dissent suggests. *See id.* at 469 (Shea, J., dissenting).

as more urgent the need to protect consumers from unscrupulous contractors than the need to protect innocent contractors from manipulative consumers."²⁶⁴ Again this statement is sensible, but unsatisfactory. In enacting the Home Improvement Act statute of frauds, the Connecticut legislature was obviously more concerned with protecting innocent consumers than with protecting innocent contractors. And if the court cannot tell the difference between an innocent contractor and an unscrupulous contractor in a particular case—if, for example, the dispute is simply a "shouting match" between the contractor and the homeowner over the existence or terms of the agreement, with no other evidence to back up either side's position—then erring on the side of punishing the contractor is a reasonable means of carrying out the legislature's intent. The court could also establish a heightened burden of proof for the contractor to meet in overcoming the presumption. But if in some cases the facts (other than testimony of the parties) strongly imply that the contractor is "innocent" and the homeowner "manipulative," it would do no harm to legislative intent to hold the consumers to their bargain.

Finally, Peters asks, "What benefit . . . has a homeowner received by getting unwanted goods and services? Judicial assessment of such a 'benefit' would necessarily be so speculative as to undermine the objectives that the statute sought to achieve."²⁶⁵ The question purports to raise an administrative cost limitation based on measurement difficulties, but falls short of supporting the court's resolution of the negligence-opportunism tradeoff. Restitution damages should not be awarded at all for "unwanted goods and services."²⁶⁶ But that is not the relevant issue. The more relevant question is whether courts can ever cheaply assess whether the goods and services were in fact wanted, and if they were, what value to place on them. These are the cases in which the court's choice matters.

But the court never squarely faces the question of whether judges can ever tell the difference between an incompetent contractor and an unscrupulous one, or between an innocent homeowner and a manipulative one, with sufficient certainty to make feasible an exception to the legislative presumption of contractor opportunism. The compan-

264. *Barrett Builders*, 576 A.2d at 460.

265. *Id.* at 461.

266. Cf. FARNSWORTH, *supra* note 47, § 6.11, at 451-52 ("There is . . . no recovery for reliance by the injured party that was not bargained for or requested and that has conferred no benefit whatsoever.").

ion cases to *Barrett Builders* suggest, however, that the answer to this question is that they can.²⁶⁷ In *Liljedahl Brothers v. Grigsby*,²⁶⁸ the homeowner did not answer the contractor's complaint, nor did he allege any dissatisfaction with the contractor's performance; rather, he simply filed a motion to strike based on the absence of a writing.²⁶⁹ In *Sidney v. DeVries*²⁷⁰ and *A. Secondino, Inc. v. LoRicco*,²⁷¹ the homeowners raised claims based on dissatisfaction with the contractors' work, but the respective trial courts found these claims to be without merit. In each of these cases, the Connecticut Supreme Court applied *Barrett Builders* to bar any recovery by the contractor without any additional analysis or explanation.²⁷² But if—as at least the *Sidney* and *A. Secondino* cases seem to demonstrate—contractors are not always opportunistic, homeowners may be, and courts can often tell the difference fairly easily, so there seems to be no reason to “furnish homeowners . . . with a virtual license to steal by invoking [the] statute after substantial work has been performed without a proper written contract.”²⁷³

The court could have responded that despite the fact that courts should generally give higher priority to deterring opportunism than to deterring negligence, in the home improvement context, deterring contractor negligence is likely to be highly effective due to the fact that contractors are repeat players in the market and are likely to learn very quickly of the court's strict approach—perhaps through their lawyers or trade associations—and clean up their acts. The court does not explicitly take this route, though its reference to the Home Improvement Act as a “consumer protection statute” suggests it. In any event, this route does not seem to be a promising one, because, as the dissent points out:

267. Courts' experience with restitutionary relief under the traditional statute of frauds, as well as in other areas of contract law, also supports this conclusion. See, e.g., *A. Secondino, Inc.*, 576 A.2d at 464; *Liljedahl Bros. v. Grigsby*, 576 A.2d 149 (Conn. 1990); *Sidney v. DeVries*, 575 A.2d 228 (Conn. 1990).

268. 576 A.2d at 149.

269. See *id.* Under the traditional statute of frauds, most courts still allow a party to admit the making of the contract and yet use the statute to insist on its unenforceability, though U.C.C. § 2-201 (1990), and some jurisdictions have abandoned this rule. See generally FARNSWORTH, *supra* note 47, § 6.10, at 446-47. In my view, the U.C.C. rule is better because it recognizes the danger of promisor opportunism.

270. 575 A.2d at 228-29.

271. 576 A.2d at 466-67 & nn.3-4.

272. *A. Secondino*, 576 A.2d at 467; *Sidney*, 575 A.2d at 229.

273. *Barrett Builders*, 576 A.2d at 464 (Shea, J., dissenting).

The term "contractor" suggests an image of affluence or economic status that is wholly unrealistic when applied to carpenters, plumbers, electricians, landscapers and other tradesmen involved in making home improvements within the definition of [the Home Improvement Act]. Many of these self-employed workers lack the education necessary to be aware of the potential impact of [the statute of frauds provision] on their occupations and are unable to afford the expense of obtaining the assistance of counsel, which may be disproportionate to the amounts of the small contracts that provide their livelihood.²⁷⁴

In fact, *Sidney* involved a self-employed contractor.²⁷⁵ The problem with the court's justification is that it wrongly assumes that "contractor" and "homeowner" are sufficiently homogenous classes that strict deterrence is likely to be effective.²⁷⁶ If "contractor" and "homeowner" are overly broad categories, however, then oral home improvement contracts will continue to exist. Under these circumstances, giving priority to deterring negligence will have the unfortunate effects of punishing trusting, incompetent contractors and rewarding deceitful homeowners. Thus, neither the court's express nor implied justifications for its strict rule are sufficient to override the general presumption advocated here that in cases in which the negligence-opportunism tradeoff is present, courts should opt for deterring opportunism.

The *Barrett Builders* "rule" may not be as harsh as it first seems, however. Chief Justice Peters does leave an escape hatch for "innocent" contractors similar to the one left by Professor Schwartz with respect to "supracompensatory" contract remedies. Peters declares near the end of the opinion that a homeowner who acts in "bad faith" may not take advantage of the statute of frauds defense.²⁷⁷ Aside

274. *Id.*

275. *See Sidney*, 575 A.2d at 229.

276. In Calabresi's terms, the question is whether the world has been sufficiently "subcategorized" into contractors and homeowners. *See COSTS OF ACCIDENTS*, *supra* note 8, at 246-49.

277. *See Barrett Builders*, 576 A.2d at 460 (holding that "[a]s a minimum, the import of § 20-429 is that the defendant was privileged, in the absence of an allegations of bad faith, to repudiate an agreement in violation of the statute"); *see also A. Secondino*, 576 A.2d at 467 (court followed the holding in *Barrett Builders* that a contractor may not recover when he has "failed to comply with the statute's written contract requirement"); *Liljedahl Bros.*, 576 A.2d at 152 (court noted that the issue had been fully discussed in *Barrett Builders* and that they would not change their holding in that case barring recovery absent a showing of bad faith); *Sidney*, 576 A.2d at 229 (court followed the holding in *Barrett Builders* in

from assuring that every complaint by a contractor against a homeowner will now contain an allegation of homeowner bad faith, it is not yet clear what effect this escape hatch will have. Nevertheless, there are indications that the court intends the hole to be very small: only blatant, not subtle, opportunism by homeowners will probably be held to meet the exception. One indication of a likely narrow interpretation of "bad faith" is that the court did not even hint that the "bad faith" exception might be applicable in any of the companion cases, despite the fact that in none of these cases was any plausible breach by the contractor alleged. If it is not "bad faith" for a homeowner without a legitimate gripe against a contractor to use the statute of frauds to withhold payment and yet keep the benefits of the contractor's performance, one can only imagine the kind of conduct that a homeowner would have to engage in before a contractor could avail itself of this exception.²⁷⁸

The other indication that the court intends to interpret homeowner bad faith narrowly is a quite remarkable footnote near the end of the opinion, which is worth quoting in its entirety:

A question remains concerning the ability of a homeowner to recover a down payment or progress payments made during the performance of home improvements but prior to the discovery of the invalidity of the contract. It is not clear whether a homeowner who has received materials and services and has made payments in recognition of that benefit can recover those payments. Arguably, a homeowner who has made such progress payments has impliedly consented to the work performed. The issue raised by a suit to recover partial payments differs substantially from that raised by refusal to pay sums alleged to be due on an invalid contract. We need not resolve that thorny issue today.²⁷⁹

holding that a contractor is barred from recovering damages when the contract was oral, unless he can prove bad faith on the part of the homeowner).

278. This is not the first time Chief Justice Peters has crafted an unduly narrow exception for opportunistic behavior. In *Mozzochi v. Beck*, 529 A.2d 171 (1987) (Peters, C.J.), the court held that lawyers could not be held liable for abuse of process to their client's opponent in other litigation, despite the fact that the lawyers knew the allegations in the other litigation were false and without merit. The court restricted third party recovery against lawyers for abuse of process to cases in which the third party can point to "specific misconduct intended to cause specific injury outside of the *normal contemplation of private litigation*." *Id.* at 174 (emphasis added). Evidently, lawyers filing factually baseless claims is within the normal contemplation of private litigation. See GEOFFREY C. HAZARD, JR. & SUSAN P. KONIAK, *THE LAW AND ETHICS OF LAWYERING*, 425-26 (1990).

279. *Barrett Builders*, 576 A.2d at 460 n.5.

Once again, Peters' argument contains a kernel of truth: if a contractor opportunistically substitutes inferior products and the homeowner does not discover this fact until after making a progress payment, the homeowner should be allowed to recover the progress payment to deter contractor opportunism.

But the footnote goes far beyond this position. First, the court's point of reference is not when the homeowner discovers the contractor's *breach*, but when the homeowner discovers the contract's *invalidity*. This seems to mean merely the fact that no sufficient writing exists to make the contract enforceable. This moment is exactly the moment when homeowner opportunism is most likely. Second, the court declines to state forcefully that a homeowner generally should not get back a progress payment because such a payment tends to suggest satisfaction with the work and therefore the lack of contractor opportunism. The court says rather that "arguably" the homeowner has "impliedly consented" and that the issue is a "thorny" one. Such a muted commitment to deterring homeowner opportunism may very well encourage such behavior. One can easily see the development, for example, of lawyer advertising that would make opponents of such activity cringe: "Are you less than 100% satisfied with your home improvement contract, for any reason? Do not pay another cent! Call us now! You may be entitled not only to withhold further payment but to a refund of any payments you have already made!" What would make such advertising troubling is the fact that it focuses the homeowner's attention not on the wrongful behavior of the contractor, but on the homeowner's (and lawyer's) possibly large recovery. The point is that the court makes homeowner opportunism more likely by making it more tempting.

Even if the Connecticut courts interpret homeowner bad faith narrowly when there is no writing at all, what of those cases like *Barrett Builders* in which there is a writing but the terms are not clear? The Home Improvement Act statute of frauds requires that the writing "contain[] the entire agreement . . ."²⁸⁰ Because courts must interpret the "entire" agreement (whether or not they are "competent" to do so), they have another vehicle through which to express concern with homeowner opportunism.

In *Barrett Builders*, the court held that the writing was insufficient because it mentioned only cabinets without specifying the type,

280. CONN. GEN. STAT. ANN. § 20-429(a)(3) (West 1992).

style, or brand.²⁸¹ But there must be some limit to the requirement that the writing contain the "entire" agreement; this limit is determined at least in part by homeowner opportunism.²⁸² To go back to the *Jacob & Youngs* scenario for a moment, suppose a writing specified "wrought iron pipe" but not the brand name. Would the Connecticut Supreme Court hold that the writing contains the "entire" agreement if the contractor used Cohoes pipe, but the homeowner insists she wanted Reading pipe? If not, then almost any alleged disagreement over terms—no matter how trivial or implausible—could give rise to a statute of frauds defense.

However, the court eventually comes out on this issue, its holding on the known facts of *Barrett Builders* is reasonably defensible. There was no evidence to support the dissent's conjecture that the contractor in this case failed to conform to the statute's requirements out of "ignorance or carelessness."²⁸³ It is also more plausible that the homeowner would care what kind of cabinet she got than it was that the homeowner in *Jacob & Youngs* cared what brand of pipe he got. In addition, the facts are consistent with the story that the contractor acted opportunistically *ex ante*: he might have misled the homeowner by showing her a fancier cabinet than the one he intended to supply and leaving the specifications deliberately vague. Thus, denying enforcement of this agreement would arguably further the purposes of the statute of frauds.

Nevertheless, the court seems to have cut off the inquiry too fast. The contractor might have been merely negligent and the dispute might have been a simple misunderstanding that the contractor was willing to fix. The less likely contractor opportunism is, the more likely the reason for the dispute is homeowner opportunism. One extra fact the court might look at is the price term. If the quoted price was the contractor's (or the industry's) usual price for "solid

281. See *Barrett Builders*, 576 A.2d at 459-60.

282. A similar problem exists under the "traditional" statute of frauds, which requires that the writing state the "essential terms" of the agreement. See FARNSWORTH, *supra* note 47, § 6.7, at 430-31. Interestingly, in interpreting this requirement, the Connecticut Supreme Court—in an opinion by then-Justice Peters—held that it was error to disallow a memorandum that referred to the "usual provisions found in . . . purchase money mortgage deeds" where "the parties' disputes about performance relate to matters entirely independent of the purchase money mortgage." *Lynch v. Davis*, 435 A.2d 977, 980 (1980) (Peters, J.), *cited with approval* in FARNSWORTH, *supra* note 47, § 6.7, at 431 n.34. In *Lynch*, the court recognized what it overlooked in *Barrett Builders*, namely that the reason for the breach always matters, because the party seeking to use the statute of frauds may be acting opportunistically.

283. *Barrett Builders*, 576 A.2d at 461 (Shea, J., dissenting).

core” cabinets, and if the contractor substituted “hollow core” cabinets (and if hollow core cabinets are cheaper), that would tend to support the court’s decision. On the other hand, if the contractor could show that it charged a lower, “hollow core” price, the inference of contractor opportunism is weaker and the argument for allowing restitution—at least for the work performed other than the installation of the cabinets (assuming it was satisfactory)—is stronger.²⁸⁴

There may be no “optimal” restitution exception to the statute of frauds; the limits and presumptions of such an exception could reasonably be crafted in different ways. And there may be better solutions to the negligence-opportunism tradeoff in the statute of frauds than allowing a plaintiff-promisee to recover in restitution. One possibility recognized by Chief Justice Peters is for the legislature to reduce the penalty for noncompliance with the statute to a fixed fine or percentage reduction in the payment.²⁸⁵ Such a solution has the advantage of encouraging contractors to put agreements in writing, but not creating a tempting pot of gold that could encourage homeowner opportunism.²⁸⁶ The point I have tried to make here is that the *Barrett Builders* holding is based on the faulty premise that in analyzing the scope of the statute of frauds, a court can ignore the reason the contract soured and can isolate one incident—the absence of a writing—and create a rule determined by that fact alone. Such a rule does not further the purposes of the statute of frauds; it is neither efficient nor just. It is a delusion fostered in part by approaches to contract law—whether traditional or economic—that fail to recognize and resolve the negligence-opportunism tradeoff.

CONCLUSION

I would like to close by responding to what I take to be the main point—although certainly not the point on which most readers

284. Under the “traditional” statute of frauds, the general rule seems to be that “if one promise is within the statute, the entire contract is within the statute, and no part of the contract is enforceable unless the statute is satisfied.” FARNSWORTH, *supra* note 47, § 6.10, at 448-49. One way the Connecticut courts could mitigate the strict rule of *Barrett Builders* is to relax the “traditional” rule regarding divisibility.

285. See *Barrett Builders*, 576 A.2d at 461.

286. A similar solution has been tried, and has met with significant success in the “plain writing” movement. New York’s plain language law imposes a flat, relatively small fine, plus actual damages for violations. N.Y. GEN. OBLIG. LAW § 5-702 (McKinney 1989). This has evidently had the effect both of deterring convoluted legal documents and discouraging opportunistic litigation. See, e.g., Carl Felsenfeld, *The Future of Plain English*, 62 MICH. B.J. 942 (1983).

focus—of Grant Gilmore's *The Death of Contract*.²⁸⁷ Despite the book's title, Gilmore's broad theme is that general theories of law do more harm than they do good.²⁸⁸ In creating and perpetuating the general theory of contract, Langdell, Holmes, and Williston were not merely wrong in choosing their particular theory. They were wrong, according to Gilmore, to create a theory at all, to think that one could ever set down general and immutable principles that cut across legal boundaries and hold true for all time.²⁸⁹ To demonstrate this proposition, Gilmore presents a series of case analyses that effectively make the theorists' views of these cases seem ridiculous. He does this by pointing out additional facts neglected by the theorists or by asking crucial questions that the theorists never considered.

Professor Wonnell has recently argued that "many of Gilmore's criticisms concern not the principle of abstraction itself, but the specific abstractions chosen."²⁹⁰ Gilmore never tells us *why* he asks the particular probing questions he does or *why* he focuses on the specific facts he does. I do not mean to suggest that Gilmore asks bad questions or focuses on the wrong facts. On the contrary, Gilmore was a great legal mind precisely because he asked the right questions. But what makes these questions right, these facts relevant? Only a theory, grounded to some extent in abstraction can tell us. In the words of Professor Wonnell, "principles of contract universally applied will direct people's attention to the relevant facts, lead to the discovery of those facts, and motivate action based on those discoveries."²⁹¹ In

287. GRANT GILMORE, *THE DEATH OF CONTRACT* (1974).

288. Professor Hillman has recently responded to the flood of contract theories that have recently emerged with Gilmorean skepticism. He argues that "modern contract law" effectively takes into account both "the principle of freedom of contract" and "fairness and the interdependence of parties," yet "modern contract scholars devote much of their writings to the essentially unanswerable and perhaps even unimportant question of the relative weight of these sometimes conflicting principles." Robert A. Hillman, *The Crisis in Modern Contract Theory*, 67 TEX. L. REV. 103, 104 (1988) (emphasis added). In my view, the resolution of the negligence-opportunism tradeoff is truly significant: it defines who we are and what we value. Moreover, I have taken the position here that it is a tradeoff about which we can say something meaningful.

289. See GILMORE, *supra* note 287, at 97-98 ("The basic idea of the Langdellian revolution seems to have been that there really is such a thing as the one true rule of law, universal and unchanging, always and everywhere the same—a sort of mythical absolute. To all of us, I dare say, the idea seems absurd.")

290. Christopher T. Wonnell, *The Abstract Character of Contract Law*, 22 CONN. L. REV. 437, 444 (1990).

291. *Id.* at 450. Wonnell argues that the crucial abstractions for contract law are abstractions of person and subject matter. *Id.* at 438. I disagree. I would prefer to construct abstractions of reasons for contracting and reasons for breaching. For example, in my view, the

my view, what Gilmore's critique successfully demonstrates is that abstractions that ignore the *purpose* of contracting and the *reasons* for nonperformance are harmful. These matter because they focus our attention on the kinds of contractual behavior we want to encourage and discourage so as to improve future contracting. The abstractions we should be focusing on, therefore, are abstractions based on presumptions of opportunistic and negligent behavior that we seek to deter through contract law.²⁹²

Gilmore might have responded that this redirected abstraction—this new classicism—is also doomed to failure because there will always be new questions and new social conditions to which the theory is not addressed.²⁹³ But that suggests only that theories must be open-ended and constantly evolving, not that they are more harmful than useful. Gilmore might even have agreed with this view of theory: after all, he probably had some implicit analytical structure in mind in focusing on the questions he did. The problem is in transmitting the technique—both its possibilities and limitations—to mere mortals.

Consider the bridge player. She learns to play bridge by mastering a point-count system of bidding and standard moves such as finesses. Now the point-count system, if followed strictly, often yields wrong or misleading results. The great bridge players are the ones who know when to deviate from the guidelines. Some may even skip the point-count system entirely and jump right to a complex analysis of the hand.

So it is with lawyers and legal theories. Law and Economics provides a kind of point-count system of guidelines and generalizations that may well yield incorrect answers in particular cases. It may also be true that some will be better off not having guidelines at all for this reason. But I believe that it is also true that without some

category "contracts breached to take advantage of a market price change" is a more useful abstraction than "construction contracts."

292. I would make the same response to Farnsworth's recent disparagement of contract theory: "The urge to have a 'theory' of contract law has tended to increase the distance between contracts scholarship and practice. In particular, it has led to an excessive emphasis by scholars on why promises are enforced." E. Allan Farnsworth, *A Fable and a Quiz on Contracts*, 37 J. LEGAL EDUC. 206, 208 (1987). I certainly agree that contract theories should not be focusing on why promises are enforced. But the fact that they do is a fault of the theories, not of theorizing.

293. See GILMORE, *supra* note 279, at 7-8 (describing the "general law of contract" as a "theoretical construct which, having little or nothing to do with the real world, would not—or could not—change as the real world changed").

guidance, many more people—with far less insight than Gilmore—will commit far worse errors. Law and Economics, when practiced well, offers useful guidelines while explicitly recognizing the empirical assumptions and theoretical basis of these guidelines.

This paper has tried to improve the Law and Economics approach to contracts by recasting the two analytic traditions of the economic analysis of contract in terms of deterring negligent and opportunistic behavior: by combining the traditions into a more general, fault-based theory; by recognizing the necessity for resolving the negligence-opportunism tradeoff; and by advocating that greater priority should be given to using contract doctrine to deter opportunistic contracting behavior. My hope is that the economic approach to contract law will be improved as a result, and that lawyers, judges, and scholars may find the expanded theory to be a useful guideline for analyzing the cases they are dealt.