

A Crisis of Faith in (the Efficiency of) Expectation Damages

Author : Shawn Bayern

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Theresa Arnold, Amanda Dixon, Madison Whalen, & Mitu Gulati, *The Myth of Optimal Expectation Damages*, ___ Marquette L. Rev. ___ (forthcoming), available at [SSRN](#).

Everyone knows that the expectation measure is the standard, default measure of damages for a bargain contract, and for the last few decades most scholars have regarded the expectation measure as backed by weighty, straightforward justifications grounded on economic efficiency. But there are several reasons to doubt both of these general propositions, as the authors of *The Myth of Optimal Expectation Damages* nicely suggest and begin to demonstrate using empirical data from bond markets.

As doctrinal background, the expectation measure is not in fact as widely established as the default damages measure in contract law as many teachers of Contracts suppose. It's true that it's one standard measure, but the law uses other defaults in several important and often neglected contexts. For example, in many states, buyers of real estate don't get expectation damages for breach by the seller unless the breach is in bad faith; instead, the buyer is often limited to reliance damages (and often quite a limited subset of reliance damages). Similarly, doctrines that are commonly regarded as non-remedial, like doctrines of mistake, increasingly lead to remedies other than expectation damages.

As economic background, the standard instrumental justification for expectation damages is, on reflection, surprisingly circular. Expectation damages are treated as necessary to require the promisor to take appropriate precautions against breach, but at bottom "appropriate" ordinarily ends up resolving to some definition that assumes the efficiency of the expectation measure. And as a purportedly comprehensive refutation of remedial measures greater than expectation damages—such as disgorgement or specific performance—the simple version of the "theory of efficient breach" still often taught uncritically by Contracts professors [has proven to be an](#) analytical disaster.

The Myth of Optimal Expectation Damages makes a specific, important empirical contribution to this debate. As the authors note, empirical contributions here are difficult for several reasons. For example, some remedial rules are mandatory rules, like those that prevent stipulated "penalties" in excess of expectation damages, so the absence of such provisions from contracts isn't evidence that parties prefer expectation damages. To get around this and other problems, the article focuses on terms that are not formally remedial but that serve an economically identical role: alternative performance terms in bond contracts that specify costs for an issuer who prepays debt in advance of the schedule otherwise contemplated in the bond. Of course, this is just one domain—though, as the authors point out, "a multi-trillion dollar one"—but the authors' data is important and is consistent with skepticism of a single, efficient measure of contract damages.

The authors' central empirical findings are clear: virtually none of the contracts they studied call for prepayment penalties that would implement expectation damages; in fact, a range of measures is used; and parties often seek what would formally be labeled "supracompensatory" damages. This finding adds to other literature showing that sophisticated parties often choose measures of damages other than the expectation measure, which undercuts one type of efficiency-based analysis in contract law: that default rules should do what theoreticians predict rational parties would want them to do.

The authors also interviewed transactional lawyers who work with debt agreements and found that these lawyers don't appear to think in terms that orthodox contract-law theory would suggest. Instead, they adopt other perspectives,

including one that the authors interestingly characterize as associated more with joint ventures than with simple contracts: borrowers may ask for “supracompensatory” damages from issuers because they want to share in the issuer’s upside in the event an issuer finds itself with the ability to prepay debt. (After all, this is only fair: borrowers face significant downside in the event an issuer is unable to pay on the original schedule.)

A coda to the article (which, admittedly as a theoretician myself, I wish were longer!) raises the notion that simple analyses of allocative efficiency may not be an appropriate basis after all for a justification of expectation damages. The authors propose one alternative (that the default availability of expectation damages is an information-forcing rule—a penalty default that parties don’t want and ought to bargain around), but others are important to consider as well. The most obvious is perhaps the administrative simplicity of expectation damages: by focusing on the contract price or the cost of substitute performance, expectation damages give courts a readily workable measure.

Another possibility, of course, is that the justification for expectation damages as at least the dominant measure of contract damages does not lie in a simple conception of efficiency at all. For example, maybe the main purpose of expectation damages is to prevent unfair speculation by one party against another in rapidly changing marketplaces. The quicker and deeper a market, the more appealing expectation damages appear to become. Of course, this rationale can be framed in economic terms too—one party ought to pay the other to reserve an option to select a future market price rather than the present market price—but it suggests that the orthodox legal-economic view needs to be rethought.

Articles like *The Myth of Optimal Expectation Damages* highlight some of the dangers in trying to defend too broadly a single remedial measure of supposedly universal applicability by means only of simple theoretical explanations. Its attention to the details of real transactional practice is a useful reminder that the world of contracting is richer than commentators often pretend.

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