Attaching Tort Claims to Contract Actions: An Economic Analysis of Contort

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I. INTRODUCTION

In *The Death of Contract*, Grant Gilmore argued that the once separate fields of contract and tort had merged into one more general area of "contort."[1] The term "contort" has since been more broadly applied to many different areas dealing with the "border" between contract and tort. This article investigates one such area: the ability of plaintiffs in breach of contract actions to sue in tort.

There are many consequences of allowing a plaintiff to sue in tort rather than contract. The most important of these is the damages the plaintiff may be awarded. Tort plaintiffs may receive expanded consequential damages, compensation for emotional distress, and punitive damages; contract plaintiffs are generally not entitled to any of these.[2]

This article first examines the goals of contract damages under an economic model. It then explores the extent to which traditional contract damages fulfill these goals and the rationale for any limits that appear to prevent this fulfillment. The article explains the common-law test for attaching a tort claim to a breach of contract action and proposes an alternative framework. Finally, the article applies this proposed framework to a few of the more common "contorts."

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[1] *See generally* GRANT GILMORE, THE DEATH OF CONTRACT (1974).

[2] *See generally* W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 92 (5th ed. 1984).

II. AN ECONOMIC ANALYSIS OF THE PURPOSE OF CONTRACT DAMAGES

In order to evaluate the common law's method of determining when a claim sounds in tort instead of contract, it is important to understand the purpose of contract damages.

In a world of perfect information and zero transaction costs, parties would write complete contingent contracts. A complete contingent contract is one that provides an agreed-upon course of action for every possible future event that might influence the contract's subject matter.[3] Such a contract would be Pareto efficient[4] if the parties could not make any changes such that both parties would be better off.[5] It is important to note that in a world with no transaction costs, any change that would make one party better off to a greater degree than it made the other worse off would be adopted, because the parties could then bargain costlessly over the net benefit created by the alteration.[6]

In a Pareto efficient complete contingent contract, the parties will contract for a penalty for breach that is sufficiently stiff to ensure that neither party will ever breach.[7] Because the contract is complete, the parties will not be concerned about unforeseen events that may change the value of performance. Ex ante, they will want to be bound in such a way that breach will not occur.[8] But note that a complete contingent contract may provide that under certain circumstances, one or both parties need not perform.[9]

Contract damages are still necessary even with a Pareto efficient complete contingent contract because the contract is only Pareto ef-

[3] *See* 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, 881 (1992); Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 466 (1980).

[4] A contract is Pareto efficient when no possible change in its terms could simultaneously make both parties better off. *See* Shavell, *supra* note 3, at 467.

[5] *See id.*

[6] *See* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2-15 (1960); *see also* Mark P. Gergen, *The Use of Open Terms In Contract*, 92 COLUM. L. REV. 997, 1000-04 (1992) (arguing that the goal of contract law is to maximize the joint expected return of the parties).

[7] *See* Shavell, *supra* note 3, at 467.

[8] *See id.*; *see also generally* John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277, 291 (1972) (explaining that "when parties with equal bargaining power negotiate about an equally understood risk or uncertainty, the court can do no better from an economic viewpoint than to enforce their understanding . . . .").

[9] *See* Shavell, *supra* note 3, at 467 n.2.

ficient ex ante. Once a particular contingency has occurred, the agreed-upon outcome may no longer bring the highest returns for both parties. For example, imagine a contract between a restaurant owner (Owner) and a sailor (Sailor) for the supply of fish to the restaurant. Owner can sell the fish each day for $20. The damage to Owner's reputation if she does not have fish to sell on any particular day is $30. The cost to Sailor of catching the fish is $10 on a normal day, but $16 if there is a storm. The chances of a storm are one in ten. There are no other events that could affect the costs or values to the two parties. A contract that provides for two possibilities—stormy weather and clear weather—will thus be a complete contingent contract.

Owner suggests two possible complete contingent contracts to Sailor. Under the first contract, Sailor must always supply Owner with fish whether there is a storm or not. Under the second contract, Sailor will only supply Owner with fish when there is no storm; on stormy days, Sailor will stay home. To induce Sailor to enter into the first (Always Perform) contract, and thus avoid enormous damage to her reputation, Owner offers to pay a higher price for the fish each day, $14. If Sailor chooses the second (Fair Weather Only) contract, Owner will only pay Sailor $11 each day for the fish, and will pay nothing on stormy days.

Sailor would choose the first, Always Perform contract. To see why this is so, we can calculate the value of each contract to both parties.

<u>Always Perform contract</u>:
Sailor: (0.9)(14-10) + (0.1)(14-16) = 3.4
Owner: (0.9)(20-14) + (0.1)(20-14) = 6.0

<u>Fair Weather Only contract</u>:
Sailor: (0.9)(11-10) + (0.1)(0) = 0.9
Owner: (0.9)(20-11) + (0.1)(-30) = 5.1

Both parties clearly prefer the Always Perform option—it is Pareto optimal relative to the "fair weather only" contract. It is also the dominant option—not only is it impossible to switch from the Always Perform contract to the Fair Weather Only contract without making one of the parties worse off, it is also impossible to do so without making both parties worse off.

Under the Always Perform contract, however, Sailor would want to breach the contract in the event of a storm. On stormy days,

Sailor loses money because she bears costs of $16 but earns only $14. Knowing that Sailor will breach once a storm arrives, Owner will refuse to offer the Always Perform contract ex ante. In order to allow the parties to enter into the contract that they both prefer, they must create some enforcement mechanism, such as contract damages, even in this Pareto optimal, complete contingent contract.

In a world where information is costly, most contracts will no longer be complete, either because of high transaction costs or because some contingencies are unverifiable.[10] One solution to this problem is renegotiation. The background term in every contract could be that if an unforeseen contingency arises, the parties will renegotiate the contract's terms under the new conditions. In the example above, Owner could offer Sailor between $17 and $20 to perform in a storm. Sailor will do so because this new price is higher than the $16 that it will cost him to perform. Renegotiation thus provides one method for achieving socially optimal solutions without contract damages.[11]

Renegotiation, however, can be costly. First, the time available to agree on a new arrangement once the contingency materializes may be insufficient. The contingency may occur immediately before performance is due, or after it has begun, and the parties may not be able to strike a new deal in time to prevent a breach. Second, renegotiation can change the balance of bargaining power, giving the nonperforming party much greater leverage than she had in the original negotiation. Particularly if the performance is time sensitive, the party that is to perform may be able to extort a much greater share of the contract's net benefit from the party in need of performance. Third, the very process of renegotiation may be prohibitively expensive. For example, the parties may be far apart at the time the unforeseen contingency occurs and perhaps unable to reach one another to discuss new terms.

Another danger that can arise in the absence of contract damages is opportunism. Even when the parties have planned for the contingency, in a nonsimultaneous contract the party that has not yet performed may attempt to seize more of the contract's net bene-

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[10] *See* Shavell, *supra* note 3, at 468-69; *see also* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 393 (1980) (discussing the costs of contract formation).

[11] Of course, the parties could have also agreed to a special "storm price" in advance, but the initial assumption was that the parties were bargaining for a fixed daily price.

fits for herself.[12] The cost of the effort to achieve this reallocation is a net social loss since its effect is only to redistribute existing income, not increase the amount of income available to be distributed. In a world without damages that relies only on renegotiation to deal with unforeseen contingencies and opportunism, many socially beneficial contracts will not be performed or will be performed at a higher social cost than necessary.

There are some non-damage mechanisms that may mitigate this effect. To protect against breach, a party can either search for contracting partners who are less likely to breach, or can expend resources to monitor its contracting partners in order to detect imminent breaches.[13] A party may also be deterred from breach by fear of damage to its reputation; if it acquires a reputation as a dishonorable partner, other parties may refuse to deal with it in the future.[14] Alternatively, a party could charge a higher price to offset the effects of anticipated breaches or could practice vertical integration to minimize the number of parties with whom it contracts.[15] Yet all of these methods are costly[16] and may prove unsuccessful.[17] Searching for "honorable" contracting partners, monitoring them, and researching their reputations are all expensive activities. In addition, these methods may not always be effective. Parties may be able to disguise their dishonorable intentions, hide their incipient breaches, and disregard the negative impact on their reputations.

Another alternative is to impose some non-monetary penalty upon breaching parties. A potential breacher could be deterred in the same way potential criminals are—by the threat of some fixed fine or imprisonment. This method might appeal to those who believe that it is morally wrong to break a contract, but this view is clearly misguided. Few would argue that it is *always* wrong to break a promise; unanticipated problems arise, new opportunities present themselves, or conditions may otherwise change such that the assumptions behind the promise are no longer valid. When conditions have changed, it is sometimes acceptable even in social situations to go back on one's word. For example, I may promise to go to

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[12] *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 89-92 (4th ed. 1992); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521-26 (1981).

[13] *See* Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1448 (1980).

[14] *See id.* at 1464-65; *see also* Muris, *supra* note 12, at 527.

[15] *See* Muris, *supra* note 12, at 527.

[16] *See* Farber, *supra* note 13, at 1448.

[17] *See* Muris, *supra* note 12, at 527-28.

my friend's house for dinner tomorrow. When tomorrow arrives, I may find that I have a 104° fever. My friend will surely understand when I tell her that I cannot come to dinner because I am ill. In fact, she would probably be quite upset with me if I insisted on coming and risked infecting all of her guests. Similarly, in the commercial context, we should not rigidly bind parties to all of their promises. Because complete contingent contracts are not possible in the real world, we want to allow some room for parties to avoid performance when new information is discovered, conditions have changed, or better opportunities have arisen.

We can best provide this "wiggle room" by awarding damages for breach of contract. A breach is socially desirable when the benefits to the breaching party outweigh the costs to the performing party.[18] Any damages imposed must be great enough to prevent breaches that cause a net social loss but small enough to allow efficient breaches. Such a damage measure serves as a gap-filling device for incomplete contracts; it creates incentives for the parties to behave in the manner in which they would have agreed to behave had they anticipated the contingency.[19] Contract damages thus provide a solution for the problem of incomplete information. They also prevent opportunism, because by definition an opportunistic breach creates a net social loss.

Damages should also be awarded for efficient breaches. Two rationales support this principle. First, the breaching party will only make efficient decisions about whether or not to breach if she bears the costs of the breach for both parties. Forcing the breaching party to pay for any damages she causes gives her an incentive to maximize the joint expected return of the contract to both parties—the objective of contract law generally.[20] Second, allowing a party to breach without paying damages would reallocate the risk of nonperformance. Parties usually intend to place the risk of nonperformance on the performing party, at least in fixed price contracts.[21] Allowing the performing party to breach with impunity when the breach is efficient would unfairly reassign the risk to the victim of nonperformance.

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[18] *See* POSNER, *supra* note 12, at 119; *see also* Barton, *supra* note 8, at 282; Farber, *supra* note 13, at 1443-44; John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1565-67 (1986).

[19] *See* Shavell, *supra* note 3, at 468; *see also* POSNER, *supra* note 12, at 92-93.

[20] *See* Gergen, *supra* note 6, at 1000-04.

[21] *See* POSNER, *supra* note 12, at 105.

Judge Posner lists seven possible damage remedies for breach of contract: reliance damages, expectation damages, liquidated damages, consequential damages, restitution, specific performance, and punitive damages.[22] Posner argues that the choice of an appropriate remedy depends on whether or not the breach is opportunistic. If the sole purpose of the promisor's breach is to take advantage of the promisee's vulnerability by seizing a greater share of the net social benefits of the contract, courts should feel free to "throw the book at the promisor."[23] Judge Posner believes that the best way to punish the promisor is to award restitution damages, thereby confiscating the promisor's profits and deterring the breach by making it worthless.[24] For non-opportunistic breaches, Posner advocates awarding expectancy damages, which would give the promisee her expected profits from the transaction.[25] Expectancy damages would provide the promisor with an incentive to perform unless a breach would be efficient.[26]

Judge Posner's approach to opportunistic breaches is flawed, and his method of dealing with non-opportunistic breaches may also be problematic. That a breach is opportunistic should not affect the damage measure. Opportunistic breaches are just one type of inefficient breach and should be treated the same as other breaches. The purpose of a contractual damage measure is to provide the proper incentives for the parties to perform by forcing them to absorb the costs of nonperformance.[27] A restitution measure of damages fails to accomplish this goal. Under a restitution rule, the breaching party must turn over the profits gained from breach, but this amount may be either greater or less than the harm suffered by the promisee. Only by sheer coincidence will this measure actually equal the total damage caused to the promisee by the breach. As a result, the promisor will either have too much or too little incentive to breach, depending on the relationship between the promisor's profits from breach and the damage caused to the promisee in each particular case.

Posner's approach to non-opportunistic breaches is also problematic. Posner defines the expectancy measure as the promisee's

[22] *See id.* at 117.

[23] *Id.*

[24] *See id.* at 117-18.

[25] *See id.* at 118-26.

[26] *See id.*

[27] *See* Shavell, *supra* note 3, at 472.

lost profits.[28] As discussed more thoroughly below, however, the promisee's lost profits may be only a part of the total damage caused by the breach. This measure fails to account for consequential damages and nonpecuniary losses, both of which may be significant. To the extent the promisor is not forced to absorb these losses, she will not make an efficient decision when considering whether or not to breach.[29]

Professor Shavell defines expectancy more broadly as putting the promisee in the position she would have been had the contract been performed. Shavell has argued, however, that even under this definition, expectancy is the best damage measure only under a relatively simple economic model of contracts.[30] Once additional complications such as reliance expenditures are taken into account, it becomes impossible to state as a general principle that expectancy is superior to other measures such as reliance and restitution; the proper measure becomes dependent on the nature of the particular contract.[31]

Since it is impossible to find a damage measure that both induces performance in all appropriate cases and provides the proper incentives to invest in reliance expenditures, it becomes necessary to choose which goal the law will pursue. Although this is fundamentally an empirical question, this article will assume that—overall—the negative effects of causing or preventing breach at inappropriate times swamp the effects of inducing an inefficient level of reliance.

This assumption seems reasonable. The reliance problem is created by awarding the relying party full expectancy damages based on her reliance expenditures at the time of breach. The relying party is thus relieved of having to account for the possibility of breach in determining her reliance level; the promisee knows that even if the promisor breaches the contract, she will still receive her expected return.[32] Ideally, the promisee would invest less in reliance to account for the possibility that the promisor might breach. Yet

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[28] *See* POSNER, *supra* note 12, at 117.

[29] Throughout this article, I refer to breach as if it were purposeful. None of the analysis, however, would change for negligent breach. A negligent breach is the result of insufficient investment in care to prevent breach. Since parties must decide on the level of resources to invest in taking care, all breaches are in a sense purposeful breaches. *See infra* Part VIII.C(2). In order to provide an incentive to take an efficient level of care, the promisor must be acquainted with the full scope of the harm caused by breach.

[30] *See* Shavell, *supra* note 3, at 472, 488.

[31] *See id.*

[32] *See id.* at 472; *see also* POSNER, *supra* note 12, at 122.

because contracts are usually performed,[33] the ideal reduction in reliance expenditures is probably rather small and easily outweighed by the negative impact of incorrectly inducing or preventing breach.

III. THE INADEQUACIES OF TRADITIONAL CONTRACT DAMAGES

If the goal of imposing damages for breach of contract is to force the breaching party to internalize the full costs of her breach, then traditional contract damages are inadequate. Traditional contract damages are sharply limited in a variety of ways: the foreseeability rule, the presumption against the award of nonpecuniary damages such as emotional distress, and the failure to account for uncertainty in detecting breach. The net result of these limitations is to under-deter breach. Because promisors will not have to pay for all of the damage caused by their breach, they will breach even when it is not efficient to do so.[34]

A. *Consequential Damages*

The foreseeability requirement limits the victim's damages in both tort and contract law,[35] but the foreseeability rule is applied more loosely in tort than in contract.[36] Tort victims are generally denied consequential damages only if "there was nothing in the situation to suggest to the most cautious mind" that the consequence would occur.[37] Victims of breach of contract, on the other hand, are generally limited to damages "such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it."[38]

An award of all damages that resulted from a breach of contract might result in disproportionately large damages for breach of a relatively minor contract. This situation frequently arises in cases dealing with misdelivered telegrams or telegrams containing some error.[39] Judges confronted with such cases often balk at the apparent

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[33] *See* Farber, *supra* note 13, at 1464.

[34] *See* Linda Curtis, Note, *Damage Measurements For Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161, 173 (1986); *see also* Farber, *supra* note 13, at 1444-45; Sebert, *supra* note 18, at 1565-66.

[35] *See* RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981); RESTATEMENT (SECOND) OF TORTS § 435(2) (1965).

[36] *See* Sebert, *supra* note 18, at 1567 n.8 and accompanying text.

[37] Palsgraf v. Long Island R.R., 162 N.E. 99, 101 (N.Y. 1928).

[38] Hadley v. Baxendale, 9 Ex. 341, 354, 156 Eng. Rep. 145 (1854).

[39] *See* Kerr Steamship Co. v. Radio Corp., 157 N.E. 140 (N.Y. 1927).

inequity of awarding damages that can be thousands of times greater than the actual value of the breached contract.[40]

In the famous case of *Hadley v. Baxendale*,[41] the court applied the strict foreseeability rule in contract. In this case, a crank shaft broke in Hadley's mill, preventing the mill from functioning.[42] Hadley sent the broken shaft to the manufacturer to have it fixed quickly, but the carrier negligently delayed delivery, causing several days' lost profits when the mill could not operate.[43] Hadley sued the carrier for lost profits.[44] The court refused to award Hadley consequential damages because Hadley had not communicated to the carrier the special circumstances of this delivery and because "the loss of profits here cannot reasonably be considered such a consequence of the breach of contract as could have been fairly and reasonably contemplated by both the parties when they made this contract."[45]

The *Hadley* rule—that a promisor is not liable for consequential damages not within the contemplation of the parties unless the special circumstances were communicated to the promisor by the promisee—has been universally adopted by the common law.[46] Some courts have made the rule even stricter, refusing to award consequential damages even when the promisee communicated the possibility of unusual damages but where the promisor did not expressly accept the greater scope of liability. For example, in *Globe Refining Co. v. Landa Cotton Oil Co.*,[47] Justice Holmes wrote that "mere notice to a seller of some interest or probable action of the buyer is not enough necessarily and as a matter of law to charge the seller with special damage on that account if he fails to deliver the goods."[48] While the *Hadley* rule may be efficient for other reasons discussed below, the limits on consequential damages have the negative effect of reducing the level of damages internalized by the breaching party below that of the actual damages caused by the breach.

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[40] *See* Barton, *supra* note 8, at 295.

[41] 9 Ex. 341, 156 Eng. Rep. 145 (1854).

[42] *See id.* at 341.

[43] *See id.* at 341-43.

[44] *See id.* at 343.

[45] *Id.* at 356.

[46] *See* Lucian Ayre Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J.L. ECON. & ORG. 284, 285 & n.2 (1991).

[47] 190 U.S. 540, 543, 545 (1903).

[48] *Id.* at 545.

B. *Nonpecuniary Damages*

Nonpecuniary damages, such as emotional distress, may also be substantial. But traditional contract doctrine narrowly restricts a party's ability to recover for emotional distress.[49] Typically, emotional distress damages are only awarded in death and burial cases,[50] in cases where the breach is accompanied by public embarrassment of the promisee,[51] or in cases where the breach results in physical harm to the promisee, as in contracts for medical services.[52]

Courts may be reluctant to award nonpecuniary damages because they are often unforeseeable, difficult to measure, or because courts fear that awarding emotional distress damages would result in a windfall to the plaintiff.[53] The exceptions to this general rule occur when these justifications are weak or nonexistent: when the contract has a personal, rather than commercial aim, and when pecuniary damages are so low that a refusal to award damages for emotional distress would deprive the plaintiff of any compensation.[54] Regardless of the rationale, the refusal of courts to award nonpecuniary damages allows a potentially breaching promisor to disregard a substantial component of the promisee's damages in deciding whether or not to breach.

C. *Punitive Damages*

The policy of disallowing punitive damages for breach of contract is based in large part on the assumption that all contract breaches will be detected.[55] If all breaches are detected, and if all detections result in full compensation to the promisee, promisors will be appropriately deterred from breach. If some percentage of breaches is not discovered, though, promisors will discount their expected liability by the chance of escaping the penalty for breach. As a result, to the extent that not all breaches are discovered, promisors will be under-deterred from breaching contracts. Supercompensatory[56] damages could remedy this problem if courts awarded a "multiple"[57] of the plaintiff's actual damages.

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[49] *See* RESTATEMENT (SECOND) OF CONTRACTS § 353 (1981); *see also* Sebert, *supra* note 18, at 1584-86.

[50] *See* Sebert, *supra* note 18, at 1585 & nn.66-67 and accompanying text.

[51] *See id.* at 1585 & n.69.

[52] *See id.* at 1585 & nn.70-71.

[53] *See id.* at 1586-91.

[54] *See id.* at 1590.

[55] *See* Curtis, *supra* note 34, at 166.

[56] This article uses the term "supercompensatory" instead of "punitive" to em-

The assumption of perfect detection may be reasonable in most commercial contexts, but inaccurate in many consumer transactions.[58] Even in commercial contexts, detection of breach may be costly or impossible, particularly for minor breaches.[59] As a result, the common-law policy against supercompensatory damages for breach of contract may result in inadequate deterrence of breach.

IV. RATIONALE FOR TRADITIONAL CONTRACT DAMAGE RULES

Despite these flaws in traditional contract damages, there are countervailing policies that argue against changing the common-law rules in typical contract disputes.

A. *Consequential Damages*

Although the failure to award consequential damages will often create improper incentives to breach a contract, the *Hadley* doctrine may be necessary in order to induce parties to disclose information about the probable consequences of breach.[60] Under *Hadley*, the promisor is only liable for a consequence of breach if the promisee has disclosed the consequence's possibility and the promisor has agreed to assume the risk of its occurrence.[61]

It will often be socially valuable for the promisor to know that the promisee faces unusually large consequential damages should the promisor breach. Without such knowledge, the promisor will not be able to take into account the unexpectedly great social loss that could result from breach when deciding whether a breach would be efficient. Simply imposing liability for consequential damages will not create efficient incentives if the information costs associated with learning of the consequence are prohibitively high. Moreover, the information costs for the promisor will generally be higher than for the promisee, who is much more familiar with her own business and thus more likely to know the consequences of a

phasize that the purpose of such damages should not be to punish—as under the common law—but to remedy deterrence failures that stem from imperfect breach detection. This article generally uses the term "punitive damages" only in referring to the common-law doctrine.

[57] This "multiple" would be calculated to compensate for the chance that the breach would go undetected. For example, if a particular type of breach would be detected only one-third of the time, the "multiple" would be set at three, and the plaintiff would receive three times her compensatory damages.

[58] *See* Curtis, *supra* note 34, at 166.

[59] *See* Farber, *supra* note 13, at 1456.

[60] *See* POSNER, *supra* note 12, at 127.

[61] *See id.*; *see also supra* Part III.A.

breach by the promisor. In addition, a rule imposing liability for consequential damages in all circumstances might actually discourage the promisee from disclosing her high consequential damages, because a disclosure could result in a higher contract price reflecting the greater expected liability.

Furthermore, the promisor may sometimes be the cheaper risk-bearer because she may be in a better position to prevent breach or may simply be less risk-averse. When the promisor is the cheaper risk-bearer, it is socially desirable for the promisee to pay the promisor to assume the risk. The possibility for gains of trade[62] in this situation already provides some incentive for the promisee to disclose the potential consequences of breach. But the promisee may not be aware that the promisor is a cheaper risk-bearer, either because the promisee is unfamiliar with the promisor's level of risk aversion or because the promisee does not know that the promisor can take steps to reduce the risk of breach. The promisee may erroneously believe that the chances of the promisor being a cheaper risk-bearer are too low to justify the costs of disclosing the necessary information. Therefore, a rule that encourages disclosure may be socially beneficial.

In some circumstances, the sharing of information may yield a net social loss. The cost of transferring the information may exceed the gains of trade, or there may not be any gains of trade. The cost of sharing information may be quite large, especially for small, routine transactions such as sending a telegram where the information transfer cost may exceed the price of the purchased service.

The *Hadley* rule encourages disclosure when sharing information would be socially beneficial but discourages disclosure when a transfer of information would yield a net social loss.[63] The alternative method, which would impose liability for consequential damages regardless of the level of disclosure, is inferior to the *Hadley* rule in this respect.

Application of the alternative method would result in one of two possibilities. The first possibility is that no one will disclose any information about the possible consequences of a breach.[64] In that

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[62] Gains of trade are possible when a bargain would make both parties better off. For example, if A prefers apples, but only has an orange, and B prefers oranges, but only has an apple, A and B could enjoy gains of trade by exchanging A's orange for B's apple.

[63] For a mathematical treatment of this point, see generally Bebchuk & Shavell, *supra* note 46.

[64] *See id.* at 290-91.

case, promisors will charge a higher average price to pay for their expanded liability and will not take the efficient level of precaution.[65] The second possibility is that promisees will only reveal the possibility of consequential damages when a breach would not cause an unusually high consequential damage award.[66] Situations with a potential for unusually high consequential damages will occur relatively infrequently,[67] or else the consequences would not be sufficiently unusual to fall outside the *Hadley* test—common consequences are generally "supposed to have been in the contemplation of both parties."[68] Therefore, this outcome is less efficient because it requires more parties to spend resources to reveal information about consequential damages.

The negative effects of the *Hadley* rule on incentives to breach a contract may be eliminated by the parties' capability to reveal the likelihood of unusually high consequential damages. Once this information is disclosed and the risk's assignment is negotiated, the party best able to avoid the loss will bear its risk. To the extent that the benefits of communication outweigh the costs, this rule is superior to the alternative rule of full liability for consequential damages.[69]

B. *Nonpecuniary Damages*

Allowing plaintiffs to recover nonpecuniary damages such as emotional distress for breach of contract would risk runaway jury verdicts, inhibit commercial transactions, and increase uncertainty for contracting parties. There is a substantial chance that juries will use a vague category such as emotional distress as a "back-door" method of awarding punitive damages.[70] Because nonpecuniary damages are so difficult to measure objectively, it may be difficult for courts to prevent this from occurring.[71]

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[65] *See id.*

[66] *See id.*

[67] *See id.* at 289.

[68] Hadley v. Baxendale, 9 Ex. 341, 354, 156 Eng. Rep. 145 (1854).

[69] *See* Bebchuk & Shavell, *supra* note 46, at 291-92. *But see* Sandra Chutorian, Note, *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, 402-06 (1986) (arguing for expanded consequential damages in contract); Curtis, *supra* note 34, at 162-63 (arguing a similar position); Jeffrey M. Perloff, *Breach of Contract and the Foreseeability Doctrine of* Hadley v. Baxendale, 10 J. LEGAL STUD. 39, 62-63 (1981) (arguing that neither rule necessarily leads to an optimal outcome if people are risk averse).

[70] *See* Sebert, *supra* note 18, at 1598-99.

[71] *But see id.* at 1654-56 (arguing that the use of devices such as a higher burden

Awarding nonpecuniary damages could also inhibit commercial transactions. Parties may be more reluctant to enter into transactions knowing that they could face liability for large nonpecuniary losses if they breached the contract. Increasing the expected damages for breach would reduce the expected value of the transaction and commensurately reduce parties' willingness to commit themselves to a contract. If there were some objective method of measuring nonpecuniary losses so that juries could award them accurately and parties could predict them with certainty, then forcing parties to take nonpecuniary losses into account would be socially beneficial for the reasons described above. But because there is so much uncertainty surrounding estimates of nonpecuniary losses, it is unlikely that juries would award the actual loss suffered by the promisee. The effect of awarding emotional distress damages might be the addition of a random "lottery" factor instead of an increase in the accuracy of deterring breach. This uncertainty becomes even more problematic once risk aversion is taken into account. Parties who would be relatively risk-neutral when faced with limited damages for breach may become more risk-averse when faced with expanded liability. Even a small chance of a disproportionately large nonpecuniary loss award could deter parties from entering into socially beneficial transactions.

Emotional distress is a real social harm that may result from breach of contract. But the problems involved in measuring it accurately, because of plaintiffs' incentives to exaggerate their losses and because there is no market for emotional distress, may cause so much distortion that the net effect of adding this element to damages would be to reduce the accuracy of deterring breach.

C. *Punitive Damages*

Punitive damages are generally not awarded for breach of contract. Parties should be free to decide between performing or paying damages for nonperformance. As Justice Holmes said, "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."[72] Punitive damages are considered inappropriate in contract cases because they would deter efficient breaches, thereby causing a net social loss.[73]

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of proof could effectively control juries' impulses to overaward nonpecuniary damages).

[72] Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

[73] *See* Curtis, *supra* note 34, at 165.

As explained in Part III.C above, supercompensatory damages designed to compensate parties for the reduction in deterrence from uncertain detection of breach would not be subject to this critique. Such damages only restore the proper level of deterrence by making up for the fact that breaches are not always detected. These damages give potential breachers the same deterrence incentives they would have if all breaches were detected.

There are, however, other reasons to deny plaintiffs supercompensatory damages. First, the efficacy of supercompensatory damages in deterring breach efficiently depends on the factfinder's ability to estimate accurately the chances of breach detection in particular cases. The question will only arise in cases where the breach was detected. As a rule, the factfinder will not have statistics available to prove how often the breach goes undetected in similar cases. The factfinder's estimate will be little more than a guess in most cases, based on circumstances that seem to point either towards or away from easy detection of the breach. This will create a great deal of uncertainty for transacting parties.

Second, the lack of objective guidance in setting a "multiple" to account for lapses in detection may lead judges and juries to substitute their own emotions about the degree to which the promisor should be punished for the chance of breach detection. This tendency would result in awarding punitive damages for breach of contract, deterring efficient breaches, and creating a net social loss.

Third, in cases where a breach is particularly hard to detect but where the promisor's breach was not malicious, factfinders may be reluctant to award the full "multiple." It will no doubt appear highly inequitable to force a breaching but well-intentioned promisor to pay many times the actual damage simply because the breach was difficult to detect. For these cases, the attempt to provide the efficient level of deterrence through supercompensatory damages may be foiled by judge and jury nullification.

Fourth, supercompensatory damages would encourage parties to overinvest in monitoring costs in the hopes of acquiring a windfall. Promisees would also be more likely to bring suit, even where their chances of success on the merits would not otherwise warrant paying litigation costs. This problem might be addressed by having the promisor pay the supercompensatory damages to the court, rather than the promisee. This would eliminate the promisee's incentive to overspend on either monitoring or litigation. However, the problems of uncertainty, jury nullification, and inaccuracy in as-

sessing the "multiple" all argue against awarding supercompensatory damages.

D. Conclusion

Despite the effect that deficiencies in contract damages have on the promisor's incentive to breach, most of the problematic doctrinal rules are justified by other policies.

V. EFFECT OF ATTACHING A TORT CLAIM

Attaching a tort claim to a breach of contract action dramatically alters the rules governing damages. First, tort claims are often governed by a different standard of liability.[74] While strict liability generally applies to contract claims, most tort claims are governed by some sort of fault standard, although strict liability does apply to some types of tort cases.[75]

Second, tort plaintiffs are eligible for a greater scope of consequential damages.[76] As in contract, foreseeability plays a role in tort damages.[77] But the foreseeability test is applied more loosely in tort than in contract.[78] In tort, the foreseeability test is applied from the time of the injury, looking backwards.[79] In contract, the focus is on the time the agreement was made; defendants are only liable for consequential damages within the contemplation of the parties at the time of contract formation.[80] Because the focus in tort is closer in time, consequential damages are generally more foreseeable than in contract cases.

Third, tort plaintiffs who have suffered some physical injury can receive emotional distress damages.[81] Emotional distress damages are not generally recoverable for breach of contract.[82] This distinction, however, is not always strictly observed. In a recent California

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74 *See* Thomas C. Galligan, Jr., *Contortions Along the Boundary Between Contracts and Torts*, 69 TUL. L. REV. 457, 463 (1994).

75 *See id.*

76 *See id.* at 465-69.

77 *See id.*

78 *See id.*

79 *See id.*; *see also* RESTATEMENT (SECOND) OF TORTS § 440 cmt. b (1965).

80 *See* Bebchuk & Shavell, *supra* note 46, at 284-85.

81 *See* Galligan, *supra* note 74, at 469-70; *see also* KEETON ET AL., *supra* note 2, § 12, at 55.

82 *See* E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.17, at 274-76 (1990); *see also* Galligan, *supra* note 74, at 471.

case, the court ordered the builder of a defective house to pay the owner emotional distress damages.[83]

Fourth, courts may award tort plaintiffs punitive damages if the harm was caused intentionally or recklessly.[84] In contract, punitive damages are not generally available unless the defendant's conduct in breaching the contract also violated a noncontractual legal duty, thereby constituting a tort.[85]

Attaching a tort claim to a breach of contract action expands the scope of damages available to the plaintiff and solves many of the incentive problems discussed above. The promisor may face liability for consequential damages and emotional distress, and may be implicitly assigned liability for a low chance of detection through punitive damages. As discussed above, however, there are good reasons for avoiding this type of solution in the typical contract case.

VI. THE COMMON-LAW TEST FOR ATTACHING A TORT CLAIM

The common law allows a plaintiff to sue in tort for a contract dispute only if the defendant's conduct constituted a separate and independent tort.[86] Courts generally allow tort claims arising out of contractual relationships for independent torts such as fraud, breach of fiduciary duty, intentional infliction of emotional distress, and negligence in personal injury. The rationale for allowing independent tort claims is that the form of the pleadings should not be allowed to dictate the type of relief awarded.[87] A claim should not be evaluated as a contract claim just because one of the parties describes it that way; claims should be dealt with in a manner consistent with their true nature. As the Supreme Court of Nebraska has written, "Whether an action is characterized as one in tort or on contract is determined by the nature of the complaint, not by the form of the pleadings, and consideration must be given to the facts which constitute the cause of action."[88]

Although this test appears straightforward, it has proven difficult to apply. Courts have developed different subsidiary rules for determining whether a claim sounds in contract or tort. Some courts have held that there must be a separate set of facts from those

[83] *See* Galligan, *supra* note 74, at 471 (citing Salka v. Dean Homes of Beverly Hills, Inc., 22 Cal. Rptr. 2d 902 (Ct. App. 1993)).

[84] *See* RESTATEMENT (SECOND) OF TORTS § 908 (1979).

[85] *See* RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981).

[86] *See id.*; *see also* FARNSWORTH, *supra* note 82, § 12.8, at 191-92.

[87] *See* Sebert, *supra* note 18, at 1601.

[88] Thomas v. Countryside of Hastings, Inc., 524 N.W.2d 311, 313 (Neb. 1994).

forming the basis of the contract claim in order for a plaintiff to sue in tort as well. Under this approach, there is a preference for interpreting causes of action as sounding in contract. The Supreme Court of Nebraska adopted this approach in *Cimino v. FirsTier Bank*.[89] In that case, the court wrote:

> We hold that even if the Ciminos stated facts sufficient to establish that FirsTier owed them a fiduciary duty, intentionally interfered with the Ciminos' contractual relations, and made material misrepresentations, the Ciminos failed to plead those theories as independent tort actions . . . . The Ciminos failed to allege any separate and distinct factual occurrences that could stand alone as a separate cause of action sounding in tort.[90]

Other courts have applied a looser test, allowing the plaintiff to choose between suing in tort or contract if the same set of facts could support either type of claim. The Supreme Court of Utah adopted this approach in *Ward v. Intermountain Farmers Association*.[91] *Ward* dealt with a crop owner who was suing a farmers association for spraying the wrong type of chemicals on his crops. The court held that the plaintiff had the option of suing for breach of contract or in tort, whichever claim seemed most advantageous to him. The court justified its position by citing the *Restatement (Second) of Torts*: "'An act and its consequences may be both a tort and a breach of contract . . . . When this is so, the injured person, although barred by a statute from maintaining an action of tort may not be barred from enforcing his contractual . . . right or vice versa . . . .'"[92]

Courts are also split between those that examine the nature of the duty violated and those that examine the nature of the loss in order to determine if a cause of action sounds in contract or in tort. West Virginia followed the first approach in *Silk v. Flat Top Construction, Inc.*[93] In *Silk*, a homeowner sued a consultant whom the owner had hired to oversee the construction of a new house.[94] The construction was completed late and at considerably greater expense than agreed to in the contract.[95] The court held that the consultant was liable only in contract, not in tort.[96] The court wrote, "Tort law is not designed . . . to compensate parties for losses suffered as a result

[89] 530 N.W.2d 606 (Neb. 1995).

[90] *Id.* at 613.

[91] 907 P.2d 264, 267 (Utah 1995).

[92] *Id.* at 267 n.2 (quoting RESTATEMENT (SECOND) OF TORTS § 899 cmt. b (1979)).

[93] 453 S.E.2d 356 (W. Va. 1994).

[94] *See id.* at 357-58.

[95] *See id.* at 358.

[96] *See id.* at 360.

of a breach of duties assumed only by agreement.... 'The controlling policy consideration underlying the law of contracts is the protection of expectations bargained for.'"[97] Because the consultant had only violated his contractual duty, and not some common-law duty of care, the plaintiff could sue only in contract.[98]

The second approach was followed by the Maryland Court of Appeals in *United States Gypsum Co. v. Mayor of Baltimore*.[99] In this case, the Mayor and City Council of Baltimore sued a building-materials manufacturer because the materials they had purchased from the manufacturer contained asbestos.[100] The court held that "a purchaser suffering only economic loss because of a defective product will normally be limited to contract causes of action, including breach of implied and express warranties ...."[101] Yet the court allowed a tort action in this case because the defect created "a substantial and unreasonable risk of personal injury."[102] The case hinged on the nature of the injury, not the nature of the duty owed by the manufacturer to the city.

The Texas Supreme Court has also applied this test. In *Jim Walter Homes, Inc. v. Reed*,[103] the plaintiff sued in tort for deceptive trade practices and gross negligence in connection with the faulty construction of a house.[104] In holding that the plaintiff was limited to a suit for breach of contract, the Texas Supreme Court wrote:

> Although the principles of contract and tort causes of action are well settled, often it is difficult in practice to determine the type of action that is brought. We must look to the substance of the cause of action and not necessarily the manner in which it was pleaded.... The nature of the injury most often determines which duty or duties are breached. When the injury is only the

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[97] *Id.* at 360 (citations omitted).

[98] *See id.* at 86; *see also* Department of Natural Resources v. Transamerica Premier Ins. Co., 856 P.2d 766, 772-77 (Alaska 1993) (employing nature of the duty violated test); Ernest F. Loewer, Jr. Farms, Inc. v. National Bank of Arkansas, 870 S.W.2d 726, 727-28 (Ark. 1994) (holding that the test is whether the "gist of the action" sounds in contract or tort); Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460-64 (Cal. 1994) (using same test); Vickers v. Hanover Constr. Co., 875 P.2d 929, 932-33 (Idaho 1994) (employing nature of the duty violated test); Roger v. Dufrene, 613 So. 2d 947, 948 (La. 1993) (applying same test); Hilton Hotels Corp. v. Butch Lewis Prods., Inc., 862 P.2d 1207, 1209-10 (Nev. 1993) (applying nature of the duty test).

[99] 647 A.2d 405 (Md. 1994).

[100] *See id.* at 408.

[101] *Id.* at 410.

[102] *Id.* at 411.

[103] 711 S.W.2d 617 (Tex. 1986).

[104] *See id.* at 617.

> economic loss to the subject of a contract itself, the action sounds in contract alone.[105]

Some courts have attempted to apply both tests simultaneously, without acknowledging that the tests may produce different results. *JBC of Wyoming Corp. v. Cheyenne*[106] dealt with a contractor suing a city and a board of public utilities because the city had not made timely payments under a construction contract. The court rejected the contractor's attempt to add a tort claim, applying both a "nature of the injury" test and a "nature of the duty" test.[107] The court wrote, "Tort recovery based on the contractual relationship should only be allowed where breach constitutes an independent injury over and above disappointment of the plaintiff's expectation interest . . . . [T]ort liability can only be premised on a duty independent of contractual duties."[108]

The Texas Supreme Court also applied both tests in a recent case. In *Southwestern Bell Telephone Co. v. DeLanney*,[109] the plaintiff sued Southwestern Bell for damages resulting from Bell's failure to publish DeLanney's Yellow Pages advertisement.[110] The court applied both the "nature of the duty" test and the "nature of the injury" test in determining that DeLanney's claim sounded only in contract.[111] The court wrote, "In determining whether the plaintiff may recover on a tort theory, it is also instructive to examine the nature of the plaintiff's loss. When the only loss or damage is to the subject matter of the contract, the plaintiff's action is ordinarily on the contract."[112] The court went on to say:

> Bell's duty to publish DeLanney's advertisement arose solely from the contract. DeLanney's damages, lost profits, were only for the economic loss caused by Bell's failure to perform. Although DeLanney pleaded his action as one in negligence, he clearly sought to recover the benefit of his bargain with Bell. We hold that Bell's failure to publish the advertisement was not a tort. Under our analysis in *Reed*, DeLanney's claim was solely in contract.[113]

The court's reference to the source of Bell's duty indicates reliance on the "nature of the duty" test, but the court also explicitly

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[105] *Id.* at 617-18 (citations omitted).
[106] 843 P.2d 1190 (Wyo. 1992).
[107] *Id.* at 1197.
[108] *Id.*
[109] 809 S.W.2d 493 (Tex. 1991).
[110] *See id.* at 493-94.
[111] *Id.* at 494.
[112] *Id.*
[113] *Id.* at 495 (footnote omitted).

stated the "nature of the injury" test.[114] The court did not acknowledge that the two tests might produce different results and did not attempt to state a rule as to which test would govern when they were in conflict.

It is easy to see that the tests might, in fact, produce different results. Suppose Builder contacts Owner and proposes to build an office park on Owner's tract of land. Owner, having heard horror stories about the problems of dealing with inexperienced builders, questions Builder closely as to Builder's experience constructing office parks. Builder assures Owner that she personally has participated in the design and construction of more than a dozen office parks, and that her company, Builders, Inc., has built more than thirty such parks. In fact, Builder has never built a thing in her life, and her company has just been formed three days earlier.

Owner, persuaded by Builder's eloquent testimonial, enters into a contract with Builder to construct an office park on her land. Three years and several million dollars later, the office park is nothing but a gaping hole in the middle of Owner's land. Owner finally researches Builder's background, learns of the deception, and sues Builder for fraud.

Under the "nature of the duty" test, Builder is liable in tort to Owner. Builder's duty to tell the truth was imposed by law, not by the contract to build the park. But under the "nature of the injury" test, Builder is liable only in contract. Owner is suing for her expectancy, the value of the office park had it been built correctly and within budget. These are typical contract damages, so Owner's suit sounds in contract.

Even when courts choose to apply only one of these two tests, they still encounter difficulties. Some cases are easy. For example, if, in the scenario above, Builder had punched Owner in a fit of rage at having been discovered, Owner would surely have a claim in tort. Owner's claim clearly passes both the "nature of the duty" (the law, not a contract, prohibits Builder from hitting people) and the "nature of the injury" (Owner is suing for her pain and suffering and medical expenses as a result of her bloody nose) tests. The contractual relationship between Builder and Owner is irrelevant. When the injury is more closely related to the underlying contract, however, courts often have a tougher time figuring out whether the claim sounds in contract or tort. The torts that present the most difficult cases are bad faith, fraud, and negligence.

[114] *Id.* at 494.

VII. A RECOMMENDATION FOR A DIFFERENT COMMON-LAW TEST

The common-law test may result in less than optimal policy choices because the connection between doctrine and policy is only indirect. The search for an independent tort acts as an imperfect proxy for determining how the policies behind contract damage limitations apply to the types of situations in which various torts arise. For example, as discussed below, the many cases that uphold a tort cause of action for promissory fraud[115]—"a promise to perform made at a time when the promisor has a present intention not to perform"[116]—are misguided.

A better approach would be to determine whether the assumptions underlying the normal contract damage limitations are weakened by the commission of various types of tort-like acts. Courts should examine each of the torts commonly attached to breach of contract actions to determine whether the normal rationale for limiting contract damages applies. When this rationale seems weak for a particular type of "contort," courts should make some or all of the more expansive tort remedies available. This approach represents an improvement over the common-law test because it targets the precise policy question at issue instead of using some rule of thumb whose results only roughly approximate the optimal.

The type of case in which the "contort" arises may also be relevant. For a particular "contort," the assumptions underlying contract damage limitations may be stronger in some contexts than in others. This may be true because of the nature of the parties' relationship, the complexity of the contract, the sophistication of the parties, or because any other trait of a particular case category affects the validity of these assumptions. Because the plaintiff's liability theory already takes into account many of the case's pertinent characteristics, the examination of the case's context will most likely prove to be of secondary importance compared to the nature of the "contort." Nevertheless, a case's context will sometimes prove to be an important "second-level" consideration.

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115 *See, e.g.*, Palm Harbor Homes, Inc. v. Crawford, 689 So. 2d 3, 9 (Ala. 1997); Lusk Corp. v. Burgess, 332 P.2d 493, 495 (Ariz. 1958); Lazar v. Superior Ct., 909 P.2d 981, 985 (Cal. 1996); Abott v. Abott, 195 N.W.2d 204, 209 (Neb. 1972); Sproul v. Fossi, 548 P.2d 970, 972-73 (Or. 1976). *But see* Steinberg v. Chicago Med. Sch., 371 N.E.2d 634, 641 (Ill. 1977) (declining to recognize a cause of action for promissory fraud).

116 BLACK'S LAW DICTIONARY 1214 (6th ed. 1990).

A. Consequential Damages

The *Hadley* rule should be reversed in cases where the promisor, not the promisee, has more information about the promisee's likely consequential damages. The *Hadley* rule forces the promisee to disclose the information that she alone possesses only when it is efficient for her to do so—when the benefits of disclosure from reallocation of the risk outweigh the costs of disclosure. Yet the same principle ought to apply to those cases in which the promisor actually has more information about the promisee's likely consequential damages than does the promisee. This might occur when the promisor is an expert of some sort who knows the likely result of her failure to complete performance.[117]

For example, suppose Owner contracts with Plumber to fix Owner's water heater. Owner knows nothing about water heaters, but she does know that hers is not working properly. Plumber is a water heater expert, and she knows that some water heater malfunctions can eventually cause them to explode. In this hypothetical, it is the promisor, Plumber, who possesses important information about Owner's likely consequential damages from Plumber's failure to perform. Only Plumber knows that if she does not fix the water heater, it may explode, destroying Owner's house. It is true that Owner better knows the house's value and contents, but she has no way of knowing that this information should be disclosed because she is completely unaware that her property is at risk.

Under the *Hadley* contract liability rule, Plumber would probably not be liable for the damaged house. As discussed in Part III.A, unless the promisee has at least notified the promisor of likely unusual consequences of breach, the promisor is only liable for damages that "may reasonably be supposed to have been in the contemplation of *both* parties, at the time they made the contract, as the probable result of the breach of it."[118] Owner probably anticipated that if Plumber failed to fix the water heater, she would suffer a fur-

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[117] Some statements of the foreseeability doctrine in contract law could be interpreted as endorsing this idea. Judge Richard Posner, for example, has written:

> The general principle is that if a risk of loss is known to only one party to the contract, the other party is not liable for the loss if it occurs. This principle induces the party with knowledge of the risk either to take appropriate precautions himself, or, if he believes that the other party might be the more efficient preventer or spreader (insurer) of the loss, to reveal the risk to that party and pay him to assume it.

POSNER, *supra* note 12, at 127.

[118] Hadley v. Baxendale, 9 Ex. 341, 354, 156 Eng. Rep. 145 (1854) (emphasis added).

ther loss of hot water. She may even have contemplated some damage to the water heater itself, but Owner certainly would not have contemplated that her house might be destroyed.[119]

In this situation, we would like to encourage Plumber either to reveal the danger to Owner, so that she may arrange for a backup plumber if necessary, or to take sufficient action to prevent the potential explosion. We can provide Plumber with the proper incentives to do so by making her liable for the consequences of the explosion, that is, the value of the house and its contents, whenever she both fails to prevent the harm and neglects to tell Owner about the danger. The proposed modified *Hadley* rule, making the promisor liable for consequential damages that she was in a better position to anticipate, will achieve this end.

B. *Nonpecuniary Damages*

The assumptions behind the rule barring nonpecuniary damages for breach of contract are weaker when a breach is likely to cause physical injury or when the subject of the contract has great emotional significance, such as a wedding or a funeral.

As discussed in Part IV.B, the primary rationale for refusing to award nonpecuniary damages in breach of contract cases was that such damages are extremely difficult to anticipate or to measure in the typical commercial contract setting. In a business environment, it is usually assumed that people are not emotionally involved in their contracts and so will not suffer emotional distress from a party's nonperformance or misperformance of the agreed-upon terms. Because this assumption will usually turn out to be correct, the cost of investigating the temperament of one's contracting partners in order to take such damages into account would almost certainly outweigh any benefit derived from more accurate breach decisions.

These concerns are reduced when the existence of nonpecuniary damages is more predictable from the outset. Parties entering into contracts that deal with topics of great emotional significance can more easily anticipate the likelihood of emotional distress resulting from their nonperformance. Similarly, a party who enters into a contract where nonperformance is likely to cause personal injury

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[119] Plumber probably would be liable under tort foreseeability rules. As discussed in Part III.A, compensation for tort victims is only limited by what "the most cautious mind" might suspect would result from the tort. *See supra* Part III.A; *see also* Palsgraf v. Long Island R.R., 162 N.E. 99, 101 (N.Y. 1928). In this scenario, "the most cautious mind" would surely have known that defective water heaters sometimes explode, so that Plumber would be liable under tort rules.

should be able to take the potentially injured party's pain and suffering into account as a likely consequence of breach. Under circumstances such as these, when nonpecuniary damages as a result of breach are the norm rather than the exception, the existence of such damages can be easily anticipated and nonpecuniary damages should be included as a remedy for breach.

Even when the existence of nonpecuniary damages is more certain, measuring such damages remains difficult and unpredictable. The measurement problem might be remedied in many cases by including a contract term providing the amount of nonpecuniary damages to be awarded in the event of breach. For some contracts, however, agreeing on the nonpecuniary damage award in advance will not be feasible. It is probably unrealistic to imagine that parties will bother with such terms for contracts that are too small to be negotiated, or where nonpecuniary damages are unexpected by both parties. For these categories of contracts, courts must make an empirical judgment about whether the problems stemming from the unpredictability of the amount of nonpecuniary damages outweigh any distortions in breach decisionmaking that are caused by allowing breaching parties to avoid paying nonpecuniary damages. When nonpecuniary damages are unexpected, it is unlikely that forcing the breaching party to pay for them could have any deterrent effect on future similarly-situated contracting parties. Yet for small contracts where such damages are predictable, the imposition of nonpecuniary damages might well tip the balance away from breach in appropriate cases.

C. *Supercompensatory Damages*

Supercompensatory damages should be awarded for breach of contract in cases where the chances of breach detection are particularly low or where the chances of detection can be calculated with some accuracy.

As explained in Part IV.C, supercompensatory damages are only justified for breach of contract as a method of boosting deterrence where deterrence levels would otherwise be inefficiently low because of uncertain breach detection. The policy against awarding supercompensatory damages in most cases is justified primarily by the difficulty of determining the appropriate number by which to multiply the actual damages in order to calculate the correct amount of punitive damages. This "punitive multiple" will be inversely related to the chance of breach detection. That is, when the chance of breach detection is high, the "multiple" will be low because deterrence will al-

ready be near efficient levels; when the chance of breach detection is low, the "multiple" will be high because too many breachers are able to avoid performance without cost.

When the "punitive multiple" is known to be high but is difficult to calculate with any precision, the award of some supercompensatory damages is warranted. Courts should be conservative in determining the "multiple," both because of the incentive problems caused by high levels of supercompensatory damages and because of the risk of supercompensatory damages being used to punish rather than to deter. But when the "multiple" is known to be high, the risk that the jury or the court will award too much money in supercompensatory damages is lower. Similarly, when it is possible to calculate the "punitive multiple" with a fair degree of accuracy, the risk that too much money will be awarded in supercompensatory damages out of a desire to punish the breacher is reduced. In either circumstance, supercompensatory damages should be awarded to compensate for the weakness in deterrence caused by a less than certain chance of breach detection.

VIII. PRELIMINARY APPLICATIONS OF THE NEW TEST

A thorough analysis of even one of the "borderline" torts would be an appropriate subject for an entire article. In order to illustrate the application of the proposed test, however, this section will (1) briefly examine how the common law has dealt with some of the more commonly raised "contorts" and (2) sketch out an argument based on the proposed test for any appropriate changes.

A. *Bad Faith*

1. Background

The Uniform Commercial Code imposes a duty of good faith and fair dealing on all contracts covered by the U.C.C.[120] Many states also impose the duty on parties to contracts not covered by the U.C.C.[121] The U.C.C. defines "good faith" as "honesty in fact in the conduct or transaction concerned."[122] In most contexts, this duty is

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[120] *See* U.C.C. § 1-203.

[121] *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); *see also* Burton, *supra* note 10, at 369; Perlstein, *supra* note 3, at 890.

[122] U.C.C. § 1-201(19) (1989).

imposed as a nonwaivable contract term, enforceable by normal contract damage rules.[123]

Some courts, in certain contexts, have awarded tort remedies for the breach of the duty of good faith and fair dealing.[124] Courts have most commonly awarded tort damages for a breach of the duty of good faith in cases involving first-party and third-party insurance claims.

The California Supreme Court first recognized that a breach of the duty could be a tort in the insurance context in *Comunale v. Traders & General Insurance Co.*[125] This case dealt with a third-party insurance claim—a suit by someone other than the insurer or the insured, who is not a party to the insurance contract.[126] The court held that the duty of good faith and fair dealing required an insurer to settle with the plaintiff suing the insured whenever it made sense to do so from the insured's perspective.[127] The court awarded the insured tort damages for the insurer's failure to comply with this standard.[128] In *Crisci v. Security Insurance Co.*,[129] the court went even further, suggesting in dicta that an insurer breached the duty of good faith whenever it refused to settle a case against an insured for an amount within the policy limits.[130]

The California Supreme Court extended the tort treatment of breaches of good faith to the first-party insurance context—suits by the insured against the insurer—in *Gruenberg v. Aetna Insurance Co.*,[131] *Silberg v. California Life Insurance Co.*,[132] *Neal v. Farmers Insurance Exchange*,[133] and *Egan v. Mutual of Omaha Insurance Co.*[134] In these cases, the court held that an insurer would be liable in tort whenever it denied an insured's claim that it knew to be valid or denied an insured's claim without an adequate investigation.[135]

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[123] *See* Matthew J. Barrett, "*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, 524 (1985).

[124] *See id.* at 525 & n.89.

[125] 328 P.2d 198, 202 (Cal. 1958).

[126] *See id.* at 200.

[127] *See id.* at 201.

[128] *See id.* at 202.

[129] 426 P.2d 173 (Cal. 1967).

[130] *See id.* at 176-77.

[131] 510 P.2d 1032, 1040 (Cal. 1973) (en banc).

[132] 521 P.2d 1103, 1108-09 (Cal. 1974) (en banc).

[133] 582 P.2d 980, 985-86 (Cal. 1978).

[134] 620 P.2d 141, 144-45 (Cal. 1979) (en banc).

[135] *See* Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141, 144-46 (Cal. 1979) (en banc); *see also Neal*, 582 P.2d at 985 & n.4; *Silberg*, 521 P.2d at 1108-09; *Gruenberg*, 510

Since *Comunale*, many other states have adopted the California Supreme Court's policy of awarding tort damages for breach of the duty of good faith and fair dealing in third-party or first-party insurance contexts.[136] Some states have refused to do so,[137] and others have allowed tort damages for third-party insurance cases but not for first-party claims.[138]

There is a conflict of interest between the insured and insurer that results from the existence of policy limits in insurance contracts. In a third-party insurance case, before trial, the insurer has different incentives to settle the case than does the insured. To illustrate, suppose the plaintiff has a fifty percent chance of winning $2000 at trial and a fifty percent chance of winning nothing. The expected value of the plaintiff's claim is then $1000, and the insurer and insured together should be willing to settle for $1000 or less, assuming all parties are risk-neutral. If the insurance policy has a limit of $1000, however, the insurer's expected payment will be less than the plaintiff's expected value. This is true because if the plaintiff obtains a judgment for $2000, the insurer will only have to pay $1000. As a result, the expected cost of the plaintiff's suit to the insurer is only $500—the probability of the plaintiff winning at trial multiplied by the amount of the judgment for which the insurer is contractually liable. The case may thus go to trial even though, if the insurer's interests were identical to those of the insured, the matter would settle. In this example, if the insurer's and insured's interests were somehow aligned—because the insurance policy contained a higher limit, for instance—both sides should be willing to settle for the case's expected value, $1000.

Proponents of allowing tort damages in the insurance context argue that the insurer is in a quasi-fiduciary relationship with the insured because, in most policies, the insured has agreed to allow the insurer to decide whether to settle or litigate.[139] Such proponents contend that the combination of the quasi-fiduciary relationship, the strong potential for a conflict of interest, and the disparity in information and bargaining power in contracts of adhesion create a "special relationship" between the insurer and its insured.[140] Courts

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P.2d at 1037-38.

[136] *See* Sebert, *supra* note 18, at 1613-14 & n.178.

[137] *See id.* at 1614 & n.179.

[138] *See id.* at 1614-15 & n.180.

[139] *See* Alan O. Sykes, *Judicial Limitations on the Discretion of Liability Insurers to Settle or Litigate: An Economic Critique*, 72 TEX. L. REV. 1345, 1345-46 (1994).

[140] *See* Sebert, *supra* note 18, at 1639-40; *see also* Michael H. Cohen, Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73

have pointed to this special relationship as the rationale for awarding tort damages for a breach of the duty of good faith and fair dealing in insurance contracts.[141]

Some courts have expanded the award of tort damages for breach of the duty of good faith to other contexts where a similar "special relationship" exists, such as employment and banking contracts.[142] In *Wallis v Superior Court*,[143] a California court extended tort damages to employer-employee relationships. That court described "special relationships" as containing five characteristics:

> (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 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.[144]

The court found such a special relationship in the employment context and held that the employer could be liable in tort for violating the duty of good faith.[145]

The tort of breach of good faith was applied in the banking context in *Commercial Cotton Co. v. United California Bank*.[146] In this case, a California court found that a special relationship existed between banks and their depositors that warranted the application of tort damages for breach of the covenant of good faith and fair dealing.[147]

The tort of bad faith breach of contract reached its apex in *Seaman's Direct Buying Service v. Standard Oil*.[148] In *Seaman's*, the California Supreme Court considered and rejected a general tort of bad

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CAL. L. REV. 1291, 1292-93 (1985).

[141] *See* Rawlings v. Apodaca, 726 P.2d 565, 576 (Ariz. 1986) (en banc); *see also* Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141, 146-47 (Cal. 1979) (en banc); Stephens v. Safeco Ins. Co. of Am., 852 P.2d 565, 567-68 (Mont. 1993); Christian v. American Home Assurance Co., 577 P.2d 899, 904-05 (Okla. 1978).

[142] *See* Cohen, *supra* note 140, at 1298-99.

[143] 207 Cal. Rptr. 123 (Ct. App. 1984).

[144] *Id.* at 129.

[145] *See id.* at 129-30.

[146] 209 Cal. Rptr. 551 (Ct. App. 1985).

[147] *See id.* at 554.

[148] 686 P.2d 1158 (Cal. 1984) (en banc), *overruled by* Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669, 679-80 (Cal. 1995).

faith breach of contract.[149] The court, however, did recognize a tort of bad faith denial of the existence of the defendant's liability under a contract.[150] In a separate opinion, Chief Justice Byrd wrote that a breach of a normal commercial contract could be tortious if the parties did not reasonably expect that the contract would be breached.[151] *Seaman's* was generally criticized by both judges and scholars,[152] and was eventually overruled in *Freeman & Mills, Inc. v. Belcher Oil Co.*[153]

Indiana courts have gone even further than California, apparently adopting the position that even ordinary breaches of contract can be tortious.[154] For example, in *F.D. Borkholder Co. v. Sandock*,[155] the court found a construction contractor liable for punitive damages for the contractor's intentional failure to follow certain elements of the owner's plans, thereby creating defects that were difficult to detect.[156] Although the contractor's conduct did not amount to fraud or misrepresentation, the court justified the award of punitive damages by referring to the contractor's fraudulent practice.[157] As a rule, the Indiana courts allow plaintiffs to receive punitive damages for breach of contract "'whenever the elements of fraud, malice, gross negligence or oppression mingle in the controversy.'"[158] This amounts to an award of tort damages for bad faith breach.[159]

2. Analysis

The cases awarding tort damages for bad faith breach of contract are misguided. None of the contexts in which tort damages have been awarded for bad faith breach contain elements that would indicate that the justifications for limiting contract damages are weakened.

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[149] *See Seaman's*, 686 P.2d at 1166-67.

[150] *See id.* at 1167.

[151] *See id.* at 1174-75 (Byrd, C.J., concurring in part and dissenting in part).

[152] *See Freeman & Mills*, 900 P.2d at 677-79.

[153] 900 P.2d 669, 679-80 (Cal. 1995).

[154] *See* Sebert, *supra* note 18, at 1629-33.

[155] 413 N.E.2d 567 (Ind. 1980).

[156] *See id.* at 568, 570.

[157] *See id.* at 570.

[158] Hibschman Pontiac, Inc. v. Batchelor, 362 N.E.2d 845, 847 (Ind. 1977) (quoting Vernon Fire & Cas. Ins. Co. v. Sharp, 349 N.E.2d 173, 180 (Ind. 1976) (quoting Taber v. Hutson, 5 Ind. 322, 325 (Ind. 1854) (citation omitted))).

[159] *See* Sebert, *supra* note 18, at 1632.

a. Commercial Insurance Contracts[160]

Commercial insurance contracts are generally negotiated, so the transaction cost of disclosing additional information about likely consequential damages is low. The low cost of transferring information makes the *Hadley* rule cheap to apply. The *Hadley* rule seems particularly necessary in a commercial insurance context because the consequential damages of breach are likely to be quite high. As a result, without the *Hadley* rule, the insured would have a large incentive to understate the magnitude of the expected damages in order to avoid paying a premium to the insurer for absorbing an unusually large risk.

The cost of acquiring information without voluntary disclosure in a commercial insurance context is likely to be high because the businesses involved can be large and complicated. Without the *Hadley* rule, the insurer would bear large research costs when it attempts to discover the insured's expected consequential damages despite the insured's attempts to hinder this effort. The *Hadley* rule lowers the social costs of these transactions by inducing the insured to cooperate by disclosing the expected consequences of the insurer's breach.

The award of nonpecuniary damages would be inappropriate in commercial insurance cases. The normal expectation in a business context is that emotions are not heavily involved in the transaction. Awarding emotional distress damages would force parties to be much more careful in choosing transaction partners. In order to avoid the uncertainty and potentially large liability for emotional distress damages, parties would have an incentive to do business only with those who are unusually calm and emotionally detached from the transaction.

In insurance cases, breaches should be easily detectable. In a first-party situation, the insured should certainly know whether or not she received an insurance settlement. In the third-party context, most commercial insureds can be expected to monitor the litigation closely enough to be aware of settlement offers and to be aware of the ultimate outcome of the suit. Accordingly, there seems little reason to award supercompensatory damages for insurance cases.

[160] The analysis might be somewhat different in the non-commercial context, a topic not addressed in this article.

b. Employment Contracts

In the employment context, the cost of disclosing the magnitude of unusually large expected consequential damages is likely to be quite high. Particularly for long-term employment contracts, the consequences of breach will probably change a great deal over time, necessitating frequent updating and renegotiation. As a result, it is very unlikely that the promisee will disclose the consequences of breach without a strong incentive to do so.

The *Hadley* rule provides such an incentive. The employee will bear the cost of disclosure if the resulting benefits from shifting the risk to the employer are sufficiently great. Because the cost of disclosure is so high, the result of applying the *Hadley* rule may be that no disclosure occurs and the employer is simply not liable for consequential damages. If this does occur, however, it will be because the cost of disclosure is greater than the gains of trade from having the employer bear the risk. Under these circumstances, it is socially desirable for the employee to bear the risk of her own consequential damages. Hence, the *Hadley* rule produces the efficient result.

Employees can frequently be expected to suffer emotional distress damages from being wrongfully terminated, yet all the reasons for excluding nonpecuniary damages from contract disputes are present in full force in employment cases. Typically, the plaintiff will be an injured, distressed individual suing a relatively wealthy and frequently impersonal corporate employer. This situation is a recipe for runaway jury verdicts and "back-door" awards of punitive damages. As explained above, the normal contract damage limitations should apply unless there is an unusual, compelling reason to award emotional distress damages or unless there is some element in a particular category of cases—for example, employment cases—that would protect against the dangers of awarding nonpecuniary damages.

Breach detection should be fairly easy in these cases. The employee will obviously be aware of her termination and will be highly motivated to search for a contract violation. Employers may sometimes be able to cloak an illegal reason for termination behind a superficially valid rationale, but it seems safe to assume that most contract breaches will be detected. If this assumption is correct, supercompensatory damages should not be awarded. Also, as explained above, the danger in this context of "back-door" punitive damage awards should make us especially reluctant to give the jury much discretion in awarding damages.

c. Bank Deposit Contracts

The arguments against tort damages in the bank deposit arena are largely the same as in the employment context. Again, the contract is likely to be long-term, making disclosure of consequential damages expensive and unlikely to occur, but also socially undesirable. Nonpecuniary damages are likely to be lower than in the employment context, since there are no ego issues of job performance involved. In addition, the same concerns about juries attempting to redistribute income from a wealthy corporate defendant to a relatively poor individual plaintiff argue against allowing either nonpecuniary damages or supercompensatory damages. Finally, to the extent consumers examine their monthly statements, the rate of breach detection should be high.

d. Bad Faith Denial

Assigning tort liability for bad faith denial of the existence of, or the defendant's liability under, a valid contract is also problematic. There is no particular reason to believe that the *Hadley* rule will fail to induce the promisee to disclose the efficient level of information, taking into account the possibility that the contract will not only be breached, but also denied. It is unlikely that parties would bargain about who would bear the consequences of a denial of the contract's existence by one of them. But the consequences of denying the contract's existence would be virtually identical to the consequences of any other complete contract breach, and the parties would be expected to negotiate about the risks of a complete breach.

The promisee may be particularly outraged that the promisor is denying the very existence of the contract. But this factor alone is insufficient to justify awarding nonpecuniary damages. The absence of any objective limitation on the jury's discretion, together with the absence of any factor indicating that nonpecuniary damages are particularly justifiable in these cases, weighs against allowing emotional distress damages for bad faith denial of a contract's existence.

There is no reason to suppose that the plaintiff will remain unaware of the defendant's wrongful denial of the contract's existence. The plaintiff clearly knows whether the contract exists, and the defendant's refusal to comply with the contract's terms should provide more than adequate notice to the plaintiff that the defendant is in breach. Since the chances of detection are relatively certain in this context, there is no compelling reason to award supercompensatory damages.

e. Bad Faith Breach

The tort of pure bad faith breach of contract, as enforced by Indiana courts, should not be recognized. As explained in Part IV, there are valid reasons for the traditional limits on contract damages. Awarding tort damages for every breach of contract that was somehow committed in "bad faith" circumvents usual damage limitations without any resulting economic justification. Whether the promisor's reason for breach was that she believed the breach was efficient or that she wanted to harm her contracting partner makes no difference. It is only when the particular type of breach contains factors that undermine the reasons for the usual limits on contract damages—such as when the nature of the breach renders the *Hadley* rule inadequate for consequential damages, when the breach is unusually likely to produce large nonpecuniary damages, or when the breach is particularly difficult to detect—that tort damages should be awarded. A general rule allowing tort damages whenever the court perceives some amorphous quality such as "bad faith" invites uncertainty and inhibits commerce without a counterbalancing economic benefit.

B. Fraud

1. Background

Fraud may sound in either tort or contract.[161] According to Keeton, the elements of fraud in tort are:

> 1. A false representation made by the defendant. In the ordinary case, this representation must be one of fact.
>
> 2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. This element often is given the technical name of "scienter."
>
> 3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
>
> 4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
>
> 5. Damage to the plaintiff, resulting from such reliance.[162]

The elements of fraud in contract are the same, except that the plaintiff need not show fault; honest misrepresentation is sufficient for liability.[163]

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[161] *See* KEETON ET AL., *supra* note 2, § 105, at 727-28.
[162] *Id.* at 728 (footnotes omitted).

The vast majority of courts also award tort damages against defendants who commit promissory fraud by making promises without the present intent to perform.[164] Courts require more than the mere breaking of a promise to find promissory fraud,[165] but a confession is not required. Promissory fraud can be found based on the surrounding circumstances of the promise,

> such as the defendant's insolvency or other reason to know that he cannot pay, or his repudiation of the promise soon after it is made, with no intervening change in the situation, or his failure even to attempt any performance, or his continued assurances after it is clear that he will not do so.[166]

Promissory fraud is distinguished from fraudulent misrepresentation, which consists of a "false statement as to material fact, made with intent that another rely thereon, which is believed by other party and on which he relies and by which he is induced to act and does act to his injury . . . ."[167]

Within the broad category of fraud, courts generally distinguish between casually acquired information—information that is obtained without incurring costs specifically targeted at the attempt to learn something new—and deliberately acquired information—information that is obtained only after bearing costs aimed at the quest for the new knowledge.[168] Courts are more protective of a party's right to keep secret any information the party has expended effort to discover.[169] Parties, however, are not permitted to lie even about deliberately acquired information; they may keep the information secret, but they may not actively mislead other parties.[170]

2. Analysis

a. Promissory Fraud

Awarding tort damages for promissory fraud is unwise. While the promisor might appear more deserving of punishment from a moral standpoint because of the deceptive nature of the breach, there are no economic justifications for awarding greater damages.

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163 *See id.* at 729.

164 *See* KEETON ET AL., *supra* note 2, § 109, at 763.

165 *See id.* at 764-65.

166 *Id.* at 765 (footnotes omitted).

167 BLACK'S LAW DICTIONARY 662 (6th ed. 1990).

168 *See* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1, 13, 18, 33 (1978).

169 *See id.*

170 *See* POSNER, *supra* note 12, at 109-13.

The fact that the promisor does not intend to keep her promise should not affect the operation of the *Hadley* rule. Since the promisee is unaware of the promisor's intentions at the time of contract formation, the promisee should retain efficient incentives to disclose the appropriate level of information regarding unusually large consequential damages from breach.

The egregious nature of the promisor's breach may produce some emotional distress in the promisee. But the increase in emotional harm over a typical contract breach should not be great in most cases. In the absence of some objective measure of the extent of emotional damage or some factor making nonpecuniary damages more predictable as a consequence of breach, nonpecuniary damages should not be awarded in contract cases.

The promisor might have some advantage in avoiding breach detection that stems from her knowledge from the outset that she would not perform. The level of breach detection, however, depends primarily on the nature of the breach, not when it was planned. Supercompensatory damages should only be awarded when the particular type of breach indicates significant uncertainty in detection. Promissory fraud in and of itself says very little about the chances of breach detection and thus does not justify the award of supercompensatory damages.

b. Fraudulent Misrepresentation

Holding defendants liable in tort for concealing casually acquired information or misrepresenting deliberately acquired information makes sense. The nature of the tort justifies supercompensatory damages and expanded consequential damages. If a court's only choice is to allow a suit to sound in contract or in tort, these cases should sound in tort. If, however, a court is allowed to pick and choose among the various elements of tort damages instead of awarding all of the tort remedies or none at all, the court should award supercompensatory damages and expanded consequential damages, not nonpecuniary damages.

The *Hadley* rule can only induce the promisee to disclose her unusually high expected consequential damages if the promisee herself knows what they will be. When the promisor has misrepresented the situation to the promisee, the promisee will often be unable to predict accurately the consequences of the promisor's breach. For this reason, the *Hadley* rule will not be effective. The next-best option is for the promisor to use her lesser knowledge of the promisee's business affairs to estimate the likely consequential damages

and to take these into account when deciding whether to breach. To force the promisor to internalize the promisee's damages, the promisor must be made liable for the full consequential damages of breach.

Ideally, nonpecuniary losses should not be awarded. Fraudulent misrepresentation is not like a personal injury or wrongful death claim, in which emotional harm can be expected to be very large. Nonpecuniary damages should not be awarded because there is nothing in a misrepresentation claim to provide objective guidance to the factfinder in setting the magnitude of the damages.

Supercompensatory damages should be allowed for fraudulent misrepresentation claims. The nature of the tort makes breach detection more difficult, because the promisee may never discover the true facts surrounding the contract. For example, a computer retailer may have told the owner of a small business that the model the retailer was selling was state of the art. The retailer charged the consumer a price appropriate to a cutting-edge computer. In fact, the model the retailer sold was three years old, putting the computer on the verge of being out of date. Unless the owner has a friend or relative with computer expertise, she may never learn that the machine is not state of the art and that she was badly overcharged. The lower chances of detection in fraudulent misrepresentation cases justify supercompensatory damages.

C. *Negligence*

1. Background

Simple nonperformance of a contract, or nonfeasance, will normally produce only contract liability.[171] But misfeasance—performing a contract negligently—can sometimes result in tort liability.[172] According to Keeton:

> [T]he American courts have extended the tort liability for misfeasance to virtually every type of contract where defective performance may injure the promisee .... The principle which seems to have emerged from the decisions in the United States is that there will be liability in tort for misperformance of a contract whenever there would be liability for gratuitous performance without the contract—which is to say, whenever such misper-

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[171] *See* KEETON ET AL., *supra* note 2, § 92, at 657.

[172] *See id.* at 660-62.

formance involves a foreseeable, unreasonable risk of harm to the interests of the plaintiff.[173]

As explained above in Part VI, courts often have difficulty distinguishing between tort and contract negligence actions and have developed different tests for distinguishing between them. One test looks to the nature of the injury while another focuses on the nature of the duty that was violated.[174]

There are also situations in which complete nonperformance can result in tort liability. Some contracts create an affirmative duty of care that, when violated, produces tort liability.[175] The typical example is a bailment contract, in which the bailee, under some circumstances, "may be liable in tort for failure to take ordinary precautions" to protect the bailed goods.[176]

2. Analysis

Contracts breached through a party's negligence should be treated no differently from contracts breached purposefully. The common law's focus on the distinction between misfeasance and nonfeasance as a basis for determining whether a suit sounds in contract or tort is unwarranted. A party breaches a contract through negligence because she has failed to take "due care" by deciding to invest too little in performance.[177] If she had invested more—by hiring more highly skilled workers, for example—she would not have been negligent and the contract would not have been breached. A party breaches through her nonperformance because she has decided not to invest in performance at all. Thus, nonperformance is merely an extreme case of inadequate investment in performance. There is nothing particularly unique about a decision to invest something in performance, even if not enough, that would warrant imposing a greater penalty than for breach through complete nonperformance.

This is not to say that tort damages should never be available for breach of contract suits involving negligence. As explained in Part

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[173] *Id.* at 660-61 (footnotes omitted).

[174] *See supra* Part VI.

[175] *See* KEETON ET AL., *supra* note 2, § 92, at 663-64.

[176] *See id.* at 663.

[177] *See* Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revised Case for Enterprise Liability*, 91 MICH. L. REV. 683, 693 (1993); *see also* Jason S. Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 COLUM. L. REV. 1385, 1392 (1987); Warren F. Schwartz, *Objective and Subjective Standards of Negligence: Defining the Reasonable Person to Induce Optimal Care and Optimal Populations of Injurers and Victims*, 78 GEO. L.J. 241, 244-45, 254-55 (1989).

VII, there are situations in which tort damages should be available for breach of contract. The common law's allowance of tort remedies for breaches of contract likely to involve personal injury, for example, makes a certain amount of sense. As argued in Part VII.B, nonpecuniary damages should be available in breach of contract cases when it was apparent at the time the contract was formed that personal injury was a likely consequence of breach. This statement is as true for cases involving negligent breach of contract as it is for cases involving purposeful breach.

Other elements of the tort remedies, such as punitive damages and expanded consequential damages, may or may not be appropriate in such cases, depending on the particular circumstances. Courts should not feel the need to choose between granting all the tort remedies or none; each element of tort damages should be awarded as appropriate in each type of case, using the reasoning process outlined above.

IX. CONCLUSION

This article examines one aspect of the "border" area between contract and tort—when it is possible to sue in tort for breach of contract. The article proposes a framework for deciding when tort remedies should be available for breaches of contract, focusing on the economic justifications for limitations on tort damages in contract actions and examining when those justifications are weakened in particular contexts. After analyzing a few of the more common "contorts," the article concludes that bad faith breach suits should sound in contract, tort remedies should be available for some types of fraud actions, and breaches of contract involving negligence should be analyzed in the same way as purposeful breaches.