TACIT AGREEMENT AND RELATIONSHIP-SPECIFIC INVESTMENT

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Default rules of contract law permit recovery of consequential damages for breach when the breaching party had "reason to know" of those damages at the time of contracting. It is a common observation that sophisticated parties systematically bargain out of these default rules, since the scope of consequential damages is highly uncertain and largely within the control of the non-breaching party. Nevertheless, some parties retain the default rules, and some contracts involving sophisticated actors contain an explicit provision allowing consequential damages, including lost profits, for breach. In effect, these parties satisfy the test that awards consequential damages only when there has been "tacit agreement" to their recovery. That test, which has been repudiated by commentators and most case law outside of New York, limits recovery of consequential damages more severely than the standard "reason to know" test. In this Article, I examine contracts that include explicit "lost profits" clauses and cases in which courts have determined whether parties either tacitly agreed to or had reason to know of prospective lost profits. I claim that the relevant contracts and cases reveal that consequential damage clauses are used to solve a contracting problem that might otherwise frustrate mutually beneficial exchange. Parties and courts have perceived that a commitment to pay lost profits can diminish the threat of opportunistic behavior that is inherent where one party must make a relationship-specific investment prior to performance by the counterparty. In transactions with those characteristics, the investing party risks holdup by its counterparty between the period when the initial investment is made and when the second party must act. I suggest that a commitment to pay lost profits in the event of breach constrains the threat of holdup, and that in these circumstances the value of the promise compensates for the efficiency loss otherwise inherent in assigning consequential damages to the party least able to avoid them. While a pledge of lost profits in the event of breach is not the exclusive response to this holdup problem, it is a plausible and perhaps superior means of avoiding it. I conclude that the combination of near-universal opt-out of the default rule for consequential damages and the explicit adoption of a broad consequential damages clause in investment cases indicates that the "tacit agreement" test may be more consistent with the preferences of commercial parties for a contract default rule than the "reason to know" test.

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Introduction: Consequential Damages and Their Disclaimer

Contract law traditionally limits recovery for consequential damages to losses foreseeable at the time of contracting. Traditional contract doctrine gauges "foreseeability" by what "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."[1] Contemporary compilations of contract law equate "contemplation" with an objective standard, and thus include within the realm of foreseeability that which a reasonable person would understand to be a "natural" consequence of the breach. The Restatement (Second) of Contracts denies recovery of a loss "that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made," [2] and defines as foreseeable a loss that follows from the breach "in the ordinary course of events," or "as a result of special circumstances . . . that the party in breach had reason to know."[3] The Uniform Commercial Code (U.C.C.) permits buyers to recover consequential damages for any loss resulting from unavoidable "general or particular requirements and needs of which the seller at the time of contracting had reason to know."[4]

Contemporary law-and-economics discussions of consequential damages tend to accept this default rule as a given and focus on the information-forcing qualities of the foreseeability restriction.[5] Yet the

[1] Hadley v. Baxendale, (1854) 156 Eng. Rep. 145, 151; 9 Ex. 341, 354.

[2] Restatement (Second) of Contracts § 351 (1981).

[3] *Id.* § 351(2).

[4] U.C.C. § 2-715(2)(a) (2002).

[5] *See* Barry E. Adler, *The Questionable Ascent of* Hadley v. Baxendale, 51 Stan. L. Rev. 1547, 1548 (1999) (framing consequential damages as a question of which party bears the contracting burden); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 108–18 (1989) (explaining that information asymmetries complicate the establishment of efficient default

same literature takes as its operating assumption the proposition that contractual default rules should reflect the preferences that most commercial parties would share in similar circumstances.[6] Failure to draft such rules will induce parties to expend resources transacting around the defaults in a way that does not alter the substance of the ultimate bargain, and may cause parties to assign the contract a lower value than if their preferred term had been available for silent incorporation into the bargain.

On this understanding, the default rules of the Restatement and the U.C.C. that permit recovery of foreseeable consequential damages make sense only if they reflect the terms to which most parties would have agreed. But most contracts literature assumes that commercial parties systematically contract out of consequential damages entirely. Commentators suggest that "consequential damage exclusions are ubiquitous" among sophisticated commercial actors, notwithstanding that the foreseeability doctrine already limits the scope of liability.[7] Brief reflection indicates why this would be the case. Foreseeability, defined in terms of "reason to know," is a notoriously indefinite doctrine, particularly where a third-party arbiter must determine from hindsight what was foreseeable at the time of contracting. To the extent that foreseeability relates only to type of damages rather than to amount, even a party aware that its breach will cause consequential damages of a particular type, such as lost profits, could be uncertain about the extent of its exposure and thus be unable to calculate optimal investments in precautions against breach.[8]

rules); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 609–11 (1990) (describing the *Hadley* rule as information forcing).

[6] *See, e.g.*, Clayton P. Gillette & Robert E. Scott, *The Political Economy of International Sales Law*, 25 INT'L REV. L. & ECON. 446, 455–58 (2005) (discussing criteria for drafting socially optimal default terms); Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 321 (1985) (stating that contractual regulations best suit parties with conventional goals and methods of expression).

[7] Alan Schwartz & Robert E. Scott, *Market Damages, Efficient Contracting, and the Economic Waste Fallacy*, 108 COLUM. L. REV. 1610, 1612 (2008); *see* Douglas G. Baird, *The Boilerplate Puzzle*, 104 MICH. L. REV. 933, 940 (2006) (explaining that consequential damage disclaimers may represent sensible risk allocation); Richard Danzig, Hadley v. Baxendale*: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249, 281 (1975) (stating that large-scale entrepreneurs, "[a]lmost without exception," contractually limit liability); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105, 108 (1989) (observing that most contractual provisions limit consequential damages); Donald J. Smythe, *Commercial Law in the Cracks of Judicial Federalism*, 56 CATH. U. L. REV. 451, 490–91 (2007) (stating that sophisticated manufacturers typically exclude consequential damages to the extent permissible).

[8] *See, e.g.*, Sun-Maid Raisin Growers of Cal. v. Victor Packing Co., 194 Cal. Rptr. 612, 615–17 (Ct. App. 1983) (finding the possibility of disastrous rains significantly increasing

Moreover, the extent to which consequential damages will materialize typically lies within the control of the aggrieved party. That party controls the degree to which it will rely on the contract to make investments that might founder in the event of breach and has better information about the benefits it anticipates receiving from full performance. Full compensation for breach thus induces overinvestment in the contract in a manner that a weapon as blunt as the mitigation doctrine may not sufficiently constrain.[9] If the aggrieved party can protect against these losses more easily than the breaching party, then rational parties would allocate the risk to the former.

But if the Restatement and U.C.C. default rules that permit recovery of foreseeable consequential damages are so inconsistent with the preferences of commercial parties that they are willing to contract around them, then it is the general default of awarding consequential damages, rather than the foreseeability limitation, that begs for explanation. Perhaps some rationale can be found in those few cases in which sophisticated commercial actors do *not* exclude consequential damages. Notwithstanding the claims of ubiquitous exclusion, some sophisticated commercial parties do not disclaim consequential damages. Contracts without disclaimers fall into two categories: (1) those in which the parties are silent about consequential damages and (2) those in which the parties restate the default. Silence may indicate intent to incorporate the defaults of the Restatement and the U.C.C. But some of these contracts may represent exceptions to "ubiquitous" exclusion only in a formal sense, since failure to bargain away from consequential damages may reflect the stickiness of the default rather than a preference for it.[10] Given the low probability of breach, and judicial discretion over the award of lost profits as consequential damages, even sophisticated parties may retain the default.[11]

The acceptance of consequential damages as a matter of contract design is clearer in a second category of non-exclusion cases, in which parties not only fail to opt out of the default, they explicitly provide

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the market price of raisins foreseeable as a matter of law and affirming full award of lost profits).

[9] On overinvestment, see, for example, Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CALIF. L. REV. 1432 (1985), William P. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39 (1984), and Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980).

[10] *See, e.g.*, Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006).

[11] *See* RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1981) (providing that courts may limit damages where "justice so requires in order to avoid disproportionate compensation").

for it, including lost profits. By restating the default, these parties arguably signal courts to impose liability for consequential damages even when judicial discretion might otherwise limit their recovery. The open-ended exposure created by such clauses indicates that parties who agree to them are not treating the clause as a simple option, such as a termination fee or liquidated-damage clause. Rather, because the breaching party's liability is not finally determinable at the time of breach, including an express consequential-damages clause appears to invite both the overreliance and inefficient risk allocation that excluding consequential damages purports to avoid. Nevertheless, the explicit nature of these clauses implies that some parties believe that the promise to pay consequential damages in the event of breach maximizes the value of the contract. That possibility suggests that cases in the first category—parties that fail to opt out of the default—may reflect a similar preference, though embodied in tacit rather than explicit agreement. That is, the absence of exclusion may signify not inattention or the stickiness of the default, but instead an affirmative desire to permit recovery of consequential damages in the event of breach.

In this Article, I explore the circumstances under which sophisticated parties commit to payment of lost profits as consequential damages in the event of breach. I claim that both the contracts in which parties expressly allow lost-profit recoveries and the cases that interpret the scope of what the parties "contemplated" reveal that a promise to pay consequential damages can solve a holdup problem that might otherwise frustrate mutually beneficial exchange. I infer that parties and, perhaps more controversially, courts have perceived that a commitment to pay lost profits can diminish the threat inherent in transactions that require one party to make a relationship-specific investment—an investment that, once made, cannot readily be utilized in an alternative transaction—before the other party is obligated to invest in the same transaction.[12] In transactions with those characteristics, the investing party risks exploitation by its counterparty after the initial investment is made. I suggest that a pledge to pay consequential lost profits in the event of breach reduces the threat of holdup. As a result, in a discrete set of circumstances the promise has value in excess of its cost, including the cost otherwise inherent in assigning

12 I adopt here Klein's broad conception of holdup that does not require any deception or obfuscation, but only a change in market conditions not specified by the contract such that "reputational capital is insufficient to prevent one transactor from taking advantage of these circumstances . . . ." Benjamin Klein, *Asset Specificity and Holdups*, *in* THE ELGAR COMPANION TO TRANSACTION COST ECONOMICS 120, 124–25 (Peter G. Klein & Michael E. Sykuta eds., 2010).

consequential damages to the party less able to avoid them. While a pledge of lost profits in the event of breach is not the exclusive response to this holdup problem, it is a plausible, and perhaps superior, means of avoiding it.

Moreover, if relationship-specific investment is sufficiently salient, then it may be possible to fashion a default rule for consequential damages that is more consistent with majoritarian preferences. Salience would permit courts more accurately to distinguish between situations in which the parties had reason to allocate the risk of consequential damages to a breaching party—who had tacitly agreed to their payment—and situations in which there seems little commercial reason for parties to have adopted the default rule. Under the latter circumstances, courts attentive to the majority practice of opting out and to the negative effects of the minority default might exercise greater discretion to exclude consequential damages under the nebulous standard of foreseeability or under other restrictions on the recovery of lost profits, such as the need to demonstrate them with reasonable certainty. But recognition of the limited circumstances in which parties would allocate the risk of lost profits to the breaching party also suggests a different rule when those circumstances materialize. Indeed, such a rule lurks in the history of consequential damages in the guise of the much-maligned "tacit agreement test," which allows recovery only of consequential damages for which the breaching party has accepted liability.

In the next part of this Article, I examine the move away from the tacit agreement test and toward the "reason to know" standard for recovery of lost profits as consequential damages. [13] In Part III, I discuss the relationship between optimal investment and holdup, and contractual mechanisms for overcoming the latter. Part IV reviews contracts in which the parties expressly assign responsibility for lost profits to the breaching party. I find that those contracts

[13] I use "lost profits" to refer only to those that constitute consequential damages. The distinction between direct or general and consequential damages is confusing and contested. Typically, direct lost profits refer to profits that the nonbreaching party would have received from payments by the breaching party, while consequential lost profits refer to profits that the non-breaching party would have earned from third parties had the breach not occurred. In this Article I am concerned only with the latter, while recognizing that courts may differ on the definition. For efforts at classification, see *Lewis Jorge Construction Management Inc. v. Pomona Unified School District*, 102 P.3d 257, 261 (Cal. 2004), which distinguishes general or natural losses from special or derivative losses, and *Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc.*, 487 F.3d 89, 109 (2d Cir. 2007), which distinguishes consequential damages, or loss of collateral profits, from general damages, or lost payment from the breaching party.

systematically allow recovery of lost profits by a party who is required to make relationship-specific investments.

In Part V, I return to the case law. Cases from New York, which has stubbornly resisted the broad "reason to know" interpretation of consequential damages in favor of the tacit agreement test, suggest that courts infer tacit agreement from contracts that are silent with respect to consequential damages only where the non-breaching party is required to make a relationship-specific investment. Of course, it is plausible that courts in "reason to know" jurisdictions arrive at similar results. They might conclude that parties had "reason to know" of consequential damages only where the transaction required unique investment. If that is the case, then the "reason to know" standard would not necessarily be less hospitable to relationship-specific investment than the tacit agreement test. I therefore examine cases from a "reason to know" jurisdiction to see whether there exists a pattern of awarding lost profits only where such investments are present.

II
The Demise of "Tacit Agreement"

A. Globe Refining *and Its Detractors*

I noted above that contemporary compilations of contract law permit recovery of consequential damages within the contemplation of the breaching party, measured either by virtue of what a reasonable person would have anticipated or by virtue of some special circumstances of which the breaching party had reason to know at the time the contract was executed. Parties cannot recover for consequences unforeseen at the time of contracting, but they can recover for foreseeable consequences of breach even if the breaching party neither explicitly nor impliedly intended to assume them.

It was not always thus. Discussions of consequential damages customarily derive from the restriction in *Hadley v. Baxendale* that limited liability to "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."[14] Some earlier interpretations of *Hadley*'s obtuse "contemplation of both parties" test limited consequential damages, and lost profits in particular, to those that were deemed "foreseeable" by virtue of the breaching party having expressly or tacitly agreed to bear their risk rather than merely having "reason to know" of their materialization. In American law, the common source for that proposition has been Justice Holmes's

[14] Hadley v. Baxendale, (1854) 156 Eng. Rep. 145, 151; 9 Ex. 341, 354.

opinion in *Globe Refining Co. v. Landa Cotton Oil Co.*[15] In that case, the plaintiff brought an action for breach of a contract to sell crude oil.[16] The trial court dismissed the claim on the grounds that it did not involve the requisite jurisdictional amount, thus upholding the defendant's contention that the plaintiff inflated damages for jurisdictional purposes.[17] The plaintiff alleged a variety of special damages that it had suffered as a consequence of the breach.[18] If recoverable, these amounts—added to admittedly recoverable damages—would presumably have satisfied the requisite jurisdictional amount.[19] Finally, the plaintiff alleged that the likelihood that it would suffer the special damages in the event of breach "was known to defendant, and in contemplation of the contract"[20]—a claim consistent with the broad "reason to know" interpretation of *Hadley*.

Rather than opining on the propriety of using "special damages" to satisfy procedural requirements, Holmes delivered a lecture on substantive contract law. The plaintiff contended that it suffered losses related to (1) its commitments to a third-party railroad, (2) transportation of tank cars that could otherwise have been used to obtain oil from other sources, (3) the loss of use of tank cars, (4) lost profits and loss of reputation from the inability to comply with downstream contracts, and (5) additional freight costs incurred to obtain oil from other sources.[21] Holmes disagreed that the plaintiff's alleged losses, even if true, satisfied the "contemplation" requirement. Recoverable damages were limited to those "the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made."[22] This followed from Holmes's conception of contract as a means by which each party takes the risk "of an event which is wholly or to an appreciable extent beyond his control."[23] The willingness to take a contractual risk was necessarily contingent on one's exposure should the risk materialize. Thus, when one decides to enter a contract, "[t]he extent of liability . . . is likely to be within his contemplation," so that a reasoned decision about whether to take the related risk can be made.[24] The question to be asked, therefore, was whether the plaintiff

15 190 U.S. 540 (1903).
16 *Id.* at 540–41.
17 *Id.* at 541.
18 *Id.* at 541–43.
19 *Id.* at 547.
20 *Id.* at 542–43.
21 *Id.*
22 *Id.* at 544.
23 *Id.* at 543.
24 *Id.*

had demonstrated "that the consequences were in contemplation of the parties in the sense of the vendor taking the risk."[25] "Contemplation" did not entail what a reasonable person would foresee as the consequence of the breach. Rather, it meant what the breaching party explicitly agreed to bear as damages or, where the contract was silent, "terms which it fairly may be presumed he would have assented to if they had been presented to his mind,"[26] since "a person can only be held to be responsible for such consequences as may be reasonably supposed to be in the contemplation of the parties at the time of making the contract."[27] Allowing recovery for consequences known to but not assumed by the breaching party would permit the aggrieved party "to obtain an advantage which he has not paid for."[28] Implicit in Holmes's analysis is the understanding that parties will assume liability only to the extent that they can price into their contracts a premium that reasonably reflects the expected value of the risk to which they are exposed.

Subsequent developments have not been kind to Holmes. His standard was consistent with earlier developments in English law.[29] But even before *Globe Refining*, courts had adopted the broader test for liability now reflected in the Second Restatement and U.C.C. formulations. For instance, a widely cited nineteenth-century New York case permitted recovery of lost profits for breach without any demonstration of a tacit agreement because "[m]ost contracts are entered into with the view to future profits, and such profits are in the contemplation of the parties." [30] Notwithstanding occasional support for Holmes's efforts to tie contract damages to the intent of the parties, [31] the "tacit agreement" test has fallen into disrepute. One recent

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[25] *Id.* at 544.

[26] *Id.* at 543.

[27] *Id.* at 544 (internal quotation marks omitted).

[28] *Id.* at 545 (quoting B.C. & Vancouver's Island Spar, Lumber & Saw-Mill Co. v. Nettleship, [1868] 3 L.R.C.P. 499 at 500 (Eng.)).

[29] *See Nettleship*, 3 L.R.C.P. at 509 (finding consequential damages only where knowledge of the special circumstances is "brought home to the party sought to be charged"); Horne v. Midland Ry. Co., [1872] 7 L.R.C.P. 583 at 591 (Eng.) (noting that it would be an "extraordinary result" to award consequential damages where "mere notice" of the circumstances was given).

[30] Wakeman v. Wheeler & Wilson Mfg. Co., 4 N.E. 264, 266 (N.Y. 1886).

[31] *See, e.g.*, Ralph S. Bauer, *Consequential Damages in Contract*, 80 U. Penn. L. Rev. 687, 702–03 (1932) (characterizing foreseeability-based interpretations of *Hadley v. Baxendale* as relying on "extreme" dicta and pushing for a tacit agreement test); Epstein, *supra* note 7, at 109 (advocating for the tacit agreement test and arguing that the alternative "leads to incorrect default rules that call for a systematic overexpansion of contract damages"); Adam Kramer, *An Agreement-Centred Approach to Remoteness and Contract Damages*, *in* Comparative Remedies for Breach of Contract 249, 250 (Nili Cohen & Ewan McKendrick eds., 2005) (arguing that the foreseeability test acts as a rule of

commentator classifies the *Globe Refining* decision among the "worst Supreme Court decisions ever," citing as evidence its explicit repudiation by courts and commentators from Kessler to Farnsworth.[32] Farnsworth observed, with apparent approval, that the test "has been generally rejected as overly restrictive and doctrinally unsound."[33] The comment accompanying the Restatement's "reason to know" provision explicitly rejects any claim that the party in breach must tacitly agree to be liable for the loss. [34] The Official Comment to the relevant U.C.C. section provides tersely: "The 'tacit agreement' test for the recovery of consequential damages is rejected."[35] Calamari and Perillo defend the general rejection as a corrective to the "dubious assumption" that damages for breach of contract are based on the contracting parties' promises to pay damages in the event of breach.[36] Even Corbin and Williston agree in their dismissal of Holmes's view.[37] Some courts have expressly disapproved it in favor of the more liberal formulations of the Restatement or the U.C.C.[38] English courts that had embraced the tacit agreement requirement subsequently abandoned it, though they may recently have resurrected it. [39]

The near-universal repudiation of tacit agreement by courts and commentaries certainly places a heavy burden on anyone who would

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thumb for the intent of the parties and is valid only "to the extent that it indicates what the parties wanted").

32 Larry T. Garvin, Globe Refining Co. v. Landa Cotton Oil Co. *and the Dark Side of Reputation*, 12 NEV. L.J. 659, 659, 679–80, 688 (2012).

33 3 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS 258 (3d ed. 2004).

34 RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (1981). Section 351(3) allows restrictions on foreseeable consequential damages when the results would be disproportionate or unjust, though it does not necessarily tie those concepts to other terms of the contract. Comment f links disproportionality to contract price in order to determine whether "the parties assumed that one of them would not bear the risk of a particular loss." Insofar as contract price is assumed to reflect an intent to accept or reject liability for consequential damages, that statement reflects the same approach as the tacit agreement test.

35 U.C.C. § 2-715 cmt. 2 (2002).

36 JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 571 (5th ed. 2003).

37 *See* 5 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1010 (1964) (explaining that damages are based on what a reasonable person could foresee and not what the parties contemplated); 11 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 1357 (1968) (same).

38 *See* Native Alaskan Reclamation & Pest Control, Inc. v. United Bank Alaska, 685 P.2d 1211, 1219 (Alaska 1984) ("[T]he 'tacit agreement' test . . . is expressly disapproved."); R.I. Lampus Co. v. Neville Cement Prods. Corp., 378 A.2d 288, 292 (Pa. 1977) ("All that is required is that the seller *have reason to know*.").

39 *See, e.g.*, Koufos v. C. Czarnikow, Ltd. (*Heron II*), [1967] 3 All E.R. (H.L.) 686 at 691 (endorsing the foreseeability rule); Victoria Laundry (Windsor), Ltd. v. Newman Indus., Ltd., [1949] 1 All E.R. 997 at 1002, 2 K.B. 528 (same). Lord Hoffman appears to have revived the requirement in *Transfield Shipping Inc. v. Mercator Shipping Inc.* [2008] UKHL 48, [12] (appeal taken from Eng.).

defend it. But before joining the rejection, it is useful to consider what has replaced Holmes's approach. The inherent vagueness of the foreseeability test appears to be universally recognized, leaving courts substantial discretion to determine a breacher's scope of liability after the fact.[40] But the most interesting characteristic of the "reason to know" rule is its near-universal rejection by those who are subject to it: commercial actors.[41] The rejection of *Globe Refining* is a repudiation of Holmes's premise that damages are part of the risk calculation that commercial actors undertake when they enter into contracts. That rejection implies that commercial actors are either indifferent to or prefer a damages rule that exposes them to unqualified liability for a type of damages that they could foresee, even if they had not undertaken responsibility for those damages. In short, it suggests that commercial actors deviate from Holmes's assumption that parties decide to enter contracts only after evaluating the related risks and benefits, and that such evaluation requires consideration of the expected exposure to the consequences of breach. The fact that most commercial actors opt out of the "reason to know" default, that liquidated-damages clauses and termination fees for walking away from prospective deals are common, and that commercial actors tend to structure contractual damage rules in a manner that reflects verifiability[42] all suggest that commercial actors adhere to Holmes's assumptions about damage rules rather than display the indifference assumed by the critics of tacit agreement. Perhaps, then, analysis of tacit agreement needs to be predicated on the objective of designing majoritarian default rules rather than on a headcount of approving and disapproving cases and commentaries.

These observations raise the question of when parties would be willing to incur the costs necessary to allocate the risk of consequential lost profits to potential breachers. After all, if recovery of consequential damages induces inefficient investment and if aggrieved parties are systematically in a superior position to control those damages, then we would anticipate that the parties would allocate the risk of consequential loss away from the breaching party. Absent an

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40 *See* FARNSWORTH, *supra* note 33, at 260–62 (discussing the role of courts in construing the scope of foreseeability).

41 *See supra* text accompanying note 7 (discussing the frequency with which parties contract to exclude recovery of consequential damages); *see also* FARNSWORTH, *supra* note 33, at 799 (noting that the question of foreseeability rarely arises as parties contract to exclude recovery of consequential damages).

42 *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1389–92 (2010) [hereinafter Gilson et al., *Braiding*] (outlining the need for verifiability).

explanation for why parties might agree that a breacher should bear the risk of lost profits, we would expect to find few examples of their express allowance in the event of breach. Moreover, we would expect to find little reason for parties to agree tacitly to such recovery, so that courts should be wary of finding any such agreement.

Parties, however, would presumably agree to impose lost-profits liability on the breaching party if doing so helped to overcome obstacles to otherwise mutually beneficial transactions. Moreover, if the conditions under which an allocation of lost-profits risk to the breaching party could increase the contractual surplus were readily observable and verifiable, then courts would have a more accurate basis for assuming, even in the absence of an express term, that parties tacitly intended to permit a lost-profits recovery.

B. The New York Doctrine

A series of New York cases has threatened the near-unanimous rejection of tacit agreement.[43] In two cases from the 1980s arising out of a breached contract to construct a stadium, the New York Court of Appeals restricted the award of recoverable consequential damages to those that were "within the contemplation of the parties." But "contemplation" meant something other than that the breaching party had reason to know the consequences a breach would engender. The first case, *Kenford Co. v. County of Erie* (*Kenford I*),[44] arose after the County failed to satisfy its commitment to negotiate a lease with the developers for the operation of the stadium and the project was abandoned. The intended operator of the stadium sued the County for the loss of prospective profits during the twenty-year period of the anticipated management contract. The stadium operator presumably would have earned the prospective profits in transactions with third parties who would use the stadium, rather than from any payments by the County itself. At trial, the plaintiffs won a multimillion-dollar judgment. The intermediate appellate court modified the judgment on the ground that expert opinion used at trial to present statistical projections of future business operations did not provide a rational basis for the calculation of lost profits.[45] But the negative implication was that

[43] Arkansas also continues to apply the tacit agreement test. *See, e.g.*, Reynolds Health Care Servs., Inc. v. HMNH, Inc., 217 S.W.3d 797, 804 (Ark. 2005) ("It must . . . appear that the defendant . . . tacitly agreed to assume responsibility.").

[44] 493 N.E.2d 234 (N.Y. 1986).

[45] That holding was consistent with longstanding law concerning the certainty with which recoverable lost profits had to be proved. *See, e.g.*, Robert M. Lloyd, *The Reasonable Certainty Requirement in Lost Profits Litigation: What It Really Means*, 12 TRANSACTIONS: TENN. J. BUS. L. 11, 19 (2010) ("The vast majority of courts have allowed

sufficiently certain damages could be recovered as long as the County had reason to know they would result from the breach.

The Court of Appeals, however, employed a broader rationale in denying consequential damages. Part of that rationale embodied the "tacit agreement" test. A plaintiff seeking lost profits, the Court of Appeals concluded, must demonstrate that the "particular damages were fairly within the contemplation of the parties to the contract at the time it was made."[46] This did not mean simply that the breaching party contemplated the possibility that breach would deny profits to the aggrieved party. That inference presumably could be made in any commercial contract. Instead, the Court of Appeals required the aggrieved party to demonstrate that "liability for loss of profits over the length of the contract" had been contractually allocated to the breacher.[47]

That factor was fatal to the plaintiffs' case, as nothing in the record revealed that the parties contemplated liability for lost profits, as opposed to their mere expectation, when they executed the contract.[48] Certainly, an explicit clause awarding lost profits would have been sufficient. But the absence of such a clause did not foreclose recovery of lost profits. Rather, contractual silence on the issue required the court to apply a "commonsense" rule of considering the scope of liability to which the breaching party would have assented had it considered the possibility of breach.[49] Thus, the court adopted both the doctrinal proposition that lost profits would be recoverable as consequential damages only if the parties had intended to impose such liability on the breaching party, and the institutional proposition that courts can competently discern the intent of the parties where the contract fails explicitly to allocate the loss. The court did not, however, disclose the alchemy by which it would surmise the requisite intent. Instead, the court summarily concluded that the evidence "fails to demonstrate that liability for loss of profits over the length of the

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the injured party to recover lost profits only when they supplied verifiable data, upon which the court can base its estimate of the loss.").

[46] *Kenford I*, 493 N.E.2d at 235.

[47] *Id.* at 236.

[48] In an apparent anomaly, the court noted that lost profits were not in the contemplation of the parties at the time of contract execution or "at the time of its breach." *Id.* Subsequent cases have ignored the relevance of what was contemplated at the time of breach. *See, e.g.*, Honeywell Int'l Inc. v. Air Prods. & Chems., Inc., 858 A.2d 392, 423 n.108 (Del. Ch. 2004), *aff'd in part, rev'd in part, and remanded*, 872 A.2d 944 (Del. 2005) (declining to "allow a party to claim even the most unforeseeable form of 'lost profits' so long as it notified the breaching party of its intention to do so at the time of breach").

[49] *Kenford I*, 493 N.E.2d at 236.

contract would have been in the contemplation of the parties at the relevant times."[50]

The court elaborated its position in a subsequent decision arising out of the same transaction. In *Kenford Co. v. County of Erie* (*Kenford II*),[51] the court rejected a claim for damages by the stadium developers for the loss of anticipated appreciation in the value of land that they had purchased on the periphery of the proposed stadium site. The contract stipulated that part of the compensation paid to the County would consist of increased real property taxes resulting from the enhanced value that the peripheral land would enjoy as a result of the stadium. That clause indicated that the County had reason to know that the plaintiffs expected to profit from development of the land and that breach would deny the plaintiffs those anticipated profits. While that knowledge might have been sufficient to satisfy the broader interpretation of *Hadley*, the court denied recovery. It concluded that the plaintiff's claim was not for "general damages," which could be awarded for the "natural and probable consequence of the breach."[52] Rather, the claim fell into the category of "unusual or extraordinary damages."[53] Citing *Hadley*, the court concluded that the plaintiffs could only recover these damages if they were within the contemplation of the parties as the probable result of a breach at the time of contracting. The court then channeled Holmes for the proposition that what was in the parties' contemplation depended on "the nature, purpose and particular circumstances of the contract known by the parties . . . as well as 'what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made.' "[54]

The anticipation of appreciated land values did not satisfy that criterion. The County's knowledge that the plaintiff intended to garner profits from proximity to the proposed stadium did not mean that the parties contemplated that the County would assume liability for this loss in the event of the County's breach. In apparent repudiation of the "reason to know" standard, the court invoked a series of cases decided between 1871 and 1930 for the proposition that "bare notice of special consequences which might result from a breach of contract, unless under such circumstances as to imply that it formed

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50 *Id.*
51 537 N.E.2d 176 (N.Y. 1989).
52 *Id.* at 178.
53 *Id.*
54 *Id.* at 179 (quoting Globe Ref. Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544 (1902)).

the basis of the agreement, would not be sufficient" to impose liability for special damages.[55] Nothing in the transaction suggested that the parties had contemplated a breaching party's liability for lost profits. Certainly the contract did not explicitly allocate that liability to the County. And the adverse consequences of imposing liability in the case contravened any "commonsense" conclusion that the parties would have allocated the losses to the County had they considered the matter. In a comment reminiscent of the critique that full expectation damages skews investment incentives,[56] the court concluded that imposing the loss on the County would require the "irrational conclusion" and "illogical" result that the County had agreed to guarantee Kenford's investment if the stadium was not constructed, so that Kenford would realize all of its anticipated gains with or without the stadium.[57] Imposing such liability would exacerbate the risk of business enterprise and deter welfare-maximizing contracts.[58]

Subsequent cases eliminated any doubt that remained about the limited scope of lost profit recoveries in New York. Mere knowledge of a counterparty's plans and expected benefits from contractual performance did not constitute an agreement to "underwrite the hypothetical profits from these plans."[59] Lost profits, the Court of Appeals later contended, might be recoverable without jumping through the logistical hoops of *Kenford I* and *Kenford II* where the alleged profits consist of payments to be made by the defendant to the plaintiff under the contract. Under these circumstances, forgone profits constitute the "direct" or general damages flowing from a breach rather than the consequential losses that have to be filtered through the contemplation of the parties. Thus, in *American List Corp. v. U.S. News and World Report, Inc.*,[60] the Court of Appeals classified payments due under a breached contract for the rental of mailing lists as "general" damages recoverable as "the natural and probable consequence of the

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[55] *Id.* Perhaps the court stopped its analysis with the pre-Depression cases because subsequent cases appeared to endorse the broader interpretation. *See, e.g.*, Spang Indus. v. Aetna Cas. & Sur. Co., 512 F.2d 365, 369 (2d Cir. 1975); 437 Madison Ave. Assocs. v. A.T. Kearney, Inc., 488 N.Y.S.2d 950, 951 (N.Y. Sup. Ct. 1985).

[56] *See, e.g.*, Yeon-Koo Che & Tai-Yeong Chung, *Contract Damages and Cooperative Investments*, 30 RAND J. ECON. 84, 87 (1999) (arguing that expectation damages encourage overinvestment).

[57] *Kenford II*, 537 N.E.2d at 180.

[58] *Id.*

[59] Goodstein Constr. Corp. v. City of N.Y., 604 N.E.2d 1356, 1362 (N.Y. 1992). The fact that the defendants in both the *Kenford* cases and *Goodstein* were municipal corporations arguably could have provided the New York Court of Appeals with a narrower basis for decision. But the court did not provide any hint that the identity of the defendant mattered.

[60] 549 N.E.2d 1161 (N.Y. 1989).

breach," rather than extraordinary "special" damages that the plaintiff would receive from potential collateral exchanges with third parties that were contingent on the breacher's performance.[61] Claims for lost profits from forgone transactions with third parties, such as lost revenues from sales at or near the stadium in *Kenford*, were, however, subject to the tacit agreement requirement. The few federal cases that have applied New York law to the question of lost profits have expressly recognized that the *Kenford* cases require application of a different rule than is mandated by the Restatement or U.C.C. standards. In those cases, federal courts have required the plaintiff to demonstrate the parties' intent to impose liability and have revealed some reluctance to find the requisite agreement.[62] The different approaches to consequential damages have, however, led to schizophrenic results in sale of goods cases involving New York law. As noted above, the U.C.C. explicitly adopts the broader "reason to know" standard.[63] Some courts, focusing on the ostensibly broad standard for recovery of consequential damages in § 2-715(2)(a), have applied that test without considering whether the parties explicitly or tacitly allocated the risk of lost profits.[64] Other cases applying New York law purport to have incorporated the *Kenford* standard into the U.C.C. provision but appear to have equated "contemplation" with reason to know, rather than with tacit agreement.[65] The result is that lost-profits recovery in New York is arguably subject to one test in goods cases and another test in non-goods cases.[66]

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61 *Id.* at 1164; *see also* Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc., 487 F.3d 89, 109 (2d Cir. 2007) (characterizing a claim for lost profits as general damages where such profits merely constitute money that the breaching party agreed to pay under the contract).

62 *See, e.g.*, Travellers Int'l, A.G. v. Trans World Airlines, Inc., 41 F.3d 1570, 1578 (2d Cir. 1994) (finding that plaintiff's claim for lost profits met the "stringent requirements" for recovery under New York law); Trademark Research Corp. v. Maxwell Online, Inc., 995 F.2d 326, 334 (2d Cir. 1993) (interpreting a prior contract that explicitly disclaimed liability for consequential damages as evidence of a course of dealing between the parties that governed a subsequent informal agreement in which the disclaimer was absent). Most federal cases that discuss *Kenford I* deal only with the issue of whether lost profits have been proven with reasonable certainty. *See, e.g.*, Britestarr Homes, Inc. v. Piper Rudnick LLP, 256 F. App'x 413, 414 (2d Cir. 2007) (finding a claim for lost profits improperly speculative).

63 *See supra* Part II.A.

64 *See, e.g.*, Canusa Corp. v. A & R Lobosco, Inc., 986 F. Supp. 723, 732–33 (E.D.N.Y. 1997) (finding that plaintiff was entitled to damages under § 2-715(2)(a) because defendant knew that plaintiff was a buyer-broker).

65 *See, e.g.*, Larsen v. A.C. Carpenter, Inc., 620 F. Supp. 1084, 1132 (E.D.N.Y. 1985), *aff'd without opinion*, 800 F.2d 1128 (2d Cir. 1986); RIJ Pharm. Corp. v. Ivax Pharms., Inc., 322 F. Supp. 2d 406, 414–15 (S.D.N.Y. 2004).

66 One Delaware case, applying New York law and subsequently reversed on other grounds, explicitly rejected the application of different standards for recovery of lost profits under U.C.C. and common law cases and applied the *Kenford* formulation to deny

Notwithstanding the use of tacit agreement, the New York cases offer little guidance about the evidence that courts should consider when making a "commonsense" inference of intent from contractual silence. As a result, presumptions and burdens of proof may do a great deal of the work in determining who bears the risk of lost profits. The default rules of the Restatement and the U.C.C. imply that contractual silence on the issue should be interpreted as consent to liability. But given the empirical observation that most commercial parties opt out of the default, the failure to include such liability explicitly may be seen as strong evidence that the parties did contemplate the subject and decided *not* to impose liability. The *Kenford* cases certainly support such an interpretation, insofar as they impose on the aggrieved party the burden of demonstrating that the parties intended the breaching party to bear the risk.[67] More recent New York cases have followed that lead, notwithstanding the default that would otherwise apply.[68]

That, however, is not the necessary conclusion to be drawn from acceptance of the tacit agreement test. Instead, a "commonsense" view can imply an admonition for courts to consider the commercial needs of the parties in the particular transaction and to inquire into whether or not the breaching party's acceptance of liability for consequential damages would have advanced the contractual relationship. That admonition requires faith in the capacity of courts to reverse-engineer contractual relationships and to discern why commercial parties have designed their contracts in particular ways. My claim in the next part of this Article is that parties allocate lost profits to the breaching party, notwithstanding overreliance and inefficiency risks, to increase the value of contracts that have a defined structure—they require relationship-specific investment and thus invite holdup. I then claim that the cases in which courts find tacit agreement to bear consequential damages are systematically characterized by that same contractual structure, so that courts that apply the tacit agreement test are intuiting to results that are consistent with the preferences of commercial parties.

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lost profits. Honeywell Int'l Inc. v. Air Prods. & Chems., Inc., 858 A.2d 392, 422–23 (Del. Ch. 2004), *aff'd in part, rev'd in part, and remanded*, 872 A.2d 944, 954 (Del. 2005) (affirming the conclusion that parties did not contemplate lost profits).

[67] *Kenford I*, 493 N.E.2d 234, 235–36 (N.Y. 1986) (concluding that contractual silence as to lost profits did not mean they should be recoverable).

[68] *See, e.g.*, Digital Broad. Corp. v. Ladenburg, Thalmann & Co., 883 N.Y.S.2d 186, 187 (App. Div. 2009).

III
Lost Profits and Optimal Investment

A. *Contractual Solutions to Holdup Risks*

A contractual commitment to invest relationship-specific assets poses a well-known risk of non-cooperative conduct.[69] Relationship-specific investments cannot readily be utilized in an alternative transaction, so returns on the investment require that the relationship continue. Examples include an electric generating plant constructed nearby a mine-mouth that was to serve as the source of coal for the plant[70] or investments in labor needed for a particular transaction.[71] The inability to transfer the investment to an alternative transaction makes the investing party vulnerable to exploitation by the counterparty in either of two ways.[72] First, the counterparty may threaten to withhold performance unless the investing party agrees to renegotiate the original allocation of the transactional surplus. A threat to withhold performance may consist of any action between chiseling on the quality of a performance to more blatant breaches. Renegotiation of sophisticated contracts is typically undesirable, because renegotiation is inconsistent with efforts to write low-cost, state-contingent contracts that yield ex post efficient results. Unless parties believe that new information might affect the efficient allocation of contractual risks and the size of the contractual surplus, they are unlikely to make ex ante specifications that require renegotiation. Nevertheless, as discussed below, credible commitments not to renegotiate may be difficult to achieve.

The second risk that the relationship-specific investment creates is that the non-investing party will engage in conduct that diminishes the value of the investment to the investing party. For instance, once it

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69 *See* Vincent P. Crawford, *Relationship-Specific Investment*, 105 Q.J. Econ. 561, 561 (1990) (stating that the party making the relationship-specific investment must be compensated under the current contract or with the safety of a long-term contract to ensure future bargaining); Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 Am. Econ. Rev. 519, 522 (1983) (suggesting reciprocal exposure by the party not making the relationship-specific investment in order to create mutual reliance).

70 *See* Paul L. Joskow, *Contract Duration and Relationship-Specific Investments: Empirical Evidence from Coal Markets*, 77 Am. Econ. Rev. 168, 170 (1987).

71 *See* Williamson, *supra* note 69, at 522.

72 *See, e.g.*, Yeon-Koo Che & Donald B. Hausch, *Cooperative Investments and the Value of Contracting*, 89 Am. Econ. Rev. 125, 125 (1999) (discussing the opportunistic behaviors inculcated by relationship-specific investment); Avery Weiner Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 Colum. L. Rev. 496, 529 (2004) (describing inefficient performance and breach as two pitfalls of relationship-specific investments); Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 Colum. L. Rev. 1428, 1447–52 (2004) (same).

secures the commitment of the investing party, the non-investing party may simultaneously pursue alternative opportunities that compete with the investing party. The investing party cannot easily remove its investment to avoid the competition. Instead, it may continue to use that investment, but achieve lower than expected returns while the non-investing party attains higher profits by utilizing both the investing party's assets and those of its competitors.

In each case, the threat of the non-investing party is credible within a range bounded by its exposure for failure to cooperate—that is, by the loss it suffers from non-cooperative conduct, including the obligation to pay damages for any breach, less the gain it receives from that same behavior. For instance, assume that once the investment is made, the non-investing party can increase its net profits by reducing its performance on that contract and pursuing other opportunities. Even with lower profits from the first contract, the total profits for the non-investing party (combining profits from the first contract and the subsequent contracts) could be greater than if it only performed the first contract. Whether or not that is the case, however, may depend on the remedy that the investing party could extract from the non-investing party for its non-cooperative conduct. For instance, even if the reduced effort constitutes a breach, the investing party may eschew cancellation of the contract, because that would require complete loss of its relationship-specific investment. Thus, it might continue the contract and avoid seeking remedies, even though performance was less profitable than anticipated.

Sophisticated parties involved in transactions that require relationship-specific investments are likely to understand that these risks of non-cooperation may interfere with welfare-maximizing transactions. To be sure, reputational capital, bilateral monopoly within the contract, or an absence of outside options may constrain opportunistic renegotiation after investment. As the economics literature suggests, contractual clauses may reinforce these effects.[73] For instance, hard terms, such as fixed prices, may bind parties to their respective commitments, so that each party is willing to invest, safe in the knowledge

[73] *See, e.g.*, Che & Chung, *supra* note 56 (examining how alternative breach remedies can create incentives for relationship-specific investment); W. Bentley MacLeod & James M. Malcomson, *Investments, Holdup, and the Form of Market Contracts*, 83 AM. ECON. REV. 811, 825 (1993) (suggesting that "escalator clauses" conditioning price on external conditions would help avoid renegotiation).

that the counterparty will have little basis for exit or renegotiation should circumstances change.[74]

Initially, one might conclude that parties could solve the renegotiation threat by simply forbidding any modification of their original deal. But parties may forgo explicit contractual prohibitions on renegotiation because such clauses are frequently deemed unenforceable.[75] As a result, parties that seek to limit renegotiation may insert a clause that has the effect of inhibiting renegotiation, even if it does not create an outright prohibition.[76] Some clauses could be seen as blatant attempts to circumvent an unenforceable prohibition on renegotiation, and thus themselves be unenforceable. For instance, Maskin and Tirole suggest a clause that penalizes any party who suggests renegotiation.[77] But a court that objects to prohibitions on renegotiation could invalidate such a clause as an effort to do indirectly what could not be done directly.

Alternatively, parties might discourage holdup by explicitly contracting for specific performance as a remedy for breach. Indeed, at least one commentator has suggested that athletes' contracts should be specifically enforced on this ground, notwithstanding the traditional admonition against employing specific performance in personal services contracts.[78] More generally, Edlin and Reichelstein suggest that, under a set of assumptions about bargaining power and sharing of the contractual surplus, an expectation of specific performance provides an incentive to choose a first-best investment.[79] Nevertheless, parties may be reluctant to bargain for specific performance, in part because courts may also deny enforcement of that remedy insofar as it imposes obligations that judges may prefer not to monitor. Moreover, parties may eschew specific performance clauses because a party that could otherwise efficiently exit a transaction by paying damages can

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[74] *See* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 453 (2009) [hereinafter Gilson et al., *Innovation*].

[75] *See, e.g.*, Kevin E. Davis, *The Demand for Immutable Contracts: Another Look at the Law and Economics of Contract Modifications*, 81 N.Y.U. L. REV. 487, 518 (2006); Christine Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203, 208–09 (1997).

[76] *See, e.g.*, MacLeod & Malcomson, *supra* note 73, at 832 (suggesting clauses that condition renegotiation on new information).

[77] *See* Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83, 99 n.13 (1999).

[78] *See* Alex M. Johnson, Jr., *The Argument for Self-Help Specific Performance: Opportunistic Renegotiation of Player Contracts*, 22 CONN. L. REV. 61, 73 (1989) (arguing that courts should not condone opportunistic behavior such as renegotiation, and thus specific performance should be an enforceable remedy).

[79] Aaron S. Edlin & Stefan Reichelstein, *Holdups, Standard Breach Remedies, and Optimal Investment*, 86 AM. ECON. REV. 478, 482–86 (1996).

be precluded from doing so, and thus can be exploited by a counterparty who demands supracompensatory damages in exchange for forgoing the specific-performance option.

Given that the non-investing party's risk of exposure for breach of contract bounds the party's willingness to exploit the counterparty's investment, a clause that imposes high damages on a breaching party may have the desired inhibiting effect. Although there is disagreement about the optimal damage terms, much of the literature concurs that damages provide credible commitments to perform as expected and not to exploit their counterparties who have made relationship-specific investments because they reduce the benefits of holdup.[80] If the potential breacher can obtain more from exploitation than it will be required to pay in damages, then its promise not to exploit is not credible. In effect, damages payable in the event of breach simply constitute the strike price for exercising an option to avoid performance.[81] A low strike price can induce exploitation that could be averted with a higher strike price. In theory, the parties could signal their willingness to pay high damages, and thus to induce relationship-specific investments, by specifying the damages to be paid in the event of breach. But as other commentators who have sought to facilitate relationship-specific investments have noted,[82] courts may refuse to enforce liquidated damages clauses if they determine that the clause constitutes a penalty.[83] While many courts have recently displayed a greater willingness to enforce liquidated damage clauses,[84] sophisticated parties would usually prefer a clause that courts are highly likely to enforce over a nominally equivalent clause of more dubious enforceability. Given the ambiguity that surrounds the validity of a liquidated

80 For instance, Che and Chung contend that for "cooperative investments," those that generate a direct benefit to the investor's counterparty rather than just to the investor, a rule of reliance damages performs better than expectation damages or liquidated damages clauses. Where, however, investment is "selfish," that is, it will confer direct benefits only on the investor, incorporation of an expectation damages measure dominates alternatives. *See* Che & Chung, *supra* note 56, at 86–87.

81 *See* Eva I. Hoppe & Patrick W. Schmitz, *Can Contracts Solve the Hold-Up Problem? Experimental Evidence*, 73 GAMES AND ECON. BEHAV. 186, 187 (2011); Scott & Triantis, *supra* note 72, at 1430.

82 *See* Daniel Markovits, *Making and Keeping Contracts*, 92 VA. L. REV. 1325, 1344 (2006) (observing that high liquidated damages are deemed to be a penalty even if used to induce relationship-specific investment); Scott & Triantis, *supra* note 72, at 1452 ("[P]enalties may serve to improve the efficiency of specific investment.").

83 *See* JMD Holding Corp. v. Congress Fin. Corp., 828 N.E.2d 604, 609, 611–12 (N.Y. 2005) (noting that if liquidated damages are clearly disproportionate, the clause will be dismissed as an "unenforceable penalty").

84 *See* XCO Int'l Inc. v. Pac. Scientific Co., 369 F.3d 998, 1002 (7th Cir. 2004) (calling penalty clauses a "tolerable" means of approximating the costs of litigation).

damages clause, parties may find it an insufficient signal of fidelity to the transaction to induce optimal investment.

Each of these contractual solutions to potential holdup is sufficiently imperfect that a clause permitting recovery of lost profits provides a viable alternative. The promise of consequential damages in the form of lost profits dilutes the incentive of the non-investing party to exploit an investment, because any breach will subject the non-investing party to substantial liability. At the same time, the possibility of recovering lost profits reduces the incentive of the investing party to renegotiate. In the event of breach, recovery of lost profits places the aggrieved party closer to the full expectation measure, so the investing party is under less compulsion to renegotiate in order to ensure realization of something close to the originally anticipated share of the contractual surplus. For the same reason, the potential recovery of lost profits limits the threat point of the potential breacher. The pledge to pay lost profits increases the exposure of the non-investing party in the event its conduct is deemed to be a breach of its obligations, and thus reduces the net benefits it can anticipate from non-cooperative conduct. As a result, that pledge constitutes a credible commitment not to exploit the investing party, and thus induces the latter to invest optimally in the common enterprise.

This is not to say that a commitment to pay lost profits in the event of breach optimally induces investment in all cases. Lost-profit recoveries are most closely associated with expectation damages. Some economics literature argues that, at least under some circumstances, investment is optimized by a reliance-damages rule rather than an expectation-damages rule.[85] Che and Chung argue that the potential investor in a cooperative investment has minimal incentive to invest optimally under expectation damages: In the event of breach, the potential investor receives the same payoff regardless of realized gains from trade, and thus has no incentive to increase those gains through investment.[86] Even if that were the case, however, reliance damages suffer from their own defects. Reliance costs may not be readily verifiable, and thus not easily contractible, particularly if they are defined to include lost opportunity costs as well as out-of-pocket expenditures.[87] In that event, even if reliance costs are viewed as a superior mechanism for inducing optimal investment, an award of lost

[85] *E.g.*, Che & Chung, *supra* note 56, at 84 (finding that reliance damages achieve the efficient outcome in situations where *ex post* renegotiation is possible).

[86] *Id.* at 87.

[87] *See* Lon L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 60 (1936) (noting the "impossibility of subjecting this type of reliance to any kind of measurement").

profits may make sense if lost profits serve as a rough, but sufficient, proxy for reliance.

If a commitment to pay lost profits in the event of breach has this effect, it may solve the general difficulty that parties face in binding themselves against renegotiation or non-cooperative behavior.[88] Unlike no-renegotiation clauses, specific-performance clauses, and liquidated-damages clauses, which suffer from questionable enforceability, a promise to pay consequential damages, including lost profits, is not only enforceable—in most jurisdictions it represents the default rule. Even if courts altered the default rule to permit recovery of lost profits under more limited circumstances that aligned with majoritarian preferences, the promise to pay them would still be presumptively enforceable within the domain of those preferences.

B. *Relationship-Specific Investment and the Certainty of Damages*

A traditional objection to awarding lost profits is that their measurement inherently involves speculation, since they require valuation of transactions that never materialized. The aggrieved party has incentives to contend that the breach frustrated exchanges that would have generated substantial returns. The breaching party has incentives to contend that those transactions would never have occurred even in the absence of the breach. Courts have responded to this conflict of counterfactuals by demanding that lost profits be proven by "reasonable certainty"—a vague, multi-factored test that provides little basis on which parties can calculate optimal precautions.[89] Where claims of lost profits are proffered by a "new business" without a proven record of success, courts demand a higher level of proof for recovery of profits, or may even deny recovery altogether.[90] In short, courts are reluctant to award lost profits even as direct damages where the financial information relevant to accurate prediction of a contract's profitability for the aggrieved party was outside the breaching party's knowledge and control.

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[88] *See* Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 26 (2004) (noting that parties "strongly prefer" that contracts not be renegotiated when they have chosen a contractual form that ensures efficient investment and trade).

[89] *See* Lloyd, *supra* note 45, at 12 ("[C]ourts have never really explained what they mean by the term 'reasonable certainty.'").

[90] *See, e.g.*, Kidder, Peabody & Co. v. IAG Int'l Acceptance Grp. N.V., 28 F. Supp. 2d 126, 131 (S.D.N.Y. 1998) (holding that "new businesses must meet a higher evidentiary burden in satisfying" the reasonable certainty standard); Coastal Aviation, Inc. v. Commander Aircraft, 937 F. Supp. 1051, 1065 (S.D.N.Y. 1996) ("[W]e have found no case from a New York State court permitting a recovery of lost profits to a 'new business.'").

But the very reasons that give rise to the relationship-specific investments that could induce an agreement to pay lost profits as a signal of fidelity to the transaction may simultaneously dilute concerns about the aggrieved party's monopoly over the expected benefits of the contract. Transactions that involve relationship-specific investments typically entail long-term mutual obligations that require significant cooperation and coordination between the parties. They are normally neither discrete transactions in which one party agrees to provide standard goods or services to the other, nor long-term supply contracts in which one party commits to providing services that are fungible with goods or services that could be provided to another party. Rather, they take on features of a joint venture in which both parties assume significant responsibility to ensure the success of the cooperative enterprise. The fact that relationship-specific investments are required for the venture entails that the investing party will be reluctant to move forward without reliable assurances that the investment will generate positive returns.

But the intertwined nature of the parties' businesses means that those assurances likely require sharing financial information that reveals the expected value of the contract to each party. Indeed, it may be largely because each party has some indication of the value of the contract to the counterparty that the holdup problem arises. But that same information-sharing between the parties reduces the risk that a potential breacher will have insufficient information to calculate the consequences of breach for the counterparty. As a result, the aggrieved party is not necessarily in a better position than the breacher to predict profits should the latter fail to perform. Thus, the standard assumption that consequential damages are likely to be disclaimed because the aggrieved party is in a superior position to avoid their materialization is less justified where the parties are involved in a relational contract that entails investment. As a result, imposing consequential damages on a breaching party in a contract involving relationship-specific investment is less likely to constitute an inefficient risk allocation. Indeed, in some situations, one party may indicate that it occupies the better position to take certain risks by agreeing to make a payment should that risk materialize. For example, a merger that is contingent on obtaining regulatory approval may subject the party best positioned to obtain that approval to a termination fee or reverse termination fee if approval is not obtained.

This rationale, however, is subject to an important caveat. Gilson, Sabel, and Scott have recently examined contracting behavior in situations where parties agree to work jointly on a project with a highly uncertain outcome, such as a joint enterprise to develop drugs or to make untested applications of existing technologies.[91] In these situations, the parties will be more uncertain about the benefits counterparties will confer and the anticipated range of profitability of the enterprise than in situations where the contract envisions an application of an existing business model or technology. As a result, the ability to make informed allocations based on expected values and identity of the party best positioned to avoid loss could be reduced. Gilson, Sabel, and Scott predict that parties in such situations will enter relatively incomplete contracts that permit the parties to adjust to new information as it develops.[92] Moreover, the novelty of and uncertainty inherent in the projects with which Gilson, Sabel, and Scott are concerned indicates that lost profits will be less verifiable to a court, and thus less worth contracting about ex ante.[93] In these situations, parties will eschew explicit risk allocations to stimulate relationship-specific investments in favor of informal enforcement mechanisms to generate cooperation. Even a party that might otherwise signal fidelity through acceptance of liability might pursue other avenues if potential damages are too uncertain.

Where lost profits are relatively estimable ex ante and verifiable ex post, however, limiting consequential damages to those explicitly or tacitly agreed to may constitute a strong signal of fidelity to the transaction. It both creates exposure sufficient to constitute a commitment not to engage in holdup and limits exposure for breach that makes the signal worth sending. The availability of alternatives that might be better suited to situations in which lost-profit damages are undesirable because of uncertainty, or in which parties trust the enforceability of alternative clauses, does not foreclose the possibility that, in some cases, parties would prefer to signal fidelity through exposure for consequential damages.

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[91] *See* Gilson et al., *Braiding*, *supra* note 42, at 1405–06 (describing a collaboration and license agreement between two pharmaceutical companies to develop drugs); Gilson et al., *Innovation*, *supra* note 74, at 434 (describing an emerging phenomenon whereby firms engage with each other in collaboration and co-design in order to keep up with rapidly developing technology).

[92] *See* Gilson et al., *Braiding*, *supra* note 42, at 1402–15 (describing how linking informal elements of contracts with formal elements helps parties make agreements in situations with a high degree of uncertainty); Gilson et al., *Innovation*, *supra* note 74, at 452 (observing that contracts will be incomplete when there is a high degree of uncertainty about future conditions).

[93] *See* Gilson et al., *Braiding*, *supra* note 42, at 1429 (citing instance of a court denying lost-profit recovery as too speculative).

IV
Contracts and Lost Profits

The claim that an agreement to pay lost profits can signal fidelity to a relationship and thus reduce concerns about holdup generates some testable hypotheses about contract design and the contractual behavior of sophisticated commercial actors. Parties who want to send the relevant signal might, for instance, accept the default rule of consequential damages rather than follow the norm of excluding them. I have suggested, however, that the "reason to know" default of the Restatement and the U.C.C. embodies a breadth of damages that parties may find too onerous or too nebulous, notwithstanding their desire to send a signal of fidelity.

Thus, parties concerned with holdup might adopt any of several strategies. First, they might follow the standard commercial procedure of excluding consequential damages and either risk vulnerability to holdup or search for some other means of avoiding it. Second, they might take the risk that a court would, consistent with the default of a broad "reason to know" test, award lost profits but constrain exposure in the event of breach to an acceptable amount, such as by limiting consequential damages to "reasonably certain" lost profits. Third, they might leave the contract silent about lost profits and expect that courts will limit any award of lost profits to those that the parties impliedly agreed would be payable in order to solve the holdup problem. In effect, these parties expect a court to apply something equivalent to the tacit agreement test notwithstanding the broader formulation in the Restatement and U.C.C. Indeed, this strategy would apply with particular force in contracts governed by New York, since, as discussed above, that jurisdiction retains the more restrictive test.[94]

If my claim has any force, however, then one would expect that at least some sophisticated commercial actors would take a fourth alternative and explicitly incorporate a clause awarding lost profits into their contract. Moreover, one would expect such a clause to appear in transactions in which one party is required to make a relationship-specific investment that exposes it to holdup and in which information about potential lost profits is relatively available ex ante to the party expressly agreeing to pay lost profits as damages.

In order to determine whether these predictions are accurate, I have examined contracts involving sophisticated commercial actors found in the searchable database of the Contracting and Organizations Research Institute (CORI) of the University of

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[94] *See supra* Part II.B.

Missouri at Columbia.[95] Most contracts within the database are taken from public disclosure filings or are filed with a regulatory agency. As a result, these contracts are likely to involve large, publicly owned companies. For purposes of my search, I limited the relevant contracts to those involving joint ventures, business transactions (primarily involving leases, sales, licenses of intellectual property, and purchases of services), and utilities. A search of documents that contain the terms "lost" and "profits" produced a sample size of 295 discrete contracts.[96] Of those, and consistent with expectations from contract theory, 232 explicitly exclude either consequential damages, lost profits, or both. A plurality of these contained a provision that excluded consequential damages and lost profits for both parties with no other stipulations.[97] Approximately sixty of the contracts contain provisions that exclude consequential damages and lost profits but permit their recovery, either by negative implication or explicit statement, in limited circumstances, such as where the counterparty engages in a willful breach or breaches a confidentiality clause.[98] Approximately seventy contracts exclude liability for lost profits and consequential damages for just one of the parties. Typically, in these situations, the party not liable for these damages had access to all remedies at law or had its remedy restricted to the price already paid.[99] As these contracts did not address consequential damages explicitly, I do not count them as relevant "lost profits" cases. Of the remaining contracts, even though the contract contained the search terms "lost" and "profits," the contract contained no clause that dealt with lost profits.

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[95] The database is available at Contracting and Orgs. Research Inst., http://cori.missouri.edu/pages/ksearch.htm (last visited Feb. 10, 2013).

[96] The list of contracts can be found on the website of the *New York University Law Review*, http://www.nyulawreview.org/online-features/gillette. The search initially returned a list of 337 documents. Of those, however, forty-two did not generate a document when clicked. Hence, the sample size of 295 documents.

[97] *See, e.g.*, U.S. Steel Corp. & Republic Engineered Prods., Pellet Supply Agreement (2002), *available at* http://cori.missouri.edu/ (No. 2609) ("Buyer and Seller agree that in no event shall either party be liable to the other for any indirect, special or consequential damages or lost profits as a result of a breach of any provision of this Agreement.").

[98] *See, e.g.*, Maxtor Standard Volume Purchase Agreement, § 1.3.C (2002), *available at* http://cori.missouri.edu/ (No. 9338) (allowing recovery for lost profits in the event of a breach due to "intentional misconduct or gross negligence"); Bridge Trading Co. Transaction System Agreement, § 7(c) (2002), *available at* http://cori.missouri.edu/ (No. 11,699) (allowing lost profits recovery in the event of a breach due to "gross negligence or willful misconduct"). I use an approximate number, because some of the contracts cannot easily be classified. For example, in one case, the indemnity clause itself excludes lost profits. Daniel C. Javitt & Glytech, Inc., Licensing Agreement, § 6.1(g) (2002), *available at* http://cori.missouri.edu/ (No. 81,767).

[99] *See, e.g.*, Amerivision Commc'ns & Task Force, Consulting Agreement, § 6 (2002), *available at* http://cori.missouri.edu/ (No. 27,912).

Two contracts explicitly impose liability for lost profits in the event of breach without restriction.[100] These are in addition to those contracts that do not exclude such recoveries under limited circumstances. The small sample means that results can only be suggestive. Nevertheless, consistent with the predictions from theory, those contracts do involve investments that qualify as relationship specific. A contract designated as a "Beverage Marketing Agreement" between Mrs. Fields Original Cookies, Inc. (MFOC) and Coca-Cola Fountain (CCF) is illustrative.[101] That contract provides that if MFOC breaches, it is responsible for credits and the return of equipment and "unearned prepaid funding" provided by CCF.[102] The contract also recites that these provisions do not restrict the remedies or damages that may result from a breach by either party. But the contract then states that, "Nothing herein shall be construed as a waiver of any right of CCF to prove consequential damages as a result of a breach by MFOC including, but not limited to lost profits, and other damages allowable."[103]

What would explain this provision that explicitly permits one party, but not the other, to recover lost profits in the event of a breach? Review of the entire contract reveals that MFOC is obligated under the contract to purchase a set amount of syrups—products that might otherwise be provided to other CCF customers and thus do not constitute a relationship-specific investment on the part of CCF. In addition, CCF leases to MFOC beverage dispensing equipment that, once used by MFOC, cannot be utilized by other potential CCF customers, who might demand "new" rather than "used" equipment. A clause in the contract reveals the value of this investment. The clause notes that MFOC is required to pay CCF at expiration or termination of the contract the "unamortized portion of the cost of installation and the entire cost of remanufacturing and removal of all equipment owned by CCF."[104] One might initially conclude that the lease payments reflect the value of the equipment and thus negate the notion that equipment constitutes a nontransferable investment. But the lease recites that MFOC "acknowledges that the rent set forth herein does not fully compensate Company [CCF] for its expenses

100 M.J. Quinlan & Assocs. & Poore Bros., License Agreement, Art. 9(3) (2000), *available at* http://cori.missouri.edu/ (No. 8588); Mrs. Fields Original Cookies & Coca-Cola Fountain, Beverage Marketing Agreement, 7 (2003), *available at* http://cori.missouri.edu/ (No. 11,288).

101 Mrs. Fields Original Cookies & Coca-Cola Fountain, *supra* note 100.

102 *Id.*

103 *Id.*

104 *Id.*

concerning its research and development efforts designed to improve fountain equipment or in providing the Equipment to Lessee . . . ."[105]

CCF also agrees to provide advance funding and marketing funds to MFOC for the explicit purpose of expanding the consumption of beverages at stores within the MFOC system. Presumably, CCF would want to protect against MFOC's diversion of these funds for purposes that did not generate benefit to CCF, and a representation by MFOC to that effect would be insufficient without the *in terrorem* benefit of a lost-profits clause. MFOC, on the other hand, makes no relationship-specific investment. Its obligation is primarily to purchase CCF products and to make the payments due under the contract.

Similarly, consider a contract between M.J. Quinlan Associates, an Australian business engaged in research and development for the production of "3-dimensional hollow fried snack food products . . . , including without limitation a kangaroo-shaped product," and Poore Brothers, a Delaware corporation engaged in the manufacture and marketing of food products.[106] The contract grants an exclusive license in the United States for Poore Brothers to use Quinlan's intellectual property relating to manufacturing three-dimensional hollow fried snack foods. Poore Brothers commits to making "reasonable commercial effort" to promote the sale of such products within its exclusive territory, to pay Quinlan specified fees and royalties, and to incorporate Quinlan's kangaroo design on the packaging of any kangaroo-shaped product it manufactures.[107] In the event of Quinlan's continuing breach after notice, Poore Brothers is entitled to withhold royalties until Quinlan remedies the breach. At that point, Poore Brothers is obligated to pay the withheld royalties, but "less any damages or lost profits suffered by Poore Brothers as a result of Quinlan's breach."[108]

The explicit reservation of the right to lost profits makes sense in light of the parties' desire to induce relationship-specific investment. While the agreement recites that Poore Brothers has the technology to manufacture two-dimensional snack foods,[109] it apparently did not have the technology to manufacture three-dimensional hollow products. Once it obtained the intellectual property rights to that

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105 *Id.* at Ex. A, Lease Agreement.

106 M.J. Quinlan & Assocs. & Poore Bros., *supra* note 100, at Whereas Clause A.

107 *Id.* art. 2(6).

108 *Id.* art. 9(3). This clause is arguably even more favorable to the investing party than a clause allowing recovery of lost profits damages, because Poore Brothers can simply offset its alleged lost profits, and the counterparty would have to demonstrate the impropriety of its actions.

109 *Id.* at Whereas Clause D.

technology, however, it would presumably also have to obtain equipment that would permit utilization of Quinlan's intellectual property in order to manufacture the products. It is plausible that such equipment would not be useful for other aspects of Poore Brothers's business. Thus, the purchase of such equipment fits within the model of relationship-specific investment that could subject Poore Brothers to holdup. The ability to retain any lost profits even after Quinlan remedies a breach dilutes the incentive for the latter to engage in any holdup activity.

The lost-profits clause is more remarkable in light of the fact that other contracts involving Poore Brothers that are within the CORI database contain the standard exclusion of liability for lost profits.[110] Perhaps the licensor in those other contracts—Warner Bros.—had more bargaining power than did Quinlan. But the dictates of contract design suggest an alternative explanation. Unlike the contract with Quinlan, the obligation of Poore Brothers in the latter contracts solely involves the distribution of Warner Bros. products, without any requirement to make relationship-specific investments. The fact that the same party used different clauses in different contracts indicates that inclusion of lost-profits damages is a well-considered and deliberate effort to accomplish some contractual goal, and the protection of non-transportable investments constitutes a reasonable objective that can be served by this contractual mechanism.

It is noteworthy, moreover, that the explicit invocation of lost profits in the Poore Brothers contract with Quinlan is one-sided. Breach by Poore Brothers does not trigger an explicit claim for lost profits, notwithstanding that Quinlan has given Poore Brothers an exclusive license, which could fit the model of relationship-specific investment. There are, however, potential explanations for the asymmetry. First, since the primary obligation of Poore Brothers under the contract is to pay royalties, the parties may have believed that Quinlan could recover unpaid royalties as direct damages, making it unnecessary to mention lost profits as recoverable consequential damages. Second, different exclusive-dealing arrangements may involve different switching costs. If Quinlan's grant of an exclusive U.S. license to Poore Brothers entails only the transmission of intellectual property—as opposed, for instance, to the delivery of manufactured equipment under the Coca-Cola contract mentioned above—then perhaps Quinlan had less concern about being exploited by Poore

110 *See* Warner Bros. & Poore Bros., Retail and Promotional License, art. 6(a) (2002), *available at* http://cori.missouri.edu/ (No. 8586); Warner Bros. & Poore Bros., Retail and Promotional License, art. 7(a) (2002), *available at* http://cori.missouri.edu/ (No. 8587).

Brothers because, in the event of a breach by Poore Brothers, Quinlan's intellectual property would not necessarily have been of reduced value to a third party.

The same rationale appears appropriate in contracts that permit a limited exception to the general exclusion of consequential damages. These contracts make up the substantial majority of those that allow recovery of lost profits, either explicitly or implicitly. For example, a "License, Option and Collaboration Agreement" between ACADIA Pharmaceuticals, Inc. and Sepracor, Inc. involved an effort to identify and develop compounds for clinical development.[111] ACADIA had apparently developed expertise and acquired proprietary rights related to some of the substances that would be the subject of Sepracor's commercialization efforts. ACADIA granted Sepracor an option to obtain an exclusive license with respect to certain compounds. Retaining the confidentiality of ACADIA's expertise presumably would be crucial to any market advantage that ACADIA possessed. Moreover, Sepracor itself presumably would want to preclude ACADIA from sharing information with third parties once Sepracor began investing in clinical development. Thus, the parties could be expected to draft contractual clauses that bound them to their "collaborative relationship."[112] Indeed, the contract reveals several binding mechanisms. In the first instance, the parties agreed to enter into a stock purchase agreement pursuant to which Sepracor would purchase and commit to purchase shares of ACADIA common stock. Damages provide an additional bonding mechanism: While the agreement includes a standard clause disclaiming liability for consequential damages, that limitation on liability contains an exception for breaches involving each party's obligation to keep confidential certain proprietary information provided to it by the other party.[113] Allowing recovery of consequential damages in this limited situation is consistent with the desire of each party to protect investment in the joint enterprise of proprietary information that would lose much of its value to the owner if it were disseminated to third parties. Notwithstanding the "new business" nature of the transaction, the collaborative nature of the relationship and the stock purchase agreement indicate that the parties have sufficient financial and product information to predict their liability exposure and thus make a potential award of consequential damages a plausible bonding mechanism. Indeed, cases of willful or grossly negligent breaches may particularly

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[111] ACADIA PHARM., INC. & SEPRACOR, INC., LICENSE, OPTION AND COLLABORATION AGREEMENT (2005), *available at* http://cori.missouri.edu/ (No. 42,087).

[112] *Id.* at Recitals.

[113] *See id.* § 10.6.

fit the model insofar as they are indicative of an actual exercise of the holdup option by the breaching party. That appears especially true where the breach that triggers consequential damages involves the unauthorized use of confidential information, which threatens to dilute the value of relationship-specific investments by making them available to third parties, and to willful breaches that may indicate a refusal to provide the return exchange for the first mover's performance in making a relationship-specific investment. For instance, in one contract, the parties explicitly permitted lost-profits damages for a failure to deliver pharmaceutical products that would be due only after the counterparty had made substantial investments in obtaining approvals for the sale of those products.[114]

The number of contracts that contain explicit lost-profits clauses is too small to offer strong empirical support for the proposition that willingness to incur such liability overcomes the holdout problem and thus induces relationship-specific investments. But the contracts that do permit unrestricted recovery of lost profits, and the more numerous contracts that allow such damages for breach of confidentiality agreements that inherently involve holdup, provide at least weak support for the claim I have made. These contracts do appear systematically to involve relationship-specific investments that render a party vulnerable to exploitation for providing goods or information that cannot easily be retrieved in the event of breach.

V
Case Law and Lost Profits

I have argued that an agreement to pay lost profits in the event of breach reduces the incentive of the investing party to withhold performance for fear of holdup, and thus provides the assurances necessary to induce optimal investment. Outside of this area, parties would eschew explicit or tacit agreement to pay lost profits in the event of breach because it would allocate liability inefficiently and would induce overinvestment. My examination of contracts in the previous Part provides at least weak evidence of the accuracy of this prediction. But perhaps a stronger claim could be made. If the default rule of contract damages only allowed lost-profits recovery under the same

114 One waiver agreement between two pharmaceutical companies follows the standard disclaimer with an exception for willful breach and then recites, "For purposes of clarity, Teva hereby explicitly agrees to be responsible for any willful breach by Plantex to timely provide ALO with Initial Quantities including special, indirect, incidental, consequential damages or lost profits whether in contract, warranty, negligence, tort, strict liability or otherwise . . . ." Alpharma, Inc. & Teva Pharm., Inc., Selective Waiver Agreement § 8.14 (2004), *available at* http://cori.missouri.edu/ (No. 46,411).

conditions in which parties would expressly agree to pay lost profits—that is, where relationship-specific investment was required—then parties could signal their fidelity to a transaction by adopting that default rule. A court that detected that the requisite conditions existed could infer from contractual silence about damages that lost profits were in the "contemplation of the parties." In other words, the court could infer that the parties tacitly had agreed that the non-investing party would bear the risk of the investing party's lost profits. In that case, the tacit agreement test would actually be doing the work that Holmes carved out for it: imposing only that scope of liability that "the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made."[115] Liability, however, would not necessarily extend to all the damages that the aggrieved party suffered and of which the breaching party has "reason to know." Instead, courts would infer tacit agreement only in circumstances that parallel those that prevail where parties explicitly opt into such damages. I next investigate the New York cases to determine whether courts' application of the tacit agreement test is consistent with the investment theory.

A. *The New York Cases and Relationship-Specific Investment*

Take first the cases in which courts applying New York law have concluded that liability for lost profits in the event of breach was within the contemplation of the parties under *Kenford I* and *Kenford II*. In *Alesayi Beverage Corp. v. Canada Dry Corp.*,[116] Alesayi had obtained an exclusive license to use Canada Dry trademarks in large portions of Saudi Arabia. The court found that Alesayi breached the agreement by distributing the products of a competitor in ways that disfavored Canada Dry and underutilized the assets that Canada Dry had assigned exclusively to Alesayi. The court then turned to the issue of damages and the efforts of Canada Dry to recover lost profits. The court concluded that the parties contemplated liability for lost profits as required by the *Kenford* cases. This outcome was largely influenced by the fact that, in the event of breach, the contract explicitly permitted the aggrieved party to "pursu[e] any . . . legal remedies [other than termination] which it may have for such breach or which may have otherwise accrued under the agreement."[117] That clause, however, only authorized recovery of damages under applicable legal

[115] Globe Ref. Co. v. Landa Cotton Oil Co., 190 U.S. 540, 544 (1902).
[116] 947 F. Supp. 658 (S.D.N.Y. 1996).
[117] *Id.* at 672 (alterations in original).

rules; it does not necessarily define the scope of recoverable damages. If the applicable legal rules did not permit recovery of lost profits, the contractual clause would not make them available.

Perhaps a more compelling explanation for the willingness to award lost profits lies in the court's recitation of the salient features of Alesayi's relationship with Canada Dry. [118] The court concluded that Canada Dry could not prevail upon another bottler to sell its products in that market because it had given Alesayi an exclusive license to bottle and sell Canada Dry products—the very essence of a nontransferable investment.[119] Of course, Alesayi's undertaking not to dilute its efforts on behalf of Canada Dry was itself a contractual device to avoid holdup after Canada Dry's investment. But the court's analysis of damages implied that lost-profits recovery played a similar role. The court concluded that "lost profits comprise a form of damages likely to flow from breach of an agreement that concerned trademark privileges, a licensed bottling facility, and extract sales."[120] Although the court did not expand on its reasoning, and Alesayi did not contest satisfaction of the contemplation test, reflection reveals that those elements of the contract entailed substantial investment that could not easily be transferred to other transactions. The extract sold to Alesayi was manufactured in Ireland and shipped to Saudi Arabia, and had a limited shelf life. Hence, the goods could not easily be reallocated to other jurisdictions in the event of Alesayi's breach. Canada Dry's failure to find an alternative distributor reveals how the exclusive arrangement with Aleyasi constrained Canada Dry from otherwise deploying its assets subject to the contract, while allowing Alesayi to do exactly what it allegedly did: dilute the value of those assets by selling competing products in a manner that maximized Alesayi's profits rather than its joint profits with Canada Dry. In essence, the court appears to have found the requisite "contemplation" of lost profits in Canada Dry's desire to condition investment in Alesayi on some assurance that Alesayi would not exploit its monopoly either by subordinating Canada Dry's interests to its own or by demanding renegotiation.

Travellers International, A.G. v. Trans World Airlines, Inc.[121] similarly involved an exclusive relationship, a joint venture under which Travellers was the sole provider of land arrangements for tours. Travellers was to plan and operate the tour programs, and design the tour brochures and marketing strategy for an annual target of 100,000

[118] *Id.* at 671.
[119] *Id.*
[120] *Id.* at 672.
[121] 41 F.3d 1570 (2d Cir. 1994).

customers. TWA was responsible for promoting Travellers's tours. After TWA ended the relationship, Travellers brought a successful action for wrongful termination. On the issue of damages, the court focused on the relationship-specific investments made by Travellers to conclude that the parties reasonably contemplated a lost-profits award for breach within the meaning of the *Kenford* cases. Over the parties' twenty-year relationship, the court concluded, Travellers had invested virtually all its resources in its relationship with TWA. Exploitation of that relationship was the very risk that the parties would have wanted to avoid; otherwise, Travellers would have been reluctant to invest in the venture. Thus, the court inferred, the parties agreed to lost profits as an assurance that the initial investment would not be exploited.[122]

In a final case, *Ashland Management, Inc. v. Janien*,[123] an employer breached a contract involving the use of a model developed by an employee for selecting investments. The contract limited the ability of the parties to disclose information to third parties. Thus, the employee was unable to use his model for any other purpose once he granted rights to the employer. In applying the *Kenford* standard, the Court of Appeals for the Second Circuit concluded that the parties' negotiations and contractual terms made "manifest" that lost profits would be recoverable in the event of breach.[124] The contract provided that if the employee left the firm "for any reason," he would be entitled to fifteen percent of the firm's gross revenues.[125] The contract also predicted the amount of business that the mathematical model would generate. Thus, the court inferred that the parties had "fully debated and analyzed" future earnings, and agreed to post-employment compensation predicated on anticipated revenues.[126] The prediction of revenues, the court concluded in a bit of a non sequitur, implied that the firm "must have foreseen that if it breached the contract defendant would be entitled to lost profits."[127]

Placing aside the logic of the court's reasoning, its conclusion was consistent with the prediction that tacit agreement can be inferred from relationship-specific investment. The commitment not to exploit the employee once that investment was made would have facilitated

[122] *Id.* at 1578.
[123] 624 N.E.2d 1007 (N.Y. 1993).
[124] *Id.* at 1011.
[125] *Id.*
[126] In its discussion of the parties' intent concerning lost profits, the court characterized the post-employment compensation as "damages." *Id.* But the compensation clause applied if Janien left Ashland "for any reason." *Id.* Presumably that would include departures unrelated to a breach by Ashland, and thus it was not necessarily a contractual damages clause.
[127] *Id.*

the employee's agreement to transfer proprietary information for the firm's exclusive use. The inference of a lost-profits recovery in the event of breach plays that role.[128]

Conversely, courts applying New York law have been more reluctant to award lost profits where the breach did not involve a relationship-specific investment. It is in these cases that the deviation between New York doctrine and the broader constructions of "reason to know" has its most significant bite, since it means courts deny damages even when the investing party satisfies the latter test. The *Kenford* cases themselves fall into this category. *Kenford I* dealt with efforts to recover prospective profits of a proposed management contract.[129] The plaintiffs, however, did not point to any relationship-specific investment in the contract; indeed their complaint was that no contract was ever executed, and thus they had not sunk into the enterprise any costs that could not be transferred to alternative transactions. In *Kenford II*, plaintiffs had purchased parcels of land that they anticipated would be used for a stadium and for enterprises around the stadium.[130] The "raw acreage" they purchased could be resold or redeployed to other uses that, while less profitable than anticipated, would have prevented plaintiffs from suffering the total loss characteristic of relationship-specific investments.[131]

Post-*Kenford* cases fall into the same pattern. In *Awards.com, LLC v. Kinko's, Inc.*, [132] Kinko's agreed to license the use of its store space for the sale of plaintiff's products within mutually selected Kinko's locations. The plaintiff brought an action against Kinko's for breach of contract and $276 million in lost profits for wrongful termination. In the absence of anything in the agreement revealing contemplation of lost profits, the appellate court applied the "commonsense" approach dictated by *Kenford*.[133] The court concluded that the start-up nature of the plaintiff's enterprise made it unreasonable to infer that Kinko's would have assumed lost-profits liability for breach.

[128] What makes the case somewhat more complicated for the theory is that, at the time of the breach, the employee had not yet fully developed the program and arguably could have taken it to another firm if he decided to proceed. Thus, one might contend that he had not made a relationship-specific investment at the time of breach. But once the court found that a contract had been created, the employee was obligated to create the model and was prohibited from revealing the information that he had developed to that point to other firms. Thus, it is plausible that the court believed that entry into the contract sufficiently locked the employee into the relationship to trigger the assumption of a commitment against exploitation.

[129] 493 N.E.2d 234.

[130] 537 N.E.2d 176.

[131] *Id.* at 178.

[132] 834 N.Y.S.2d 147 (App. Div. 2007), *aff'd*, 925 N.E.2d 926 (N.Y. 2010).

[133] *Id.* at 152.

Common sense, however, is perhaps equally informed by the nature of the transaction. The plaintiff's products consisted of "personalized corporate awards and promotional items" that, if not sold at Kinko's, could have been readily removed and made available for sale at other locations.[134] Thus, Kinko's breach, if any, did not implicate the susceptibility to opportunistic behavior that would result if the plaintiff had made investments that could not be used in replacement transactions.

Similarly, in *Trademark Research Corp. v. Maxwell Online, Inc.*,[135] a Second Circuit case applying New York law, the purchaser of a trademark database and search system that the defendant was to custom design sued for lost profits when the designer could not deliver a system that would operate as promised. The court reversed a trial court's award of lost profits.[136] It concluded that the plaintiff had failed to establish that liability for lost profits was within the contemplation of the parties, even though it was clear that the plaintiff sought the system to increase its market share of products sold to third parties, a factor that would seem to satisfy the broader "reason to know" test of the Restatement. Instead, the court inferred from a prior contract between the parties that had excluded consequential damages that the parties to the current contract intended the same result.[137] Of course, one could have inferred just the opposite from the omission of the clause, given its presence in the prior contract. Perhaps the court was motivated by the absence of any relationship-specific investments in the project by the plaintiff, although the defendant invested resources in the design and construction of the failed system.

In *Schonfeld v. Hilliard*,[138] the court denied the plaintiff's claim of lost profits in the amount of $269 million for a breached contract concerning a failed cable television channel. The plaintiff had agreed to provide "time and effort" in negotiating contracts,[139] but the opinion does not indicate that the plaintiff contributed any non-redeployable asset, including any specific investment of time and effort in actual negotiations. Indeed, it was the plaintiff who sought recovery for the failure of the defendants to comply with their promise to make relationship-specific investments.

Two recent invocations of the *Kenford* cases by the New York Court of Appeals blurred the distinctiveness of the *Kenford* cases by citing both Restatement (Second) § 351 and Holmes in *Globe*

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[134] *Id.* at 150.
[135] 995 F.2d 326 (2d Cir. 1993).
[136] *Id.* at 334.
[137] *Id.*
[138] 218 F.3d 164 (2d Cir. 2000).
[139] *Id.* at 168.

Refining. In the more reasoned case, *Bi-Economy Market, Inc. v. Harleysville Insurance Co. of New York*,[140] an insured company claimed breach of its insurance policy and sought recovery from its insurer for consequential damages related to the demise of its business. The policy explicitly excluded coverage for "consequential loss," and the insurer contended that this exclusion demonstrated that, in accordance with the test of *Kenford I*, the parties did not intend that the insurer bear the loss of consequential damages.[141] The court held that damages related to the demise of the insured by virtue of the insurer's breach were sufficiently foreseeable to be compensable.[142] The court interpreted the contractual exclusion as applying only to losses engendered by delays caused by third-party actors and not "consequential damages" caused by the insurer itself.[143] The court's rationale, therefore, fits as easily within a "reason to know" conception of consequential damages as an "intention of the parties" conception. Nevertheless, the court's reliance on the insurer's breach of the covenant of good faith and fair dealing implied in insurance contracts suggests that the court may have been more willing to carve out an insurance exception to its prior rule.[144]

B. *Judicial Application of the "Reason to Know" Test*

The New York cases arguably are consistent with the intent of sophisticated commercial parties insofar as they permit the award of lost profits if, but only if, there was at least tacit agreement that a breaching party would incur such liability. Moreover, those cases are also consistent with the conduct of the majority of commercial actors, who exclude consequential damages in the absence of such investment. But the "reason to know" test is sufficiently nebulous that it plausibly could be interpreted in the same manner as the tacit agreement test, notwithstanding its broader verbal formulation. That is,

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[140] 886 N.E.2d 127 (N.Y. 2008).

[141] *Id.* at 129.

[142] The opinion in the second case, *Panasia Estates, Inc. v. Hudson Insurance Co.*, 886 N.E.2d 135 (N.Y. 2008), was quite cursory and relied on *Bi-Economy* for the proposition that consequential damages were recoverable by the insured if they were the foreseeable result of the insurer's breach.

[143] *Bi-Economy*, 886 N.E.2d at 132.

[144] Indeed, that is how some courts have read the decision. *See, e.g.*, Haym Salomon Home for the Aged, LLC v. HSB Grp., Inc., No. 06-CV-3266(JG)(JMA), 2010 WL 301991, at *5 n.1 (E.D.N.Y. Jan. 20, 2010) ("[A]n insured can seek consequential damages for an insurer's breach of the covenant of good faith and fair dealing." (citing *Bi-Economy*, 886 N.E.2d at 130)); Silverman v. State Farm Fire & Cas. Co., 867 N.Y.S.2d 881, 883 (Sup. Ct. 2008) ("[A] failure [to provide coverage] may indeed support . . . a claim [for consequential damages] if it flows from a breach of good faith and fair dealing, which the courts will read into all insurance contracts." (citing *Bi-Economy*, 886 N.E.2d 127)).

courts might intuit to the results the tacit agreement test dictates, and apply "reason to know" or "foreseeability" to encompass only those risks within the contractual structures that the narrower test recognizes. The possibility of convergence is increased by the Restatement rule that permits courts to deny lost profits even with respect to foreseeable damages where awarding them would cause disproportionate damages or would be unjust,[145] and by applying the common law principle that permits denial of lost profits that are not "reasonably certain."[146] If courts actually interpret and apply the "reason to know" test in a manner that is consistent with the parties' intent, then there would be little practical difference between it and tacit agreement. If, on the other hand, courts interpret the "reason to know" test in a manner that complicates the parties' efforts to determine their exposure ex ante or that imposes on them a degree of liability that they have not agreed to bear, the different tests have different practical effects. Thus, before drawing any inferences about the superiority of the tacit agreement test, it would be useful to know whether courts that apply the "reason to know" test tend to find the requisite foreseeability only where relationship-specific investments have been made.

In order to explore that issue, I examined cases in California, a jurisdiction that has a reputation for coherent contract law and that embraces, at least as a formal matter, the "reason to know" test for consequential damages.[147] In its most recent foray into the issue, the California Supreme Court considered a contractor's ability to recover lost profits allegedly suffered after a school district's breach of contract caused a reduction in the contractor's bond coverage and precluded the contractor from bidding on other contracts.[148] The court denied recovery of general damages on the grounds that lost profits from unidentified contracts with third parties were not awarded in construction contracts.[149] The court then invoked *Hadley* for the proposition that lost profits might qualify as special or consequential damages.[150] But the contractor had not proven that the district "could

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145 RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1981).

146 *See* Lloyd, *supra* note 45 (explaining the common law doctrine and analyzing how courts apply it).

147 *See, e.g.*, Applied Equip. Corp. v. Litton Saudi Arabia Ltd., 869 P.2d 454, 460 (Cal. 1994) ("Contract damages are generally limited to those within the contemplation of the parties when the contract was entered into or at least reasonably foreseeable by them at that time; consequential damages beyond the expectations of the parties are not recoverable.").

148 Lewis Jorge Constr. Mgmt., Inc. v. Pomona Unified Sch. Dist., 102 P.3d 257 (Cal. 2004).

149 *Id.* at 264–65.

150 *Id.* at 262.

have reasonably contemplated that its breach of the contract would probably lead to a reduction of [contractor] Lewis Jorge's bonding capacity by its surety, which in turn would adversely affect Lewis Jorge's ability to obtain future contracts."[151] To have contemplated those consequences, the court concluded, the district would have had to have known "what [the contractor's] balance sheet showed or what criteria [the contractor's] surety ordinarily used to evaluate a contractor's bonding limits."[152] In short, the court adopted a straightforward foreseeability test and, given the stringent conditions that had to be foreseen as reasonably probable to result from the breach, that test was not satisfied. Whether the parties intended that the school district bear liability for such losses was not part of the explicit calculus.

At one point, the court raised the issue that underlies tacit agreement. It noted that damages are intended to give the aggrieved party the benefit of its bargain, and thus required a threshold inquiry into the nature of the bargain.[153] The court then found that the terms of the bargain protected only the profit that the contractor would receive from the district's payment of the contract price, and thus excluded liability for profits from collateral contracts with third parties.[154] That analysis resonates with the "tacit agreement" test. But the court used its "bargain of the parties" argument in order to determine whether the contractor's lost profits from forgoing other contracts qualified as general damages that constitute "the direct and immediate fruits of the contract"[155] or "that naturally flow from a breach."[156] When the court turned to the question of whether lost profits qualified as special or consequential damages, the nature of the bargain was irrelevant. Such damages, the court concluded, could not be recovered if they were unforeseeable or uncertain.[157] Here, the district's lack of reason to know the contractor's financial status rendered the alleged lost profits too unforeseeable to allow recovery.[158]

It is difficult to find a relationship-specific investment in the California case, so that failure to award consequential damages is not necessarily inconsistent with the result that would obtain under tacit agreement. To find conflict between the two tests would require a case in which a party that clearly had not made a relationship-specific

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151 *Id.* at 267.

152 *Id.*

153 *Id.* at 263.

154 *Id.* at 264.

155 *Id.* at 263 (quoting Shoemaker v. Acker, 48 P. 62, 64 (Cal. 1897)).

156 *Id.* at 265.

157 *Id.* at 267.

158 *Id.*

investment was still awarded lost profits for foreseeable damages. I have not found such a case in the California Supreme Court, and thus it is plausible that the court has applied the "reason to know" test in a manner consistent with tacit agreement. What does seem clear is that the court's formal analysis is unrelated to the structure of the contractual relationship. The court's focus on knowledge as the measure of foreseeability still entails decisions about lost profits that are disembodied from contractual risk allocations. It is perhaps not surprising, therefore, that two unpublished appellate opinions in California (including one that also involved damages due to reduced bonding capacity) have distinguished *Lewis Jorge* and found lost profits sufficiently foreseeable to be recoverable, notwithstanding that neither case involved any relationship-specific investment.[159] At the very least, the ambiguity of "reason to know" appears to reduce the predictability of liability that would flow from consideration of the parties' intended risk allocations as evidenced by the structure of their contractual relationship.

Conclusion

Maybe Justice Holmes was correct after all. Notwithstanding that most sophisticated parties reject the inefficiencies inherent in the broad "reason to know" default, an obligation to pay consequential damages in the event of breach can play a useful role in some transactions. Commercial parties presumably would accept liability to receive some corresponding advantage, such as inducing relationship-specific investments that increase the value of the bargain. The tacit agreement test arguably facilitates that tradeoff and thus reflects the behavior and preferences of sophisticated actors. By restricting recovery to liabilities assumed by non-investing parties, the test can reduce the risk of overinvestment. By constraining recovery to that which was assumed and could be priced, the test permits a credible signal of fidelity to the transaction without exposing the promisor to liability that is open-ended or noncompensable. And by allowing the dictates of contract design to determine the scope of liability, it arguably provides courts with a better metric than the vagaries of "reason to know" foreseeability for discerning the intent of contractual parties.

My objective here, however, is less about advocating re-adoption of the tacit agreement test and more about investigating how

[159] Masterpiece Accessories, Inc. v. Sahab, No. B207716, 2009 WL 3260965, at *7 (Cal. Ct. App. Oct. 13, 2009); BEGL Constr. Co. v. L.A. Unified Sch. Dist., 66 Cal. Rptr. 3d 110, 113, 115 (Ct. App. 2007).

sophisticated commercial actors are implementing the lessons of contract design. The contracts I have considered indicate that parties actually include clauses that theory predicts could solve transacting problems. Applications of the tacit agreement test suggest that courts can validate those efforts by identifying the situations in which parties have applied the lessons of contract theory and interpreting contractual provisions accordingly. The Restatement and U.C.C. tests for consequential damages are largely indifferent to parties' intent; they ask only whether the parties had reason to know that the damages could materialize as a consequence of breach. Contractual behavior suggests that sophisticated parties can signal their intent to assume liability for lost profits. Judicial opinions suggest that—guided by a proper test—courts have the capacity to receive and amplify those signals, but are perhaps less likely to do so when they employ a test that requires less attention to parties' intent. The lessons of contract design are more valuable if courts apply them as the parties intended. On that score, a tacit agreement test that directs courts to be attentive to contractual intent is preferable to one that directs courts to consider ambiguous factors less reflective of the parties' bargain.