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THE CASE FOR PUNITIVE DAMAGES IN CONTRACTS

WILLIAM S. DODGE†

ABSTRACT

The majority of American jurisdictions do not allow punitive damages for breach of contract unless the breach constitutes an independent tort. Increasingly, courts and commentators have relied on the theory of “efficient breach” to explain the rule against punitive damages in contracts. In this Article, Professor Dodge argues that economic efficiency supports a different rule—one allowing punitive damages for any willful breach of contract.

Willful breaches fall into two categories: those that are “opportunistic” and those that are “efficient.” An “opportunistic” breach does not increase the size of the economic pie; the breaching party gains simply by capturing a larger share of the pie at the expense of the nonbreaching party. An “efficient” breach, by contrast, increases the size of the pie, allowing the breaching party to compensate the nonbreaching party and still come out ahead. Detering opportunistic breaches with the threat of punitive damages is efficient because such breaches by definition do not increase societal wealth. Thus, punitive damages should be routinely available in cases of op-

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portunistic breach, such as pretextual termination, stonewalling, and bad faith refusal to pay a debt.

Efficiency also supports extending liability for punitive damages to those breaches that are, in theory, "efficient." The threat of punitive damages will not require inefficient performance because the potentially breaching party may negotiate with the other party for a release. Relying on Calabresi and Melamed's distinction between "property rules" and "liability rules," Professor Dodge shows that requiring the potentially breaching party to negotiate for a release is more efficient than allowing her to breach and pay damages because the transaction costs of negotiation, while not negligible, are generally lower than the assessment costs of litigation. He also explains why other forms of "property rule" protection, like specific performance and penalty clauses, are insufficient to ensure that negotiation occurs before breach.

INTRODUCTION

Traditionally, punitive damages have not been available for breach of contract. The goal of contract remedies has been to compensate the promisee for the breach rather than to compel the promisor to perform.¹ Justice Holmes wrote in *The Common Law*:

The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses.²

Although the original reasons for the rule against punitive damages in contracts are obscure,³ law and economics scholars have

1. See RESTATEMENT (SECOND) OF CONTRACTS, intro. note to ch. 16, at 100 (1981) [hereinafter RESTATEMENT] ("The traditional goal of the law of contract remedies has not been compulsion of the promisor to perform his promise but compensation of the promisee for the loss resulting from breach."); E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1147 (1970) ("Our system, then, is not directed at compulsion of promisors to prevent breach; rather, it is aimed at relief to promisees to redress breach.").

2. OLIVER WENDELL HOLMES, JR., *THE COMMON LAW* 301 (1881).

3. See Timothy J. Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 221 (1977):

[O]ne of the principal impediments to analysis of contract cases treating the question of punitive damages is the consistent absence, particularly in the early cases, of any meaningful judicial discussion of the philosophy of damage law. . . . [W]e must begin without any firm idea of why, beyond adherence to traditional English standards,

found a contemporary justification in the theory of “efficient breach.” As Chief Judge Posner has put it, “Holmes’s dictum . . . contains an important economic insight. In many cases it is uneconomical to induce completion of performance of a contract.”⁴ If a widget manufacturer, by breaching her contract with *A* and selling to *B*, can make enough to compensate *A* for his loss and still come out ahead, she should do so. The manufacturer is better off, *A* is no worse off, and the widgets end up with *B*, who values them most. The manufacturer should not be liable for punitive damages because “[a] penalty would deter efficient . . . breaches, by making the cost of the breach to the contract breaker greater than the cost of the breach to the victim.”⁵ Efficient breach has now become the standard explanation of why punitive damages are not awarded for breach of contract. The *Restatement (Second) of Contracts*⁶ and a large number of contracts casebooks⁷ and treatises⁸ rely on the theory of efficient breach to explain why punitive damages are not allowed. Courts have also in-

American courts have held, as a general rule, that punitive damages should not be awarded for breach of contract.

4. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 131 (5th ed. 1998).

5. *Id.* at 142.

6. See RESTATEMENT, *supra* note 1, intro. note to ch. 16, at 100 (“The answer provided by at least some economic analysis tends to confirm the traditional response of common-law judges in dealing with this question.”); *id.*, reporter’s note at 101 (“To prevent [efficient breach] by compelling performance, it is argued, would result in a less efficient distribution of wealth since the party in breach would lose more than the injured party would gain.”); *id.* (“[A] breach of contract will result in a gain in ‘economic efficiency’ if the party contemplating breach . . . will gain enough from the breach to have a net benefit even though he compensates the other party for his resulting loss.”).

7. See, e.g., STEVEN J. BURTON, *PRINCIPLES OF CONTRACT LAW* 289-91 (1995) (discussing the similarity of “the prevailing law of contract” to that dictated by the efficient breach hypothesis); JOHN D. CALAMARI ET AL., *CASES AND PROBLEMS ON CONTRACTS* 626-28 (2d ed. 1989) (excerpting an opinion by Judge Posner that gives efficient breach as the reason for denying punitive damages); E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, *CONTRACTS: CASES AND MATERIALS* 20-21 (5th ed. 1995) (suggesting efficient breach as a reason for denying punitive damages for breach of contract); ROBERT W. HAMILTON ET AL., *CONTRACTS: CASES AND MATERIALS* 71 (2d ed. 1992) (same); CHARLES L. KNAPP & NATHAN M. CRYSTAL, *PROBLEMS IN CONTRACT LAW: CASES AND MATERIALS* 999 (3d ed. 1993) (same).

8. See, e.g., E. ALLEN FARNSWORTH, *CONTRACTS* § 12.3, at 157 (2d ed. 1998) (“Punitive damages should not be awarded for breach of contract because they will encourage performance when breach would be socially more desirable.”); JOHN EDWARD MURRAY, JR., *MURRAY ON CONTRACTS* § 6, at 15 (3d ed. 1990) (stating that efficient breach analysis “is consistent with the fundamental concept of contract remedies, i.e., to compensate the injured party by placing him in the position he would have occupied had the contract been performed”).

creasingly turned to the theory of efficient breach to justify their holdings denying punitive damages for breach of contract.⁹

There are two basic problems with the efficient breach argument against punitive damages. First, the efficient breach argument provides no excuse for shielding *opportunistic* breaches of contract—those in which the breaching party attempts to get more than she bargained for at the expense of the nonbreaching party¹⁰—from punitive damages. As Judge Posner has recognized, when a promisor breaches opportunistically, “we might as well throw the book at the promisor. . . . Such conduct has no economic justification and ought simply to be deterred.”¹¹ Yet many courts apply the rule against punitive damages to shield not just involuntary breaches and efficient breaches, but opportunistic breaches as well. Ironically, some have even done so while relying on the theory of efficient breach to support their decisions.¹²

Second, and more fundamentally, allowing a promisor to breach and pay only expectation damages¹³ is not the most efficient way to avoid inefficient performance. Subjecting a widget manufacturer who wishes to escape her contract with *A* to the threat of punitive damages will not require an inefficient performance. It will, however, lead her to negotiate with *A* for a release rather than making a unilateral decision to breach. A rule that forces such negotiation will tend to be more efficient than a rule that allows one party to breach and pay damages without the other party’s consent because the costs of nego-

9. See, e.g., *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir.1988); *L.L. Cole & Son, Inc. v. Hickman*, 665 S.W.2d 278, 280 (Ark. 1984); *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 676 (Cal. 1995); *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 445 (Del. 1996); *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 984 (Ind. 1993); *Story v. City of Bozeman*, 791 P.2d 767, 774 (Mont. 1990); *McGinnis v. Honeywell, Inc.*, 791 P.2d 452, 460 (N.M. 1990); *Grynberg v. Citation Oil & Gas Corp.*, 573 N.W.2d 493, 500 (S.D. 1997).

10. See *Patton*, 841 F.2d at 751 (defining an opportunistic breach as one in which “the promisor wants the benefit of the bargain without bearing the agreed-upon cost”).

11. POSNER, *supra* note 4, at 130.

12. See, e.g., *Freeman & Mills*, 900 P.2d at 676-77 (holding that punitive damages are not available for withholding payment without good faith belief in right to do so); *Miller Brewing Co.*, 608 N.E.2d at 984 (holding that punitive damages are not available in pretextual termination cases). For further discussion of these cases and the opportunistic nature of the breaches involved, see *infra* notes 169-73, 188-92 and accompanying text.

13. Expectation damages are damages that put the nonbreaching party “in as good a position as he would have been in had the contract been performed.” RESTATEMENT, *supra* note 1, § 344(a); see also *id.* § 347 (explaining how expectation damages are measured).

tiation will tend to be lower than the costs of litigation necessary to establish expectation damages.

In this Article, I argue on economic grounds that punitive damages should be available for all willful breaches of contract, including both opportunistic breaches and efficient breaches.¹⁴ To make this argument, I rely on the analytic framework that Guido Calabresi and Douglas Melamed set forth in their classic article *One View of the*

14. Several writers have argued in favor of allowing punitive damages for opportunistic, but not efficient, breaches of contract. *See, e.g.*, Thomas A. Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425, 443-46 (1981); Barry Perlstein, *Crossing the Contract-Tort Boundary: An Economic Argument for the Imposition of Extracompensatory Damages for Opportunistic Breach of Contract*, 58 BROOK. L. REV. 877, 879-90 (1992); Michael H. Cohen, Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291, 1302, 1309-10 (1985). Other authors take a more restricted view. *See, e.g.*, Frank J. Cavico, Jr., *Punitive Damages for Breach of Contract—A Principled Approach*, ST. MARY'S L.J. 357, 445 (1990) (arguing that punitive damages should be allowed for an "outrageous" breach—i.e., "an intentional breach where the defendant maliciously or oppressively caused harm to the plaintiff"); Charles M. Louderback & Thomas W. Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187, 189 (1982) (arguing that punitive damages should be allowed for bad faith breach where there is a relationship of adhesion and dependency between the parties); Patricia H. Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 ARIZ. L. REV. 733, 760 (1982) (arguing that punitive damages should be allowed against a "subcategory of willful breacher who knows that his breach will have a detrimental effect on the other party but breaches anyway").

A few other writers have advocated extending punitive damages to willful, nonopportunistic breaches in at least some instances. *See, e.g.*, Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1448-62 (1980) (arguing that punitive damages may be justified when difficulty of detection, costs of litigation, or difficulty measuring compensatory damages is high or when the breaching party acted unreasonably); A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 936-39 (1998) (arguing for punitive damages when a nonperforming party has a chance of escaping detection and liability); John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based upon Contract: Toward Achieving the Objective of Full Compensation*, 33 U.C.L.A. L. REV. 1565, 1656-67 (1986) (arguing for punitive damages when the breach was intentional and the breaching party knew that there was no legal justification for nonperformance); Linda Curtis, Note, *Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161, 166-70 (1986) (arguing for punitive damages when the actual harm suffered by the nonbreaching party is greater than the compensatory damages recognized by law or when the probability of the nonbreaching party detecting and suing for breach is less than one). However, these scholars have emphasized the role of punitive damages in more fully compensating the nonbreaching party, *see* Farber, *supra*, at 1448-55; Sebert, *supra*, at 1656-67; Curtis, *supra*, at 168-70, or in correcting for the possibility that the breach will not be detected, *see* Farber, *supra*, at 1455-64; Polinsky & Shavell, *supra*, at 936-39; Curtis, *supra*, at 166-68. None of them has argued, as this Article does, that punitive damages should be allowed for willful breach of contract because it is more efficient for the party that does not want to perform to negotiate for a release.

Cathedral.¹⁵ Calabresi and Melamed identified two ways of protecting a legal entitlement: "property rules" and "liability rules." Property rules require a person who wishes to remove an entitlement to negotiate with the entitlement holder.¹⁶ Liability rules allow a person to remove the entitlement without the holder's consent and pay an amount determined by a court.¹⁷ Among contract remedies, expectation damages operate as a liability rule: they permit nonperformance without the promisee's consent upon payment of damages determined by a court. In contrast, punitive damages, *in terrorem* liquidated damages, and specific performance operate as property rules: they either deter or prohibit nonperformance, and thus require the promisor who does not wish to perform to negotiate with the promisee for a release. I argue that because the transaction costs of negotiating a release are typically lower than the assessment costs of establishing damages at trial, contractual entitlements should be protected with property rules, including punitive damages.¹⁸ Thus, punitive damages should be available for any willful breach.

15. Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). Calabresi and Melamed's arguments about the efficiency of property rules and liability rules have prompted a large literature, much of it quite recent. See, e.g., Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703 (1996); Ian Ayres & Eric Talley, *Distinguishing Between Consensual and Nonconsensual Advantages of Liability Rules*, 105 YALE L.J. 235 (1995) [hereinafter Ayres & Talley, *Distinguishing*]; Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995) [hereinafter Ayres & Talley, *Solomonic Bargaining*]; Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988); Richard A. Epstein, *A Clear View of The Cathedral: The Dominance of Property Rules*, 106 YALE L.J. 2091 (1997); David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CAL. L. REV. 1 (1990); Louis Kaplow & Steven Shavell, *Do Liability Rules Facilitate Bargaining? A Reply to Ayres & Talley*, 105 YALE L.J. 221 (1995) [hereinafter Kaplow & Shavell, *Reply*]; Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996) [hereinafter Kaplow & Shavell, *Property Rules*]; James E. Krier & Stewart J. Schwab, *Property Rules and Liability Rules: The Cathedral in Another Light*, 70 N.Y.U. L. REV. 440 (1995); Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); A. Mitchell Polinsky, *Resolving Nuisance Disputes: The Simple Economics of Injunctive and Damage Remedies*, 32 STAN. L. REV. 1075 (1980); Carol M. Rose, *The Shadow of The Cathedral*, 106 YALE L.J. 2175 (1997). This Article both builds on and responds to many of these works. See *infra* Part II.C.2.a-d.

16. See Calabresi & Melamed, *supra* note 15, at 1092.

17. See *id.*

18. A few writers have applied Calabresi and Melamed's analytic framework to argue on economic grounds for specific performance. See, e.g., Kronman, *supra* note 15; Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341, 366-71 (1984). Others have argued for liquidated damages that operate as penalties on similar grounds without expressly invoking Calabresi and Melamed. See, e.g.,

American law currently falls far short of this recommendation. A majority of jurisdictions adhere to the traditional rule that bars punitive damages unless the conduct constituting the breach is also an independent tort or falls within a few other limited exceptions.¹⁹ Only a few jurisdictions allow punitive damages against opportunistic breachers.²⁰ And almost none permit punitive damages simply upon a showing of willful breach.²¹ American law is also currently moving in the wrong direction. Although the 1970s and early 1980s witnessed an increased willingness on the part of several states to permit punitive damages for breach of contract, for the past ten years the trend clearly has been in the other direction, with many of the leading cases allowing punitive damages either limited or overruled.²²

In Part I of this Article, I review the availability of punitive damages for breach of contract in American law, tracing its expansion and contraction and summarizing the state of the law today. In Part II, I argue that punitive damages should be available for any willful breach. I begin by distinguishing between involuntary, opportunistic, and "efficient" breaches. Next, I make the relatively straightforward argument that punitive damages should be available for opportunistic breaches of contract, which by definition do not increase societal wealth. Then, I argue that courts should allow punitive damages for all willful breaches, even those that are "efficient," because it is cheaper for the parties to negotiate a release from an inefficient contract than it is to litigate the question of damages. Finally, I explain why punitive damages should not be awarded for involuntary breaches. In Part III, I offer preliminary responses to some anticipated objections to my proposal.

Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties, and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977). However, these writers have not extended their analysis to consider how punitive damages operate as a property rule and in what circumstances punitive damages might be preferable to specific performance and liquidated damages, as I attempt to do. See *infra* Part II.C.2.e.

19. See *infra* Part I.B.1.

20. See *infra* Part I.B.2.

21. See *infra* notes 88, 122 and accompanying text.

22. See *infra* Part I.A. This trend appears to be part of a general conservative trend in contract law. See, e.g., E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. 203 (1990); Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 ORE. L. REV. 1131 (1995).

I. PUNITIVE DAMAGES IN THE LAW OF CONTRACTS

Section 355 of the *Restatement (Second) of Contracts* states the traditional rule: "Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable."²³ Apart from this "independent tort" exception, there are a few other exceptions to the rule barring punitive damages for breach of contract, exceptions which are so well-established and so widely recognized that they should be counted as part of the traditional rule: breach of a contract to marry;²⁴ breach of a contract by a public service company;²⁵ breach of a contract that is also a breach of a fiduciary duty;²⁶ and, most recently, bad faith breach of an insurance contract.²⁷ Each of these ex-

23. RESTATEMENT, *supra* note 1, § 355. The independent tort most commonly alleged in breach of contract actions is fraud. It bears mention that making a promise without a present intention to perform constitutes promissory fraud, which is considered a tort in most jurisdictions. See William Prosser, *The Borderland of Tort and Contract*, in WILLIAM PROSSER, SELECTED TOPICS ON THE LAW OF TORTS 380, 400-01 (1954) (noting that all but six American jurisdictions recognize the tort of promissory fraud); Sebert, *supra* note 14, at 1607 & n.152 (citing cases).

24. See 5 ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 1077, at 440-43 (1964); 11 SAMUEL WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 1340, at 212 (Walter H.E. Jaeger ed., 3d ed. 1957); Sullivan, *supra* note 3, at 222-23. Perhaps the first punitive damages case of any kind in the United States was an action for breach of a promise to marry. See *Coryell v. Colbaugh*, 1 N.J.L. 90 (N.J. 1791). The exception has been widely recognized, see, e.g., *Newton v. Standard Fire Ins. Co.*, 229 S.E.2d 297, 301 (N.C. 1976) ("North Carolina follows the general rule that punitive or exemplary damages are not allowed for breach of contract, with the exception of breach of contract to marry . . ."), although at least 11 states have prohibited suits for breach of promise to marry by statute, see Rebecca Tuslmet, Note, *Rules of Engagement*, 107 YALE L.J. 2583, 2586 & n.13 (1998) (tracing this development).

25. See, e.g., *Stevenson v. Jolin J. Grier Hotel Co.*, 251 S.W. 355, 355 (Ark. 1923); *Mihner Hotels v. Brent*, 43 So. 2d 654, 656 (Miss. 1949); see also 5 CORBIN, *supra* note 24, § 1077, at 443-44; 11 WILLISTON, *supra* note 24, § 1340, at 213; Sullivan, *supra* note 3, at 223-25.

26. See, e.g., *Brown v. Coates*, 253 F.2d 36, 40 (D.C. Cir. 1958) (holding that "imposition of punitive damages" is appropriate for a real estate agent's breach of "fiduciary responsibilities"); *Newton v. Hornblower, Inc.*, 582 P.2d 1136, 1149 (Kan. 1978) ("This court, on several occasions, has approved the recovery of punitive damages as well as actual damages where a breach of a fiduciary duty is involved."); *Balsemides v. Perle*, 712 A.2d 673, 685 (N.J. Super. Ct. App. Div. 1998) ("While punitive damages are usually not awarded in litigation involving breach of a commercial contract, they may be awarded where there is a breach of trust between the parties beyond the contractual breach."); see also *Clark v. Lubritz*, 944 P.2d 861, 867 (Nev. 1997) (per curiam) (characterizing breach of fiduciary duty as an independent tort for which punitive damages may be imposed); *Holt v. Williamson*, 481 S.E.2d 307, 315 (N.C. Ct. App. 1997) (same); Sullivan, *supra* note 3, at 226-29.

27. Courts typically distinguish between third-party cases and first-party cases. See *infra* notes 35-36 and accompanying text (defining these terms). At least 45 states recognize bad faith breach of an insurance contract as a tort in third-party cases. See Douglas R. Richmond, *An Overview of Insurance Bad Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 80 n.33

ceptions involves a relationship with a high degree of dependence and trust and, indeed, each appears to rest at bottom on a fiduciary principle.²⁸ Unless a case fits within one of these exceptions, states following the traditional rule will not allow punitive damages “even though the breach be wilful, malicious or oppressive.”²⁹

A. *Expansion and Backlash*

A few states have long permitted punitive damages for breach of contract even in the absence of an independent tort or one of the other traditional exceptions. As early as 1904, South Carolina allowed punitive damages “[w]hen . . . the breach of the contract is accompanied with a fraudulent act.”³⁰ New Mexico adopted the same rule in 1940.³¹

The expansion of punitive damages for breach of contract began in earnest in the 1970s and 1980s, with some states allowing plaintiffs

(1994) (listing cases). In first-party cases, at least 25 states, see Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions After Two Decades*, 37 ARIZ. L. REV. 1153, 1153-54 nn.2-25 (1995) (listing statutes and cases), and perhaps as many as 30 do so, see Richmond, *supra*, at 104 n.170 (listing cases).

28. See Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 912-13, 929-38. Courts have frequently explained the imposition of punitive damages on an insurance company by describing its relationship with the insured as similar to a fiduciary relationship. See, e.g., *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 686 P.2d 1158, 1166 (Cal. 1984) (per curiam) (insurance relationship is “characterized by elements of public interest, adhesion, and fiduciary responsibility”); *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1141 (Colo. 1984) (“The standard of conduct on the part of the insurer when dealing with claims arising under an insurance policy is shaped by, and must reflect, the quasi-fiduciary relationship that exists between the insurer and the insured by virtue of the insurance contract.”); *Romero v. Mervyn's*, 784 P.2d 992, 998 n.3 (N.M. 1989) (“We have allowed the award of punitive damages in insurance cases under a more relaxed standard in part because of the fiduciary obligations inhering in insurance relationships”); *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 375 (Wis. 1978) (“[T]he duty on the insurance company [is] analogous to that of a fiduciary.”).

29. *Newton v. Standard Fire Ins. Co.*, 229 S.E.2d 297, 301 (N.C. 1976).

30. *Welborn v. Dixon*, 49 S.E. 232, 234 (S.C. 1904). South Carolina defines “fraudulent act” as “any act characterized by dishonesty in fact, unfair dealing, or the unlawful appropriation of another’s property by design.” *Perry v. Green*, 437 S.E.2d 150, 152 (S.C. Ct. App. 1993). Thus, a contract plaintiff need not prove the tort of fraud to recover punitive damages.

31. See *Stewart v. Potter*, 104 P.2d 736, 740 (N.M. 1940) (holding that punitive damages are permitted “where the breach of contract is accompanied by a fraudulent act”); see also *Whitehead v. Allen*, 313 P.2d 335, 336 (N.M. 1957) (holding that punitive damages are permitted “if the breach is accompanied by a fraudulent act, wanton in character and maliciously intentional”). The New Mexico Supreme Court subsequently clarified that a plaintiff need not prove fraud if it could show that the contract was breached maliciously. See *Bank of New Mexico v. Rice*, 429 P.2d 368, 378 (N.M. 1967).

to recover punitive damages directly in contract actions³² and others achieving the same result indirectly by characterizing some contractual breaches as torts.³³ The initial impetus came from insurance cases. In the 1973 case *Gruenberg v. Aetna Insurance Company*,³⁴ the California Supreme Court extended tort liability for an insurer's breach of the implied covenant of good faith and fair dealing from third-party cases, in which the insurer refuses in bad faith to defend or settle a claim against the insured by a third party,³⁵ to first-party cases, in which the insurer refuses in bad faith to pay a claim by the insured herself.³⁶ Three years later, in *Vernon Fire & Casualty Insurance Co. v. Sharp*,³⁷ the Indiana Supreme Court also recognized the possibility of punitive damages for an insurer's bad faith refusal to pay a claim by the insured. The Indiana court did not limit its statement of the rule to the insurance context, however, concluding that "an independent tort need not always be established"³⁸ and that punitive damages should be available "[w]henver the elements of fraud, malice, gross negligence or oppression mingle in the controversy."³⁹ Moreover, the Indiana court soon applied this rule outside the insurance context, upholding the award of punitive damages in two well-

32. See, e.g., *Boise Dodge v. Clark*, 453 P.2d 551, 556 (Idaho 1969); *Hibschman Pontiac, Inc. v. Batchelor*, 362 N.E.2d 845, 847-48 (Ind. 1977); *Romero*, 784 P.2d at 998; *Floyd v. Country Squire Mobile Homes, Inc.*, 336 S.E.2d 502, 503 (S.C. Ct. App. 1985); *Hilder v. St. Peter*, 478 A.2d 202, 210 (Vt. 1984).

33. See, e.g., *Rawlings v. Apodaca*, 726 P.2d 565, 574-76 (Ariz. 1986) (holding that a breach of the implied covenant of good faith is a tort); *Seaman's*, 686 P.2d at 1167 (same); *Dold v. Outrigger Hotel*, 501 P.2d 368, 372 (Haw. 1972) (same); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1370 (Nev. 1987) (same).

Conceptualizing breach of the implied covenant of good faith as a tort is helpful in avoiding statutes that do not allow punitive damages for breach of contract, which are found in California, Nevada, and Montana, among others. See CAL. CIV. CODE § 3294(a) (1998); MONT. CODE ANN. § 27-1-220(2)(a) (1997); NEV. REV. STAT. § 42.005(1) (1997). Otherwise, it does not seem to make much difference for the availability of punitive damages which option a state chooses, and this Article will not further distinguish among those states that allow punitive damages for breach of contract in contract and those that allow them in tort.

34. 510 P.2d 1032 (Cal. 1973).

35. See *Crisci v. Security Ins. Co.*, 426 P.2d 173, 177 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 201 (Cal. 1958).

36. *Gruenberg*, 510 P.2d at 1037-38.

37. 349 N.E.2d 173 (Ind. 1976).

38. *Id.* at 180.

39. *Id.* (quoting *Taber v. Hutson*, 5 Ind. 322, 324 (1854)).

known cases—*Hibschman Pontiac, Inc. v. Batchelor*⁴⁰ and *F.D. Borkholder Co. v. Sandock*.⁴¹

While these developments in California and Indiana attracted a good deal of attention,⁴² Hawaii, Idaho and Vermont were simultaneously expanding the availability of punitive damages for breach of contract. In *Dold v. Outrigger Hotel*,⁴³ the Hawaii Supreme Court rejected the independent tort requirement and held that “where a contract is breached in a wanton or reckless manner as to result in a tortious injury, the aggrieved person is entitled to recover in tort.”⁴⁴ In *Boise Dodge, Inc. v. Clark*,⁴⁵ the Supreme Court of Idaho upheld an award of punitive damages, noting that “punitive damages may be assessed in contract actions where there is fraud, malice, oppression or other sufficient reason for doing so.”⁴⁶ And in *Clarendon Mobile Home Sales, Inc. v. Fitzgerald*,⁴⁷ the Vermont Supreme Court held that when “the breach has the *character* of a wilful and wanton or fraudulent tort, punitive damages may be allowed.”⁴⁸ In explaining why punitive damages should be allowed, these 1970s decisions often questioned the wisdom of distinguishing sharply between contracts and torts. They reasoned that if the defendant’s conduct was essentially tortious, it should not be immune from punitive damages simply

40. 362 N.E.2d 845 (Ind. 1977) (upholding award of punitive damages, although reducing it, for automobile dealer’s bad faith breach of warranty).

41. 413 N.E.2d 567, 571 (Ind. 1980) (upholding award of punitive damages for contractor’s intentional deviation from building plans).

42. Farnsworth, for example, describes *Hibschman* as a case in which the court went to “considerable lengths” to find tortious conduct. FARNSWORTH, *supra* note 8, § 12.8, at 196. *Hibschman* is used as a case on punitive damages in contracts in CALAMARI ET AL., *supra* note 7, at 635-39; THOMAS D. CRANDALL & DOUGLAS J. WHALEY, CASES, PROBLEMS AND MATERIALS ON CONTRACTS 400-05 (2d ed. 1993); JAMES F. HOGG & CARTER G. BISHOP, CONTRACTS: CASES, PROBLEMS AND MATERIALS 511-13 (1997); and ROBERT E. SCOTT & DOUGLAS L. LESLIE, CONTRACT LAW AND THEORY 809-13 (2d ed. 1993). *Borkholder* is used as a case on punitive damages in EDWARD J. MURPHY ET AL., STUDIES IN CONTRACT LAW 850-53 (5th ed. 1997).

43. 501 P.2d 368 (Haw. 1972).

44. *Id.* at 372 (stating that a hotel’s refusal to honor reservations might warrant punitive damages if the conduct were “deliberate or wanton”). On the facts of this case, however, the Hawaii Supreme Court held that punitive damages were not warranted. *See id.* at 371.

45. 453 P.2d 551 (Idaho 1969) (upholding award of punitive damages against automobile dealership that set odometer readings back several thousand miles).

46. *Boise Dodge*, 453 P.2d at 553-56 (Idaho 1969). *Boise Dodge* is used in MURPHY ET AL., *supra* note 42, at 853-56.

47. 381 A.2d 1063 (Vt. 1977).

48. *Clarendon*, 381 A.2d at 1065 (emphasis added). The Vermont Supreme Court has made it clear that proof of an independent tort is not required. *See Ainsworth v. Franklin County Cheese Corp.*, 592 A.2d 871, 874 (Vt. 1991).

because it occurred in the context of a contractual relationship and not all the elements of a tort had been proved.⁴⁹

The expansion of punitive damages for breach of contract continued in the 1980s. The best known case in this expansion is the California Supreme Court's decision in *Seaman's Direct Buying Service v. Standard Oil Co.*⁵⁰ Building explicitly on its decisions in the insurance context,⁵¹ the court held that "a party to a contract may incur tort remedies [including punitive damages] when, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists."⁵² *Seaman's* was widely discussed in the law reviews⁵³ and made it into a number of casebooks.⁵⁴ More importantly, *Seaman's* was at least in part responsible for prompting the expansion of punitive damages for

49. See *Dold*, 501 P.2d at 372 ("We have recognized the fact that certain situations are so disposed as to present a fusion of the doctrines of tort and contract."); *Boise Dodge*, 453 P.2d at 556:

The rule established in Idaho is that punitive damages may be assessed in contract actions where there is fraud, malice, oppression or other sufficient reason for doing so. This rule recognizes that in certain cases elements of tort, for which punitive damages have always been recoverable upon a showing of malice, may be inextricably mixed with elements of contract, in which punitive damages generally are not recoverable.

(footnote omitted); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976) (holding that a defendant will not be shielded from punitive damages "when it appears from the evidence as a whole that a serious wrong, tortious in nature, has been committed, but the wrong does not conveniently fit the confines of a predetermined tort").

50. 686 P.2d 1158 (Cal. 1984) (per curiam).

51. See *id.* at 1166 (citing *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958)).

52. *Id.* at 1167.

53. See, e.g., C. Delos Putz, Jr. & Nona Klippen, *Commercial Bad Faith: Attorney Fees—Not Tort Liability—Is the Remedy for "Stonewalling"*, 21 U.S.F. L. REV. 419, 452-60 (1987); Seibert, *supra* note 14, at 1638-42; Matthew J. Barrett, Note, "Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, *Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 515-20 (1985); Sandra Clutorian, Comment, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 387-89 & *passim* (1986); Cohen, *supra* note 14, at 1296-98; James H. Cook, Comment, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case*, 71 IOWA L. REV. 893 (1986); John Monaghan, Note, *Extending the Bad Faith Tort Doctrine to General Commercial Contracts*, 65 B.U. L. REV. 355, 363-67 (1985); Eileen A. Scallen, Case Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161 (1985).

54. See CALAMARI ET AL., *supra* note 7, at 629-35; KNAPP & CRYSTAL, *supra* note 7, at 861-73 (3d ed. 1993); JOHN EDWARD MURRAY, JR., *CONTRACTS: CASES AND MATERIALS* 491-97 (4th ed. 1991); ARTHUR ROSETT, *CONTRACT LAW AND ITS APPLICATION* 447-58 (5th ed. 1994).

breach of contract in other states, including Montana, New Mexico, Arizona, Nevada, and Wyoming.

Montana first recognized the bad faith tort in an insurance context⁵⁵ and soon extended it to employment contracts.⁵⁶ Then, its resolve apparently strengthened by *Seaman's*, the Montana Supreme Court extended the tort to contracts between two commercial parties and upheld an award of punitive damages in *Nicholson v. United Pacific Insurance Co.*⁵⁷ In 1989, the New Mexico Supreme Court reaffirmed its prior cases,⁵⁸ holding that “punitive damages may be recovered for breach of contract when the defendant’s conduct was malicious, fraudulent, oppressive, or committed recklessly with a wanton disregard for the plaintiff’s rights.”⁵⁹ Citing *Seaman's*, it noted that “the award of punitive damages in some cases serves important social ends” by deterring “[o]verreaching, malicious, or wanton conduct . . . [that] tends to undermine the stability of expectations essential to contractual relationships.”⁶⁰ *Seaman's* also influenced the Supreme Courts in Arizona, Nevada, and Wyoming, each of which began to permit punitive damages in noninsurance cases where there was a “special relationship” between the parties.⁶¹

These 1980s decisions tended to justify awarding punitive damages somewhat differently than did the 1970s decisions. Whereas the 1970s decisions tended to question the distinction between contracts and torts,⁶² the 1980s decisions explained that awarding punitive damages in some instances could further the goals of contract law by

55. See *Lipinski v. Title Ins. Co.*, 655 P.2d 970, 977 (Mont. 1982); *First Sec. Bank v. Goddard*, 593 P.2d 1040, 1047 (Mont. 1979).

56. See *Dare v. Montana Petroleum Mktg. Co.*, 687 P.2d 1015, 1020 (Mont. 1984); *Gates v. Life of Mont. Ins. Co.*, 668 P.2d 213, 215 (Mont. 1983).

57. 710 P.2d 1342, 1347-48 (Mont. 1985) (citing, with approval, the discussion in *Seaman's*, 686 P.2d at 1161, 1166).

58. See cases cited *supra* note 31.

59. *Romero v. Mervyn's*, 784 P.2d 992, 998 (N.M. 1989).

60. *Id.* at 1000-01.

61. See *Rawlings v. Apodaca*, 726 P.2d 565, 574-76 (Ariz. 1986) (relying on *Seaman's* and subsequent decisions by the California Courts of Appeal); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1371 (Nev. 1987) (quoting, with approval, *Seaman's*, 686 P.2d at 1166); *Wilder v. Cody Country Chamber of Commerce*, 868 P.2d 211, 221-22 (Wyo. 1994) (not discussing *Seaman's* but relying on *Ponsock* and other Nevada cases). Such “special relationships” extend beyond the categories recognized under the traditional rule, see *supra* notes 23-29 and accompanying text, and may include employment relationships. See, e.g., *Ponsock*, 732 P.2d at 1370-72; *Wilder*, 868 P.2d at 221. For further discussion of the “special relationship” states, see *infra* Part I.B.2.a.

62. See, e.g., cases cited *supra* note 49.

protecting the parties' expectations⁶³ and discouraging breaches that would effectively deprive one of the parties of a contract's benefits.⁶⁴ To the extent that these 1980s decisions acknowledged the theory of efficient breach, they viewed punitive damages as consistent with that theory.⁶⁵

Since the late 1980s, however, American contract law has experienced a backlash against punitive damages, based largely on the theory of efficient breach. The turning point was the 1988 case *Foley v. Interactive Data Corp.*,⁶⁶ in which the California Supreme Court refused to extend the bad faith tort to employment contracts.⁶⁷ Emphasizing the traditional, compensatory role of contract remedies, the need for predictability in commercial relationships, and the idea of efficient breach,⁶⁸ the court rejected dicta from *Seaman's* suggesting

63. See, e.g., *Seaman's*, 686 P.2d at 1167 (“[Stonewalling] goes beyond the mere breach of contract. It offends accepted notions of business ethics. . . . Acceptance of tort remedies in such a situation is not likely to intrude upon the bargaining relationship or upset reasonable expectations of the contracting parties.”) (citation omitted); *Nicholson v. United Pacific Ins. Co.*, 710 P.2d 1342, 1348 (Mont. 1985) (“Where one party acts arbitrarily, capriciously or unreasonably, that conduct exceeds the justifiable expectations of the second party. The second party then should be compensated for damages resulting from the other’s culpable conduct.”); *Romero*, 784 P.2d at 1001 (“Overreaching, malicious, or wanton conduct such as targeted by our rule is inconsistent with legitimate business interests, violates community standards of decency, and tends to undermine the stability of expectations essential to contractual relationships.”).

64. See, e.g., *Rawlings*, 726 P.2d at 575 (“In contractual relationships in which one party primarily has sought protection or security rather than profit or advantage, contract damages not only fail to provide adequate compensation but also fail to provide a substantial deterrence against breach by the party who derives a commercial benefit from the relationship.”); *Ponsock*, 732 P.2d at 1372 (“If all a large corporate employer had to do was to pay contract damages for this kind of conduct, it would allow and even encourage dismissals of employees on the eve of retirement with virtual impunity.”).

65. In *Nicholson*, for example, the Montana Supreme Court noted that “[c]ontract law is based in part upon the assumption that certain intentional breaches are to be encouraged.” 710 P.2d at 1348 (quoting *Diamond*, *supra* note 14, at 453). The Montana court continued: “[W]hether performing or breaching, each party has a justifiable expectation that the other will act as a reasonable person.” *Id.* When the breaching party acts unreasonably, punitive damages are appropriate. See *id.*

66. 765 P.2d 373 (Cal. 1988).

67. See *id.* at 389-401. The composition of the seven member court had changed dramatically between 1984 and 1988, with Chief Justice Bird and Justices Grodin and Reynoso having been removed by election in 1986.

The previous year, the Colorado Supreme Court had reaffirmed that punitive damages may not be recovered in breach of contract actions and had overturned a line of decisions by the courts of appeals allowing punitive damages for breach of contract where the defendant showed a “maleficent intent.” *Mortgage Fin., Inc. v. Podleski*, 742 P.2d 900, 903-04 (Colo. 1987).

68. See *Foley*, 765 P.2d at 389.

that employment relationships were similar to insurance contracts.⁶⁹ Two years later, the Montana Supreme Court overruled *Nicholson* and held that punitive damages would be allowed for breach of commercial contracts only where there was a “special relationship” between the parties.⁷⁰ As the primary reason for its change of heart, the Montana court relied on the argument that “tort damages upset[] the concept of efficient breach.”⁷¹ In 1993, the Indiana Supreme Court, whose decisions in *Borkholder*, *Hibschman Pontiac*, and *Vernon* had been leading cases allowing punitive damages for breach of contract,⁷² reverted to the traditional rule and held that a plaintiff seeking punitive damages “must plead and prove the existence of an independent tort.”⁷³ The Indiana court reasoned that the public interest would not be served by a policy that “prohibits one party to a contract from exercising his common law rights to breach a contract and pay a rightful amount of compensatory damages.”⁷⁴ Finally, in the 1995 case *Freeman & Mills, Inc. v. Belcher Oil Co.*,⁷⁵ the California Supreme Court expressly overruled *Seaman’s* and readopted the traditional rule.⁷⁶ The California court also relied on the efficient breach argument, noting that the traditional rule of contract damages “encourages efficient breaches, resulting in increased production of goods and services at lower cost to society.”⁷⁷

69. *See id.* at 392. *Foley* distinguished the insurance cases on the grounds (1) that a terminated employee could find another job while an insured could not find another insurance company to cover a loss already sustained, (2) that employers, unlike insurers, do not perform a “quasi-public” service, and (3) that it is generally in the employer’s interest to retain good employees, whereas an insurer’s and an insured’s financial interests are always at odds once a loss has occurred. *See id.* at 396.

70. *See* *Story v. City of Bozeman*, 791 P.2d 767, 774-76 (Mont. 1990).

71. *Id.* at 774. The court went on to observe that “efficient breach is rarely efficient [because] the winning party must pay the cost of recovering contract damages.” *Id.* But it argued that “[i]n written contracts, the parties can avoid this inequity by providing in the contract for an award of costs and attorney’s fees to the prevailing party.” *Id.* The court also worried that “evidence of moral wrongdoing” pertinent to punitive damages might mislead and inflame the jury. *Id.*

72. *See supra* notes 37-41 and accompanying text.

73. *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 984 (Ind. 1993).

74. *Id.* The court also noted that punitive damages might interfere with predictability, are a “windfall” to the nonbreaching party, and might increase litigation. *See id.* at 981, 983-84.

75. 900 P.2d 669 (Cal. 1995).

76. *See id.* at 679-80.

77. *Id.* at 676-77 (quoting *Harris v. Atlantic Richfield Co.*, 17 Cal. Rptr. 2d 649, 653-54 (Ct. App. 1993) (citation omitted). The court also reasoned that *Seaman’s* had created confusion, that punitive damages undermine stability, that such damages might be excessive, and that such innovation was best left to the legislature. *See id.* at 680.

As Montana, Indiana, and California have all retreated from allowing punitive damages in contract cases, other states have reaffirmed their adherence to the traditional rule, citing the theory of efficient breach to justify it. For example, in *E.I. DuPont de Nemours & Co. v. Pressman*,⁷⁸ the Supreme Court of Delaware overturned an award of punitive damages for pretextual termination.⁷⁹ It noted that the traditional rule was “supported by the more recent theory of efficient breach” and suggested that punitive damages would “lead to inefficient results.”⁸⁰ And in *Grynberg v. Citation Oil & Gas Corp.*,⁸¹ the South Dakota Supreme Court explained that one of the public policies underpinning its rule against punitive damages for breach of contract was that “our free market system allows economically efficient breaches of contract, for example, when it costs less for one party to breach an unwise contract and to pay the other party compensatory damages than it would cost to completely perform.”⁸²

In sum, the 1970s and early 1980s witnessed an expansion of punitive damages for breach of contract, not only in Indiana and California, but also in Hawaii, Idaho, Vermont, Montana, New Mexico, Arizona, Nevada, and Wyoming. However, the past ten years have seen a significant retrenchment in states like Indiana, California, and Montana, justified by the theory of efficient breach. Meanwhile, other states have relied on the same theory to explain their continued adherence to the traditional rule barring punitive damages for breach of contract.

B. Punitive Damages in Contracts: 1998

Where does the law on punitive damages for breach of contract stand today?⁸³ As of December 1998, thirty-nine American jurisdic-

78. 679 A.2d 436 (Del. 1996).

79. See *id.* at 448; see also *id.* at 446-47 (failing to take note of *Freeman & Mills* but relying extensively on the California Supreme Court's reasoning in *Foley*). A termination is pretextual when a party who has no legitimate basis for escaping a contract attempts to fabricate such a basis. For further discussion of pretextual terminations, see *infra* Part II.B.3.a.

80. *Pressman*, 679 A.2d at 445-46.

81. 573 N.W.2d 493 (S.D. 1997).

82. *Id.* at 500.

83. For earlier reviews of the law on punitive damages for breach of contract, see Mark Pennington, *Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years*, 42 ARK. L. REV. 31 (1989); David A. Rice, *Exemplary Damages in Private Consumer Actions*, 55 IOWA L. REV. 307 (1969); Laurence P. Simpson, *Punitive Damages for Breach of Contract*, 20 OHIO ST. L.J. 284 (1959); Sullivan, *supra* note 3. For a discussion focus-

tions require the plaintiff to plead and prove the existence of an independent tort to recover punitive damages in a breach of contract suit or maintain even more stringent limits on punitive damages.⁸⁴ On the other hand, twelve states either expressly allow or appear to allow punitive damages for breach of contract under limited circumstances without proof of an independent tort.⁸⁵

1. *The Traditional Rule and Stricter Rules.* Today, thirty-five American jurisdictions adhere to the traditional rule⁸⁶ and require that a contract plaintiff plead and prove the existence of an independent tort in order to recover punitive damages.⁸⁷ In the

ing on Florida law, see Phyllis G. Coleman, *Punitive Damages for Breach of Contract: A New Approach*, 11 STETSON L. REV. 250 (1982).

84. See *infra* Part I.B.1.

85. See *infra* Part I.B.2.

86. See *supra* notes 23-29 and accompanying text (discussing the traditional rule).

87. These jurisdictions are Alabama, Alaska, Arkansas, California, Colorado, Connecticut, Delaware, the District of Columbia, Florida, Georgia, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Hampshire, New Jersey, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, South Dakota, Texas, Utah, Virginia, West Virginia, and Wisconsin. See *Hobson v. American Cast Iron Pipe Co.*, 690 So. 2d 341, 344-45 (Ala. 1997); *Arco Alaska, Inc. v. Akers*, 753 P.2d 1150, 1153-54 (Alaska 1988); *Wheeler Motor Co. v. Roth*, 867 S.W.2d 446, 450 (Ark. 1993); *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 679-80 (Cal. 1995); *Mortgage Fin., Inc. v. Podleski*, 742 P.2d 900, 902-05 (Colo. 1987); *Barry v. Posi-Seal Int'l, Inc.*, 672 A.2d 514, 519 (Conn. App. Ct. 1996); *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 445 (Del. 1996); *Bernstein v. Fernandez*, 649 A.2d 1064, 1073 (D.C. 1991); *Ferguson Transp., Inc. v. North Am. Van Lines, Inc.*, 687 So. 2d 821, 822 (Fla. 1996) (per curiam); *Trust Co. Bank v. Citizens & S. Trust Co.*, 390 S.E.2d 589, 592 (Ga. 1990); *Cramer v. Insurance Exch. Agency*, 675 N.E.2d 897, 904 (Ill. 1996); *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 984 (Ind. 1993); *White v. Northwestern Bell Tel. Co.*, 514 N.W.2d 70, 77 (Iowa 1994); *Farrell v. General Motors Corp.*, 815 P.2d 538, 549 (Kan. 1991); *Federal Kemper Ins. Co. v. Hornback*, 711 S.W.2d 844, 845 (Ky. 1986); *Drinkwater v. Patten Realty Corp.*, 563 A.2d 772, 776 (Me. 1989); *Schaefer v. Miller*, 587 A.2d 491, 492 (Md. 1991); *DeRose v. Putnam Mgmt. Co.*, 496 N.E.2d 428, 432 (Mass. 1986); *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d 50, 55 (Mich. 1980); *Wild v. Rarig*, 234 N.W.2d 775, 789 (Minn. 1975) (per curiam); *Peterson v. Continental Boiler Works, Inc.*, 783 S.W.2d 896, 902-03 (Mo. 1990); *Lawton v. Great S.W. Fire Ins. Co.*, 392 A.2d 576, 580 (N.H. 1978); *Pickett v. Lloyd's*, 621 A.2d 445, 454-55 (N.J. 1993); *Newton v. Standard Fire Ins. Co.*, 229 S.E.2d 297, 301 (N.C. 1976); *Pioneer Fuels, Inc. v. Montana-Dakota Utils. Co.*, 474 N.W.2d 706, 709 (N.D. 1991); *Digital & Analog Design Corp. v. North Supply Co.*, 540 N.E.2d 1358, 1367 (Ohio 1989); *Z.D. Howard Co. v. Cartwright*, 537 P.2d 345, 347 (Okla. 1975); *Express Creditcorp v. Oregon Bank*, 767 P.2d 493, 495-96 (Or. Ct. App. 1989); *Johnson v. Hyundai Motor Am.*, 698 A.2d 631, 639 (Pa. Super. Ct. 1997); *Grynberg v. Citation Oil & Gas Corp.*, 573 N.W.2d 493, 500-01 (S.D. 1997); *Jnn Walter Homes, Inc. v. Reed*, 711 S.W.2d 617, 618 (Tex. 1986); *Jorgensen v. Jolin Clay & Co.*, 660 P.2d 229, 232 (Utah 1983); *Kamilar Corp. v. Haley*, 299 S.E.2d 514, 518 (Va. 1983); *Berry v. Nationwide Mut. Fire Ins. Co.*, 381 S.E.2d 367, 374 (W. Va. 1989); *Landwehr v. Citizens Trust Co.*, 329 N.W.2d 411, 414 (Wis. 1983).

absence of an independent tort, “[t]he general rule in most jurisdictions is that punitive damages are not allowed *even though the breach be wilful, malicious or oppressive*.”⁸⁸ For example, in *White v. Benkowski*,⁸⁹ a case often used to illustrate the unavailability of punitive damages,⁹⁰ the Benkowskis deliberately breached a contract to supply their neighbors, the Whites, with water.⁹¹ Although the jury found that the Benkowskis “maliciously shut off the Whites’ water supply for harassment purposes,”⁹² the Wisconsin Supreme Court reversed the award of punitive damages: “[P]unitive damages are not available in breach of contract actions. This is true even if the breach, as in the instant case, is wilful.”⁹³

Beyond these thirty-five independent-tort jurisdictions, four states maintain even tighter limits on punitive damages in contracts, which reflect more stringent rules on punitive damages generally. The Nebraska Constitution prohibits all punitive damages unless used to support the public schools.⁹⁴ Louisiana and Washington do

88. *Newton*, 229 S.E.2d at 301 (emphasis added); see also *Bernstein*, 649 A.2d at 1073 (“Punitive damages will not lie for breach of contract, even if it is proven that the breach is willful, wanton, or malicious.” (quoting *Bedell v. Inver Housing, Inc.*, 506 A.2d 202, 206 (D.C. 1986))); *Drinkwater*, 563 A.2d at 776 (“No matter how egregious the breach, punitive damages are unavailable under Maine law for breach of contract”); *Lickteig v. Alderson, Ondov, Leonard & Sween, P.A.*, 556 N.W.2d 557, 561 (Minn. 1996) (“[E]ven a malicious or bad-faith motive in breaching a contract does not convert a contract action into a tort action sufficient to support an award of . . . extra-contractual damages, such as punitive damages”) (citation omitted); *Pioneer Fuels*, 474 N.W.2d at 710 (“A breach of contract even if intentional, malicious, or in bad faith, is not enough to convert a contract action into a tort action.” (quoting *Hay v. Dahle*, 386 N.W.2d 808, 811 (Minn. Ct. App. 1986))); *Farris v. United States Fidelity & Guar. Co.*, 587 P.2d 1015, 1022 (Or. 1978) (“Even where the breach is malicious and unjustified, exemplary damages are not allowable.” (quoting Charles T. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 81, at 286 (1935))).

89. 155 N.W.2d 74 (Wis. 1967).

90. See BURTON, *supra* note 7, at 281-85; FARNSWORTH & YOUNG, *supra* note 7, at 14-17; SCOTT & LESLIE, *supra* note 42, at 813-16 (2d ed. 1993); ROBERT S. SUMMERS & ROBERT A. HILLMAN, CONTRACT AND RELATED OBLIGATION: THEORY, DOCTRINE & PRACTICE 22-26 (2d ed. 1992).

91. See *White*, 155 N.W.2d at 75.

92. *Id.*

93. *Id.* at 77.

94. See NEB. CONST. art. VII, § 5(1) (“[A]ll fines, penalties, and license money arising under the general laws of the state . . . shall belong and be paid over to the counties respectively where the same may be levied or imposed” and “shall be appropriated exclusively to the use and support of the common schools.”), construed in *Distinctive Printing & Packaging Co. v. Cox*, 443 N.W.2d 566, 574 (Neb. 1989) (“[P]unitive, vindictive, or exemplary damages contravene Neb. Const. art. VII, § 5, and thus are not allowed in this jurisdiction.”).

not allow punitive damages unless expressly authorized by statute.⁹⁵ And in New York, a contract plaintiff seeking punitive damages must not only plead and prove the existence of an independent tort but must also show that “such conduct was part of a pattern of similar conduct directed at the public generally.”⁹⁶

2. *Broader Rules.* Twelve states either expressly allow, or appear to allow, punitive damages in a broader range of cases. Of these twelve, four (Arizona, Montana, Nevada, and Wyoming) may be characterized as “special relationship” states. Eight others (Hawaii, Idaho, Mississippi, New Mexico, Rhode Island, South Carolina, Tennessee, and Vermont) either expressly allow, or appear to allow, a contract plaintiff to recover punitive damages without showing either an independent tort or a special relationship.

a. *“Special relationship” states.* Arizona, Montana, Nevada, and Wyoming have held that, even in the absence of an independent tort, punitive damages may be awarded for breach of contract where a “special relationship” exists between the parties.⁹⁷ The “special relationship” idea springs from the California Supreme Court’s opinion in *Seaman’s*,⁹⁸ as elaborated by the California Court of Appeal in *Wallis v. Superior Court*.⁹⁹ *Wallis* listed the following requirements for a special relationship:

(1) The contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a non-profit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party “whole”; (4) one party is especially vulnerable because of

95. See *International Harvester Credit Corp. v. Seale*, 518 So. 2d 1039, 1041 (La. 1988) (“Under Louisiana law, punitive or other ‘penalty’ damages are not allowable unless expressly authorized by statute.”); *Barr v. Interbay Citizens Bank*, 635 P.2d 441, 444 (Wash. 1981) (“Since 1891, in an unbroken line of cases, it has been the law of this state that punitive damages are not allowed unless expressly authorized by the legislature.”).

96. *Rocanova v. Equitable Life Assurance Soc. of the United States*, 634 N.E.2d 940, 944 (N.Y. 1994).

97. See *Rawlings v. Apodaca*, 726 P.2d 565, 574-76 (Ariz. 1986); *Story v. Bozeman*, 791 P.2d 767, 776 (Mont. 1990); *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1371 (Nev. 1987); *Wilder v. Cody County Chamber of Commerce*, 868 P.2d 211, 221-22 (Wyo. 1994).

98. 686 P.2d 1158, 1167 (Cal. 1984) (per curiam).

99. 207 Cal. Rptr. 123 (Ct. App. 1984).

the type of harm it may suffer and of necessity places trust in the other party to perform; and (5) the other party is aware of this vulnerability.¹⁰⁰

In some sense, this is simply an expansion of the traditional exception allowing punitive damages for breach of fiduciary duty.¹⁰¹ Examples of such special relationships include insurer and insured, carrier and passenger, innkeeper and guest, physician and patient, and attorney and client.¹⁰² Significantly, Nevada and Wyoming have held that they include some employment relationships.¹⁰³

b. Other rules. Of the eight remaining states, Vermont and Hawaii appear to maintain the closest tie to the “independent tort” exception. Vermont allows punitive damages where “the breach has the character of a wilful and wanton or fraudulent tort,”¹⁰⁴ while Hawaii requires the contract to have been breached “in a wanton or reckless manner as to result in a tortious injury.”¹⁰⁵ The Vermont Supreme Court has, however, explicitly distinguished its own position from the “independent tort” states,¹⁰⁶ upholding awards of punitive damages for the pretextual firing of an employee and for the breach of a real estate contract that involved a good deal of reliance.¹⁰⁷ The Hawaii Supreme Court has always found that the breach fell short of its standard,¹⁰⁸ with one exception. In *Chung v. Kaonohi Center Co.*,¹⁰⁹

100. *Id.* at 129.

101. *See supra* notes 24-28 and accompanying text.

102. *See Rawlings*, 726 P.2d at 575.

103. *See K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1370-72 (Nev. 1987); *Wilder v. Cody County Chamber of Commerce*, 868 P.2d 211, 222 (Wyo. 1994); *see also Garcia v. UniWyo Fed. Credit Union*, 920 P.2d 642, 646 (Wyo. 1996) (“Usually, the special relationship giving employees an action on the implied covenant of good faith and fair dealing stems from a long term employment relationship coupled with a discharge calculated to avoid employer responsibilities to the employee, e.g., benefits or commissions.”).

104. *Clarendon Mobile Home Sales Inc. v. Fitzgerald*, 381 A.2d 1063, 1065 (Vt. 1977).

105. *Dold v. Outrigger Hotel*, 501 P.2d 368, 372 (Haw. 1972).

106. *See Ainsworth v. Franklin County Cheese Corp.*, 592 A.2d 871, 874 (Vt. 1991).

107. *See Ainsworth*, 592 A.2d at 875 (pretextual firing); *Glidden v. Skinner*, 458 A.2d 1142, 1145 (Vt. 1983) (breach of contract to sell farm after plaintiffs worked for six weeks on the farm). The Vermont Supreme Court has also stated that a landlord’s breach of the implied warranty of habitability would warrant punitive damages, but it denied those damages in the case in which it made the statement because the issue was waived on appeal. *See Hilder v. St. Peter*, 478 A.2d 202, 211 (Vt. 1984).

108. *See, e.g., Ross v. Stouffer Hotel Co. (Hawaii) Ltd.*, 879 P.2d 1037, 1049 (Haw. 1994) (breach of employment contract); *Amfac, Inc. v. Waikiki Beachcomber Inv. Co.*, 839 P.2d 10, 37 (Haw. 1992) (breach of indemnification agreement); *Quedding v. Arisumi Bros., Inc.*, 661 P.2d 706, 708-10 (Haw. 1983) (per curiam) (breach of construction contract); *Island Holidays*,

the Hawaii court found that a shopping mall's actions in negotiating with other parties after agreeing to lease space to the plaintiff "were reprehensible and clearly amounted to wanton and/or reckless conduct sufficient to give rise to tort liability."¹¹⁰ Tort liability in *Chung*, though, simply meant damages for emotional distress because the plaintiffs had failed to appeal the trial court's refusal to instruct the jury on punitive damages.¹¹¹ The Hawaii court's opinion leaves little doubt, however, that the plaintiff's claim for punitive damages would have been upheld had the issue been preserved.

South Carolina has continued to adhere to its rule, first established in 1904, that permits punitive damages when "the breach of the contract is accompanied with a fraudulent act."¹¹² Distinguishing "fraudulent act" from the tort of fraud, South Carolina courts define "fraudulent act" as "any act characterized by dishonesty in fact, unfair dealing, or the unlawful appropriation of another's property by design."¹¹³ Despite the apparent breadth of this rule, the South Carolina Supreme Court has held that "[p]unitive damages are not recoverable for the mere failure or refusal to pay a debt,"¹¹⁴ the paradigmatic example of an opportunistic breach.¹¹⁵

Idaho, Mississippi, and New Mexico's rules appear to be the broadest and seem roughly similar. Idaho permits punitive damages for breach of contract "where there is fraud, malice, oppression or other sufficient reason for doing so."¹¹⁶ Mississippi has held that punitive damages "are recoverable where the breach results from an intentional wrong, insult, or abuse as well as from such gross negligence as constitutes an independent tort."¹¹⁷ And New Mexico has held that

Inc. v. Fitzgerald, 574 P.2d 884, 894 (Haw. 1978) (breach of commercial lease agreement); *Uyemura v. Wick*, 551 P.2d 171, 175 (Haw. 1976) (breach of contract to sell real estate); *Dold*, 501 P.2d at 370-71 (breach of contract between hotel and guest).

109. 618 P.2d 283 (Haw. 1980).

110. *Id.* at 289.

111. *See id.* at 287 n.4.

112. *Welborn v. Dixon*, 49 S.E. 232, 234 (S.C. 1904).

113. *Perry v. Green*, 437 S.E.2d 150, 152 (S.C. Ct. App. 1993).

114. *Vann v. Nationwide Ins. Co.*, 185 S.E.2d 363, 364 (S.C. 1971).

115. *See infra* Part II.B.3.c (discussing bad faith refusal to pay a debt).

116. *Boise Dodge v. Clark*, 453 P.2d 551, 556 (Idaho 1969). The Idaho Supreme Court has also stated that punitive damages should be allowed "where the breaking of a promise [is] an extreme deviation from standards of reasonable conduct, and [is] done with knowledge of its likely effects." *Linscott v. Rainier Nat'l Life Ins. Co.*, 606 P.2d 958, 964 (Idaho 1980).

117. *American Funeral Assurance Co. v. Hubbs*, 700 So. 2d 283, 286 (Miss. 1997) (quoting *Blue Cross & Blue Shield v. Maas*, 516 So. 2d 495, 496 (Miss. 1987)). Some Mississippi cases employ a slightly different verbal formulation, holding that punitive damages may be recovered

punitive damages may be recovered for breach of contract when the defendant's conduct was "malicious, fraudulent, oppressive, or committed recklessly with a wanton disregard for the plaintiff's rights."¹¹⁸ The apparent similarity disguises some differences in results, though. Each of these states seems to allow punitive damages for opportunistic breaches like pretextual termination,¹¹⁹ stonewalling,¹²⁰ or bad faith refusal to pay.¹²¹ Idaho and Mississippi, however, seem to allow punitive damages merely upon a showing of willfulness,¹²² while the New Mexico Supreme Court has refused to award punitive damages simply on the basis that the breach was willful.¹²³

if the breach "is attended by intentional wrong, insult, abuse or such gross negligence as to consist of an independent tort." *Progressive Cas. Ins. Co. v. Keyes*, 317 So. 2d 396, 398 (Miss. 1975). Cases employing this formulation make clear that the "independent tort" language modifies only "gross negligence." *See, e.g., Willard v. Paracelsus Health Care Corp.*, 681 So. 2d 539, 544 (Miss. 1996) (holding that trial judge erred by refusing a punitive damage instruction after finding an "intentional wrong"); *Polk v. Sexton*, 613 So. 2d 841, 845 (Miss. 1993) (holding that lying to get out of an option to sell commercial property constitutes a "gross and willful" breach of contract justifying punitive damages).

118. *Albuquerque Concrete Coring Co. v. Pan Am World Servs., Inc.*, 879 P.2d 772, 775 (N.M. 1994) (quoting *Romero v. Mervyn's*, 784 P.2d 992, 998 (N.M. 1989)). The New Mexico Supreme Court has declared that "[t]he courts of New Mexico do not distinguish between tort and contract in the application of punitive damages." *Hood v. Fulkerson*, 699 P.2d 608, 611 (N.M. 1985).

119. *See, e.g., Willard*, 681 So. 2d at 544 ("[A] reasonable jury could find [that the pretextual firing was] an intentional wrong . . . necessitating the imposition of punitive damages."). For further discussion of pretextual termination as an example of opportunistic breach, see *infra* Part II.B.3.a.

120. *See, e.g., Romero*, 784 P.2d at 1001 n.6 ("[L]ogic suggests that punitive damages be available when a party has breached a contract believing the wronged party cannot afford to contest the matter in court."). For further discussion of stonewalling as an example of opportunistic breach, see *infra* Part II.B.3.b.

121. *See, e.g., DynaSteel Corp. v. Aztec Indus.*, 611 So. 2d 977, 984 (Miss. 1992) (holding that bad faith refusal to pay for work done pursuant to a contract "is a ground upon which punitive damages may legitimately be granted"). For further discussion of bad faith refusal to pay as an example of opportunistic breach, see *infra* Part II.B.3.c.

122. *See Mitchell v. Barendregt*, 820 P.2d 707, 718 (Idaho Ct. App. 1991) (holding that a jury must be instructed on punitive damages in a case involving a "deliberate or willful" breach of contract to buy potatoes (quoting *White v. Doney*, 351 P.2d 380 (Idaho 1960))); *Davis v. Gage*, 682 P.2d 1282, 1286 (Idaho Ct. App. 1984) (upholding punitive damages for "willful, wanton, malicious" breach of a covenant not to compete); *Polk*, 613 So. 2d at 845 (allowing punitive damages upon a finding of "gross and willful" breach).

123. *See Construction Contracting & Mgmt. v. McCounell*, 815 P.2d 1161, 1165-66 (N.M. 1991) (stating that punitive damages are generally not available "[a]bsent a showing of malicious, fraudulent, or oppressive conduct, or conduct committed recklessly with a wanton disregard for the wronged party's rights"). New Mexico has also apparently accepted Judge Posner's "efficient breach" argument. *See McGinnis v. Honeywell, Inc.*, 791 P.2d 452, 460 (N.M. 1990) (citing *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir. 1988)).

Finally, there is language in both Rhode Island and Tennessee cases that would support the awarding of punitive damages for some breaches of contract. The Rhode Island Supreme Court has stated that “punitive damages do not lie in [contract] actions, absent the most egregious circumstances.”¹²⁴ Similarly, the Tennessee Court of Appeals has recently stated that while “as a general rule punitive damages are not proper in breach of contract cases . . . exceptions [exist] in cases involving ‘fraud, malice, gross negligence or oppression.’”¹²⁵ Despite these statements, there appear to be no cases in either Rhode Island or Tennessee that have actually upheld an award of punitive damages.

Thus, while a significant minority of states do permit punitive damages for some breaches of contract, most states do not. Moreover, as I have already noted, the current trend is in the direction of contracting rather than expanding the availability of punitive damages.

II. THE CASE FOR PUNITIVE DAMAGES

It is necessary, at the outset, to distinguish among involuntary, opportunistic, and efficient breaches. After explaining those distinctions in Section II.A, my argument proceeds in two parts. In Section II.B, I argue that punitive damages should be awarded to deter opportunistic breaches of contract. I also discuss three examples of opportunistic breach—pretextual termination, stonewalling, and bad faith refusal to pay—in order to show that many states are unwisely prohibiting punitive damages in cases of opportunistic breach. In Section II.C, I argue on economic grounds that punitive damages should be available for any willful breach of contract, even if that breach is “efficient.”

A. *Three Kinds of Breaches*

In discussing the proper remedy for breach of contract, it is useful to distinguish among different kinds of breaches.¹²⁶ First, we may divide breaches into two basic categories: involuntary and willful. In-

124. *O’Coin v. Woonsocket Instit. Trust Co.*, 535 A.2d 1263, 1266 (R.I. 1988).

125. *Medley v. A.W. Chesterton Co.*, 912 S.W.2d 748, 753 (Tenn. Ct. App. 1995) (citations omitted) (quoting *Bryson v. Bramlett*, 321 S.W.2d 555, 557 (Tenn. 1958)).

126. *See generally* POSNER, *supra* note 4, at 130-31 (distinguishing involuntary, opportunistic, and efficient breaches); *Patton*, 841 F.2d at 751 (same).

advertently installing the wrong kind of pipe in a house would be an involuntary breach.¹²⁷ So would breaching a contract in the good faith belief that some defense like impossibility excused performance, even though a court later determined that the requirements for the defense had not been met, because the promisor would not think at the time that she was voluntarily breaching the contract. The category of willful breach, on the other hand, includes any deliberate breach. A party who withholds payment in bad faith after the other party has performed is breaching willfully. So, too, is a party who deliberately decides not to perform because performance has become more expensive than anticipated (though not so expensive as to raise the defense of impossibility) or because a better opportunity has come along.

Willful breaches may be further subdivided into two categories: opportunistic and efficient. A breach is opportunistic if the breaching party attempts to get more than he bargained for at the expense of the nonbreaching party.¹²⁸ "The opportunistic actor creates more value for himself, but only by taking an equivalent amount or more from others."¹²⁹ For example, a party who withholds payment in bad faith after the other party has performed in the hope of obtaining a reduction in the contract price is breaching opportunistically.¹³⁰ By contrast, a breach is efficient if it makes the breaching party so much

127. See *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889, 890 (N.Y. 1921) ("The evidence sustains a finding that the omission of the prescribed brand of pipe was neither fraudulent nor willful. It was the result of oversight and inattention of the plaintiff's subcontractor.").

128. See *Patton*, 841 F.2d at 751 (defining an opportunistic breach as one where "the promisor wants the benefit of the bargain without bearing the agreed-upon cost"); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1139 n.118 (1981) ("[O]pportunistic behavior only redistributes portions of an already allocated contractual pie."); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521 (1981) ("[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 . . .").

Others have defined "opportunism" as taking advantage of the other party's vulnerability, see Victor P. Goldberg, *Relational Exchange: Economics and Complex Contracts*, 23 AM. BEHAV. SCI. 337 (1980), reprinted in READINGS IN THE ECONOMICS OF CONTRACT LAW 16, 17 (Victor P. Goldberg ed., 1989), as "self-interest seeking with guile," OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 47 (1985), or as "any contractual conduct by one party contrary to the other party's reasonable expectations based on the parties' agreement, contractual norms, or conventional morality," George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 957 (1992) (footnotes omitted). For the purposes of this Article, however, the narrower "trying to get more than you bargained for" definition will suffice.

129. Perlstein, *supra* note 14, at 880.

130. For further examples of opportunistic breaches, see *infra* Part II.B.3.

better off that she could compensate the nonbreaching party for his losses and still come out ahead. For example, if a widget manufacturer, by breaching her contract with *A* and selling to *B*, can make enough to compensate *A* for his losses and still be better off, it would be efficient for her to breach the contract with *A*.¹³¹ If the breaching party is required to compensate the nonbreaching party, the breach is Pareto efficient; if the breaching party is not required to do so, the breach is simply Kaldor-Hicks efficient.¹³² Discussions of efficient breach generally employ the Pareto understanding of efficiency because they assume the availability of expectation damages, which are designed to ensure that the nonbreaching party is compensated for his losses,¹³³ and I, too, will use Pareto efficiency in making my argument. Thus, the distinction between opportunistic and efficient breaches, as I have defined them, boils down to this: An opportunistic breach does not increase the size of the economic pie; the breaching party gains simply by capturing a larger share of the pie at the expense of the nonbreaching party. An efficient breach, on the other hand, increases the size of the pie, allowing the breaching party more without decreasing the amount that the nonbreaching party receives.

We are left, then, with three basic kinds of breaches: involuntary, opportunistic, and efficient. Both opportunistic and efficient breaches fall into the category of willful breaches. Because contractual liability is strict liability, even an involuntary breacher is liable for damages, but no one—myself included—argues that an involuntary breach of contract should subject the breacher to punitive damages.¹³⁴ The question, then, is whether punitive damages should not be allowed for any breach of contract, whether they should be allowed for opportunistic but not efficient breaches, or whether they should be allowed for all willful breaches, even those that are efficient. The traditional rule, adopted by the *Restatement (Second) of Contracts* and followed in a majority of states, does not allow punitive damages in the ab-

131. See POSNER, *supra* note 4, at 133; Patton, 841 F.2d at 750.

132. A transaction is Kaldor-Hicks efficient if it increases net wealth, regardless of any change in wealth distribution. In other words, a transaction is Kaldor-Hicks efficient if the gainers gain more than the losers lose. By contrast, a transaction is Pareto efficient if it results in a net increase in wealth *and* no person is made worse off by the transaction. Pareto efficiency's second criterion requires that gainers compensate losers for any losses caused by the transaction. See generally ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 41-42 (2d ed. 1997) (explaining and distinguishing between these two concepts).

133. See, e.g., POSNER, *supra* note 4, at 133 (describing a Pareto-efficient breach).

134. For further discussion, see *infra* Part II.D.

sence of an independent tort, even if the breach is opportunistic.¹³⁵ Judge Posner approves of punitive damages for opportunistic breaches,¹³⁶ but not for efficient ones.¹³⁷ I agree with Judge Posner that punitive damages should be available to discourage opportunistic breaches of contract,¹³⁸ but I go further and argue that punitive damages should be available for all willful breaches of contract, even those that are “efficient.”¹³⁹

B. Punitive Damages for Opportunistic Breach of Contract

As I will demonstrate below, opportunistic breaches of contract are inefficient. They not only fail to create wealth, but actually consume it. Compensatory damages are not sufficient to deter these breaches, and thus punitive damages are necessary.¹⁴⁰ In the absence of an independent tort, however, the traditional rule shields opportunistic breachers from punitive damages, encouraging inefficient opportunism.

1. *The Inefficiency of Opportunism.* By definition, opportunistic behavior does not create wealth but simply redistributes wealth from one party to another.¹⁴¹ Indeed, opportunism actually consumes existing wealth because “potential opportunists and victims expend resources perpetrating and protecting against opportunism.”¹⁴² The opportunist may expend resources looking for loopholes in a contract or trying to make its cheating more difficult to detect. The victim, on the other hand, may try to guard against opportunistic behavior by investigating its prospective contractual partners more carefully, by drafting a more detailed contract, or by spending more resources monitoring the other party’s performance.¹⁴³ None of these

135. See *supra* notes 23-29 and accompanying text.

136. See POSNER, *supra* note 4, at 130 (recommending that the law “throw the book” at opportunistic parties).

137. See *id.* at 142 (discussing “good reasons for not awarding punitive damages for nonopportunistic breaches”).

138. See *infra* Part II.B.

139. See *infra* Part II.C.

140. See POSNER, *supra* note 4, at 130; Perlstein, *supra* note 14, at 881-90.

141. See Cohen, *supra* note 128, at 973; Perlstein, *supra* note 14, at 879-80.

142. Muris, *supra* note 128, at 524.

143. See *id.*

expenditures increases society's total wealth.¹⁴⁴ Thus, as Judge Posner recognizes, the law should discourage opportunistic breaches of contract:

It makes a difference in deciding which remedy to grant whether the breach was opportunistic. If a promisor breaks his promise merely to take advantage of the vulnerability of the promisee in a setting (the normal contract setting) where performance is sequential rather than simultaneous, we might as well throw the book at the promisor. An example would be where A pays B in advance for goods and instead of delivering them B uses the money in another venture. Such conduct has no economic justification and ought simply to be deterred.¹⁴⁵

2. *Compensatory Damages Do Not Discourage Opportunism.*

Compensatory damages are not sufficient to discourage opportunism. An opportunistic breacher will sometimes escape liability, either because the nonbreaching party fails to detect the breach or because the nonbreaching party cannot afford to bring suit to enforce his rights. If an opportunistic breacher need only pay compensatory damages when she is held liable and can keep her opportunistic gains when she is not, opportunism may prove to be a profitable strategy.¹⁴⁶ The Nevada Supreme Court made exactly this point in upholding punitive damages for the pretextual firing of an employee in order to deny him retirement benefits:

If all a large corporate employer had to do was to pay contract damages for this kind of conduct, it would allow and even encourage dismissals of employees on the eve of retirement with virtual impunity. Having to pay only contract damages would offer little or no

144. See Cohen, *supra* note 128, at 973-74 ("Investments 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.").

145. POSNER, *supra* note 4, at 130; see also *id.* at 103 ("[T]he fundamental function of contract law (and recognized as such at least since Hobbes's day) is to deter people from behaving opportunistically toward their contracting parties . . .") (footnote omitted); Muris, *supra* note 128, at 532-88 (discussing ways in which contract law attempts to discourage opportunism).

146. See Polinsky & Shavell, *supra* note 14, at 936-37 ("[T]he award of punitive damages sometimes can promote the interests of contracting parties—when a non-performing party has a chance of escaping detection and liability."); Curtis, *supra* note 14, at 163 ("[E]xtra-contractual damages are justified on efficiency grounds . . . where the probability of the victim detecting and suing for breach is less than one . . .").

deterrent to the type of practice apparently engaged in by K Mart in this case.¹⁴⁷

In his discussion of opportunistic breaches, Judge Posner suggests that the opportunistic breacher be made to pay restitution of any benefits received from the breach. "We can deter this kind of behavior by making it worthless to the promisor, which we do by making him hand over all his profits from the breach to the promisee; no lighter sanction would deter."¹⁴⁸ Because there is at least some chance that the opportunistic breacher will not be held liable at all, however, restitution alone is not sufficient to deter opportunistic breaches. Perhaps for this reason, Judge Posner approves of what he sees as a judicial trend towards awarding "punitive damages . . . as a sanction for opportunistic breaches."¹⁴⁹

Unfortunately, no such trend exists. Most opportunistic breaches of contract do not constitute "independent torts." Thus, punitive damages are not available to deter them in those states that follow the traditional rule. Even among the relatively few states that permit punitive damages in the absence of an independent tort, several do not permit punitive damages for some opportunistic breaches.¹⁵⁰ Indeed, the current trend is against imposing punitive damages for breach of contract—even for opportunistic breaches¹⁵¹—and, ironi-

147. *K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1372 (Nev. 1987).

148. POSNER, *supra* note 4, at 130-31.

149. *Id.* at 142. Judge Posner's perception of such a trend likely stems in part from his exposure to Indiana law in *Patton v. Mid-Continent Systems*, 841 F.2d 742 (7th Cir. 1988). Prior to 1993, Indiana was one of the leading states in allowing punitive damages for breach of contract. See *supra* notes 37-41 and accompanying text. In *Patton*, Judge Posner concluded that opportunistic "seems the common element in most of the Indiana cases that have allowed punitive damages to be awarded in breach of contract cases." *Patton*, 841 F.2d at 751. The Indiana Supreme Court has subsequently overruled this line of cases and now requires a plaintiff seeking punitive damages to plead and prove the existence of an independent tort. See *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 981-84 (Ind. 1993); *supra* notes 72-74 and accompanying text.

150. See, e.g., *Vann v. Nationwide Ins. Co.*, 185 S.E.2d 363, 364 (S.C. 1971) (holding that punitive damages are not available for bad faith refusal to pay a debt). Arizona, Montana, Nevada and Wyoming do not allow punitive damages for breach of contract unless there is a "special relationship" between the parties. See *supra* Part I.B.2.a. Thus, in these states, opportunistic breaches that occur outside such relationships are not subject to punitive damages.

151. See, e.g., *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 679-80 (Cal. 1995) (holding that punitive damages are not available for bad faith refusal to pay a debt); *Foley v. Interactive Data Corp.*, 765 P.2d 373, 401 (Cal. 1988) (holding that punitive damages are not available for pretextual termination of an employment contract). For further discussion of the opportunistic nature of the breaches in *Freeman & Mills* and *Foley*, see *infra* text accompanying notes 158-63, 188-92.

cally, courts are increasingly relying on the theory of efficient breach in refusing to impose punitive damages.¹⁵²

3. *A Few Examples of Opportunistic Breach.* Opportunistic breaches come in many varieties. To illustrate the points made above, I will concentrate on just a few: pretextual termination of a contract; stonewalling; and bad faith refusal to pay for services already performed.

a. Pretextual termination. One common sort of opportunistic breach is the termination of a contract on pretextual grounds—a party who has no legitimate basis for escaping the contract attempts to fabricate such a basis. Pretextual termination often occurs in the context of an employment relationship. In one common scenario, the employer creates “cause” for firing an employee in order to deny the employee retirement or severance benefits. In *K Mart Corp. v. Ponsock*,¹⁵³ for example, the plaintiff Ponsock, a fork-lift driver and a tenured employee, was fired after nine and a half years of service when he was approximately six months away from full vesting of his retirement benefits.¹⁵⁴ Ponsock was fired for defacing company property and misappropriating merchandise after he used a discarded can of spray paint to cover a sticky area on his forklift.¹⁵⁵ The Nevada Supreme Court held that Ponsock was entitled to recover in tort because K Mart had discharged him “in bad faith for the improper motive of defeating contractual retirement benefits”¹⁵⁶ and upheld an award of punitive damages.¹⁵⁷

152. See *supra* note 9 and accompanying text.

153. 732 P.2d 1364 (Nev. 1987).

154. See *id.* at 1366.

155. See *id.* at 1366-67.

156. *Id.* at 1370.

157. See *id.* at 1373. The Vermont Supreme Court has also upheld an award of punitive damages where the defendant “fabricated grounds for termination solely to deny plaintiff his severance allowance.” *Ainsworth v. Franklin County Cheese Corp.*, 592 A.2d 871, 875 (Vt. 1991); see also *Garcia v. UniWyo Fed. Credit Union*, 920 P.2d 642, 646 (Wyo. 1996) (“Usually, the special relationship giving employees an action on the implied covenant of good faith and fair dealing stems from a long term employment relationship coupled with a discharge calculated to avoid employer responsibilities to the employee, e.g., benefits or commissions.”).

If the employment is at will and the fabricated grounds for termination do not deny the employee any contractual rights, then fabricating those grounds would not constitute a breach of the employment contract, much less an opportunistic one. See, e.g., *Wagenseller v. Scottsdale Mem'l Hosp.*, 710 P.2d 1025, 1038-41 (Ariz. 1985) (holding that termination without cause does

Other courts, however, have not been willing to allow punitive damages for pretextual firings. In *Foley v. Interactive Data Corp.*,¹⁵⁸ the California Supreme Court held that the plaintiff had sufficiently alleged an implied-in-fact contract limiting the defendant's right to discharge him without cause, which the defendant had breached by firing him pretextually.¹⁵⁹ Nevertheless, the court held that the plaintiff should be limited to expectation damages,¹⁶⁰ rejecting dicta in *Seaman's* that had suggested that punitive damages might be available for bad faith breach of an employment contract.¹⁶¹ In rejecting the *Seaman's* dicta, the *Foley* court relied on the theory of efficient breach.¹⁶² The problem, of course, is that a pretextual firing, which denies an employee his contractual right to be discharged only for cause, or only after following an agreed procedure, or to retirement or severance benefits, is not Pareto efficient—it is opportunistic. The employer is not compensating the employee for the loss of his contractual rights, as would be the case in an efficient breach scenario; it is attempting to benefit precisely by denying the employee those rights. In short, the employer is attempting to get more than it bargained for *at the expense* of the employee.¹⁶³

The problem of pretextual termination is not limited to employment contracts. In *Nicholson v. United Pacific Insurance Co.*,¹⁶⁴ the defendant precipitated disputes over plans for a renovation as a justification for rescinding a commercial lease.¹⁶⁵ The Montana Supreme Court upheld the jury's award of punitive damages on the ground that the defendant's breach amounted to "oppression, fraud

not breach the implied covenant of good faith and fair dealing in an at-will employment relationship).

158. 765 P.2d 373 (Cal. 1988).

159. *See id.* at 387-88.

160. *See id.* at 396.

161. *See id.* at 392.

162. *See id.* at 389 n.25 (citing, *inter alia*, RESTATEMENT, *supra* note 1, reporter's note to ch. 16, at 101-02 ("[A] breach of contract will result in a gain in 'economic efficiency' if the party contemplating breach evaluates his gains at a higher figure than the value that the other party puts on his losses . . .")).

163. One other employment case deserves brief mention. In *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436 (Del. 1996), the Delaware Supreme Court held that punitive damages were not available for pretextual breach of an employment contract. *See id.* at 445-48. That holding would appear to shield opportunistic breaches of employment contracts from punitive damages. Nevertheless, the result in *Pressman* may have been correct because the plaintiff was an at-will employee, *see id.* at 442, and therefore his termination, though pretextual, was not opportunistic. *See supra* note 157.

164. 710 P.2d 1342 (Mont. 1985).

165. *See id.* at 1344.

or malice.”¹⁶⁶ The Montana Supreme Court, however, has since overruled *Nicholson’s* holding on punitive damages and now requires proof of a “special relationship” between the parties,¹⁶⁷ which specifically excludes commercial contracts.¹⁶⁸ Another example from outside the employment context is *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*,¹⁶⁹ a case in which the defendant had fabricated grounds for terminating a distributorship contract to escape the effect of a state statute protecting beer wholesalers from unfair terminations that had been expressly incorporated into the contract.¹⁷⁰ The Indiana Supreme Court, overturning several of its past decisions,¹⁷¹ held that the plaintiff was not entitled to punitive damages for the pretextual termination of its distributorship agreement unless it could “plead and prove the existence of an independent tort.”¹⁷² In limiting the availability of punitive damages for pretextual terminations, both the Indiana and the Montana courts relied on the theory of efficient breach.¹⁷³ But the pretextual terminations involved in all of these cases were not Pareto efficient. In each case, the defendant who created the pretext for terminating the agreement was seeking to benefit at the expense of the plaintiff by denying the plaintiff its contractual rights without compensation.

166. *Id.* at 1348. The Mississippi Supreme Court has also upheld an award of punitive damages in the context of a commercial lease. *See Polk v. Sexton*, 613 So. 2d 841, 845 (Miss. 1993). Sexton had leased commercial space from Polk with an option to buy at a specified price. *See id.* at 842. Polk subsequently told Sexton he could not sell her the property because his bank would not allow it. *See id.* at 843. In fact, the bank had never been asked, and Polk declined to sell because the property was worth twice what he had agreed to sell it for. *See id.* The Mississippi Supreme Court agreed with the trial court that Polk’s breach was “gross and willful” and affirmed the award of punitive damages. *See id.* at 845.

167. *See Story v. City of Bozeman*, 791 P.2d 767, 775-76 (Mont. 1990).

168. *See id.* at 776 (“[T]he motivation for entering the contract must be a non-profit motivation . . .”) (quoting *Wallis v. Superior Court*, 207 Cal. Rptr. 123, 129 (Ct. App. 1984)).

169. 608 N.E.2d 975 (Ind. 1993).

170. *See id.* at 976-79.

171. *See supra* notes 37-41, 72-74 and accompanying text.

172. *Miller*, 608 N.E.2d at 984.

173. *See id.* at 984 (holding that the public interest is not served by a policy that “prohibits one party to a contract from exercising his common law rights to breach a contract and pay a rightful amount of compensatory damages”); *Story*, 791 P.2d at 774 (“Primarily, the specter of tort damages upsets the concept of efficient breach. Parties have traditionally been free to breach their contract and pay contract damages whenever performance was not economically efficient.”).

b. *Stonewalling*. The classic “stonewalling” case is *Seaman’s Direct Buying Service, Inc. v. Standard Oil Co. of California*.¹⁷⁴ According to *Seaman’s*, it had entered a contract in 1972 under which Standard agreed to supply fuel for its marine fuel dealership.¹⁷⁵ Following the Arab oil embargo, Standard tried a number of ways to get out of its obligation¹⁷⁶ and ultimately just denied that any contract existed.¹⁷⁷ After noting that punitive damages would be available for threatening to bring a lawsuit in bad faith, the California Supreme Court wrote:

There is little difference, in principle, between a contracting party obtaining excess payment [by threatening to bring a lawsuit], and a contracting party seeking to avoid all liability on a meritorious contract claim by adopting a “stonewall” position (“see you in court”) without probable cause and with no belief in the existence of a defense. Such conduct goes beyond the mere breach of contract. It offends accepted notions of business ethics.¹⁷⁸

In the end, the *Seaman’s* court limited its holding to allowing punitive damages for “denying, in bad faith and without probable cause, that the contract exists.”¹⁷⁹ The New Mexico Supreme Court has endorsed *Seaman’s* on this point.¹⁸⁰

Stonewalling, however, is not generally recognized as an “independent tort.”¹⁸¹ Thus, punitive damages are not available to de-

174. 686 P.2d 1158 (Cal. 1984) (per curiam).

175. *See id.* at 1160-61.

176. *See id.* at 1161-62.

177. *See id.* at 1162 (“*Seaman’s* asked Standard to stipulate to the existence of a contract, explaining that it could not continue in operation throughout the time that a trial would take. In reply, Standard’s representative laughed and said, ‘See you in court.’”).

178. *Id.* at 1167.

179. *Id.*

180. In *Romero v. Mervyn’s*, 784 P.2d 992 (N.M. 1989), the court stated:

[P]unitive damages long have been recognized as an appropriate remedy in situations in which exposure merely to compensatory damages is an inadequate deterrent to prevent such oppressive conduct. . . . [L]ogic suggests that punitive damages be available when a party has breached a contract believing the wronged party cannot afford to contest that matter in court.

Id. at 1001 n.6 (citation omitted); *see also id.* at 1000 (“Acceptance of tort remedies [for a bad faith breach of contract] is not likely to intrude upon the reasonable expectations of the contracting parties.” (quoting *Seaman’s*, 686 P.2d at 1167)). The *Romero* court did not actually have to decide this issue because there was insufficient evidence that Mervyn’s was “stonewalling.” *See id.* at 1000 n.6.

181. In New Hampshire, raising a defense in bad faith is a tort. *See Aranson v. Schroeder*, 671 A.2d 1023, 1028 (N.H. 1995) (recognizing the common law tort of “malicious defense”).

ter stonewalling in most states. The Iowa Supreme Court has recently made this explicit in overturning an award of punitive damages:

The [trial] court also based its punitive damage award on a finding that [medical] payments were denied in an effort to force White to settle his claim. Again, however, we are confronted with a claim that is not recognized in tort. While we agree that US West's treatment of White was shabby, merely objectionable conduct is insufficient¹⁸²

Moreover, the California Supreme Court has recently overruled *Seaman's*, citing the theory of efficient breach as one reason for doing so.¹⁸³ But stonewalling is not Pareto efficient—by definition, a stonewalling party is not agreeing to pay the other party's expectation damages. When a party denies liability in bad faith, hoping that the other party will not be able to afford to litigate or will be forced to settle for less than it is entitled to, it is acting opportunistically, hoping to benefit at the other party's expense.¹⁸⁴

c. *Bad faith refusal to pay.* Perhaps the paradigmatic example of an opportunistic breach is when one party refuses to perform its part of the bargain after the other party has performed.¹⁸⁵ One state has expressly held that an "obstinate and willful refusal to pay . . . is a ground upon which punitive damages may legitimately be granted."¹⁸⁶ But this is highly unusual, and even some states that generally allow punitive damages for breach of contract deny such damages for willful refusal to pay a debt.¹⁸⁷

However, New Hampshire appears to be alone in recognizing malicious defense as a tort. See *infra* note 346 and accompanying text.

182. *White v. Northwestern Bell Tel. Co.*, 514 N.W.2d 70, 77 (Iowa 1994).

183. See *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 676-77 (Cal. 1995) (stating that the rule against punitive damages "encourages efficient breaches, resulting in increased production of goods and services at lower cost to society" (quoting *Harris v. Atlantic Richfield Co.*, 17 Cal. Rptr. 2d 649, 653-54 (Ct. App. 1993))).

184. See *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 751 (7th Cir. 1988) (giving as an example of an opportunistic breacher "the promisor [who] wants the benefit of the bargain without bearing the agreed-upon cost, and exploits the inadequacies of purely compensatory remedies").

185. See *supra* text accompanying note 130.

186. *DynaSteel Corp. v. Aztec Indus.*, 611 So. 2d 977, 984 (Miss. 1992) (internal quotation omitted).

187. See, e.g., *Vann v. Nationwide Ins. Co.*, 185 S.E.2d 363, 364 (S.C. 1971) ("Punitive damages are not recoverable for the mere failure or refusal to pay a debt."). Presumably, states that require a "special relationship" between the parties in order to award punitive damages, see

Take the California Supreme Court's decision in *Freeman & Mills, Inc. v. Belcher Oil Co.*¹⁸⁸—the case that overruled *Seaman's*—as an example. Belcher Oil had retained the law firm of Morgan, Lewis and Bockius to defend it in a lawsuit. With Belcher's approval, Morgan retained Freeman & Mills, an accounting firm, to provide financial analysis. Ultimately, Belcher discharged Morgan and refused to pay for the services Freeman & Mills had rendered.¹⁸⁹ The jury found that "Belcher Oil had denied the existence of the contract and had acted with oppression, fraud, or malice," and awarded Freeman & Mills punitive as well as compensatory damages.¹⁹⁰ The California Supreme Court affirmed the judgment of the court of appeal, which had reversed the trial court's judgment.¹⁹¹ Perhaps because the court was focused on whether it should overrule *Seaman's*, its discussion completely ignored the facts of the case before it: the court relied on the theory of "efficient breach" in readopting the traditional rule barring punitive damages in contracts¹⁹² even though the breach in *Freeman & Mills* was not Pareto efficient. If one accepts the jury's finding of bad faith as true, as the *Freeman & Mills* court was required to do, then Belcher's breach was a classic example of opportunism—Belcher was refusing to pay for services it had already received without any good faith belief that it was entitled to do so.

d. Conclusion. The three kinds of opportunistic breaches discussed here obviously do not exhaust the possibilities. But the cases decided in each of these areas do show that many courts are failing to distinguish between opportunistic and efficient breaches of contract and are improperly relying on the theory of efficient breach to shield opportunistic breaches of contract from punitive damages. To repeat Judge Posner's words, when a promisor breaches opportunistically, "we might as well throw the book at the promisor. . . . Such conduct has no economic justification and ought simply to be deterred."¹⁹³

supra Part I.B.2.a, also would not award punitive damages for bad faith refusal to pay a debt in the absence of such a relationship.

188. 900 P.2d 669 (Cal. 1995).

189. *See id.* at 670-71.

190. *Id.* at 671.

191. *See id.* at 680.

192. *See id.* at 676-77.

193. POSNER, *supra* note 4, at 130.

C. Punitive Damages for "Efficient" Breach of Contract

Although Judge Posner would allow punitive damages to discourage opportunistic breaches of contract, he would not allow punitive damages for other willful breaches. He explains:

Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee's actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn't want to bring about such a result.¹⁹⁴

In this section, I argue that Judge Posner's analysis is wrong. Allowing a party to breach a contract and pay damages is not as efficient as forcing that party, with the threat of punitive damages, to negotiate with the other party for a release from the contract.

1. *The Efficient Breach Argument.* Sometimes it is more efficient not to perform a contract. The seller might receive a better offer from a second buyer, or the buyer might receive a better offer from a second seller; the seller might find that its cost of performance has risen, or the buyer might find that the value of performance has diminished.¹⁹⁵ To take the first possibility as an illustration,¹⁹⁶ assume that a manufacturer has agreed to produce widgets for *A*. After the contract is made, *B* comes along and offers a better price. If the manufacturer can make enough by selling to *B* to compensate *A* for his loss and still come out ahead, then it would be efficient for her to breach the contract with *A* and sell to *B*. The widgets will end up in the hands of the party that values them most.¹⁹⁷ Moreover, *B* is better off, the seller is better off, and *A* is no worse off—a Pareto-superior result. Expectation damages, the argument goes, promote efficiency

194. *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir. 1988).

195. See generally Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 473-74 (1980) (analyzing these four possibilities).

196. The seller who receives a better offer from a second buyer is the most commonly used example of efficient breach, but the same basic analysis applies to the other examples noted in the text. See Craswell, *supra* note 15, at 634 & n.6.

197. The widgets could also end up in the hands of the party who values them most if *B* had negotiated with *A* for an assignment of *A*'s contractual rights or if *A* had taken delivery of the widgets and resold them to *B*.

because they permit such efficient breaches.¹⁹⁸ Punitive damages, on the other hand, deter efficient breaches because they require the breaching party to pay more than the nonbreaching party's actual losses.¹⁹⁹

There are a number of problems with this analysis, several of which other writers have already identified. First, the efficient breach argument assumes that the breaching party willingly agrees to make good the nonbreaching party's actual losses and does not try to take advantage of the costs of litigation to avoid paying altogether or to force the nonbreaching party to settle for less than his actual damages. So many breaching parties act opportunistically in refusing to pay damages, though, that one may wonder whether a separate category of "efficient" breaches even exists.²⁰⁰ "[T]he voluntary payor is so rare as to be an almost purely hypothetical figure."²⁰¹ Second, the efficient breach argument assumes that expectation damages do, in fact, put the nonbreaching party in as good a position as performance. As a number of writers have pointed out, though, the requirements of certainty and foreseeability and the fact that nonbreaching parties typically may not recover for emotional distress, attorneys' fees, or prejudgment interest means that expectation damages generally fail to compensate the nonbreaching party fully.²⁰² If the breaching party is not responsible for the nonbreaching party's full losses, then there is an incentive to breach even when the breach would not be efficient.²⁰³ While a few writers have advocated punitive damages as a way of remedying these problems with the efficient breach ar-

198. See POSNER, *supra* note 4, at 132-33. The earliest expressions of this idea are found in Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273 (1970) and John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277 (1972).

199. See *Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir. 1988) (Posner, J.) ("If [the promisor] is forced to pay more than [the promisee's actual losses], an efficient breach may be deterred, and the law doesn't want to bring about such a result."); POSNER, *supra* note 4, at 142 ("A penalty would deter efficient as well as inefficient breaches, by making the cost of the breach to the contract breaker greater than the cost of the breach to the victim . . .").

200. See *supra* Part II.B.3.b-c (discussing "stonewalling" and bad faith refusal to pay as examples of opportunistic breach).

201. Putz & Klippen, *supra* note 53, at 431.

202. See sources listed *supra* at note 14; sources listed *infra* at note 205.

203. See, e.g., Seibert, *supra* note 14, at 1573 ("By systematically undercompensating plaintiffs, we risk encouraging too much breach rather than too little.").

gument,²⁰⁴ the more common proposal is to reform expectation damages to make them more fully compensatory.²⁰⁵

My argument is different from these. I am willing to assume that a breacher will voluntarily pay the nonbreaching party's expectation damages (although she may in good faith dispute the amount of those damages) and that expectation damages are sufficient to put the nonbreaching party in the same position as performance. Even with these assumptions, however, the efficient breach argument against punitive damages is mistaken because breach is not the only alternative to inefficient performance. The promisor facing the prospect of inefficient performance may approach the promisee and seek a release from her contractual obligations.²⁰⁶

Proponents of the efficient breach argument have not completely ignored the possibility of seeking a release. For example, in the context of discussing specific performance (another form of property-rule protection), Judge Posner notes that "[t]he results of decreeing specific performance are not catastrophic, since the seller can always pay the buyer to surrender the right of specific performance and presumably will do so if a substitute transfer would yield a higher price."²⁰⁷ The same goes for punitive damages: a promisor who wants to avoid them can always pay the promisee for a release. However, Judge Posner argues, "the additional negotiation will not be costless."²⁰⁸ Indeed, the potential transaction costs of the additional negotiation are quite high because there is a "bilateral monopoly"²⁰⁹—neither party has an alternative to dealing with the other and each may act strategically to obtain a larger share of the gain from the second transaction.²¹⁰ What Judge Posner tends to ignore are the

204. See, e.g., *id.* at 1656-67; Farber, *supra* note 14, at 1448-55; Curtis, *supra* note 14, at 168-70.

205. See, e.g., Putz & Klippen, *supra* note 53, at 481-98 (arguing that awarding attorneys' fees is preferable to awarding punitive damages); Barrett, *supra* note 53, at 527-28 (same); Chutorian, *supra* note 53, at 403-06 (arguing that requirements of foreseeability and certainty be relaxed for bad faith breaches); Scallen, *supra* note 53, at 1189-96 (same).

206. See generally Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 950-53 (1982) (noting that breach is only one of the ways to avoid performance of an inefficient contract).

207. POSNER, *supra* note 4, at 146.

208. *Id.*

209. *Id.*

210. For further discussion of bilateral monopoly and strategic behavior, see *infra* Part II.C.2.b.i-ii.

costs of litigation²¹¹ and the fact that the same problems of bilateral monopoly and strategic behavior also arise in litigation. To evaluate the claim that allowing a party to breach and pay damages is more efficient than encouraging negotiations with the threat of punitive damages (or specific performance), one must compare the costs of such negotiations with the costs of assessing damages.

2. *The Analytic Framework.*

a. *Property rules, liability rules, and contract remedies.* In *One View of the Cathedral*, Guido Calabresi and Douglas Melamed identified two ways of protecting a legal entitlement: "property rules" and "liability rules." "An entitlement is protected by a property rule to the extent that someone who wishes to remove the entitlement from its holder must buy it from him in a voluntary transaction in which the value of the entitlement is agreed upon by the seller."²¹² An entitlement is protected by a liability rule if someone may remove it without the entitlement holder's consent and pay an amount determined by a court.²¹³ Thus, in a nuisance context, a neighborhood's entitlement to clean air is protected by a property rule if the neighborhood may enjoin a factory from polluting; it is protected by a liability rule if the factory may pollute and pay damages.²¹⁴ Both property rules and liability rules allow entitlements to change hands. The factory liable for damages may deprive the neighborhood of clean air if it pays those damages, while the factory subject to an injunction may negotiate with the neighborhood to be released from the injunction. Property rules and liability rules differ fundamentally, however, with respect to how the "price" of the entitlement is set. Under a property rule, the parties determine the price through bargaining; under a liability rule, a court determines the price.

211. While explaining that expectation damages are efficient because they encourage efficient breach, Judge Posner does note that assignment of contractual rights from one buyer to another, rather than having the seller breach and pay damages, avoids litigation costs. See POSNER *supra* note 4, at 133. But generally he assumes that litigation is costless while negotiations are expensive.

212. Calabresi & Melamed, *supra* note 15, at 1092.

213. *See id.*

214. *See id.* at 1115-16.

Although Calabresi and Melamed wrote primarily about property and tort remedies, contract remedies may also be divided into property rules and liability rules.²¹⁵ As one commentator explained:

The ordinary remedy of expectation damages resembles a liability rule, for it allows one party to break the contract whenever she is willing to pay the court's estimate of the value of her performance to the other party. By contrast, the remedy of specific performance protects the promisee with a property rule, barring the promisor from breaking the contract unless she negotiates her release from the promisee.²¹⁶

Liquidated damages clauses that operate as penalties and punitive damages also protect the promisee with a property rule because they make breaching the contract prohibitively expensive.²¹⁷ A promisor who wishes to avoid performance has to negotiate with the promisee for a release from her contractual obligations.²¹⁸ One can see immediately that American contract law displays an overwhelming preference for liability rules.²¹⁹ The usual remedy for breach of contract is expectation damages. Specific performance is awarded only in limited situations when expectation damages would be inadequate,²²⁰ liquidated damages clauses are not permitted if they operate as pen-

215. Tony Kronman was the first to recognize this. See Kronman, *supra* note 15, at 352.

216. Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 4 (1993); see also Kronman, *supra* note 15, at 352.

217. See Craswell, *supra* note 216, at 4 (classifying penalty clauses and punitive damages as property rules); Kaplow & Shavell, *Property Rules*, *supra* note 15, at 724 (“[A] liability rule with very high damages is equivalent to property rule protection of victims.”); Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1041 (“[I]f the damages are greater than . . . the highest valuation of any potential defendant . . . then the plaintiff’s entitlement is ‘property-like’ in nature.”).

Restitution generally does not operate as a property rule, even though it may exceed expectation damages. Because the breaching party may sometimes escape liability, requiring restitution is not sufficient to deter breach. See *supra* notes 148-49 and accompanying text.

218. See Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1041 (“With such relatively high damages, potential takers would be deterred from nonconsensual takings, and the entitlement would be transferred only by consensual agreement.”).

219. Civil law systems, by contrast, tend to protect contractual entitlements with property rules. They generally allow the promisee to choose specific performance and to enforce penalty clauses. See RUDOLPH B. SCHLESINGER ET AL., *COMPARATIVE LAW: CASES—TEXT—MATERIALS* 663-84 (5th ed. 1988); Ugo Mattei, *The Comparative Law and Economics of Penalty Clauses in Contracts*, 43 AM. J. COMP. L. 427, 434-38, 441 (1995).

220. See RESTATEMENT, *supra* note 1, § 359(1). But see DOUGLAS LAYCOCK, *THE DEATH OF THE IRREPARABLE INJURY RULE* 37-48 (1991) (arguing that courts routinely find that damages are inadequate when the plaintiff prefers specific performance).

alties,²²¹ and punitive damages are generally banned.²²² Is this preference for liability rules justified?

Calabresi and Melamed suggested that liability rules might be appropriate when the transaction costs of voluntary negotiations are high.²²³ For example, in a nuisance context with multiple entitlement holders, one might prefer a liability rule because holdout problems would make voluntary negotiations impractical.²²⁴ When transaction costs are low, on the other hand, it has generally been assumed that property rules are preferable because the parties are in a better position than a court to determine the value of an entitlement. James Krier and Stewart Schwab note that later commentators have converted Calabresi and Melamed's observations into a familiar piece of conventional wisdom: "When transaction costs are low, use property rules; when transaction costs are high, use liability rules."²²⁵ This is not what Calabresi and Melamed actually wrote, though. Rather, they called for a *comparison* of the costs of negotiation (market valuation) with the costs of valuation by a court (collective valuation): "[A] very common reason, perhaps the most common one, for employing a liability rule rather than a property rule to protect an entitlement is that market valuation of the entitlement is deemed inefficient, that is, it is either unavailable or too expensive *compared to* a collective valuation."²²⁶ Thus, as Krier and Schwab have recently re-emphasized, liability rules are appropriate not where the transaction costs of voluntary negotiations are high in absolute terms, but where they are high relative to the costs of having a court determine the correct level of damages (what they call "assessment costs").²²⁷

To determine whether contract law's preference for liability rules in general, and its aversion to punitive damages in particular, is justified, the transaction costs of negotiating a release from a contractual obligation must be compared with the assessment costs of de-

221. See RESTATEMENT, *supra* note 1, § 356.

222. See *id.* § 355; see also *supra* notes 23-29 and accompanying text.

223. See Calabresi & Melamed, *supra* note 15, at 1106-08.

224. See *id.* at 1119.

225. Krier & Schwab, *supra* note 15, at 451. Krier and Schwab have challenged the conventional wisdom that liability rules are better when transaction costs are high. See *id.* at 452. On the other hand, two other recent articles have challenged the conventional wisdom that property rules are better when transaction costs are low. See Ayres & Talley, *Solomonic Bargaining*, *supra* note 15; Kaplow & Shavell, *Property Rules*, *supra* note 15. For discussion of these arguments and their implications for contract remedies, see *infra* Part II.C.2.b.iii.

226. Calabresi & Melamed, *supra* note 15, at 1110 (emphasis added).

227. See Krier & Schwab, *supra* note 15, at 453-57.

terminating damages where the promisor deliberately decides to breach.²²⁸

b. Transaction costs and assessment costs. Judge Posner generally argues in favor of protecting contractual entitlements with a liability rule (expectation damages) and against protecting such entitlements with property rules (like specific performance) on the ground that property-rule protection requires an additional transaction to achieve efficiency.²²⁹ If a widget manufacturer is required to negotiate a release from *A* before selling to *B*, two transactions are required; if she may breach and pay damages there is only one transaction, between the manufacturer and *B*. As Daniel Friedmann points out, though, whether property-rule protection requires more transactions than liability-rule protection depends on which transactions one counts.²³⁰ If one recognizes that the dispute between the manufacturer and *A* over *A*'s damages is a transaction, then requiring the seller to negotiate a release from *A* before selling to *B* does not increase the total number of transactions.²³¹

The real issue, then, is not the total number of transactions but the transaction costs associated with negotiation as compared to the assessment costs associated with litigation.²³² Negotiations potentially give rise to many forms of transaction costs.²³³ In some contexts, there

228. Of course if there were no transaction costs, then under the Coase Theorem it would not matter whether contractual entitlement were protected by a property rule or a liability rule since the parties could bargain around either rule to reach an efficient result. See generally Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

229. See POSNER, *supra* note 4, at 133 (noting that expectation damages avoid additional transaction); *id.* at 146 (noting that specific performance requires an additional transaction). But see *id.* at 142-45 (advocating enforcement of *in terrorem* liquidated damages clauses); *id.* at 130 (arguing that courts should "throw the book" at opportunistic breachers).

230. See Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 6-7 (1989).

231. See *id.* In fact, the property might end up in *B*'s hands with only one more transaction if the seller performs and *A* then sells the property to *B*. See *id.* at 6. This assumes, however, that *A* will be able to discover *B*'s identity, which is not necessarily realistic.

232. For the sake of simplicity, I will treat litigation and pre-breach negotiation as the parties' only alternatives. Of course, I realize that the parties may negotiate a settlement following the breach in order to avoid litigation. As Ian Macneil has noted, however, "talking after a breach" may be one of the more expensive forms of conversation to be found, involving, as it so often does, engaging high-priced lawyers, and gambits like starting litigation, engaging in discovery, and even trying and appealing cases." Macneil, *supra* note 206, at 968-69. Because post-breach negotiations involve many of the same costs as litigation, it does not seem necessary to consider post-breach negotiations as a separate alternative.

233. For a useful typology, see COOTER & ULEN, *supra* note 132, at 84-86.

are the costs of identifying the party with whom to negotiate.²³⁴ Then there are the basic costs of bargaining—communicating with the other party, spending the time necessary to reach an agreement, and perhaps reducing that agreement to writing. In situations involving multiple parties, there are additional bargaining costs created by holdout and free rider problems.²³⁵ In situations involving only two parties, there are additional bargaining costs because of strategic behavior: the parties are trapped in a “bilateral monopoly,” in which neither has an alternative to dealing with the other, and each tries to obtain as much from the other party as possible.²³⁶

Litigation also involves a kind of transaction costs, which Krier and Schwab call “assessment costs.”²³⁷ These costs can be broken down into two basic categories: valuation costs and error costs.²³⁸ Valuation costs include the costs to the parties and to the court of obtaining and processing the information necessary to determine damages. Error costs are simply the costs of a court being wrong. For example, a court might award the nonbreaching party an amount less than his actual losses.²³⁹

i. Transaction costs: bilateral monopoly and strategic behavior. Negotiating a release from contractual obligations generally does not involve either identification costs or holdout/free rider problems.²⁴⁰ There are only two parties, and these parties not only know each other, but have also bargained successfully in the past.²⁴¹ Rather, the problem of bilateral monopoly and the possibility of strategic behavior present the biggest barriers to successful negotiation.²⁴²

234. See Calabresi & Melamed, *supra* note 15, at 1108-09 (pointing to these costs as justifying a liability rule in the case of automobile accidents).

235. See *id.* at 1119 (pointing to these problems as justifying a liability rule in pollution nuisance cases).

236. This problem is sometimes also characterized as a problem of private or asymmetric information. See Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1035.

237. See Krier & Schwab, *supra* note 15, at 459.

238. See *id.*; see also POSNER, *supra* note 4, at 599 (“The objective of a procedural system, viewed economically, is to minimize the sum of [error costs and administrative costs].”).

239. See Calabresi & Melamed, *supra* note 15, at 1108 (identifying incorrect valuations as a problem with liability rules).

240. See Kronman, *supra* note 15, at 353.

241. See Ulen, *supra* note 18, at 369.

242. See Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1029-30; Ulen, *supra* note 18, at 381-82. For a good theoretical discussion of strategic behavior in bargaining, see Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 20-24 (1982).

Before considering how strategic behavior might hinder a mutually beneficial exchange, it is important to recognize how the possibility of a mutually beneficial exchange comes about. To return to the example of the widget manufacturer, assume that this manufacturer has agreed to supply *A* with 1,000 widgets for \$1 each. *A*'s intended use of these widgets will earn *A* a profit of \$250. Now assume that *B* offers the manufacturer \$1,500 for the same widgets but that the manufacturer may not sell the widgets to *B* unless *A* agrees to release her from the first contract. One can see that there is a range of possible prices for the release that will benefit both the manufacturer and *A*. The manufacturer will be better off even if she has to pay \$499 for the release; *A* will be better off even if he is paid only \$251 for the release. Indeed, at any price between \$250 (*A*'s expected profit under the first contract) and \$500 (the manufacturer's expected profit from being able to get out of the first contract), both parties will be better off.²⁴³

However, each party has an incentive to behave strategically in order to obtain as much of the surplus as possible. The party who wants a release is likely to understate its true value to her, while the party from whom the release is sought is likely to overstate the value of performance to him. "[E]ach party may be so determined to engross the greater part of the potential profits from the transaction that they never succeed in coming to terms."²⁴⁴ On the other hand, the

243. The example in the text assumes that what *B* offers for the widgets is greater than the market price. If the market price for 1000 widgets were \$1,500, then *A*'s expected profit under the first contract would be \$500, which is what *A* would gain from reselling the widgets on the market, and there would be no deal with the manufacturer that would make *A* better off.

244. POSNER, *supra* note 4, at 68-69; *see also* COOTER & ULEN, *supra* note 132, at 85-86 ("In forming a bargaining strategy, each party tries to anticipate how much the opponent will concede. If the parties miscalculate the other party's resolve, each will be surprised to find that the other does not concede, and as a result, negotiations may fail."); Polinsky, *supra* note 15, at 1092 ("In order to acquire more of the gains from trade, or to establish reputations as tough bargainers, parties adopt 'hold out' tactics. If both parties are stubborn, they may never reach an agreement."); Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1030:

[S]elf-interested bargainers have a strong incentive to misrepresent their private valuations so as to capture a larger share of the bargaining "pie." . . . Sellers tend to overstate the value they place on the bargained-for item, while buyers tend to understate their desire to purchase it. As a result of such strategic behavior, the parties may fail to detect and exploit a mutually beneficial trade, and even when they can it is usually after considerable and costly delay.

parties have a strong incentive to reach an agreement, since doing so would make both of them better off.²⁴⁵

Experimental tests conducted by Elizabeth Hoffman and Matthew Spitzer suggest that strategic behavior does not in fact prevent parties from reaching efficient results in two-party bargaining situations analogous to negotiating a release from a contract.²⁴⁶ Hoffman and Spitzer ran a series of tests with college students to see if they would bargain to Pareto-optimal solutions. One series of tests involved two parties and limited information: each subject was told what her own payoff would be from a particular choice but not what the other party's payoff would be.²⁴⁷ Moreover, one of the parties was given the power to choose the outcome unilaterally, which is analogous to protecting that party with a property rule.²⁴⁸ In twenty experiments, nineteen of the pairs bargained to the Pareto-optimal choice.²⁴⁹ Hoffman and Spitzer confirmed these results in later experiments.²⁵⁰ In thirty-eight experiments, thirty-six of the pairs bargained to the Pareto-optimal solution.²⁵¹ These experiments justify an assumption that strategic behavior generally will not prevent mutually beneficial exchanges and "that the parties can and will exhaust the gains from trade by voluntary agreement."²⁵²

It is generally agreed that strategic behavior will not prevent parties from coming to terms.²⁵³ Advocates for liability rules still worry,

245. As Robert Cooter points out, "the optimal strategy is found by trading off a higher payoff in the event of settlement against a lower probability of settlement." Cooter, *supra* note 242, at 21.

246. See Elizabeth Hoffman & Matthew L. Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J.L. & ECON. 73 (1982) [hereinafter Hoffman & Spitzer, *Small Bargaining Groups*]; Elizabeth Hoffman & Matthew L. Spitzer, *Experimental Tests of the Coase Theorem with Large Bargaining Groups*, 15 J. LEGAL STUD. 149 (1986) [hereinafter Hoffman & Spitzer, *Large Bargaining Groups*].

247. See Hoffman & Spitzer, *Small Bargaining Groups*, *supra* note 246, at 86-87.

248. See *id.* at 84.

249. See *id.* at 92 tbl.2.

250. See Hoffman & Spitzer, *Large Bargaining Groups*, *supra* note 246, at 154. In the second set of experiments they decided which of the parties would have the power to make the choice unilaterally not by the toss of a coin, as they had in the first set of experiments, but based on who won a simple game. The idea was to create a sense of moral justification for the property right protection and to reduce the chances that the party protected by a property right would behave altruistically. See *id.*

251. See *id.* at 158 tbl.3.

252. *Id.* at 151.

253. See POSNER, *supra* note 4, at 69 ("Although the frustration of a potentially value-maximizing exchange is the most dramatic consequence of bilateral monopoly, it is not the usual consequence. Usually the parties will bargain to a mutually satisfactory price."); Ulen,

though, that strategic behavior will make negotiations costly.²⁵⁴ For the sake of argument, one may concede that, although bilateral monopoly and strategic behavior do not prevent efficient exchanges, they increase the costs of those exchanges.²⁵⁵ One must still weigh these transaction costs, however, against the assessment costs of litigation. As I demonstrate, those assessment costs are likely to be higher because litigation is subject to the same sort of strategic behavior, which increases valuation costs, as well as subject to additional valuation costs and error costs that are not present with voluntary negotiations.

ii. *Assessment costs: strategic behavior, litigation costs, and error costs.* Just as negotiations involve transaction costs, so litigation involves assessment costs. Assessment costs include both valuation costs, the costs to the parties and to the court of obtaining and processing the information necessary to determine damages, and error costs, the costs of the court being wrong.²⁵⁶ In considering assessment costs, it is important to recognize that litigation over damages, like negotiations for a release, occur in a situation of bilateral monopoly. There are just two parties, and neither has an alternative to dealing with the other. It should not be surprising, therefore, to see that litigation over damages is also susceptible to strategic behavior.²⁵⁷ A party from whom a release is sought may overstate the value to him of performance as easily in litigation as he may in negotiation. "Judges will have problems assessing the correct values for the same reason private bargainers would: limited, hidden

supra note 18, at 382 n.133 ("The economic literature stresses . . . indeterminacy of price and quantity in bilateral monopoly. Nowhere does that literature suggest that an exchange will not take place between the monopolists."); Polinsky, *supra* note 15, at 1092 n.37 ("In a two party bargaining situation . . . strategic behavior is probably more likely to result in delay and extra expense than in a permanent failure to reach an agreement."); see also RONALD H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 161-62 (1988) (observing that breakdowns in bargaining because of strategic behavior are rare).

254. See POSNER, *supra* note 4, at 69 ("Bilateral monopoly is a social problem, because the transaction costs incurred by each party in an effort to engross as much of the profit of the transaction as possible are a social waste."); Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1030.

255. Hoffman and Spitzer did not attempt to measure the transaction costs of negotiating a Pareto-optimal solution. See *supra* notes 246-52 and accompanying text.

256. See *supra* notes 237-39 and accompanying text.

257. See Polinsky, *supra* note 15, at 1079 ("[D]amage remedies are just as susceptible to strategic behavior problems as injunctive remedies when, realistically, courts cannot correctly determine actual damages.").

information. If parties can hide their valuations from each other, they can hide them from a judge."²⁵⁸

In the context of litigation, the costs of strategic behavior are mitigated to some extent by two factors. First, in litigation only one of the parties—the nonbreaching party—has an opportunity to act strategically because only the nonbreaching party's valuation (his actual loss) is relevant in determining damages. The breaching party has no opportunity to act strategically because how much she valued being able to escape the contract has no bearing on the question of damages. In pre-breach negotiations for a release, by contrast, each party has an opportunity to act strategically: the promisor by understating the value of a release to her; the promisee by overstating the value of performance to him. Second, in litigation, the availability of discovery limits the nonbreaching party's ability to overstate his damages to a certain extent.

But discovery does not make the problem of strategic behavior in litigation disappear. The nonbreaching party may not have documents to be discovered that would contradict his perhaps overstated claims of loss. Even if he does, discovery is not cheap and obtaining the information to prevent the nonbreaching party from acting strategically may be prohibitively expensive.²⁵⁹ Finally, in some cases, the value of performance to the nonbreaching party will be highly idiosyncratic, and the nonbreaching party's assertion that performance was worth a great deal to him simply cannot be contradicted.²⁶⁰ Thus, strategic behavior will often create significant assessment costs in litigation, even though those costs will tend to be somewhat lower than the transaction costs created by strategic behavior in negotiations for a release.

Whatever advantages litigation may offer over negotiation with respect to strategic behavior, there are enough additional assessment costs in litigation to outweigh these advantages. First, there are the costs to the parties of conducting the litigation. These are analogous to the costs to the parties of conducting a negotiation,²⁶¹ but are likely to be much higher, for while the parties may conduct negotiations for a release by themselves, they must retain lawyers in order to litigate.

258. Krier & Schwab, *supra* note 15, at 462.

259. These costs are simply further examples of the litigation costs summarized *infra* at 261-263 and accompanying text.

260. In cases of idiosyncratic value, error costs are also increased. *See infra* text following note 263.

261. *See supra* text following note 234.

Second, there are the costs of informing the court about the contract, the industry, and the parties' valuations,²⁶² costs that are borne in part by the parties in the form of more attorney time and in part by the publicly subsidized court system.²⁶³ These costs do not arise in negotiations because the parties already know the relevant information.

Finally, litigation over damages raises the possibility of error costs. A court might award the nonbreaching party less than its actual damages or it might award the nonbreaching party an amount greater than the gain that the breaching party obtained from the breach. In either case, one party is worse off than if the contract had been performed—an inefficient result. Voluntary negotiations, on the other hand, do not impose error costs. The party from whom a release is sought will not accept less than his actual damages and the party who seeks a release will not agree to pay more than she would gain from the release.

If the transaction costs of negotiation are compared with the assessment costs of litigation, it becomes clear that negotiation tends to be cheaper. Strategic behavior increases the costs of either option, although it may contribute more to the transactions costs of negotiation than it does to the assessment costs of litigation. Litigation, however, is accompanied by additional costs that tend to make it more expensive than negotiation: (1) the cost of hiring lawyers; (2) the cost of informing the court; and (3) the error costs of misdetermining damages.²⁶⁴ These additional costs associated with litigation suggest that protecting contractual entitlements with a liability rule like expectation damages is not as efficient as protecting them with a property rule like punitive damages.²⁶⁵ The threat of punitive damages for willfully breaching a contract will force the party who wants to get

262. See Ulen, *supra* note 18, at 368-69.

263. See POSNER, *supra* note 4, at 631 (noting that “the taxpayer also bears some of [the parties’ litigation costs]”).

264. Indeed it is in order to avoid at least some of these costs that the parties to a contractual dispute frequently settle before trial. For discussion of the effects of punitive damages on the likelihood of settlement, see *infra* notes 338-41 and accompanying text.

265. This would be true even if the liability rule were “fixed” by awarding attorneys’ fees so that expectation damages would come closer to putting the nonbreaching party in the same position as if the contract had been performed, as several authors have suggested. See, e.g., Putz & Klippen, *supra* note 53, at 481-98; Barrett, *supra* note 53, at 527-28. In other words, the assessment costs of determining damages would not change even if contract damages were made more fully compensatory. Because, as I have argued, these assessment costs will tend to be larger than the transaction costs of the parties negotiating a release from the contract, it is more efficient to protect contractual entitlements with a property rule that discourages willful breaches altogether.

out of the contract to negotiate a release from the other party, which will tend to be cheaper than litigating the amount of damages.²⁶⁶

iii. *Other arguments for a liability rule.* Two recent articles argue that entitlements should generally be protected with liability rules, even when transaction costs are low.²⁶⁷ Ian Ayres and Eric Talley argue that protecting entitlements with a liability rule “can reduce the incentive to behave strategically during bargaining, thereby enhancing economic efficiency.”²⁶⁸ Ayres and Talley, however, have a specific kind of liability rule in mind: an “*untailored* liability rule[]” that requires the breaching party to pay a set amount of damages regardless of whether the nonbreaching party can demonstrate actual loss.²⁶⁹ If the untailored damages amount is common knowledge, which the authors concede is not the case in many litigation contexts,²⁷⁰ then the promisee will be forced to reveal whether he values performance more than the damage amount because only a promisee who values performance more than this amount would be willing to negotiate with the promisor and attempt to pay the promisor not to breach.²⁷¹ While an untailored liability rule forces the promisee to reveal a limited amount of information, however, it actually “exacerbate[s] [the promisor’s] incentive to misrepresent

266. Richard Craswell has argued that one must also consider what effect the choice of contract remedies will have on what he calls “precaution” and “selection” decisions—i.e., how much to spend on precautions to prevent a breach and how risky a partner with which to contract. See Craswell, *supra* note 15, at 646-56. He argues that supracompensatory damages may distort these decisions, leading promisors to spend inefficiently large amounts to avoid the possibility of breach and disfavoring risky sellers, who must charge a higher price to insure against the possibility of extracompensatory damages. See *id.* However, if punitive damages are limited to willful breaches, as I suggest, neither of these distortions will occur. A promisor who fails to take extra precautions against breaching would not by virtue of that fact alone be deemed to have willfully breached the contract. Similarly, a risky seller would not be liable for punitive damages unless she willfully breached the contract. Since that factor is within her control, she would not have to charge more to insure against it. Craswell’s arguments against supracompensatory damages are better directed at liquidated damages clauses, which operate without regard to the reasons for breach. See *infra* notes 304-09 and accompanying text (discussing liquidated damages).

267. See Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1032-33; Kaplow & Shavell, *Property Rules*, *supra* note 15, at 716-18.

268. Ayres & Talley, *Solomonic Bargaining*, *supra* note 15, at 1030.

269. *Id.* at 1032 n.13.

270. See *id.* at 1046 n.60.

271. See *id.* at 1044-45. Tailoring the damages to reflect the promisee’s actual loss undermines this dynamic because it “gives the [promisee] a form of ‘perfect insurance’ against bargaining breakdown.” *Id.* at 1066.

valuation.²⁷² As Louis Kaplow and Steven Shavell have pointed out, Ayres and Talley “do not explain why this countervailing factor is not controlling.”²⁷³ Ultimately, Ayres and Talley’s creative argument offers little of practical value in choosing contract remedies. Its requirement that the damage amount not attempt to reflect the nonbreaching party’s actual losses is contrary to the conventional understanding of expectation damages and introduces enormous error costs in the perhaps unfounded hope of reducing strategic behavior.²⁷⁴

In another recent article, Louis Kaplow and Steven Shavell argue for liability rules not as a way of facilitating bargaining but as a way of reducing the costs when bargaining fails.²⁷⁵ Essentially, they argue that “before any bargaining occurs, at the beginning of the ‘race’ between the two types of rule[s], the liability rule is ahead of

272. *Id.* at 1047.

273. Kaplow & Shavell, *Reply*, *supra* note 15, at 227.

274. Even more recently, Ayres and another coauthor, J.M. Balkin, have proposed protecting entitlements through an internal auction, in which the parties are allowed to take and retake entitlements at continually higher prices, in order to mitigate strategic behavior. *See* Ayres & Balkin, *supra* note 15, at 707-17. Applying this notion to the remedy for breach of contract, Ayres and Balkin suggest that “[a]fter a promisor signaled her intention to breach, the promisee might be given the option to purchase ‘specific performance’ by paying an amount above and beyond the initial contract price.” *Id.* at 745. “The [promisor] could either accept this amount and perform, or breach the contract and pay ordinary damages *plus the additional amount that the [promisee] offered to pay.*” *Id.* at 746. The beauty of this solution is that it mitigates the promisee’s incentive to act strategically. The promisee will not offer to pay more unless he really believes that performance is worth more than expectation damages because he does not know, when he makes the offer, whether he will have to pay the additional amount (which would happen if the promisor accepts the offer) or whether he will receive the additional amount in addition to his damages (which would happen if the promisor rejects the offer and breaches). *See id.* at 746-47.

However, Ayres and Balkin’s thoughtful solution will not work either because, while it mitigates the promisee’s incentive to act strategically, it allows the promisor to act opportunistically. First, and most obviously, Ayres and Balkin’s proposal works only if the promisor gives the promisee advance notice of her intention to breach. The promisor could defeat their scheme and avoid the possibility of having to pay more than regular expectation damages by breaching without notice, giving the promisee no opportunity to purchase performance by offering an additional amount. Second, Ayres and Balkin’s proposal allows the promisor to act opportunistically to extort more than the contract price from the promisee. A promisor who has no intention to breach might nevertheless threaten to do so in the expectation that the promisee will offer her more than the contract price to perform, since expectation damages typically fall short of the promisee’s actual losses. This possibility for opportunistic behavior by the promisor already exists with expectation damages, but Ayres and Balkin’s proposal would do nothing to alleviate it and would, in a sense, institutionalize it.

275. *See* Kaplow & Shavell, *Property Rules*, *supra* note 15, at 734-37. Kaplow and Shavell focus on property rights and do not specifically consider contract remedies, although they suggest that their analysis “may have some bearing on contract law.” *Id.* at 716 n.1.

the property rules.²⁷⁶ This is because only liability rules can result in efficiency in the absence of bargaining.²⁷⁷ Kaplow and Shavell argue that if one assumes bargaining is possible but will not always be successful,²⁷⁸ then liability rules are still more efficient:

Because an efficient outcome is more likely under the liability rule, bargaining need not take place as often, so the prospect that bargaining will fail is irrelevant in a greater range of cases. And because the extent of the initial inefficiency tends to be less under the liability rule, the failure of bargaining will be less serious when it does occur.²⁷⁹

This argument depends critically, however, on the assumption that litigation is inexpensive or at least is no more expensive under a liability rule than under a property rule.²⁸⁰ Specifically, Kaplow and Shavell assume that litigation must occur under either a property rule or a liability rule: under a liability rule to set the amount of damages and under a property rule to determine which party holds the entitlement.²⁸¹ Here, the authors' focus on nuisance cases becomes apparent. In the case of a polluting factory, litigation is necessary to determine whether the pollution is a nuisance even under a property rule. The same is not true in contracts. Litigation generally is not necessary to determine who holds the entitlement because the contract itself establishes that the promisee does. Once one recognizes that in contract law liability rules impose greater assessment costs than property rules, the liability rule's supposed "head start" disappears.²⁸²

276. *Id.* at 735.

277. *See id.* at 724-28.

278. If bargaining is always successful, then property rules and liability rules are equally efficient. *See id.* at 733-34. This is simply an application of the Coase Theorem. *See Coase, supra* note 228, at 2-8.

279. Kaplow & Shavell, *Property Rules, supra* note 15, at 736.

280. *See id.* at 741-42.

281. *See id.*

282. *See Ayres & Talley, Distinguishing, supra* note 15, at 245 ("Adding litigation costs . . . eliminates the nonconsensual advantage of liability rules."). Ayres and Talley argue that liability rules are even more effective in forcing information from entitlement owners once one considers litigation costs because they give entitlement owners with an intermediate valuation an additional motivation to sell in order to avoid these costs. *See id.* at 247-50. However, Ayres's and Talley's argument for the efficiency of liability rules in the presence of litigation costs is still subject to the substantial qualifications noted above: (1) that the liability rule must be "untailored" in that it makes no attempt to compensate the entitlement owner for his actual loss; (2) that the untailored damage amount be known to both parties; and (3) that the non-owner's incentive to misrepresent her valuation, which an untailored liability rule exacerbates,

c. *Punitive damages as the default rule.* Adopting punitive damages for willful breach of contract as the default rule for willful breach of contract would not preclude parties from contracting around that rule. Some parties would likely choose to include a provision barring punitive damages for breach²⁸³ or, more directly, a provision giving the promisor the option not to perform upon payment of the promisee's expectation damages or a fixed sum. In other words, the promisor could always buy the right to breach.

This suggests, however, that making punitive damages available for willful breach might increase the costs of contract formation by requiring parties to contract around such a default rule. This argument might carry some weight if one could show that contracting parties are equally content with performance or damages, as Holmes suggested they are.²⁸⁴ It is not at all clear, though, that Holmes was right. As Karl Llewellyn wrote in one of the comments to the *Uniform Commercial Code*: "[T]he essential purpose of a contract between commercial men is actual performance and they do not bargain merely for a promise, or for a promise plus the right to win a lawsuit."²⁸⁵ Even Holmes admitted that "when people make contracts, they usually contemplate the performance rather than the breach."²⁸⁶ For example, empirical studies suggest that merchants want to be

does not overwhelm the advantages of forcing some information from the entitlement owner. See *supra* notes 268-74 and accompanying text.

283. Cf. U.C.C. § 2-719(3) (1995) (allowing the parties to limit liability for consequential damages unless unconscionable); Ulen, *supra* note 18, at 377-79 (predicting that if specific performance were routinely available some parties would use boilerplate provisions to stipulate money damages).

284. See HOLMES, *supra* note 2, at 301 ("The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses."); Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else.").

285. U.C.C. § 2-609, cmt. 1 (1995); see also Karl N. Llewellyn, *A Realistic Jurisprudence—The Next Step*, 30 COLUM. L. REV. 431, 437 (1930) ("It is a heresy when Coke or Holmes speaks of a man having liberty under the law to perform his contract, or pay damages, at his option."). Daniel Friedmann has suggested that the tort of interference with contractual relations also shows that performance, not damages, is the background assumption in contract law. See Friedmann, *supra* note 230, at 20 ("There is . . . a marked incongruity between the 'right' to break a contract theory and the tort of interference with contractual relations: why should a person be liable for inducing another to exercise his right?").

286. HOLMES, *supra* note 2, at 302.

able to insist on performance even if in practice they frequently modify a contract to accommodate the other party.²⁸⁷

Even if it could be shown that most contracting parties prefer not to have punitive damages be available for willful breach, making those damages available and allowing the parties to contract out of them would still be preferable to the current state of the law because it would accommodate those parties who *do* prefer performance. Current law does not permit the parties to contract into property-rule protection. They cannot specify that their contract will be specifically enforceable or that the breacher will be subject to punitive damages. Neither can they include an *in terrorem* liquidated damages clause to compel performance.²⁸⁸ Unless they can show that they have no adequate remedy at law and are therefore entitled to specific performance, they must be content with expectation damages. Giving parties the option of property-rule protection (whether through specific performance, *in terrorem* liquidated damages, or punitive damages for willful breach²⁸⁹) will tend to increase the welfare of contracting parties on the whole by giving them the option of compelling performance. Parties who prefer liability-rule protection could make that choice in their contract.

d. Distributional differences. I have argued above that requiring the promisor to negotiate for a release by allowing punitive damages for willful breach (property-rule protection) is more efficient than allowing the promisor to breach and pay damages (liability-rule protection). But it is important to note that protecting contractual entitlements with a property rule will also have significant distributional effects.

Consider, once again, the example of the widget manufacturer who has agreed to supply *A* with 1,000 widgets for \$1 each, which *A* will use to earn a profit of \$250. With a liability rule of expectation damages, if *B* now offers \$1,500 for the same widgets, the manufacturer is free to breach the contract with *A*, pay *A* \$250 in expectation

287. See Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1801-02 (1996) (discussing merchants' opposition to abandonment of the perfect tender rule).

288. See RESTATEMENT, *supra* note 1, § 356(2) (forbidding the use of liquidated damages clauses that operate as penalties).

289. For a discussion of the relative advantages and disadvantages of these various forms of property-rule protection, see *infra* Part II.C.2.e.

damages,²⁹⁰ and pocket *all* of the gains from the second transaction—i.e., all of the remaining \$250. With a property rule of punitive damages for willful breach, on the other hand, the widget manufacturer will have to negotiate a release from *A* before selling to *B*, and *A* will no doubt insist that the manufacturer *share* some, or even most, of the gains from the second transaction as the price of obtaining the release. *A*'s insistence on sharing the seller's gains from the second transaction is sometimes characterized as "extortion."²⁹¹

A's insistence on sharing the seller's gains can only be considered extortion, though, if the manufacturer is somehow entitled to keep all of these gains.²⁹² Expectation damages give all of the gains to the breacher. As Charles Goetz and Robert Scott have asked: "Why should this end result be regarded as any 'fairer' than one which splits the gains fifty-fifty or gives them all to the non-breacher?"²⁹³ Indeed, a strong argument can be made that the widgets, once promised to *A*, belong to *A* and that most of the gain from selling the widgets to *B* rightfully belongs to *A* too. If the widgets had actually been delivered to *A*, the manufacturer could not retake them and sell them to *B*, even if she were willing to make *A* whole. Does delivery make such a difference in the equities that *A* is entitled to all of the gains from a second transaction after delivery but to *none* of the gains before delivery?²⁹⁴

Richard Craswell argues that the distributional effects of contract remedies are not quite so simple:

290. This assumes that the market price of the widgets has not risen above \$1,250. Otherwise, *A*'s expectation damages would be greater than \$250, specifically the difference between the contract price and the market price. See *supra* note 243.

291. See Polinsky, *supra* note 15, at 1077-78 (noting the existence of the "extortion" argument against property rules); Krier & Schwab, *supra* note 15, at 465-67 (same).

292. See Polinsky, *supra* note 15, at 1110 ("Neither party is 'entitled' to these gains in the first place; rather, the desirability of those transfers depends on the distributional goal society wishes to promote."); Krier & Schwab, *supra* note 15, at 466-67 ("[N]either party is, prima facie, entitled [to the gains from trade]. . . . In order to assure that *R* doesn't extort something from *P*, the court extorts everything from *R*!").

293. Goetz & Scott, *supra* note 18, at 568.

294. Richard Epstein makes the same point with the example of a house:

If *A* and *B* agree to the sale of *A*'s house to *B* for \$100,000, then *B* should normally get the house and not just a damage remedy. A damage remedy looks as though it were a unilateral revision of the original deal. If *B* collects \$10,000 in damages, it is as though the house were first sold for \$100,000 and then, against *B*'s will, retaken by *A* for \$110,000.

Epstein, *supra* note 15, at 2098.

If the legal rule allows the seller to keep most of the gains in those cases where a better offer is later received, the seller will be able to quote a lower price than that which could be quoted under a rule allowing buyers to capture most of those gains. . . . [T]he availability of punitive remedies does not really 'give' buyers the right to more of the profits. Instead, it 'sells' that right to them."²⁹⁵

Assuming, however, that punitive damages were available for willful breach of contract, buyers who preferred a lower price in exchange for relinquishing punitive damages would be free to make that deal.²⁹⁶ Today, with punitive damages and other forms of property-rule protection barred, buyers who prefer to pay a higher price in order to be assured of performance are not able to exercise that preference. In short, while punitive damages may indeed "sell" a buyer the right to share the gains from a second transaction, the prohibition on punitive damages prevents them from "buying" that right even if they wish to do so.

Ultimately, however, the efficiency of punitive damages for willful breach of contract does not turn on whom one thinks should get the gains from a second transaction. Pareto efficiency is served so long as the rule chosen allows goods and services to flow to the people who value them most, increasing society's total welfare; it does not matter how those gains in welfare are distributed so long as no party is left worse off than before.²⁹⁷ Thus, even if one believes that a breaching party should be allowed to keep all of the gains from a sec-

295. Craswell, *supra* note 15, at 642. Alan Schwartz takes this argument one step further, arguing that a rational promisee would never *want* punitive damages if she had to pay extra for them. See Alan Schwartz, *The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 390 (1990). My point is not that a rational promisee should prefer a chance at collecting punitive damages but that she should prefer that the promisor negotiate with her for a release if the promisor wishes not to perform because this is a cheaper way of establishing the value of the contractual entitlement than litigation. Moreover, if the parties truly do not prefer supracompensatory remedies, they can always contract around them.

296. See *supra* text accompanying note 283.

297. See Polinsky, *supra* note 15, at 1077-78 (noting that "the extortion argument relates to the goal of distributional equity, not economic efficiency"); Kronman, *supra* note 15, 353 n.12 (stating that under a property rule "the only difference is a distributional one"); Ulen, *supra* note 18, at 383 (stating that "the distribution of this surplus between A and B is not at issue in an efficiency analysis"); Goetz & Scott, *supra* note 18, at 559:

In order to maintain the efficiency value of the rule, however, it is only necessary that some minimal amount of benefits are retained by the breacher in order to induce him not to perform. The allocation of the gains from breach is, therefore, largely a question of wealth transfer between the contracting parties.

ond transaction, one must consider whether this distributional goal is worth the loss in efficiency.

e. Comparing punitive damages with specific performance and liquidated damages. As I noted above, punitive damages are not the only way to protect contractual entitlements with a property rule.²⁹⁸ Specific performance and liquidated damages clauses that operate as penalties also operate as contractual property rules. Specific performance and liquidated damages each have advantages that punitive damages lack, which may explain why law and economics scholars who argue in favor of specific performance²⁹⁹ and liquidated damages³⁰⁰ on efficiency grounds have generally failed to extend the same analysis to punitive damages. Specific performance and liquidated damages also have substantial limitations, though, which suggest that if contractual entitlements are to be protected by a property rule to encourage negotiation and increase efficiency, punitive damages must be available for willful breach of contract.

Specific performance has the advantage of placing the non-breaching party in the same position as if the contract had not been broken.³⁰¹ It does not leave the nonbreaching party in a *better* position than performance or leave the breaching party in a *worse* position than performance, as punitive damages may. Sometimes, however,

298. See *supra* notes 216-22 and accompanying text.

299. See, e.g., Ulen, *supra* note 18; Peter Linzer, *On the Amoralism of Contract Remedies—Efficiency, Equity, and the Second Restatement*, 81 COLUM. L. REV. 111 (1981); Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979). But see POSNER, *supra* note 4, at 145-47 (arguing that specific performance is less efficient because it requires negotiations for a release); Kronman, *supra* note 15 (arguing that traditional limitations on specific performance are efficient); Timothy J. Muris, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053, 1061-68 (arguing that specific performance is inefficient, assuming damages are easily calculable, because it requires negotiations for a release); Edward Yorio, *In Defense of Money Damages for Breach of Contract*, 82 COLUM. L. REV. 1365 (1982) (arguing for money damages on economic, noneconomic, and flexibility grounds).

300. See, e.g., POSNER, *supra* note 4, at 142-45; Goetz & Scott, *supra* note 18; Mattei, *supra* note 219; Phillip R. Kaplan, Note, *A Critique of the Penalty Limitation on Liquidated Damages*, 50 S. CAL. L. REV. 1055 (1977). But see Kenneth W. Clarkson et al., *Liquidated Damages v. Penalties: Sense or Nonsense?*, 1978 WIS. L. REV. 351 (arguing that liquidated damages clauses may create incentives to induce breach); Comment, *Liquidated Damages and Penalties Under the Uniform Commercial Code and the Common Law: An Economic Analysis of Contract Damages*, 72 NW. U. L. REV. 1055 (1978) [hereinafter, Comment, *Liquidated Damages*] (same).

301. See Schwartz, *supra* note 299, at 274 (“Specific performance is the most accurate method of achieving the compensation goal of contract remedies because it gives the promisee the precise performance that he purchased.”). Specific performance may be coupled with damages to compensate the nonbreaching party for a loss because of the delay in performance.

specific performance is not practicable—for example, where supervising the performance would impose a great burden on the court.³⁰² Moreover, a breacher who wishes to avoid specific performance may be able to do so relatively easily by selling the goods in question to an innocent third party.³⁰³ In each of these circumstances, protecting contractual entitlements with a property rule requires more than relaxing the limitations on specific performance. It requires a penalty such as punitive damages that may be imposed when supervision is impractical or performance is no longer possible and that will serve to deter the breach in the first place.

Liquidated damages may operate as a penalty to deter breach just like punitive damages. They have the advantage of being expressly agreed to by the promisor, who presumably has calculated that her gains from agreeing to such a clause outweigh the costs.³⁰⁴ If courts were willing to enforce *in terrorem* liquidated damages clauses, then parties would be able to contract into property-rule protection when it suited them. The effect of such a rule would be similar to permitting punitive damages for breach of contract, which the parties could contract out of at their option. However, liquidated damages have one major drawback not shared by punitive damages: they are payable regardless of whether the contract was breached willfully or involuntarily.³⁰⁵ As a number of writers have observed, this can create an incentive for the promisee to act opportunistically and attempt to induce a breach by the promisor in order to collect the liquidated damages.³⁰⁶ This is particularly problematic where the promisor's performance requires the promisee's cooperation, as in many construc-

302. See RESTATEMENT, *supra* note 1, § 366 (stating that specific performance may be denied where difficulty in supervision outweighs its advantages); Ulen, *supra* note 18, at 398 (“One of the most troubling issues in making specific performance the routine remedy for breach of contract is that there may be circumstances in which the costs to the court of supervising the performance of the breacher may be inefficiently high.”).

303. See Kronman, *supra* note 15, at 377 (noting this possibility). Kronman argues for the imposition of a constructive trust on the breaching party's profits in order to weaken her incentive to breach the original contract without having first negotiated a release. See *id.* at 377, 380-82.

304. See POSNER, *supra* note 4, at 142.

305. An *in terrorem* liquidated damages clause that exempted involuntary breaches would be equivalent to awarding punitive damages for willful breach. The only difference would be whether the default rule would be property-rule protection (which would be the case with punitive damages) or liability-rule protection (which would be the case with such a liquidated damages clause). For further discussion of default rules, see *supra* Part II.C.2.c.

306. See, e.g., Clarkson et al., *supra* note 300, at 368-72; Goetz & Scott, *supra* note 18, at 588; Comment, *Liquidated Damages*, *supra* note 300, at 1080.

tion contracts, for example.³⁰⁷ Liquidated damages clauses can discourage good faith modifications to avoid breach for the same reason: the promisee has little incentive to agree to a modification unless doing so would be worth more to him than the liquidated damages.³⁰⁸ Punitive damages do not raise the same concerns because they would be imposed only upon a showing that the promisor's breach was willful. The promisee would have no incentive to induce breach because a breach that was not the result of the promisor's deliberate choice would not entitle the promisee to more than expectation damages. Nor would the promisee be inclined to refuse a modification to avert breach because of circumstances beyond the promisor's control. Thus, punitive damages may be preferable to enforcing *in terrorem* liquidated damages clauses.³⁰⁹

Punitive damages are the missing piece of the property-rule puzzle. When specific performance is practical, it may be the better remedy because it gives the promisee precisely what he bargained for. When specific performance is not possible, however, punitive damages are necessary to promote negotiations. Moreover, punitive damages may be preferable to liquidated damages because they create no incentive on the part of the promisee to induce a breach by the promisor.³¹⁰

3. *A Few Examples of "Efficient" Breach.* I have argued above that punitive damages should be available for any willful breach of contract. This is not, however, what the law currently permits. Even

307. See Comment, *Liquidated Damages*, *supra* note 300, at 1080.

308. See POSNER, *supra* note 4, at 143; Eric L. Talley, Note, *Contract Renegotiation, Mechanism Design, and the Liquidated Damages Rule*, 46 STAN. L. REV. 1195, 1218-41 (1994).

309. Judge Posner notes that penalty clauses allow the promisor to communicate information about its reliability to the promisee. See POSNER, *supra* note 4, at 142. However, a promisor could convey much of the same information by not seeking to limit its liability for punitive damages in the case of willful breach. The only information that could not be sent if punitive damages were permitted and penalty clauses were not is information regarding the promisor's estimate of the chances that it might breach involuntarily.

310. One could also protect contractual entitlements with a property rule by throwing all willful breachers in jail. However, such a sanction seems stronger than is needed to encourage negotiations for a release. It is worth noting that there are other kinds of conduct that are thought sufficiently serious to justify the imposition of punitive damages but that do not give rise to criminal sanctions. See, e.g., 42 U.S.C. § 1981a(b)(1) (1994) (authorizing punitive damages for employment discrimination where the employer acted "with malice or with reckless indifference"); see also Kronman, *supra* note 15, at 375 n.76 (distinguishing breach of contract from criminal takings on the grounds that: (1) criminal takings may be more difficult to detect and so require greater deterrence; (2) criminal takings often involve physical violence; and (3) physical takings are frequently committed by strangers).

in those states that have been willing to allow punitive damages for breach of contract, only a few courts have allowed punitive damages for willful breaches of contract that were not opportunistic. One of these few is the court that decided *Chung v. Kaonohi Center Co.*,³¹¹ a case in which the defendant, having agreed to lease commercial space to the plaintiffs, continued to look for better offers while the plaintiffs ran up substantial expenses in reliance on the lease. Continuing to look for better offers constitutes an essential step towards efficient breach, and the theory of efficient breach would have permitted the defendants to lease the space to a different party upon the payment of damages (including the plaintiffs' substantial reliance damages). The Hawaii Supreme Court nonetheless concluded that "[t]he actions of appellants in this case were reprehensible and clearly amounted to wanton and/or reckless conduct sufficient to give rise to tort liability."³¹²

More frequently, however, willfulness alone has not been deemed sufficient, even in states like New Mexico that allow punitive damages for breach of contract. In *Construction Contracting & Management, Inc. v. McConnell*,³¹³ for example, the defendant contractor refused to perform after realizing that the contract would not be profitable. The New Mexico Supreme Court held that the trial court properly refused to submit the issue of punitive damages to the jury.³¹⁴ Referring to the theory of efficient breach, the court stated that "even an intentional breach, where the nonbreaching party is fully compensated for his loss, may promote the interests of society as a whole"³¹⁵ The court continued:

[U]nder our economic system, a party's inability to perform a contract without incurring a substantial financial loss would constitute a legitimate business reason and, although subjecting the party to full liability for the nonbreaching party's compensatory damages, would

311. 618 P.2d 283 (Haw. 1980).

312. *Id.* at 289. In *Chung*, the plaintiffs recovered damages for their emotional distress in tort. *See id.* at 288-89. Punitive damages were not at issue because the plaintiffs did not appeal the trial court's refusal to instruct the jury on punitive damages. *See id.* at 287 n.4. Reading the opinion leaves little doubt, though, that the Hawaii court would have upheld punitive damages on the facts of the case.

313. 815 P.2d 1161 (N.M. 1991).

314. *See id.* at 1166.

315. *Id.* at 1165.

not, without more, expose the breaching party to liability for punitive damages.³¹⁶

The threat of punitive damages would not, however, have forced the construction company to perform the contract at a loss if doing so was not necessary to protect the nonbreaching party's expectation interest. The threat of punitive damages would simply have forced the construction company to buy its way out of the contract and would have determined the nonbreaching party's expectation interest more cheaply and more accurately.

D. *Exempting Involuntary Breaches of Contract*

Finally, it may be worth asking why punitive damages should not also be allowed for involuntary breaches of contract.³¹⁷ Involuntary breaches are those that do not involve a deliberate decision by the promisor to breach. They include breaches that arise because of mere oversight or because the breaching party refuses to perform in the good faith (though mistaken) belief that her performance is excused by some defense.³¹⁸ There are several reasons why such breaches should not be subject to punitive damages.

First, it is important to reemphasize that the reason for allowing punitive damages in contracts is not simply to penalize breachers or to provide additional compensation to nonbreaching parties. Rather, the reason for allowing punitive damages is to encourage negotiations for a release because the parties can establish the value of the contractual entitlement more efficiently than a court. Negotiation is not possible, though, if the decision to breach is not deliberate. If a contractor inadvertently installs the wrong kind of pipe in a house,³¹⁹ it would be futile to impose punitive damages in the hopes of forcing negotiations. Because the contractor had no intention of breaching, it would never have occurred to her to approach the other party and ask for permission to install a different kind of pipe. Thus, imposing

316. *Id.* at 1165-66. It bears emphasizing that the defendant appeared to have no defense based on either mistake or changed circumstances.

317. On the efficient measure for damages for involuntary breach of contract, see generally Lucian Arye Bebchuk & I.P.L. Png, *Damage Measures for Inadvertent Breach of Contract* (Nov. 1996) (Discussion Paper No. 204, John M. Olin Center for Law, Economics, and Business at Harvard Law School) (on file with author).

318. See *supra* text following note 127.

319. This is, of course, what happened in the famous case *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921).

punitive damages for involuntary breaches would not serve to encourage negotiations.

Of course, imposing punitive damages for involuntary breaches might encourage promisors to take additional precautions against such breaches—the contractor might double check the brand of pipe to ensure that it matched the contract specifications—but such additional precautions would not be efficient.³²⁰ Precautions are efficient if they cost less than the amount of the loss they are designed to prevent, discounted by the probability of that loss occurring.³²¹ Investing in precautions beyond that amount is inefficient—it does not promise an adequate return on the investment. Punitive damages for involuntary breaches would encourage promisors to take an inefficient amount of precautions in order to avoid the possibility of punitive damages.³²²

Making punitive damages available for involuntary breaches might have another undesirable effect on promisors: it might discourage them from raising legitimate defenses to performance. Assume that after a widget manufacturer enters a contract to produce widgets for A, the cost of a key component triples because of civil strife in the country producing that component. The manufacturer might have a good faith claim that her performance is excused on grounds of impossibility, but if she would be liable for punitive damages in the event that defense failed, she will be less likely to raise the defense.³²³

Extending punitive damages to involuntary breaches may also have undesirable effects on the promisee's incentives. They would operate much like *in terrorem* liquidated damages, which are payable regardless of the reasons for breach. Punitive damages might discourage the promisee from agreeing to a modification that would

320. See Craswell, *supra* note 15, at 646-47; see also Polinsky & Shavell, *supra* note 14, at 879 ("If damages equal harm, potential injurers will in theory have socially correct incentives to take precautions.").

321. This is Learned Hand's classic formula for negligence. See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

322. As I have already noted, punitive damages for willful breach will not result in an inefficient level of precautions because the promisor can avoid such damages simply by not breaching the contract deliberately. See *supra* note 266.

Imposing punitive damages for involuntary breaches would also distort the choice of contracting party. Parties who were more likely to breach for reasons beyond their control would have to charge a premium to insure against the possibility of punitive damages, raising their prices beyond what their riskiness alone justifies. See Craswell, *supra* note 15, at 650-53. Punitive damages for willful breach will not result in this distortion either. See *supra* note 266.

323. For discussion of the argument that awarding punitive damages for willful breach (as I suggest) might discourage promisors from raising defenses in good faith, see *infra* Part IV.C.

avert breach in the hopes of collecting punitive damages. They might even give the promisee an incentive to induce the promisor to breach.³²⁴

A final reason for exempting involuntary breaches from punitive damages is that they simply do not involve the level of culpability traditionally required for punitive damages. In torts, for example, punitive damages are not awarded for mere negligence.³²⁵ Punitive damages are awarded, however, where the defendant acted willfully³²⁶ or with reckless disregard for the plaintiff's rights.³²⁷ Extending punitive damages to cover willful breaches of contract is consistent with the standard for punitive damages generally applied in torts, but awarding punitive damages for involuntary breaches would not be.³²⁸

324. See *supra* notes 306-09 and accompanying text.

325. See, e.g., *Badger v. Paulson Inv. Co.*, 803 P.2d 1178, 1186 (Or. 1991) ("The prerequisite for imposition of punitive damages is a degree of culpability greater than inattention or simple negligence."); *Cabe v. Lunich*, 640 N.E.2d 159, 162 (Ohio 1994) ("Something more than mere negligence is always required before an award of punitive damages may be made."). Some states allow punitive damages for gross negligence, see, e.g., *Taylor v. Browning*, 927 P.2d 873, 884 (Idaho 1996); *Gonzales v. Surgidev Corp.*, 899 P.2d 594, 597 (N.M. 1995), but others do not, see, e.g., *Bowden v. Caldor, Inc.*, 710 A.2d 267, 276 (Md. 1998); *J.B. Hunt Transp., Inc. v. Doss*, 899 S.W.2d 464, 469 (Ark. 1995).

326. See, e.g., *Taylor*, 927 P.2d at 884 ("The justification for punitive damages must be that the defendant acted with an extremely harmful state of mind, whether that be termed 'malice, oppression, fraud or gross negligence;' 'malice, oppression, wantonness;' or simply 'deliberate and willful.'" (quoting *Walston v. Monumental Life Ins. Co.*, 923 P.2d 456, 465 (Idaho 1996) (quoting *Cheney v. Palos Verdes Inv. Corp.*, 665 P.2d 661, 669 (Idaho 1983))); *Sorrentino v. All Seasons Serv., Inc.*, 717 A.2d 150, 161 (Conn. 1998) ("To support an award of punitive damages, the evidence must reveal 'a reckless indifference to the rights of others or an intentional and wanton violation of those rights.'" (quoting *Gargano v. Heyman*, 525 A.2d 1343, 1347 (Conn. 1987))).

327. See, e.g., *Cummings v. Sea Lion Corp.*, 924 P.2d 1011, 1022 (Alaska 1996) ("[R]eckless indifference to the rights of others, and conscious action in deliberate disregard of them . . . may provide the necessary state of mind to justify punitive damages." (quoting *Barber v. National Bank*, 815 P.2d 857, 864 (Alaska 1991))); *Taylor v. Medemica*, 479 S.E.2d 35, 46 (S.C. 1996) ("In order for a plaintiff to recover punitive damages, there must be evidence the defendant's conduct was willful, wanton, or in reckless disregard of the plaintiff's rights.").

328. Some may argue that because contractual liability is a form of strict liability, distinguishing between willful and involuntary breaches is inappropriate. See, e.g., *Farnsworth*, *supra* note 1, at 1147 ("In its essential design . . . our system of remedies for breach of contract is one of strict liability and not of liability based on fault . . ."). It is true that contractual liability is "strict" in the sense that a breaching party is liable for damages even if the breach was involuntary. See *RESTATEMENT*, *supra* note 1, § 235(2) ("When performance of a duty under a contract is due any non-performance is a breach."). It is not true, though, that fault is irrelevant in determining remedies for breach of contract. See generally *Marschall*, *supra* note 14, at 735-36. The willfulness of a breach is a key factor in determining whether the nonbreaching party is entitled to the cost of completion or simply to the diminution in value. See, e.g., *Groves v. John Wunder Co.*, 286 N.W. 235, 236 (Minn. 1939); *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889, 891 (N.Y. 1921); see also *Sebert*, *supra* note 14, at 1644-46 (characterizing the use of the cost-of-

III. PRELIMINARY RESPONSES TO SOME ANTICIPATED OBJECTIONS

In the preceding discussion, I have already dealt with a number of possible objections to my proposal—that punitive damages will discourage “efficient” breaches,³²⁹ that awarding attorneys’ fees would be sufficient,³³⁰ and that fault is irrelevant in determining contract remedies.³³¹ There are, however, a few other predictable objections that deserve separate treatment.

A. *Collapse the Boundaries Between Contract and Tort*

A number of courts have expressed a fear that allowing punitive damages for breach of contract will collapse the traditional boundaries between contract and tort.³³² Even if recognizing breach of the implied covenant of good faith and fair dealing as a tort, as some states do, creates this possibility, allowing contracts plaintiffs to recover punitive damages directly, as other states have, does not.³³³ All this Article proposes is that punitive damages be available for willful breaches of contract in order to discourage such breaches and encourage negotiations. I do not suggest that other distinctions between

completion measure against a willful breacher as a covert form of punitive damages). An intentional deviation from a contract may be grounds for denying restitution to the breaching party. See RESTATEMENT, *supra* note 1, § 374 cmt. b. And against a willful breacher, the requirement that damages be proved with reasonable certainty is relaxed. See *id.* § 352 cmt. a (“A court may take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty . . .”). Thus, contract law already distinguishes between willful and involuntary breaches in the context of remedies, and awarding punitive damages for willful breaches would simply make one more contract remedy turn on that distinction.

329. See *supra* Part II.C.

330. See *supra* note 265.

331. See *supra* note 328.

332. See, e.g., *Arco Alaska, Inc. v. Akers*, 753 P.2d 1150, 1154 (Alaska 1988) (“Care must be taken to prevent the transmutation of every breach of contract into an independent tort action through the bootstrapping of the general contract principle of good faith and fair dealing.” (quoting *Martin v. Federal Life Ins. Co.*, 440 N.E.2d 998, 1006 (Ill. App. 1982))); *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 677 (Cal. 1995) (stating that recognizing breach of the implied covenant of good faith and fair dealing as a tort has “the potential for converting every contract breach into a tort”); *Cramer v. Insurance Exch. Agency*, 675 N.E.2d 897, 904 (Ill. 1996) (“To allow a bad-faith action would transform many breach of contract actions into independent tort actions.”); see also E. Allan Farnsworth, “*Contracts Is Not Dead*”, 77 CORNELL L. REV. 1034, 1037-38 (1992) (citing *Foley’s* limitation of *Seaman’s* as evidence that contract law is not dead).

333. For a discussion of the difference between awarding punitive damages directly in contract actions and awarding them indirectly by recognizing certain breaches of contract as torts, see *supra* text accompanying notes 32-33.

contract and tort law, such as liability for unforeseeable harm, be abolished.

B. Increase Litigation and Decrease Settlement

Some courts have suggested that awarding punitive damages in contract actions will increase litigation. For instance, Judge Kozinski has written: "*Seaman's* throws kerosene on the litigation bonfire by holding out the allure of punitive damages, a golden carrot that entices into court parties who might otherwise be inclined to resolve their differences."³³⁴ Such an argument assumes, though, that the number of contract breaches would remain the same once punitive damages were allowed. In fact, making punitive damages available for willful breach of contract will encourage promisors who would previously have been inclined to breach to negotiate with their promisees for releases. By decreasing the number of breaches, the threat of punitive damages should *decrease* the amount of contracts litigation.³³⁵

A related argument is that the need for courts to distinguish between willful and involuntary breaches will increase the cost of contracts litigation. It is not clear, however, that distinguishing between willful and involuntary breaches is any more difficult than distinguishing between opportunistic and efficient breaches, as Judge Posner would have courts do.³³⁶ Moreover, the law of contract remedies already requires courts to determine whether a breach was willful in a number of different contexts.³³⁷ Besides, even if it is true that distin-

334. *Oki Am., Inc. v. Microtech Int'l, Inc.*, 872 F.2d 312, 315 (9th Cir. 1989) (Kozinski, J., concurring). The Indiana Supreme Court has also expressed fear about opening "the floodgates of punitive damages in contract cases" and letting "all disputes and quarrels over broken contracts and disappointed business ventures become the subject of acrimonious litigation over punitive damages." *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 984 (Ind. 1993) (quoting *Indiana & Michigan Elec. Co. v. Terre Haute Indus.*, 507 N.E.2d 588, 617 (Ind. Ct. App. 1987)).

335. See *Diamond*, *supra* note 14, at 449:

If the sanctions imposed for bad faith breach are sufficient to induce commencement of litigation by the promisee, they are also sufficient to induce avoidance of the breach by the promisor To the extent the tort deters wrongful conduct, and it surely will, it will decrease the need for litigation.

See also *Kronman*, *supra* note 15, at 373 ("[I]f all promises were specifically enforceable . . . a resulting increase in the voluntary transfer of contract rights might lower the number of breaches—and perhaps even of lawsuits—and in this way reduce the actual involvement of courts in contractual relationships.").

336. See *supra* notes 136-37, 145, 194 and accompanying text.

337. See *supra* note 328.

guishing between willful and involuntary breaches will increase litigation costs in those cases that go to trial, these costs should be more than offset by the decrease in the number of breaches and the corresponding decrease in the amount of contracts litigation.

It is more difficult to predict the effect that allowing punitive damages for willful breaches of contract will have on settlements. Mitchell Polinsky suggests that punitive damages cases may be more likely to settle because greater stakes mean greater risks for both parties and greater litigation costs.³³⁸ On the other hand, he also notes that in punitive damage cases the parties may be more likely to disagree about the expected recovery at trial, which would tend to make settlement less likely.³³⁹ Because both scenarios are plausible, the possible effect of punitive damages on settlement should be counted neither as an argument in favor of, nor as an argument against, allowing such damages for willful breaches of contract.³⁴⁰

It does seem reasonable to think that the threat of punitive damages would tend to increase the size of settlements in cases of willful breach.³⁴¹ This should not, however, be cause for alarm. The promisor can avoid the possibility of a larger settlement in the same way that she can avoid the possibility that a jury would award punitive damages: by negotiating a release from her contractual obligations rather than committing a willful breach.

C. Discourage Meritorious Defenses

A more serious concern is that the threat of punitive damages would discourage contract defendants from raising meritorious defenses. The California Court of Appeal cited this fear in refusing to

338. See A. Mitchell Polinsky, *Are Punitive Damages Really Insignificant, Predictable, and Rational? A Comment on Eisenberg et al.*, 26 J. LEGAL STUD. 663, 667-68 (1997).

339. See *id.* at 669-70.

340. There is currently almost no empirical data on the effect of punitive damages on settlements and the obstacles to obtaining such data are daunting. See Tom Baker, *Transforming Punishment into Compensation: In the Shadow of Punitive Damages*, 1998 WIS. L. REV. 211, 212-13; Thomas Koenig, *The Shadow Effect of Punitive Damages on Settlements*, 1998 WIS. L. REV. 169, 208-09; Herbert M. Kritzer & Frances Kahn Zeinans, *The Shadow of Punitives: An Unsuccessful Effort to Bring it into View*, 1998 WIS. L. REV. 157, 159, 164-66.

341. See Theodore Eisenberg et al., *The Predictability of Punitive Damages*, 26 J. LEGAL STUD. 623, 625 (1997) (“[P]retrial effects should reflect what juries have done in prior cases.”). However, even here, one must proceed with caution. As Tom Baker has noted: “It is to be expected that punitive damages claims and higher settlements will be closely correlated, but that does not mean that the one causes the other . . . [T]he far more plausible causal connection is between aggravated fault and the settlement amount.” Baker, *supra* note 340, at 213.

extend *Seaman's* from bad faith denial of a contract's existence to bad faith denial of contractual liability.³⁴² If punitive damages were allowed for bad faith denials of liability, the court reasoned, "then any party attempting to defend a disputed contract claim would risk, at the very least, exposure to the imposition of tort damages and an expensive and time-consuming expansion of the litigation into an inquiry as to the motives and state of mind of the breaching party."³⁴³

Certainly one would not want to impose punitive damages on a contract defendant simply for having raised an *unsuccessful* defense. Such liability would indeed chill potentially valid defenses because the defendant would have to consider the possibility that the defense, though well-founded, might be rejected by the jury, exposing him to punitive damages. I have defined "willful breach," however, to exclude nonperformance that is voluntary but is based on a good faith belief that performance is excused by some defense.³⁴⁴

The argument that preserving the right to raise defenses in *bad faith* is necessary to protect the right to raise defenses in good faith is harder to make. It assumes that juries are not capable of distinguishing claims for which there is probable cause from claims for which there is not. Yet juries are asked to make precisely that determination in the majority of states that recognize the tort of wrongful civil proceedings.³⁴⁵ One might suspect that there is some valid reason for treating plaintiffs who act in bad faith differently from defendants who act in bad faith because only one state expressly recognizes a

342. See *DuBarry Int'l v. Southwest Forest Indus., Inc.*, 282 Cal. Rptr. 181, 193-94 (Cal. Ct. App. 1991).

343. *Id.*; see also Putz & Klippen, *supra* note 53, at 478:

If tort liability were to be imposed for unreasonable denials of contractual liability, institutional defendants might choose to pay claims when they believed they had valid defenses rather than risk even a minor exposure to punitive damages if a jury disagreed with the reasonableness of the defendant's position and found that its actions were "oppressive."

344. See *supra* text following note 127.

345. The California Supreme Court relied on this analogy in permitting punitive damages for "stonewalling" in *Seaman's*:

There is little difference, in principle, between a contracting party obtaining excess payment [by threatening a lawsuit without probable cause], and a contracting party seeking to avoid all liability on a meritorious contract claim by adopting a "stonewall" position ("see you in court") without probable cause and with no belief in the existence of a defense.

Seaman's Direct Buying Serv. v. Standard Oil Co., 686 P.2d 1158, 1167 (Cal. 1984) (per curiam).

tort of malicious defense³⁴⁶ while most states recognize the tort of wrongful civil proceedings.³⁴⁷ The argument generally used to support the distinction is that the defendant has been “involuntarily haled into court.”³⁴⁸ As the California Supreme Court stated:

“The plaintiff sets the law in motion; if he does so groundlessly and maliciously, he is the cause of the defendant’s damage. But the defendant stands only on his legal rights,—the plaintiff having taken his case to court, the defendant has the privilege of calling upon him to prove it to the satisfaction of the judge or jury, and he is guilty of no wrong in exercising this privilege.”³⁴⁹

When a defendant intentionally breaches a contract and forces the plaintiff to sue her for damages, though, it seems wrong to say that the plaintiff is in court “voluntarily” and that the defendant is not. “A defendant who, in bad faith, forces a plaintiff to prove the validity of an obligation or debt that the parties know to be legitimate has in effect precipitated the litigation by the unjustified refusal to pay.”³⁵⁰

In short, a promisee does not breach willfully if she had a good faith belief that her performance is excused. So long as juries are

346. See *Aranson v. Schroeder*, 671 A.2d 1023, 1027 (N.H. 1995) (recognizing tort of malicious defense). A few other states have hinted that they might do the same. See *Bertero v. National Gen. Corp.*, 529 P.2d 608, 616 (Cal. 1974) (holding that action for malicious prosecution may be based on the defendant’s filing of cross-pleading); *Cisson v. Pickens Sav. & Loan Ass’n*, 186 S.E.2d 822, 825 (S.C. 1972) (dictum) (“[I]t would appear that an action for malicious prosecution may be predicated on the interposition of a defense by a defendant, where the other conditions of an action for malicious prosecution are met.”).

347. See *W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS* 889 (5th ed. 1984).

348. *Bertero*, 529 P.2d at 615. Two other arguments are sometimes raised against the tort of malicious defense: (1) the defendant must have breathing room to assert his rights; and (2) recognizing such a tort would multiply the number of lawsuits. See Jonathan K. Van Patten & Robert E. Willard, *The Limits of Advocacy: A Proposal for the Tort of Malicious Defense in Civil Litigation*, 35 HASTINGS L.J. 891, 917-21 (1984). There might be some truth to the first, but it applies equally to plaintiffs. See *id.* at 918-19. The second has not been borne out by experience with the tort of wrongful civil proceedings. See *id.* at 921. Moreover, as I have already argued, the threat of punitive damages should decrease the number of lawsuits. See *supra* notes 334-35 and accompanying text.

349. *Eastin v. Bank of Stockton*, 4 P. 1106, 1109-10 (Cal. 1884) (quoting John D. Lawson, *The Action for the Malicious Prosecution of a Civil Suit*, 21 AM. L. REG. 281, 370 (1882)); see also *Baxter v. Brown*, 111 P. 430, 431 (Kan. 1910) (declining to recognize tort of malicious defense):

Indeed, it has been said that self-defense is the first law of nature, and one who physically assaults another cannot recover damages of the other for physical injuries inflicted so long as the other acts simply on the defensive and does no more than is necessary to repel the attack

350. Van Patten & Willard, *supra* note 348, at 920.

trusted to distinguish between good and bad faith claims, there should be no fear that imposing punitive damages for willful breaches of contract will chill contract defendants from raising defenses in good faith.

D. Unpredictability and Jury Discretion

Some courts have worried that punitive damages for breach of contract are unpredictable and give too much discretion to the jury. "In inventing the tort of bad faith denial of a contract," Judge Kozinski has written, "the California Supreme Court has created a cause of action so nebulous in outline and so unpredictable in application that it more resembles a brick thrown from a third story window than a rule of law."³⁵¹

Judge Kozinski's simile notwithstanding, recent empirical research shows that punitive damages tend to correlate strongly with a plaintiff's actual damages.³⁵² Even when there is a great disparity between the compensatory and the punitive damages awarded, this disparity may result from the failure of the compensatory damages to capture all of the harm to the plaintiff because of limitations on expectation damages such as certainty and foreseeability. For example, in *Story v. City of Bozeman*,³⁵³ the Montana case that limited punitive damages in contracts to cases involving "special relationships,"³⁵⁴ the jury had awarded \$13,236 in expectation damages and \$360,000 in punitive damages, leading the Montana Supreme Court to comment that "[t]his great disparity between contract and tort damages is symptomatic of a common problem in the use of the bad faith tort in contract litigation; the 'tort tail' has begun to wag the 'contract dog.'"³⁵⁵ On retrial, however, the jury awarded Story \$850,000 in expectation and compensatory damages!³⁵⁶

351. *Oki Am., Inc. v. Microtech Int'l, Inc.*, 872 F.2d 312, 315 (9th Cir. 1989) (Kozinski, J., concurring).

352. See Eisenberg et al., *supra* note 341.

353. 791 P.2d 767 (Mont. 1990).

354. See *id.* at 776.

355. *Id.* at 772.

356. See *Story v. City of Bozeman*, 856 P.2d 202, 207 (Mont. 1993). An alternative explanation would be that the jury was seeking to punish the defendant under the guise of compensatory damages. See Baker, *supra* note 340, at 214 (predicting that if punitive damages are limited or banned "what is likely to happen is that 'punishment' will come increasingly in the guise of 'compensation'").

The concern that punitive damages give too much discretion to the jury is longstanding,³⁵⁷ but it is not limited to punitive damages in contracts. Moreover, there are ways to control jury discretion in awarding punitive damages without going so far as to prohibit such damages entirely. For example, a majority of states now require that a plaintiff prove the conduct warranting punitive damages by clear and convincing evidence.³⁵⁸ Review by the trial judge and by appellate courts may also limit excessive punitive damage awards.³⁵⁹ Or a state might choose to vest the decision of how much, if any, punitive damages to award in the judge rather than the jury, as Kansas and Connecticut have done.³⁶⁰

E. Stability in Contractual Relations

Finally, a number of courts have cited “the need for stability and predictability in commercial affairs”³⁶¹ as a reason for denying punitive damages in contracts. One can think about stability from the point of view of the promisor and from the point of view of the promisee. From the promisor’s point of view, some courts have suggested that the rule against punitive damages promotes stability because it allows the promisor to predict its potential liability in the

357. See, e.g., *Tynberg v. Cohen*, 13 S.W. 315, 317 (Tex. 1890) (“A power such as may be exercised by juries in awarding exemplary damages is liable to great abuse . . . [J]uries, under commendable impulses, but with judgment warped by passion, no doubt often render excessive verdicts . . .”).

358. Thirty states and the District of Columbia have adopted the “clear and convincing” standard for punitive damages either by statute or judicial decision. See *Rodriguez v. Suzuki Motor Corp.*, 936 S.W.2d 104, 110 & nn.1-2 (Mo. 1996) (listing statutes and cases). Section 5(a)(2) of the Model Punitive Damages Act also requires clear and convincing evidence.

On the other hand, the Mississippi Supreme Court has recently held that the Mississippi statute requiring clear and convincing evidence for punitive damages does not apply to contract suits. See *American Funeral Assurance Co. v. Hubbs*, 700 So. 2d 283, 285-86 (Miss. 1997). Thus, in Mississippi, a contract plaintiff need only establish conduct that warrants punitive damages by a preponderance of the evidence. See *id.* at 286.

359. See 1 LINDA L. SCHLUETER & KENNETH R. REDDEN, PUNITIVE DAMAGES §§ 6.2-6.3, at 346-53 (3d ed. 1995) (discussing a trial court’s power to order remittitur or a new trial); *BMW of North America, Inc. v. Gore*, 517 U.S. 559, 585-86 (1996) (holding a punitive damages award unconstitutional); *Pacific Mnt. Life Ins. Co. v. Haslip*, 499 U.S. 1, 20-22 (1991) (explaining and approving Alabama’s procedures for appellate review of punitive damages).

360. See GEN. STAT. CONN. §§ 31-290a(b), 35-53(b), 36a-618, 42-110g(a), 46a-98(d), 52-240b (1997); KAN. STAT. ANN. § 60-3701(a) (1994). Whether doing so would violate the Seventh Amendment or analogous provisions in the constitutions of the states is an open question. See Paul Mogin, *Why Judges, Not Juries, Should Set Punitive Damages*, 65 U. CHI. L. REV. 179, 183-207 (1998).

361. *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 680 (Cal. 1995).

event of breach.³⁶² A promisor, however, may obtain at least the same predictability under a rule allowing punitive damages for willful breach simply by negotiating a release from the promisee. Indeed, negotiation offers the promisor greater predictability since she will know exactly what she must pay to get out of the contract, whereas there is always some uncertainty in the assessment of damages.

Strangely, some courts have also suggested that barring punitive damages promotes the promisee's interest in stability.³⁶³ A promisee who may only recover expectation damages will never be sure, though, if the promisor will perform or will choose to breach and pay damages. If the promisee fears that expectation damages will fall short of his actual damages, he may expend time and resources insuring against the possibility of breach. On the other hand, a promisee who may recover punitive damages for a willful breach can be assured that the promisor will not breach intentionally without consulting him first, which gives the promisee a measure of stability not provided by expectation damages.

Courts sometimes make the related argument that "[p]arties would be more reluctant to join in contractual relationships, or would expend more effort explicitly defining such relationships, if they faced the prospect of damages which could be out of proportion to the amounts involved in the contract."³⁶⁴ Because liability for punitive damages would require proof of a willful breach, it seems unlikely that the parties would need to spend more effort spelling out their obligations in the contract, as they might if punitive damages were available for inadvertent breaches too. Promisors should not be deterred from entering contracts by the possibility of punitive damages for willful breach since such damages could be avoided prospectively by prohibiting them in the contract³⁶⁵ or retrospectively by negotiating a release. Promisees should be encouraged to enter contracts by

362. See, e.g., *Miller Brewing Co. v. Best Beers of Bloomington, Inc.*, 608 N.E.2d 975, 981 (Ind. 1993) ("[T]he well-defined parameters of compensatory and consequential damages which may be assessed against a promisor who decides for whatever reason not to live up to his bargain lend . . . needed . . . stability and predictability to the free enterprise system . . ." (quoting *Vernon Fire & Cas. Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1977))).

363. See, e.g., *Grynberg v. Citation Oil & Gas Corp.*, 573 N.W.2d 493, 500 (S.D. 1997) ("[W]hile compensatory damages encourage reliance on business agreements, the threat of additional punitive damages would create uncertainty and apprehension in the marketplace." (quoting 1 SCHLUETER & REDDEN, *supra* note 359, at § 7.2, at 376)).

364. *E.I. DuPont de Nemours & Co. v. Pressman*, 679 A.2d 436, 446 (Del. 1996).

365. This would be equivalent to the promisee negotiating an explicit option to breach. Presumably the promisee would be required to pay something for this right.

the possibility of punitive damages since they would be more assured of performance.

Thus, contrary to the fears of many courts, stability in contractual relations is likely to be promoted by a rule permitting punitive damages for willful breaches of contract. As the New Mexico Supreme Court has said, “[o]verreaching, malicious, or wanton conduct such as targeted by [punitive damages] is inconsistent with legitimate business interests, violates community standards of decency, and tends to undermine the stability of expectations essential to contractual relationships.”³⁶⁶

CONCLUSION

The majority of American jurisdictions do not allow punitive damages for breach of contract unless the breach constitutes an independent tort or falls within a few other limited exceptions. Even among those states that do allow punitive damages in the absence of an independent tort, very few permit them simply upon a showing that the contract was willfully breached. Increasingly, courts have turned to the theory of efficient breach to explain why punitive damages may not be recovered.

Efficiency, however, supports a very different rule from the one most courts employ—a rule allowing punitive damages for any willful breach of contract. At a minimum, courts concerned with efficiency should permit the recovery of punitive damages on a showing that the breach was opportunistic. Opportunistic breaches by definition do not increase societal wealth. They have “no economic justification and ought simply to be deterred.”³⁶⁷ For example, punitive damages should be permitted where an employee is fired for pretextual reasons,³⁶⁸ where a party engages in “stonewalling” by denying contractual liability in bad faith,³⁶⁹ and where a party refuses in bad faith to pay for goods or services received.³⁷⁰

366. *Romero v. Mervyn's*, 784 P.2d 992, 1001 (N.M. 1989).

367. POSNER, *supra* note 4, at 130.

368. *See, e.g., K Mart Corp. v. Ponsock*, 732 P.2d 1364, 1373 (Nev. 1987); *see also supra* Part II.B.3.a.

369. *See Seaman's Direct Buying Serv. v. Standard Oil Co.*, 686 P.2d 1158 (Cal. 1984) (*per curiam*); *see also supra* Part II.B.3.b.

370. *See, e.g., Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 670-71 (Cal. 1995); *see also supra* Part II.B.3.c.

Efficiency also supports extending liability for punitive damages beyond opportunistic breaches to those that are, in theory, "efficient." This Article has argued that the threat of punitive damages will not require inefficient performance but will simply require the promisor to negotiate with the promisee for a release from her contractual obligations. Whether such negotiations are more efficient than allowing the promisor to breach and pay damages turns on a comparison of the costs of negotiation and the costs of litigation. This Article has shown that the transaction costs of negotiation, while not negligible, are generally lower than the assessment costs of litigation. The problem of strategic behavior that complicates negotiations in a situation of bilateral monopoly also affects litigation. Litigation, however, involves other costs that need not be incurred in negotiations, such as the cost of hiring lawyers, the costs of informing the court, and the error costs of misdetermining damages. While one might encourage negotiations through other "property rules" like specific performance and *in terrorem* liquidated damages, each of these has limitations that suggest that punitive damages are necessary to ensure that promisors negotiate rather than breach willfully.

Nor will punitive damages increase the amount of litigation or undermine the stability of contractual relations as many have feared. Such arguments ignore the fact that the threat of punitive damages for willful breach will decrease the number of breaches. Fewer breaches should mean less litigation as well as greater stability and predictability in contracts. Allowing punitive damages for willful breaches of contract is the best way to encourage negotiations by the parties and to reduce the number of occasions on which damages of any sort need be awarded.

