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**CONTRACT REMEDIES: FORESEEABILITY,  
PRECAUTION, CAUSATION AND MITIGATION**

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**Abstract**

This section discusses undercompensatory damages rules in contract law. These are rules that reduce the award to the promisee to an amount below that to which he would be entitled under the expectations rule. The reason for reducing compensation is to encourage the promisee to behave in a value-maximizing manner. The Hadley rule, which denies recovery for losses that the promisor could not ordinarily foresee, is thought to provide promisees with incentives to reveal how much they value performance, in order to give the promisor optimal with incentives to take care. The mitigation rule, which denies recovery for losses that the promisee could have avoided by mitigating damages after the breach, is thought to provide promisees with the proper incentives to reduce losses caused by the promisor's breach. Several theoretical and empirical ambiguities, however, weaken these arguments. Two other undercompensatory damages rules - the reasonable certainty doctrine and the emotional distress doctrine - are also discussed.

The section also deals with precautionary behavior by both the promisor and the promisee. The expectations rule encourages the promisor to take optimal precautions, but it also discourages the promisee from taking precautions. To encourage the promisee also to take optimal precautions, damages must be invariant with respect to the amount of reliance and, ideally, should be set at the efficient level of reliance. Causation is not an important concept in contract law and scholarship.

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**1. Introduction**

The expectation measure of contract damages, which requires the breaching promisor to pay the promisee an amount of money sufficient to put the promisee in the position it would have been in if the promisor had performed,

is the standard measure of damages in Anglo-American law, but it is subject to several exceptions. First, the award is reduced when a portion of the promisee's loss is attributable to circumstances that the promisor could not ordinarily foresee. This result is due to the rule of consequential damages, also known as the Hadley rule, after *Hadley v. Baxendale* (1854). Second, the award is reduced when a portion of the promisee's loss is attributable to the promisee's failure to take actions that would have minimized its losses subsequent to the promisor's breach. This result is due to the mitigation rule. Two less important doctrines hold that the award is reduced when the promisee cannot show that the loss was reasonably certain, and when the loss consists of emotional distress. Because these four rules on average produce an award lower than that produced by the expectation rule if applied unconditionally, they can be thought of as composing a larger category of undercompensatory contract damages rules.

The value of the Hadley, mitigation, reasonable certainty and emotional distress rules, like that of all other rules of contract law, depends on their effects on the various forms of contract-related behavior. This behavior includes the selection of contracting partners, the choice of contracting rather than using other forms of commitment, the care in drafting the contract, the disclosure by each party of private information, investment in anticipation of performance, the taking of precautions to minimize the expected loss from breach, the allocation of risk, performance rather than breach, and the readiness to renegotiate contractual obligations in light of changed circumstances. We concentrate on the promisee's incentives to disclose information, to take precautions and to mitigate damages. The Hadley rule and the mitigation rule have their greatest impact on these forms of behavior, and they will be discussed in the first and second sections of this chapter. The third section discusses the effect of damages rules on the parties' incentives to take precautions. The fourth section discusses causation, which, however, is not an important concept in contract law. The fifth section briefly discusses the reasonable certainty and emotional distress rules; however, these rules either have not received much attention in the literature or are discussed in other chapters of this encyclopedia.

## 2. The Hadley Rule

The Hadley rule states that promisors are not liable for losses that are not 'foreseeable'. This term has attracted a great deal of criticism. Some commentators charge that courts simply call a loss 'unforeseeable' whenever they believe, for an unarticulated reason of policy, that the loss should not fall on the promisor (see Fuller and Perdue, 1936). Whether or not this skepticism is justified, the term does not provide much guidance, because sophisticated parties can foresee and often do foresee the range of losses considered

unforeseeable by courts. For example, if a carrier fails to deliver goods or delivers them late, and this breach causes large losses for the shipper, perhaps because the goods were to perform a crucial role in the production process, the carrier will usually be liable for a limited amount, such as the purchase price, rather than the amount necessary to satisfy the shipper's expectation. In the traditional doctrine, the shipper receives full expectation damages only if the losses are predictable or if the shipper informs the carrier of the size of the anticipated loss prior to agreement. But surely the uninformed carrier can 'foresee' that some shippers place a greater value on performance than other shippers. When courts say that a loss is unforeseeable, the best interpretation of this conclusion is that the loss is considerably greater than the average of the losses that result from the kind of breach in question.

The Hadley rule is a default rule: parties are free to bargain around it and frequently do. Carriers, for example, often limit their liability and separately sell insurance against losses from misdelivery of expensive goods. The question asked by the Hadley literature is why the default rule limits liability to foreseeable damages, rather than imposing full liability on the promisor. It is thus typical to compare the Hadley (or 'limited liability' rule) to a full expectation rule (or 'unlimited liability').

Default rules have well-recognized functions: by providing background terms they spare the parties the costs of negotiating 'complete' contracts and they provide a focus to their negotiations. Assuming for the moment that the only purpose of default rules is to minimize transaction costs, the optimal default rule is the one that on average minimizes the necessity of bargaining, or, what is the same thing, that maximizes the *ex ante* value of the contract.

The relative advantages of the Hadley rule and expectation damages depend on which of the forms of behavior mentioned above has the greatest impact on the *ex ante* value of the contract. Inefficient breach, for example, is not fully deterred by the Hadley rule. To see why, consider a promisor (for concreteness, the 'seller') who would gain more from breaching than keeping its promise to the promisee (the 'buyer'). Suppose that when deciding whether to breach, the seller accurately anticipates the buyer's loss from breach. If the seller expects to be required to pay only average damages, it will breach even when the loss to the buyer from breach exceeds the seller's gains from breach. In contrast, the expectations measure deters inefficient breach. The reason for the different outcomes is that the Hadley rule does not permit compensation for the loss of the buyer's private, idiosyncratic value if not disclosed to the seller; but this loss is real, and if the seller is permitted to ignore it, then it will breach even when the buyer's loss exceeds the seller's gain. The effects of the rules on precaution - to take another example - are more complex. By forcing the buyer to incur part of the loss caused by the breach, any undercompensatory damages rule, including the Hadley rule, gives the buyer an incentive to take precautions

against the loss. There is, however, no necessary relation between the Hadley rule and the optimal level of buyer precaution. (More on this later.)

Unifying the analysis of the different effects of the Hadley and expectation rules is difficult. It is possible that for some broad class of transactions the *ex ante* value of contracts depends mostly on deterring inefficient breach, whereas for another class of transactions the *ex ante* value of contracts depends mostly on deterring insufficient precaution-taking by the promisee. If so, the Hadley rule should be enforced more vigorously in the second class than in the first. This approach has not, however, been taken in the literature, and it is not clear whether it would be fruitful.

The literature has focused instead on the problem of asymmetric information. Suppose that the carrier deals with two kinds of customers: high-value shippers, who suffer a large loss in case of misdelivery, and low-value shippers, who suffer a small loss in case of misdelivery. The carrier does not know whether a particular customer is high-value or low-value, but does know the proportion of each type in the population. Shippers know their own type. All parties are neutral with respect to risk. Because the loss avoided by investing in precautionary measures increases from the low type to the high type, the optimal contract with the high-value shipper would require the carrier to take costly precautions, whereas the optimal contract with the low-value shipper would require the carrier to take few precautions. Suppose that the expectation rule prevails. With full information the carrier would simply charge a higher fee for the high-precaution shipments than for the low-precaution shipments, and take the optimal level of precaution in each case. Without full information, the carrier would take an intermediate level of precaution and charge an intermediate price, producing two sorts of inefficiency. First, the carrier would take a suboptimal level of care when making high-value shipments. Second, too few contracts with low types will occur, because the intermediate price charged for unnecessary care will drive some of the low types from the market; and too many contracts with high types will occur, because their price is subsidized by the low types who remain in the market.

The Hadley literature originated with an influential argument that the Hadley rule cures these two inefficiencies. The argument asserts that under the expectation rule the high-value shipper has no incentive to reveal information. Whether or not the high-value shipper reveals its type, the expectation rule awards it damages sufficient to cover its loss. Because the shipper therefore expects full compensation whether the carrier breaches or not, it is indifferent as to whether the carrier breaches or not; and so it does not care whether the carrier minimizes the chance of breach by taking the optimal (high) level of precaution. The carrier can take the optimal level of precaution only if it knows the shipper's valuation; but because the shipper does not care about whether the carrier takes precautions, the shipper does not disclose its high valuation.

Under the Hadley rule, in contrast, the high-value shipper is undercompensated if it does not disclose its type, because the average level of damages is intermediate between high and low. To ensure adequate compensation in case of breach, the high-value shipper discloses its type. Now 'foreseeing' the large loss should it breach, the carrier will be liable under the Hadley rule for high damages if it breaches. To limit its expected liability the carrier invests in precautions until their marginal cost equals the marginal gain from avoided loss. Thus does the carrier invest in optimal precaution. Meanwhile, the carrier can distinguish the low-value shippers as those who do not state that they belong to the high type. The carrier can therefore charge the low-value shippers a lower fee, also taking the fewer precautions that are optimal for low-value shippers. Thus are the optimal number of low-value contracts entered. The Hadley rule cures both forms of inefficiency (see Barton, 1972; more recent treatments include Perloff, 1981; Bishop, 1983; Quillen, 1988; Cooter and Ulen, 1988; Ayres and Gertner, 1989; Bebchuk and Shavell, 1991; Eisenberg, 1992; and Posner, 1992).

A problem with some of the earlier discussions in the literature results from their focus on the behavior of the high-value shippers to the exclusion of the behavior of the low-value shippers. The argument tacitly assumes that although high-value shippers can and do contract out of the Hadley rule, low-value shippers would not contract out of the expectation rule. If the low-value shippers cannot contract around the expectation rule, then, of course, inefficiencies result. If the low-value shippers can contract around the rule, however, they will. The reason is that the low-value shippers prefer a package offering a low price, few precautions and low damages, to the package offering intermediate price, intermediate precautions and intermediate damages. Therefore, the low-value shippers will identify themselves as low-value shippers and offer to agree to limited liquidated damages in case of breach. Because their liability in case of breach of contract with low-value shippers is thus limited, the carriers take fewer precautions. The carriers also charge the low-value shippers a reduced fee, which attracts back into the market all low-value shippers who value shipment more than its marginal cost to the carrier. This cures the problem of too few contracts with low-value shippers. Since the carriers know that only high-value shippers would decline to identify themselves as low-value shippers, the carriers know to charge a high fee to any shipper that fails to identify itself as a low-value shipper. Because the carriers remain subject to full expectation damages with respect to the high-value shippers, and because they can accurately predict the extent of their liability (now that the high-value shippers are no longer pooled with the low-value shippers), they will increase their level of precaution to the optimal level with respect to the high types. This cures the problem of inefficient precaution (see Perloff, 1981; Ayres and Gertner, 1989; Bebchuk and Shavell, 1991).

Barring further analysis or empirical work, the arguments are in equipoise. To see more clearly why, observe that to compare default rules, one sums (1) the expected costs of contracting around the rules (also sometimes called the 'communication costs'), and (2) the losses resulting from the failure to contract around when doing so is not individually cost-justified. Consider one element of the expected costs of contracting around each rule: the proportion of high and low types in the population. If low types form a majority, then more contracts require disclosure of information under the expectation rule, where low types bargain around, than under the Hadley rule, where high types bargain around. If it is costly to bargain around contracts by disclosing information, then, everything else being equal, the Hadley rule generates fewer costs. The problem with the argument, however, is that there is no reason for believing that low types outnumber high types. More likely, the valuations are approximately normally distributed, and if a model requires bifurcation of the distribution then it should assume that half the types are high and half are low, an assumption which, unfortunately, renders the analysis indeterminate. These considerations appear to account for the skepticism toward the Hadley rule in Perloff (1981). Ayres and Gertner (1989) and Bebchuk and Shavell (1991) argue informally that the Hadley rule is superior when communication is socially optimal, but it is clear from their models, as the authors appear to recognize, that this conclusion depends on the assumption that high types form a minority.

Consider now the costs of bargaining around a default rule - the costs of communicating one's type and of negotiating and drafting the contracts. Suppose that the low types and the high types are equal in number. The Hadley rule is favored if the cost to low types is systematically higher than the cost to high types. There is no reason, however, to assume that the different types would typically incur different bargaining costs. As an aside, note that if the bargaining costs are trivial, never preventing parties from bargaining around, then the entire default analysis becomes irrelevant, since the parties can always choose the optimal terms.

Finally, when the cost of communication exceeds the gains produced when the carrier takes the optimal level of precaution rather than the intermediate level of precaution, it is socially suboptimal for communication to occur, but under certain conditions the Hadley rule, but not the expectation rule, will cause the high types to communicate (see Bebchuk and Shavell, 1991). To see why, imagine that the equilibrium obtains in which only the high types communicate. If a high type were to deviate, then it would save the costs of communication, but it would incur an expected loss as a result of the carrier's move from high to low precautions. The high type would stop communicating its type only if the former exceeded the latter. But from the perspective of social welfare, the relevant comparison is between the savings in communication costs, on the one hand, and the loss resulting from the move from the high level

of precaution to the *intermediate* level of precaution. The reason is that if no high types communicated, then the carrier would offer the intermediate package of precaution, price and damages, not the low package. It is thus possible that communication costs for high types are high enough that no communication is socially optimal, but also low enough that no high type would decline to communicate, given that all other high types are communicating. To be sure, the low types are injured by a move from a communication to a no-communication equilibrium, since they communicate in neither case and prefer the package of price, precaution and damages in the first case. But under the right conditions their injury is smaller than the gain to the high types.

In sum, although a cursory reading of the literature may suggest otherwise, the information revelation arguments do not clearly favor the Hadley rule or the expectation rule. The Hadley rule dominates the expectation rule only under special conditions, and there is no reason to believe that these conditions generally prevail or that, when they do prevail, courts can reliably identify them for the purpose of applying the rules. The indeterminacy is not surprising, given that the Hadley articles so far discussed rely on signaling models, and the difficulty of ranking equilibria produced in signaling models is well-known.

Another branch of the Hadley literature also assumes asymmetric information but assumes further that the party without the private information has market power. Suppose the carrier has market power and the shippers do not. The existence of market power changes the high-value shippers' calculations under the Hadley rule. If they reveal their type, they will expect the carrier to respond by charging them a supracompetitive price. If they do not reveal their type, however, they will not gain the benefit of full compensation in case of breach. In weighing these costs, shippers will sometimes choose not to reveal information, resulting in the precaution and number-of-transactions inefficiencies discussed above (Wolcher, 1989; Johnston, 1991). In contrast, under the expectation rule, the low-value shippers lose nothing from revealing their type. Indeed, they gain. Because the carrier can price-discriminate against the high types only if it can identify them, and it can identify them only if the low-value shippers disclose their type, the carrier will offer the low types a lower price in order to encourage such disclosure. The parties thus distinguished, the carrier will offer each type a different package of price, compensation and care. On these grounds Johnston (1990) prefers the expectation rule to the Hadley rule.

The argument does not, however, show that the expectation rule dominates the Hadley rule under general conditions. To see why, observe that the carrier can force the parties to reveal their types only by offering alternative contracts, one of which (the 'high' contract) the high types prefer to the other (the 'low' contract), but the other of which the low types prefer to no contract at all. At the same time, the carrier will maximize profits by exploiting its monopoly

power, and this means charging prices that are as close to the types' valuations as possible. To encourage the low types to accept the low contract, the carrier must give them a price below their valuation; but if this price is too low, the high types will choose the low contract over the high contract, frustrating the carrier's attempt to maximize profits. To make the low contract sufficiently unattractive to the high types, the carrier will set the damages level at a low level. Obviously, the carrier would not set the damages level above the low type's valuation; but it can also be shown mathematically (see Ayres and Gertner, 1992, pp. 768-769) that the damages level in the low contract will be lower than the low type's valuation. (The intuition for this result is that a high damages level for the low contract would drive the price for the low contract down, leading to a greater difference in prices for the high and low contracts, which would attract the high types to the low contract, but this would prevent the carrier from price discriminating against them.) But if the damages level in the low contract is less than the low type's valuation, then the carrier will take an inefficiently low level of precautions. This efficiency loss occurs under both the expectations and the Hadley rule. The relative size of the efficiency loss depends on a variety of factors, such as the parties' relative valuations, the proportions of types in the population, and so on, so that one cannot describe abstract conditions under which each rule produces better outcomes.

The analysis of Hadley thus plummets into theoretical indeterminacy, but a few routes may lead out of this impasse. First, greater attention to historical and current commercial practices may reveal that some common assumptions are implausible and can safely be ignored in analysis. Legal and commercial constraints, for example, may inhibit the exercise of market power by carriers and other promisors. The empirical efforts of Danzig (1975), Landa (1987), Epstein (1989) and Johnston (1990) provide a foundation for such work. Second, greater attention to institutional issues may put helpful constraints on the analysis. If courts have general knowledge about valuations in an industry, if they can reliably distinguish between cases in which transaction costs are high and cases in which they are low, and if they can detect market power, then they should apply a rule that makes the extent of liability turn on all these factors; but if they cannot, then perhaps a bright-line rule should be used, such as unlimited liability, on the grounds that it would put the least demands on their abilities.

### **3. The Mitigation Rule**

The mitigation doctrine requires the promisee to take steps to reduce the loss from breach after it learns of the breach or acquires reason to know of it. If the promisee fails to take such steps, it will not recover full expectation damages. Instead, it will receive damages sufficient to compensate it for the loss that it

would have incurred if it had taken the proper steps to mitigate. In this way, the mitigation doctrine, like the Hadley rule, is an undercompensatory damages remedy. Also like the Hadley rule, the mitigation doctrine is a default rule.

The buyer (that is, the promisee) often has a chance to minimize the loss resulting from breach. For example, upon learning that the seller will not make a timely delivery of components that the buyer plans to use in producing goods, the buyer can consider buying replacements on the market and using them instead, or it can suffer a delay in production. If it does not purchase replacements, then it will lose profits from the delay in production. If it does purchase replacements and their price exceeds the contract price of the promised goods, then it will incur a loss equal to the difference in price. Mitigation refers to the buyer's choice of the response that minimizes the loss resulting from breach.

The most thorough analysis of the mitigation doctrine is that of Goetz and Scott (1983). See also Wittman (1981), and the comments in Bebchuk and Shavell (1991). Suppose that renegotiation is prohibitively expensive and that no mitigation rule exists, and that after the seller breaches, the buyer has the opportunity to reduce its expected loss from \$100 to \$50 by taking some action, like purchasing a substitute on the spot market. (For simplicity, the cost of mitigation is built into the loss; this could also be understood as the buyer incurring a \$10 expense to reduce the expected loss from breach to \$40.) We also assume throughout that the buyer can more cheaply reduce the expected loss than the seller can; otherwise, there is no problem, since the seller has every incentive to reduce its own liability. Under the rule of expectation damages, the buyer expects to be fully compensated for its loss regardless of whether it mitigates. If it mitigates properly, then it will incur only a \$50 loss, but it will receive only the \$50 damages necessary to compensate it. If it fails to mitigate and so loses profits, then it will incur a \$100 loss, but it will receive the \$100 in damages necessary to compensate it. Thus, the buyer has no incentive to engage in mitigation in the absence of the mitigation rule. But clearly mitigation is efficient: it reduces net losses by \$50. The reason the buyer does not mitigate is that the seller enjoys the gains while the buyer incurs the costs. To give the buyer the incentive to mitigate, it must be penalized when it fails to do so. The mitigation rule produces this penalty by imposing on the buyer the loss that the seller would otherwise incur from the buyer's failure to mitigate. If the buyer fails to mitigate, it would incur a loss of \$100 but receive damages of only \$50; if it mitigates, the \$50 damages would fully compensate it for the \$50 loss. Therefore, the buyer would mitigate.

Notice that the buyer has an incentive to mitigate as long as it does not recover actual damages and that the amount it does receive is unrelated to actual loss. While the mitigation doctrine performs this function, so would any damages rule that provides an amount that is invariant with respect to the

actual loss - for example, a rule of zero damages.

The argument is less straightforward if renegotiation costs are low. In the absence of the mitigation rule, the seller could, at the time of breach or in anticipation of breach, offer to pay the buyer to mitigate. Since the seller bears the full costs of the failure to mitigate, it will pay the buyer to the extent that the gains from mitigation exceed its costs; and as long as this is the case, the buyer would be willing to accept the payment and to engage in mitigation. In the example, the seller would offer to pay the buyer up to \$50 to mitigate, since mitigation would reduce the seller's liability by \$50. The efficient outcome is obtained. The only difference between this result and the result under the mitigation rule is that the cost of mitigation is fully borne by the buyer under the mitigation rule, whereas in the absence of the rule the cost of mitigation is fully or partly borne by the seller, depending on its bargaining power.

This argument, at first glance, suggests that the value of the mitigation rule depends on its effect on incentives to engage in *ex post* renegotiation. One might argue that the no-mitigation rule creates worse incentives to renegotiate. Under the no-mitigation rule the buyer has strong incentives to hold out for a large payment from the seller and the seller has strong incentives to pay as little as possible, so that the gains from mitigation would be dissipated as the parties haggle. This problem, however, is offset by an advantage of the no-mitigation rule, namely, that it forces the seller to disclose an anticipated breach at the earliest possible moment. In contrast, under the mitigation rule the buyer must guess the likelihood and time of breach, and take steps to mitigate in light of its incomplete information. For discussions of the complex problems of the timing of breach, and of repudiation and cure, see Jackson (1978), Goetz and Scott (1983) and Craswell (1990).

Even supposing low renegotiation costs, the mitigation and the no-mitigation rules have different effects on behavior. Consider, for example, the parties' incentives to take precautions against loss. The seller has higher expected costs under the no-mitigation rule than under the mitigation rule, because under the former it must pay the buyer to mitigate in case of breach. These costs will encourage the seller to take precautions against the loss from breach; but at the same time the expected gain to the buyer in mitigation payments in case of breach will deter the buyer from taking precautions. Under the mitigation rule, the buyer no longer has this disincentive to take precautions, but now the seller, because it no longer expects to have to pay the buyer to mitigate, has less reason to take precautions. Another example of the different effects the rules have on the parties' behavior concerns the allocation of risk. Under the no-mitigation rule, the seller charges the buyer a premium to make up for the expected cost of paying the buyer to mitigate. The premium can be thought of as the cost of a lottery ticket that gives the buyer the chance, equal to the probability of breach, to gain the value of the premium. There is

no reason to think that a buyer would be willing to purchase this lottery ticket. Risk-averse buyers do not want to take on risk, and risk-preferring buyers can gamble more profitably by visiting a casino (compare Craswell, 1990). The no-mitigation rule creates an added cost to contracting, and this cost will deter people from entering otherwise value-maximizing contracts.

If a mitigation rule seems superior to a no-mitigation rule, some authors doubt that courts apply the mitigation rule in a proper way. For example, some courts award the buyer the difference between the contract price and the market price of the substitutes without taking into account the possibility that the buyer should mitigate also by purchasing fewer substitutes or substitutes of lower quality. But when prices of goods rise, users of them generally should reduce consumption (see Fenn, 1981). Another example is the practice of refusing to compensate buyers who engage in high-risk mitigation strategies that result in no actual loss reduction, or allowing full compensation of buyers who decline to engage in mitigation strategies that require high capital outlays. As MacIntosh and Frydenlund (1987) point out, the net present value of a mitigation strategy, not its riskiness or costliness, determines its suitability. These criticisms, however, do not undermine the mitigation rule so much as raise the issue of whether it should be enforced as a series of strict liability rules, as reflected in the doctrines criticized, or as a negligence-like standard as the authors implicitly argue. A standard taxes judicial competence, but whether this cost outweighs the systematic distortions caused by rules is not known.

To return to more general issues, one might ask why the mitigation analysis and the Hadley analysis follow such different paths. The disclosure of information, which is the focus of the Hadley analysis, and the mitigation of losses, which is the focus of the mitigation analysis, are but aspects of promisee behavior that minimizes the expected loss from breach. Indeed, the Hadley rule encourages the promisee to mitigate post-breach whenever the 'unforeseeability' of the magnitude of its prospective loss threatens it with an undercompensatory remedy. And the mitigation rule encourages the promisee to disclose information prior to contracting whenever the disclosure of information would enable the promisor to take precautionary steps that are more cost-effective than post-breach mitigation by the promisee. Both the Hadley rule and the mitigation rule threaten the promisee with undercompensatory damages in order to encourage it to engage in loss-minimizing behavior: in this way, they address the same problem in a similar manner. The convenient but artificial distinction in the doctrine has created an unjustified divergence in scholarly analysis.

#### **4. The Precaution Decision**

A 'precaution' can be defined as any act by a person that reduces the expected loss from breach of contract. A person can take precautions by using care in selecting a contracting partner, by disclosing information to that partner, by drafting the contract in clear and simple language, by purchasing insurance against loss from breach, by modifying its capital investments to minimize the loss from breach, by mitigating, by renegotiating, and so on - in short, by taking any of the value-maximizing steps that were discussed in prior sections. One should take care in reading the literature, because commentators use the word 'precaution' in different ways. Goetz and Scott (1980) limit their discussion of precaution to the promisor's use of clear contracting language that encompasses an adequate quantity of contingencies. Cooter (1985) limits his discussion of precaution to efforts made by the promisor and the promisee to minimize the expected loss from breach of contract between the signing of the contract, on the one hand, and performance or breach, on the other. Because we have already discussed disclosure of information and mitigation, and because discussion of the other aspects of precaution can be found in Chapter 4600, we follow Cooter.

The only sustained discussion of precautionary behavior as an aspect of contract law (it appears routinely, however, in commentary on the law of products liability and, of course, on the law of torts generally) is that of Cooter (1985) (see also Cooter and Ulen, 1988). In Cooter's model, a promisor agrees to deliver goods at a certain time. The promisor and the promisee choose whether to take precautions, and the jointly maximizing behavior of each party is to take precautions. For example, if the promisor agrees to rent warehouse space to the promisee at a future date, the promisee can take a precaution against breach by reserving storage space at another site or by letting its inventory run down. The precaution is costly to the promisee, but we suppose that it reduces the expected loss from breach by more than it costs the promisee. It is therefore efficient for the promisee to take the precaution, in the sense that the gains from the precaution exceed the cost. Indeed, a complete contract would require the promisee to take the precautions. When transaction costs prevent the parties from describing the promisee's duty to take a particular precaution, however, the promisee would not take the precaution in the absence of a legal rule compelling it to do so. The reason is that it incurs the costs of the precaution but the promisor enjoys the gains. A legal rule that forced the promisee to take the precaution might therefore seem desirable.

Similarly, the promisor can incur costs to lower the expected loss from breach. For example, the promisor can take a precaution against breach by hiring a guard to protect the premises, so that the warehouse will not be destroyed by fire. If the cost of hiring the guard is less than the expected loss, the promisor would maximize the value of the contract by hiring the guard. A

legal rule should force the promisor to take such a precaution.

What kind of rules would serve these purposes? For the promisor, expectation damages would ensure the optimal level of precaution. Since expectation damages force the promisor to bear the promisee's loss, the promisor would take precautions to the point where their marginal cost equals the marginal expected reduction in the promisee's loss. The problem with expectation damages, however, is that they would discourage the promisee from taking precautions. The reason is that if the promisee is fully compensated whether or not it takes precautions, it has no incentive to take them. Another rule is necessary for encouraging the promisee to take precautions.

One possibility is a rule that awards zero damages. To see why, imagine that the breach would result in an expected loss of \$100 if the promisee fails to take a precaution, and in an expected loss of \$50 if the promisee takes a precaution that costs it \$10. Under the zero damages rule, the promisee expects to bear the full loss, and so would take the \$10 precaution in order to reduce the loss from \$100 to \$50. The problem with zero damages, however, is that it gives the promisor no incentive to take precautions. Thus, there is a tension between creating incentives for the promisor to behave properly and creating incentives for the promisee to behave properly.

One possible resolution is a rule, analogous to the mitigation rule, that would require the promisee to take precautions whenever they produce gains greater than their costs. Such a rule might hold that the promisee must take 'reasonable' precautions against breach, meaning that the promisee suffers a reduction in damages equal to the amount of loss it could have avoided by taking precautions minus the cost of those precautions. Under this rule the promisee will take cost-justified precautions in order to avoid the reduction in damages. Then the promisor would bear any residual losses caused by its (the promisor's) failure to take cost-justified precautions, and to avoid these costs the promisor would take precautions as well.

Another possibility is a rule that limits the promisee's damages to an amount that is invariant with respect to its level of reliance. We already saw that a rule that gave the promisee zero damages would cause it to use the precaution, because by doing so it incurs a \$10 cost in order to reduce its losses by \$50. Similarly, a rule that gave the promisee \$50 of damages would cause it to use the precaution, because the \$10 cost of the precaution is less than the reduction in the uncompensated loss from \$50 (that is, \$100 loss minus \$50 damages) to \$0 (that is, \$50 loss minus \$50 damages). Even a rule that gave the promisee \$200 in damages would cause it to use the precaution. The promisee expects to gain more from taking the precaution ( $-\$50 - \$10 + \$200 = \$140$ ) than by failing to take the precaution ( $-\$100 + \$200 = \$100$ ). The crucial distinction between this rule and expectation damages is that under the former the promisee benefits from taking precautions, whereas under the latter the

promisor benefits when the promisee takes precautions. The promisee can be forced to internalize the cost of failing to take precautions only by a rule that makes its damages award invariant with respect to the amount which it invests in precautions. To be sure, the \$200 rule, like the \$0 rule, would create improper incentives for the promisor. It would cause the promisor to take too many precautions and to perform when it should breach. The optimal damages rule with respect to both promisor and promisee incentives would require an amount equal to what would be necessary to put the promisee in the position it would have been in if the promisor had performed *and* the promisee had taken efficient precautions.

The reader might recall from Chapter 4600 that a similar conclusion was reached with respect to the question of promisee 'reliance'. The connection between precaution and reliance is indeed very close. Scholars often talk of the promisee engaging in too much reliance or engaging in too little reliance on promises, by which they mean that the promisee invests more or less than the jointly value-maximizing amount between the signing of the contract and the completion of performance. The notions of promisee reliance and promisee precaution capture similar phenomena but from opposite directions: a promisee who takes too few precautions relies too much; a promisee who takes too many precautions relies too little. Commentary on reliance has focused on the behavior of the promisee in relation to the promisor's incentive to breach, whereas analysis of precaution has dealt with the precautionary behavior of both the promisor and the promisee. But the conclusions of the two analyses are the same: the remedy of expectation damages is suboptimal because it allows the promisee to externalize costs on the promisor. The optimal damages rule would give the promisee the value of the expectation it would have had if it had engaged in the optimal level of reliance or - what is the same thing - the optimal level of precaution.

This rule, however, does not exist. No rule straightforwardly encourages promisees to take efficient precautions. To be sure, promisees may fear that the Hadley rule and the mitigation rule will result in undercompensatory damages, and thus take precautions in order to limit their expected losses (compare Cooter, 1985). But neither the Hadley rule nor the mitigation rule directs courts to take account of a promisee's precautions other than those of disclosing information pre-contract and mitigating damages post-breach. Cooter (1985) notes that parties can contractually limit damages to encourage the promisee to rely, but parties are free (usually) to contract around any damages rule. The question is why there is no default rule that, on an analogy to the Hadley rule and the mitigation rule, encourages precautionary behavior when transaction costs prevent the parties from stipulating damages in advance. There is not an obvious answer, but one possible direction of research would inquire into whether courts are more competent at making some kinds of evaluations, such as the reasonableness of mitigation, than others, such as the propriety of

precautionary behavior.

## 5. Causation

Causation is not an important concept in Anglo-American contract law. This is partly because the concept of causation is captured by other contract doctrines. If the promisee fails to mitigate, one might say that the promisor did not cause the entire loss, and therefore should not be fully liable; but this result is produced through application of the mitigation doctrine, and a separate 'causation doctrine' is not necessary, as it is in tort law. In only a handful of contract cases do courts discuss causation as a distinct issue. These cases involve a promisee who has separate contracts with two different breaching promisors, both of which breaches are sufficient to cause some or all of the loss. These cases have not attracted the attention of scholars, probably because of their rarity. The tort doctrine of proximate causation has an analogy in the Hadley doctrine and the doctrine of 'reasonable certainty'. All of these doctrines release the wrongdoer from some or all liability when the victim's loss is not entirely attributable to the promisor's wrongdoing.

## 6. Related Doctrines

Two other doctrines are related to the themes that have been discussed. The first limits expectation damages to an amount sufficient to compensate the promisee for a loss that is 'reasonably certain'. The second denies promisees compensation for emotional distress arising from a breach of contract. Both doctrines, like the Hadley rule and the mitigation rule, are undercompensatory. The reasonable certainty doctrine requires the promisee to prove its loss with a greater degree of certainty than that required by the preponderance of evidence test that governs the other elements of civil actions. Some commentators argue that, in practice, the courts use the doctrine in a highly flexible way to prevent recovery of damages whenever they seem to overcompensate the promisee. Possibly, courts use the doctrine to punish promisees who engage in too much reliance, take too few precautions, or misbehave in other ways. This would support the analysis of Cooter (1985), described above.

Another possibility is that the reasonable certainty doctrine actually does have analytic bite, and serves the purpose of preventing parties from externalizing the cost of resolving disputes on the courts. Unlike the injurers and victims under tort law, which has no analogous doctrine, the parties to a contract can anticipate a legal dispute and take steps in advance of performance to facilitate adjudication. For example, if they anticipate that a loss, such as the

loss of good will or the loss of personal enjoyment of the goods or services, will be hard for a court to measure, they can arrange for a liquidated damages provision to specify that loss in advance. To deter parties from externalizing the cost of determining loss onto the courts, and to encourage them instead to supply a liquidated damages provision, a doctrine denying compensation for uncertain loss might be justified. See Chapter 4600 for discussion of the closely related issue of subjective loss.

The 'emotional distress' doctrine raises issues similar to those raised by the reasonable certainty doctrine, but it raises one additional issue. The tort literature suggests that the case for compensation for emotional distress is uneasy. On the one hand, it is not clear that people would purchase insurance against nonpecuniary loss, because the marginal utility of money in the accident state of the world, once pecuniary losses are compensated, is not necessarily higher than the marginal utility of money in the non-accident state of the world. On the other hand, if the promisor is not forced to pay damages for emotional distress, it will have an incentive to take too few precautions against breach. For discussion of these issues, see Chapter 5140.

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