
THE MISSING ELEMENTS OF CONTRACT DAMAGES

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In this Article, we juxtapose two classic contract doctrines to expose a subtle, but dramatic, anomaly of damage law. After Jack Dempsey breached a contract to pursue another championship boxing match, the spurned promoter sued for all his costs but the court allowed only the postcontract costs, thereby wiping out precontract expenses. Separately, though, the Red Owl promissory estoppel line of cases allows recovery of costs reasonably incurred in reliance on a precontractual promise despite the lack of a finalized agreement. Our linkage of Dempsey and Red Owl uncovers the striking possibility that an aggrieved party on a finalized contract might receive less than if he had failed to finalize the deal.

Beyond this first anomaly, our critical analysis of a Judge Posner opinion reveals another unrecognized inconsistency. We show how an aggrieved party recovers precontract and fixed overhead costs on final contracts that provide in advance a fixed return, but not on those with variable returns. Yet Judge Posner curiously defends the current law as providing “symmetrical” results.

In response to the more general undercompensation possibility in contract law, some scholars have proposed transferring all the breaching party's gains from breach to the aggrieved party. We utilize the movie Rocky to demonstrate the excesses of this disgorgement remedy. Suppose a small-time boxer breached a club fight contract for the opportunity to fight for the championship. Why deprive the boxer of all his hard-fought revenue regardless of the promoter's harm?

Finally, we propose an innovative solution in lieu of disgorgement for variable return contracts: a presumptive recovery of all costs plus a reasonable risky rate of return over the investment period. Our proposal essentially extends the well-established presumption that the aggrieved party can recover postcontract costs in lieu of lost revenue. Our default presumption could be rebutted upon a proper showing of lesser value by the breaching party.

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I. INTRODUCTION

We begin by juxtaposing two classic contract doctrines to expose a striking, unrecognized anomaly of contract law. Our joint analysis of the legendary *Chicago Coliseum Club v. Dempsey*¹ and *Hoffman v. Red Owl Stores, Inc.*² cases reveals that a party negotiating a deal might be more likely to recover costs made in preparation for the contract when the other side backs out before executing a contract than when the counterparty reneges on a fully enforceable contract. Contract doctrine has developed several mechanisms—including the *Red Owl* promissory estoppel line—that allow recovery of expenditures made in the absence of a contract. By contrast, *Dempsey* disallows recovery of precontract expenditures in cases where the parties actually reach a “meeting of the minds” but do not sufficiently fix in advance the return on the contract (an “open-return contract”).

We then uncover a related but independent inconsistency in contract law between the recoveries available under two different types of finalized contracts. By comparing the recovery under an open-return contract, as in *Dempsey*, with the likely recovery under a contract whose return is fixed in advance (a “set-return contract”), we demonstrate that precontract and fixed overhead expenses are treated differently and more harshly under an open-return contract.³ After unmasking these inconsistencies,

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1. 265 Ill. App. 542 (1932).

2. 133 N.W.2d 267 (Wis. 1965).

3. To understand the difference between a “set-return contract” and an “open-return contract,” consider the following examples. First, suppose that a promoter enters into a contract with a boxer whereby the boxer agrees to pay the promoter \$1 million for the promoter’s services—such a contract would be deemed a set-

we propose a new damage regime that reduces these disparities in treatment, more accurately reflects business expectations, and creates better incentives for efficient behavior.

Consider first the famous Jack Dempsey case.⁴ Dempsey contracted with Chicago Coliseum to fight Harry Wills in a heavyweight championship match.⁵ Rather than negotiating a straight fee for their promotional efforts, the Coliseum agreed to a percentage-of-the-gate arrangement.⁶ Dempsey then broke the contract to fight instead Gene Tunney, thereby altering boxing history forever.⁷ Although Dempsey's repudiation prevented the Coliseum from potentially earning substantial revenues, the damage award was insignificant.⁸ The court denied expectancy damages for the "too speculative" lost profits, finding that it could not estimate the gate receipts for the cancelled match.⁹ Instead, the court limited recovery to only reliance expenditures made after the contract signing and before breach, thereby denying recovery for precontractual promotional costs and fixed salaries to corporate officers.¹⁰ In

return contract because the contract specifies the price for the promoter's services. Now, suppose that the promoter enters into a similar contract, but instead of agreeing to a set price for his services he agrees to provide his services for a percentage of the revenue generated by the match—such a contract would be deemed an open-return contract because the contract does not specify the price for the promoter's services; rather, his return is contingent on the success of the match.

4. *Dempsey*, 265 Ill. App. at 542.

5. The contract was executed on March 13, 1926, but was dated March 6 of that year. *Id.* at 544. Chicago Coliseum was an Illinois corporation in the business of promoting athletic purposes and conducting boxing matches for prizes. *Id.*

6. *Id.* at 545.

7. Tunney's victory over Dempsey in the fight then led to the famous "Long Count" rematch, "one of the most controversial prize fights in boxing history." See Michael Lamkin, *Gene Tunney vs. Jack Dempsey II*, FIGHT WORLD, <http://www.fightbeat.com/judgejake/tunneydempsey2.php> (last visited Nov. 14, 2011) (describing the rematch in detail). In the rematch, Dempsey knocked down Tunney for more than ten seconds, but nonetheless failed to get the knockout win. *Id.* The referee did not begin counting right upon the knockdown since Dempsey failed to follow the new neutral corner rule, which required the successful puncher to go to a neutral corner before the countdown would begin. *Id.*

8. See *Dempsey*, 265 Ill. App. at 549–54 (allowing the Coliseum Club to recover only "[e]xpenses incurred after the signing of the agreement and before the breach").

9. *Id.* at 549–50. Expectancy damages seek to put the aggrieved party in the position he would have been in had the contract been performed. See, e.g., *Hawkins v. McGee*, 146 A. 641, 644 (N.H. 1929) (citing 1 J.G. SUTHERLAND, LAW OF DAMAGES § 92 (John R. Berryman ed., 4th ed. 1916)) (holding that the aggrieved party was entitled to the difference between the value of the hand he was promised by the doctor and the value of his hand after the unsuccessful surgery). In an attempt to recover expectancy damages, the Coliseum offered proof that the boxing exhibition between Dempsey and Wills would have brought a gross receipt of \$3,000,000 and the expenses would have been \$1,400,000, leaving a net profit of \$1,600,000. *Dempsey*, 265 Ill. App. at 549. Despite this evidence, the court found that "[t]he character of the undertaking was such that it would be impossible to produce evidence of a probative character sufficient to establish any amount which could be reasonably ascertainable." *Id.* Further, the two fights that did take place between Dempsey and Tunney, one in 1926 and the other in 1927, generated gate receipts of \$1,895,000 and \$2,658,000, respectively. JOHN P. DAWSON ET AL., CONTRACTS: CASES AND COMMENT (9th ed. 2008).

10. *Dempsey*, 265 Ill. App. at 552–53. Damages based on the reliance interest include "expenditures made in preparation for performance or in performance." RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981). This provision has been interpreted to exclude precontract reliance expenditures. See William Hart, Comment, *The Detriment of the Bargain: How the Limiting Principle and Preclusion of Pre-Contractual Expenditures Place Undue Risk on a Non-Breaching Party*, 18 REGENT U. L. REV. 349, 360 (2006) (discussing

disallowing fixed overhead and precontract costs where lost profits were indeterminate (the “Dempsey Rule”), the court reasoned that the execution of the final contract was the pivotal point for determining liability, rather than an earlier time during negotiations when the parties “indicated an agreement between them.”¹¹

Consider next a variation of the *Dempsey* case to highlight how the recovery would have differed if a final contract had not been executed and the Coliseum could assert a claim under the *Red Owl* promissory estoppel approach.¹² Suppose that after Dempsey promised the Coliseum that he would fight Wills in a heavyweight championship match, but before all of the terms of the contract were finalized, the Coliseum reasonably incurred expenses in identifying secondary investors, meeting with other promoters, and locating a suitable venue. Dempsey then refused to finalize the contract with the Coliseum. Under these circumstances, the Coliseum would not be entitled to damages on the contract as there was never a finalized agreement. However, under the *Red Owl* approach, the Coliseum could likely recover its precontract expenses under the equitable theory of promissory estoppel because Dempsey made a promise on which the Coliseum reasonably relied and acted upon to its detriment.¹³

Dempsey and *Red Owl* have been extensively analyzed over time, albeit independently of each other. By now jointly analyzing the two, we expose the possibility that the aggrieved party on a successfully negotiated contract might receive a lesser recovery than if he had been unsuccessful in negotiating the final contract! In particular, although *Red Owl* permits recovery even though final negotiations fail, *Dempsey* cuts off precontract expenditures when the aggrieved party successfully finalizes the deal.

that reliance damages are meant to return the plaintiff to his precontractual position). As an alternative to expectancy damages, the promoter in *Dempsey* sought recovery under a reliance theory for his expenditures. See *Dempsey*, 265 Ill. App. at 552–53. The court allowed damages for special expenses incurred after the execution of the contract on March 13, 1926 (even though it was dated as of an earlier date) and before notice of repudiation on July 10, 1926, including the expenses of traveling to Colorado for Dempsey to take his physical examination, and expenses in making arrangements for publicity and accommodations. *Id.* at 553. However, the court denied recovery for the promotional expenditures because the coliseum entered into the contract with Andrew Weisberg for such services before Dempsey signed the contract for the prizefight, even though the Weisberg contract was executed after the date the Dempsey contract was dated (i.e., the Dempsey contract was pre-dated). *Id.* at 552.

11. *Dempsey*, 265 Ill. App. at 551.

12. See *Hoffman v. Red Owl Stores, Inc.*, 133 N.W.2d 267 (Wis. 1965) (awarding reliance damages under the theory of promissory estoppel because Hoffman incurred substantial expenditures in reasonable reliance on Red Owl’s promises and assurances of a supermarket franchise). The *Red Owl* case, already one of the most analyzed and studied cases, has recently received even more attention because Professor Scott was able to obtain and review the full trial transcript. See Robert E. Scott, *Hoffman v. Red Owl Stores and the Myth of Precontractual Reliance*, 68 OHIO ST. L.J. 71, 74–85 (2007) (describing the story revealed in the full trial transcript); William C. Whitford & Stewart Macaulay, *Hoffman v. Red Owl Stores: The Rest of the Story*, 61 HASTINGS L.J. 801 (2010) (describing the interview recently conducted of Hoffman).

13. Promissory estoppel is appropriate where the following conditions are met: (a) There is a promise that the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee; (b) the promise induces such action or forbearance; and (c) injustice can be avoided only by enforcement of the promise. RESTATEMENT (SECOND) OF CONTRACTS § 90. See *infra* Part II.A for a detailed discussion of promissory estoppel.

The main stated justification for the Dempsey Rule is that aggrieved parties do not incur precontract expenditures in reliance on the contract.¹⁴ The argument ignores the fact that some precontract costs might have been incurred in reliance on precontract negotiations or preliminary understandings. The *Dempsey* “integration” approach, which places great weight on the timing of the ultimate contract, wipes out these reliance-induced expenditures.¹⁵ Moreover, our critical analysis of Judge Posner’s opinion in *Autotrol Corp. v. Continental Water Systems Corp.*¹⁶ reveals yet another underappreciated inconsistency of current contract law. Aggrieved parties generally recover all precontract costs and fixed overhead on finalized set-return contracts without regard to reliance since the set amount recovery subtracts out only postcontract saved costs under mitigation principles. As such, recovery on the set-return contract includes, for example, costs incurred even prior to any negotiations. So although aggrieved parties can recover their costs absent any reliance on set-return contracts, the Dempsey Rule disallows recovery of precontract expenses under open-return contracts. Yet Judge Posner curiously defends the current state of the law as providing “symmetrical” results between set and open-return contracts!¹⁷

One might attempt to explain the disparate treatment between set-return and open-return contracts on the ground that there is no need to separately determine each recoverable cost on the set-return contract; compensation is built into the ordinary damage remedy. Juxtaposition of *Dempsey* and *Red Owl* undermines this argument, because under the *Red Owl* approach the component costs can be recovered when there has been no contract, even though those costs need to be separately determined. Why, then, should the need to ascertain those costs be an obstacle when the parties have reached an open-return contract? Indeed, the contract price can be even less determinable under the *Red Owl* line than the *Dempsey* line given the lack of a contract finalizing the terms. And once again, why should the aggrieved party be treated more harshly when he in fact successfully negotiates a finalized deal? Furthermore, the set-return scenario also can require consideration of component costs since postbreach saved costs reduce the aggrieved party’s recovery of the set contract price.

The problem, then, is that current law can treat the aggrieved party of an open-return contract less favorably than the aggrieved party of a set-return contract and less favorably than a party who has made expenditures without ever reaching a contract.¹⁸ This Article will demonstrate that both of these disparities can be best addressed by reversing the Dempsey Rule and allowing recovery of precontract and fixed overhead costs on open-return contracts. Reversing the Dempsey Rule is not merely a matter of

14. See 22 AM. JUR. 2d *Damages* § 51 (2010) (“Reliance damages in breach-of-contract cases are limited to those expenses incurred after an agreement has been reached. Because reliance damages seek to measure an injured party’s ‘cost of reliance’ on a breached contract, that party may not recover for costs incurred prior to its execution of the contract.”).

15. See *infra* Part II.A for a discussion of integration principles that can limit recovery to only expenses incurred after the signing of the contract.

16. 918 F.2d 689 (7th Cir. 1990).

17. See *infra* part II.B for a discussion of the Posner opinion and the disparate treatment of sunk costs under set-return versus open-return contracts.

18. See *infra* Part IV.A.1 for a discussion of the old Dempsey Rule and its effects in different jurisdictions.

fairness. The Dempsey Rule also leads to undercompensation of aggrieved parties as well as an increased risk of opportunistic behavior and deterring efficient precontract investments.¹⁹

One response to the undercompensation problem is to require the breaching party to disgorge profits made as a consequence of the breach. However, disgorgement can lead to overcompensation and the risk of deterring even efficient breaches.²⁰ Consider another variation of *Dempsey*, modeled after the movie classic *Rocky*,²¹ to highlight the disgorgement overcompensation problem. Chicago Coliseum, a promoter of sports events, spends several weeks and thousands of dollars seeking the perfect contenders for a boxing match, locating a suitable arena, and hiring assistants to help with promotional efforts and ticket sales for the event. Eventually, Jack Dempsey, a popular club fighter, agrees with the Coliseum to fight another club fighter. A few weeks later, Gene Tunney (Dempsey's Apollo Creed), the undisputed heavyweight champion, offers Dempsey the chance of a lifetime, to replace his original contender who broke his hand and fight for the title. Confident that Dempsey's hometown roots and local popularity would draw a large gate, Tunney offers Dempsey significantly more money to fight for the championship. Since Dempsey cannot take on both fights, Dempsey breaches his original contract for a chance of a lifetime payday and fame. Facing possible serious harm at Tunney's lethal hands, Dempsey greatly intensifies his training regime and "goes the distance" in fifteen grueling rounds with Tunney, albeit in a loss. Even assuming difficulty in ascertaining the Coliseum's lost revenues from Dempsey's breach, we find unsatisfying a disgorgement approach that might require Dempsey to pay the Coliseum his entire take from the fight, and possibly even more.²²

This Article proposes instead a more moderate solution, which validates the undercompensatory concerns of the disgorgement proposals without going too far in the other direction. It proposes a presumptive recovery for aggrieved parties on open-return contracts equal to their entire investment costs (pre- and postcontract; fixed and variable) plus a risky rate of return on that capital investment for the investment period. This proposed solution essentially extends the well-established presumption in contract law that the aggrieved party will recover at least what his postcontract variable expenditures would have been if the contract had not been breached.²³ Under current law, this presumptive recovery of postcontract variable costs is disallowed to the extent the aggrieved party would not have regained such outlays absent the breach, but the breaching party appropriately bears the burden to prove such a "losing contract," since the breaching party's actions caused the lack of an actual revenue stream from the

19. See *infra* Part III.A for a discussion of the problems of undercompensation.

20. See *infra* Part III.B for a discussion of the problems of disgorgement.

21. For a brief summary of the movie, see *Plot Summary for Rocky*, THE INTERNET MOVIE DATABASE, <http://www.imdb.com/title/tt0075148/plotsummary> (last visited Nov. 14, 2011).

22. See *infra* Part III.B.1 for a discussion of the disgorgement rule. In this case, the disgorgement rule might possibly encourage the Coliseum to sue Dempsey for earnings from any rematch and subsequent championship fights if Dempsey won the rematch, like in *Rocky*, on grounds that Dempsey would have never had the rematch but for the original breach.

23. See, e.g., *L. Albert & Son v. Armstrong Rubber Co.*, 178 F.2d 182, 189 (2d Cir. 1949).

venture.²⁴ Drawing upon classic investment principles, this Article demonstrates why this reasoning should be extended to all investment costs in a venture along with a profitable return thereon. The current presumption is too narrow, as it is based on the factually counter-intuitive premise that aggrieved parties would have recouped only their postcontract variable costs.²⁵ As will be shown, most rational investors realistically expect to recoup, on average, all their investment costs plus some actual profit for the investment period.

Part II of this Article explores the undercompensation of aggrieved parties to open-return contracts, as compared to aggrieved parties who fail to successfully negotiate a contract or who negotiate a set-return contract. Part III.A demonstrates the problems of such undercompensation, for instance, how it creates incentives for opportunistic breaches. Part III.B then considers potential responses to the problem, including disgorgement as a remedy, and demonstrates how such solutions go too far in the other direction, that is, they create a reciprocal problem of deterring even efficient breaches. Part IV suggests a reversal of the Dempsey Rule to allow a presumptive recovery of all reasonable costs, including precontract and fixed overhead, plus a risky profitable rate of return thereon. Such a presumption would more accurately reflect the ex ante business expectations of the parties, would encourage efficient precontract expenditures, and would place the burden of proof on the appropriate party, as it was the breaching party's actions that prevented the aggrieved party from earning an actual revenue stream on the contract.

II. THE DEMPSEY PARADOXES: BROKEN PROMISES AND SUNK COSTS

A. *Damages May be Higher for Broken Promises Without a Contract than with a Finalized Deal*

To understand the inconsistent results that may arise when applying the Dempsey Rule, compare the award of damages from the actual case, which involved the breach of a percentage-of-the-gate or open-return contract, with the award that would likely have been recovered had negotiations terminated before a final contract was executed. Several theories, such as promissory estoppel, breach of the duty of good faith, and breach of a preliminary commitment, have emerged to award damages in the latter situation but are not applicable in the former.²⁶

24. See, e.g., *Beefy Trail, Inc. v. Beefy King Int'l, Inc.*, 267 So. 2d 853, 860 (Fla. Dist. Ct. App. 1972) (Owen, J., concurring and dissenting) ("The proof that full performance would have resulted in a loss to the plaintiff is a matter of defense; there is no burden on [the aggrieved party] to prove that there would not have been any loss.")

25. Some skeptics might object to an extension of the presumption on grounds that there was no reliance. However, as we will demonstrate, reliance should not be the dispositive issue for two main reasons. First, aggrieved parties are generally entitled to recover precontract expenditures on set-return contracts without proving reliance. Second, such an extension fits within classic reliance theory, which includes a notion of lost opportunity costs. As will be shown in the risky return section, *infra* Part IV.B, the aggrieved party should be entitled to a presumed risky rate of return on his investment during the time his money was exposed and he was denied the opportunity to invest elsewhere.

26. This Article focuses on the recovery available under the theory of promissory estoppel. For a discussion of the recovery available for breach of the obligation of good faith, see, for example, Reprossystem,

First, consider how precontract expenses are treated under traditional contract damage doctrine. Specifically, whether an aggrieved party, like the Coliseum in the *Dempsey* case, would be entitled to recover any of its precontractual reliance expenditures upon breach.²⁷ The answer is far from simple under the murkiness of the current damages regime and depends in large part on whether profits are determinable.²⁸

Where revenues are determinable, such as under a straight fee or set-return contract, the aggrieved party implicitly recovers these expenditures as part of his expectancy damages, assuming the parties accurately priced the deal.²⁹ As example, in the *Dempsey* case, had Dempsey and the Coliseum negotiated a contract which provided that the Coliseum would promote the boxing match for a straight fee of \$1 million, then upon Dempsey's breach the Coliseum would likely recover its fee (potentially offset by saved costs under mitigation principles) as expectancy damages. Presumably, the Coliseum would have built all of its expenses (both pre- and postcontract) into its fee and the precontract costs would not be offset against its recovery on mitigation principles as these costs could not have been avoided upon learning of the breach.

However, where revenues are indeterminate, such as under a percentage-of-the-gate or other open-return contract, lost revenues would generally be denied as "too speculative." In these situations, the Dempsey Rule would limit the aggrieved party's damages to those expenditures incurred after contract formation and before notice of breach or repudiation.³⁰ In denying recovery for precontract expenditures, the *Dempsey* court reasoned:

B.V. v. SCM Corp., 727 F.2d 257, 264 (2d Cir. 1984) (holding that the duty to negotiate in good faith does not arise until an "agreement in principle," which is not necessarily a contract, is formed). For a discussion regarding breach of preliminary commitments, see generally Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661 (2007).

27. For ease of exposition, this Article assumes the lack of any benefit conferred upon the breaching party to avoid complicating the analysis with a consideration of a possible restitution recovery.

28. This Section focuses on recovery under an open-return contract. See *infra* Part II.B for a discussion of recovery under a set return contract. For instance, if contract revenues for the Red Owl franchise were determinable, Hoffman would have received not only a profit return, but also recovery for precontract expenditures and a portion of overhead expenses.

29. Expectancy damages are the normative measure of contract damages, which seek to put the aggrieved party in the situation he would have been in absent the breach. See, e.g., *Hawkins v. McGee*, 146 A. 641, 644 (N.H. 1929).

30. See *Dempsey*, 265 Ill. App. at 549–51 (denying recovery for precontract costs, including those incurred in trying to get Dempsey to sign the contract and in hiring a promoter for the prizefight). Three leading treatises also explain that contract damages are generally limited to expenses incurred after the contract is finalized and before it is breached. See 22 AM. JUR. 2D *Damages* § 51 (2010) (limiting reliance damages in breach of contract cases to "expenses incurred after an agreement has been reached"); 3 E. ALLEN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.16, at 280 (3d ed. 2004) (injured parties may not "recover costs incurred *before* the contract was made" (emphasis in original)); 11 JOSEPH M. PERILLO, CORBIN ON CONTRACTS § 57.6, at 261 (rev. ed. 2005) ("Expenses incurred in inducing the making of the contract are not expenses in preparation and part performance."). *But see* *Security Stove & Mfg. Co. v. American Ry. Express Co.*, 51 S.W.2d 572 (Mo. Ct. App. 1932) (permitting the recovery of precontractual expenditures because Security Stove knew it could call on American Railway Express's common-law duty to accept and transport the shipment with reasonable dispatch); *Anglia Television Ltd. v. Reed*, [1971] 3 All E.R. 690 at 692 (Eng.) (holding that although breaching party would not have been liable for losses had he not entered contract, "it

It may be argued that there had been negotiations pending between [the Coliseum] and Dempsey which clearly indicated an agreement between them, but the agreement in fact was never consummated until sometime later. The action [was] based upon the written agreement Any obligations assumed by the [Coliseum] prior to that time are not chargeable to [Dempsey].³¹

In other words, where an action is based upon a finalized contract, the aggrieved party can only recover losses sustained as a consequence of the contract and cannot recover precontract expenditures unless the breaching party “affirmatively . . . assume[s] responsibility for them.”³² This result is counter-intuitive when compared to the possible results if the contract had never been consummated.

Now, consider how these precontract costs would have been treated if Dempsey backed out of negotiations before a final agreement was reached but after he promised to fight Wills and the Coliseum incurred expenses in reasonable reliance on that promise. Under the theory of promissory estoppel, the Coliseum may recover all of its expenditures made in reasonable reliance on the promise.³³ In *Hoffman v. Red Owl Stores, Inc.*,³⁴ one of the bedrock promissory estoppel cases, the jury awarded damages where a promise was made and the aggrieved party reasonably relied on the promise and incurred substantial costs to his detriment.³⁵ In affirming the verdict, the Supreme Court of Wisconsin reasoned that, in a situation where a contract is never finalized, promissory estoppel is a necessary tool to prevent injustice and “to keep remedies abreast of increased moral consciousness of honesty and fair representations in all business dealings.”³⁶ In the absence of a promissory estoppel cause of action, the promises would not have been enforceable because the parties never reached a final

does not lie in his mouth to say he is not liable, when it was because of his breach that the expenditure has been wasted”).

31. *Dempsey*, 265 Ill. App. at 551.

32. *Drysdale v. Woerth*, 153 F. Supp. 2d 678, 684 (E.D. Pa. 2001) (quoting 22 AM. JUR. 2D *Damages* § 594 (1988)); see also *Autotrol Corp. v. Cont’l Water Sys. Corp.*, 918 F.2d 689, 695 (7th Cir. 1990) (recognizing that expenses incurred before contract execution are not recoverable, but not adjusting the jury award because the amount was nominal); *Energy Capital Corp. v. United States*, 47 Fed. Cl. 382, 426–427 (2000) (denying recovery for any expenses incurred before contract formation); *Gruber v. S–M News Co.*, 126 F. Supp. 442, 446–47 (S.D.N.Y. 1954) (denying recovery for the cost of making printing plates incurred in the performance of an oral agreement to print Christmas cards but prior to execution of a final contract); *Moore v. Lewis*, 366 N.E.2d 594, 599 n.3 (Ill. App. Ct. 1977) (citing *Dempsey*, 265 Ill. App. at 550–51) (denying recovery of expenditures allegedly made on a promise to issue a contract to sell a mortgage because at the time expenditures were made there was no contract on which the promisee could rely); *Schatzinger Consol. Realty Co. v. Stonehill*, 29–39 Ohio C.C. Dec. 587, 592–93 (Cir. Ct. 1912) (denying recovery of precontract fees paid for architectural plans before a land sale contract was finalized).

33. See *supra* note 13 for a list of the elements of a promissory estoppel claim under § 90 of the *Restatement (Second) of Contracts*.

34. 133 N.W.2d 267 (Wis. 1965).

35. *Red Owl*, 133 N.W.2d at 277.

36. *Id.* at 273 (quoting *Peoples Nat’l Bank of Little Rock v. Linebarger Constr. Co.*, 240 S.W.2d 12, 16 (Ark. 1951)).

agreement.³⁷ Allowing recovery under the doctrine of promissory estoppel for precontract reliance expenditures when negotiations break down is controversial, but has been widely accepted.³⁸ The difficult issue in determining liability is evaluating what kind of promise is sufficient to justify recovery for some or all of the promisee's expenditures.³⁹

Rather than searching for an actionable promise on which to base recovery where a final contract is never reached, some modern courts have permitted limited recovery based on an obligation to bargain and negotiate in good faith,⁴⁰ and some scholars have more narrowly advocated for recovery based on an obligation to make precontract investments in accordance with the terms of a preliminary agreement.⁴¹

37. See *Vigoda v. Denver Urban Renewal Auth.*, 646 P.2d 900, 905 (Colo. 1982) (explaining that promissory estoppel encourages fair dealing in business negotiations and discourages conduct that unreasonably causes foreseeable economic loss to one party because of its reliance on a specific promise).

38. See Michael B. Metzger & Michael J. Phillips, *The Emergence of Promissory Estoppel as an Independent Theory of Recovery*, 35 RUTGERS L. REV. 472, 496 (1983) (noting that promissory estoppel "has been used to enforce promises too indefinite or incomplete to constitute valid offers"). See, e.g., *Cyberchron Corp. v. Calldata Sys. Dev.*, 47 F.3d 39, 44-45 (2d Cir. 1995) (allowing computer hardware manufacturer to recover under promissory estoppel for materials purchased in reliance on initial purchase order that was never finalized); *Budget Mktg., Inc. v. Centronics Corp.*, 927 F.2d 421, 426-27 (8th Cir. 1991) (submitting promissory estoppel theory to jury even when the letter of intent specifically denied the existence of a contract); *Arcadian Phosphates, Inc., v. Arcadian Corp.*, 884 F.2d 69, 73-74 (2d Cir. 1989) (denying summary judgment on promissory estoppel ground because the evidence suggested that the seller made a clear, unambiguous promise that the buyer detrimentally relied on); *Chedd-Angier Prod. Co. v. Omni Publ'ns Int'l, Ltd.*, 756 F.2d 930, 935-37 (1st Cir. 1985) (allowing promissory estoppel for an illusory contract); *Werner v. Xerox Corp.*, 732 F.2d 580, 582-83 (7th Cir. 1984) (adopting promissory estoppel when enforcement is necessary to avoid injustice); *Goodman v. Dicker*, 169 F.2d 684, 685 (D.C. Cir. 1948) (permitting recovery for reliance expenditures, but not lost profits, where lease was too indefinite to be an enforceable contract); *Grouse v. Group Health Plan, Inc.*, 306 N.W.2d 114, 116 (Minn. 1981) (finding that promissory estoppel allows for recovery under an at will employment contract); *Neiss v. Ehlers*, 899 P.2d 700, 703-07 (Or. Ct. App. 1995) (surveying case law from other jurisdictions and extending the doctrine of promissory estoppel in Oregon to apply to promises that are too indefinite or incomplete to create enforceable obligations, including agreements to agree, on the grounds that promissory estoppel focuses on the unfair harm done to the aggrieved party). For a discussion of the development and trajectory of the doctrine of promissory estoppel, see generally Jay M. Feinman, *Promissory Estoppel and Judicial Method*, 97 HARV. L. REV. 678 (1984).

39. Schwartz and Scott demonstrate that courts do not generally impose liability for representations made during preliminary negotiations. Schwartz & Scott, *supra* note 26, at 691-705. However, courts are divided over the question of liability based on preliminary agreements. *Id.*

40. The duty of good faith is imposed where parties indicate their intent to be bound by entering into some form of preliminary commitment that expresses mutual assent on some terms but leaves other significant terms unresolved. See, e.g., *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491, 497-98 (S.D.N.Y. 1987) (recognizing the ability of parties to reach a preliminary agreement that contains "open terms that remain to be negotiated"); see also *Reprosystem, B.V. v. SCM Corp.*, 727 F.2d 257, 264 (2d Cir. 1984) (suggesting a multifactor analysis to determine when the duty arises). Although the parties are not bound to perform under a preliminary commitment, the parties are bound to negotiate the open issues in good faith in an attempt to reach the contractual objective within the general framework. *Teachers Ins. & Annuity*, 670 F. Supp. at 497-98. One court referred to this theory of liability as being the "modern trend in contract law." *Burbach Broad. Co. of Del. v. Elkins Radio Corp.*, 278 F.3d 401, 409 (4th Cir. 2002); see CORBIN ON CONTRACTS, *supra* note 30, § 57.6 (noting that there has been a growth of cases recognizing a duty to negotiate in good faith).

41. Concerned that the duty of good faith provides too little normative guidance, Schwartz and Scott developed a framework for determining liability for precontract reliance expenditures. See Schwartz & Scott,

Accordingly, under the Dempsey Rule, it is possible that an aggrieved party may obtain a larger recovery where he does not successfully obtain a final contract after promises are made or a preliminary agreement is reached than he would be if a final contract is consummated and then breached soon thereafter. Such disparities in treatment might create incentives for opportunistic and bad faith behavior (i.e., Dempsey may have decided to execute the contract only to breach it the next day in order to protect himself against any potential claims for precontract expenditures).⁴²

No commentators have squarely addressed these incongruous results. One possible explanation for this omission is that some scholars believe where a final contract is consummated the parties will have negotiated how to compensate for prior expenditures (possibly in a liquidated damages clause) and how to divide the expected surplus.⁴³ However, this assumes too much. Many parties do not specify a contract price or include provisions regarding expenditures in their contracts, so it is necessary to have default rules in this regard.⁴⁴ Further, a liquidated damages clause regarding precontractual expenditures may be deemed a penalty because aggrieved parties generally would not have a right to recover such sunk costs absent the provision, so it would not be a reasonable estimate of damages.⁴⁵

Another reason for not focusing on this inconsistency may be that skeptics simply believe that the aggrieved party would be entitled to recover precontract expenditures made in reliance on a promise or a preliminary commitment even if a final contract is

supra note 26, at 691–705. They demonstrate that it is unnecessary to impose a duty so long as the law reimburses precontract expenditures where parties enter into preliminary agreements requiring them to invest at roughly the same time and one party breaches by intentionally delaying investment. *See id.* at 702–05.

42. *See infra* Part III.A for a discussion of the problems of undercompensation.

43. *See, e.g.,* Lucian Ayre Bebchuk & Omri Ben-Shahar, *Precontractual Reliance*, 30 J. LEGAL STUD. 423, 424 (2001) (“If the contract is entered into, it will stipulate how to divide the surplus that will be generated in part by the reliance investments.”); *see also* Schwartz & Scott, *supra* note 26, at 682 (“If the project turns out to be profitable to pursue, the parties will write a complete contract. Because their *ex ante* agreement did not describe or price the particular project they will trade, the parties must bargain as if from scratch to divide a profitable project’s expected gains.”)

44. The sheer number of cases involving the issue of whether the aggrieved party is entitled to recover precontract expenditures demonstrates that it is not uncommon for contracts to lack a provision regarding recovery of these expenditures where profits are speculative. *See, e.g.,* Autotrol Corp. v. Cont’l Water Sys. Corp., 918 F.2d 689, 689–95 (7th Cir. 1990) (recognizing that expenses incurred before contract execution are not recoverable, but not adjusting the jury award because the amount was nominal); Energy Capital Corp. v. United States, 47 Fed. Cl. 382, 426–427 (2000) (denying recovery for any expenses incurred before contract formation); Gruber v. S–M News Co., 126 F. Supp. 442, 446–47 (S.D.N.Y. 1954) (denying recovery for the cost of making printing plates incurred in the performance of an oral agreement to print Christmas cards but prior to the execution of a final contract); Moore v. Lewis, 366 N.E.2d 594, 599 n.3 (Ill. App. Ct. 1977) (citing *Dempsey*, 265 Ill. App. at 550–51) (denying recovery of expenditures allegedly made on a promise to issue a contract to sell a mortgage because at the time expenditures were made there was no contract on which the promisee could rely); Schatzinger Consol. Realty Co. v. Stonehill, 29–39 Ohio C.C. Dec. 587, 592–93 (Cir. Ct. 1912) (denying recovery of precontract fees paid for architectural plans before a land sale contract was finalized).

45. *See* Schwartz & Scott, *supra* note 26, at 689 (adopting similar reasoning to understand why parties do not include liquidated reliance damages clauses in preliminary agreements). A liquidated damages clause may also be rejected if set too low, rather than too high. *See* RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (1981).

consummated.⁴⁶ However, that seems to ignore possible integration problems for the aggrieved party.⁴⁷ The parol evidence rule sharply restricts the admissibility of evidence regarding prior agreements or negotiations when a contract is reduced to a writing intended to be the complete expression of the parties' agreement.⁴⁸ The rule is meant to "simplify the administration of the resulting contract and to facilitate the resolution of possible disputes by excluding from the scope of their agreement those matters that were raised and dropped or even agreed upon and superseded during the negotiations."⁴⁹ Accordingly, the aggrieved party might not be permitted to recover precontract expenditures if the term is not included in the final agreement, even when the other party explicitly promised during negotiations to cover the expenses.⁵⁰ Given that result, then *a fortiori*, the aggrieved party can get wiped out when the other side does not explicitly make such a statement. Further, even if evidence of the underlying promise is admissible, the *Red Owl* line does not seem to fit so well where the promise (i.e., a promise to finalize the contract) is fulfilled and a final contract is executed and later breached.

A third possibility for the lack of attention to this discrepancy is that some commentators may believe that courts would simply backup the contract date to the date of the earlier promises or the preliminary agreement to make all expenditures

46. There is some support for finding that precontract reliance expenditures are recoverable where a breaching party had been made aware that such expenditures had been or would be incurred and breach would cause an aggrieved party to suffer damages in the amount expended. *See, e.g.*, 22 AM. JUR. 2D *Damages* § 97 (2010) (explaining that expenses incurred before mortgage company agreed to provide construction financing may be recoverable if bank had knowledge of those expenditures); *see also* Westfed Holdings, Inc. v. United States, 407 F.3d 1352, 1367 (Fed. Cir. 2005) (permitting recovery of damages based on letter of intent, but denying recovery of other precontract expenditures made before the execution of the letter of intent); DPJ Co. Ltd. P'ship v. FDIC, 30 F.3d 247, 249–50 (1st Cir. 1994) (permitting reimbursement for precontractual expenditures because they were incurred in trying to fulfill conditions of the commitment letter—there was a reasonable expectation at the time expenditures were incurred that the loan would be issued).

47. "An integrated agreement is a writing . . . which in view of its completeness and specificity reasonably appears to be a complete agreement . . ." RESTATEMENT (SECOND) OF CONTRACTS § 209. Some contracts expressly include integration or merger clauses stating that there are no promises or representations except those found in the writing. "Such a clause . . . if agreed to is likely to conclude the issue whether the agreement is completely integrated." *Id.* § 216 cmt. e.

48. *Id.* § 213. The Uniform Commercial Code (UCC), governing the sale of goods, contains a similar provision regarding parol evidence: "Terms . . . [in] a final expression of their agreement . . . may not be contradicted by evidence of any prior agreement . . . but may be explained or supplemented . . . by evidence of consistent additional terms." U.C.C. § 2-202 (2004); *see also* FARNSWORTH, *supra* note 30, § 7.2 at 225–26 (explaining that the parol evidence rule may bar the use of extrinsic evidence to supplement a written contract).

49. FARNSWORTH, *supra* note 30, § 7.2 at 225; *see also* Patton v. Mid-Continent Sys., Inc., 841 F.2d 742, 745 (7th Cir. 1988) (ruling that the parol evidence rule limits the admissibility of evidence regarding negotiations preceding the written contract); Lipsit v. Leonard, 315 A.2d 25, 29 (N.J. 1974) (holding that alleged oral promises were inadmissible under the parol evidence rule).

50. Consider the following example, which is a modification of an illustration from the Restatement: Suppose the promisor enters into a preliminary agreement promising to compensate the promisee for eighty percent of all reasonable reliance expenditures incurred prior to the execution of the agreement. A lawyer then drafts a final agreement that does not include a provision for pre-reliance expenditures. If the written agreement is a binding integrated agreement, any agreement for reimbursement of costs would be discharged absent an invalidating cause, such as illegality, fraud, duress, or mistake, or if the relief sought is rescission or restitution. *See* RESTATEMENT (SECOND) OF CONTRACTS § 213, illus. 2; *see also id.* § 214(d)–(e).

postcontract.⁵¹ However, there are at least some courts, including the *Dempsey* court, that have found that the signing of the contract signals the starting date of the arrangement, either based on integration principles discussed above or on a general refusal to permit the aggrieved party to back the contract up in time just to pile on damages.⁵²

In short, comparing the results from the *Dempsey* case with the likely outcome if there was never a finalized agreement and the Coliseum could recover based on the theory of promissory estoppel (or a related theory) reveals disturbing results. Ironically, a promisee may be worse off in a situation where he successfully negotiates an open-return contract that is later breached than he would be if negotiations broke down.

B. *Disparate Treatment of Sunk Costs in Set-Return Versus Open-Return Contracts*

This Section highlights a second problematic inconsistency under the *Dempsey* approach. This discrepancy relates to the recovery of two categories of “sunk costs”:⁵³ precontract expenditures and fixed overhead.⁵⁴ As developed below, the aggrieved party generally recovers all of his expenditures under a set-return contract, regardless of whether such expenditures are (i) fixed or variable or (ii) incurred before or after the time of contract formation.⁵⁵ In stark contrast, the *Dempsey* Rule generally denies outright any recovery for precontract expenditures or fixed overhead under an open-return contract.

51. See Robert E. Hudec, *Restating the “Reliance Interest”*, 67 CORNELL L. REV. 704, 721 (1982) (explaining that courts may adopt various time-bending constructions to justify awarding precontract expenses as reliance damages).

52. The *Dempsey* court emphasized that liability should only accrue after the date the agreement was consummated even if there were negotiations clearly indicating an agreement between the parties as of an earlier date. *Chicago Coliseum Club v. Dempsey*, 265 Ill. App. 542, 551 (Ill. Ct. App. 1932) (“The action is based upon the written agreement . . . any obligations assumed by the [Coliseum] prior to that time are not chargeable to [Dempsey].”).

53. Sunk costs or relation-specific investments are retrospective (past) costs that have already been incurred and cannot be recovered. Under traditional economic theory, sunk costs should not be considered when making rationale investment decisions. See Robert A. Prentice & Jonathan J. Koehler, *A Normality Bias in Legal Decision Making*, 88 CORNELL L. REV. 583, 604–05 (2003) (“Economists widely agree that sunk costs should be ignored when deciding whether to take on additional costs.” (emphasis omitted)).

54. Note that there is some overlap between these categories (i.e., fixed overhead relating to periods prior to the contract signing). Nonetheless, they are two separate categories, as precontract expenditures can include variable expenditures as well, and the fixed overhead issue can arise for periods after the contract signing. See, e.g., *Autotrol Corp. v. Cont’l Water Sys. Corp.*, 918 F.2d 689, 692–93 (7th Cir. 1990) (distinguishing between precontract and variable expenditures, both of which are recoverable overhead costs under Texas law).

55. This statement focuses on expenditures incurred prior to the breach by the breaching party. As discussed in greater detail below, the analysis is a little more nuanced once the focus expands to include postbreach expenditures (generally recovery, then limited to only truly fixed overhead). Further, note how the aggrieved party would not recover all its expenditures where it can be shown that the contract would have generated a loss for the aggrieved party. See *L. Albert & Son v. Armstrong Rubber Co.*, 178 F.2d 182, 189 (2d Cir. 1949) (shifting burden of proving amount promisee lost in potential future revenue had promisor not caused delay in performance of promise on promisor); *Cont’l Water*, 918 F.2d at 694 (stating that “[t]he defendants do not deny that Autotrol would have done well enough on the contract to cover the overhead expenses allocated to it, and with that concession Autotrol’s case is complete”). See also *infra* Part IV.B for a discussion of how, even under our proposed risky return profit theory, a breaching party may limit recovery by the non-breaching party if it can be shown that the contract would have resulted in a loss.

Judge Posner's *Autotrol v. Continental Water Systems Corp.*⁵⁶ opinion neatly illustrates the sunk cost divergence with respect to fixed overhead costs. Autotrol entered into a joint venture with Continental Water regarding the production and sale of water purification systems. Since Autotrol's return on the joint venture was not a set amount, Autotrol sued to recover its costs, including overhead incurred after contract formation and before breach. The opinion held that the prebreach overhead⁵⁷ should be allowed only if it were not "really [a] fixed cost": that is, only if Autotrol could have avoided the cost had the joint venture never been formed by either cutting back resources or allocating them to another deal.⁵⁸

As part of his analysis, Judge Posner began the path toward exposing the anomaly with a sharp comparison to the treatment of overhead on a set-return contract. Unfortunately, though, he stopped short of uncovering the divergent results. Judge Posner began the comparison by noting how overhead is properly subtracted from the aggrieved party's recovery on a set-return contract only if the aggrieved party could recoup it via a substitute deal after the breach or could avoid it via an overhead cutback.⁵⁹ Restated, the aggrieved party indirectly recovers the overhead (via denial of a reduction to the set contract price) unless the cost is really a variable cost, not a fixed one. This follows from the classic damage formula of the full contract price reduced only by the aggrieved party's saved costs.⁶⁰ Importantly for our purposes, note how *prebreach* overhead remains fully recoverable by the aggrieved party on a set-return contract without any further inquiry since it cannot be avoided (or recovered) going forward.⁶¹ Thus, the inquiry into whether the overhead could have been reallocated or reduced applies only to *postbreach* overhead. Judge Posner's very simple example neatly illustrates the overhead recovery:

Suppose that the overhead and other expenses that Autotrol incurred before the breach were \$1 million, the costs it would have (but had not yet) incurred to complete the systems after the breach \$2 million, and the price it would have obtained for the systems \$4 million. Then its damages would be \$2

56. 918 F.2d 689 (7th Cir. 1990).

57. "Prebreach overhead" will be used herein to refer to overhead incurred before breach but after contract formation. Overhead incurred before both contract formation and breach is covered more generally as part of precontract expenditures. *Cont'l Water*, 918 F.2d at 694.

58. *Id.* at 694.

59. *Id.* This essentially applies the mitigation doctrine.

60. *E.g.*, *Leingang v. City of Mandan Weed Bd.*, 468 N.W.2d 397, 398 (N.D. 1991) (aggrieved party entitled to the contract price less costs avoided by breach). Judge Posner's formulation also comports with an alternate, equivalent calculation equal to all expenditures incurred plus the overall profit on the contract. *E.g.*, *Rockingham Cnty. v. Luten Bridge Co.*, 35 F.2d 301, 308 (4th Cir. 1929) (aggrieved party entitled to expenses incurred in part performance plus profits it would have earned if there was full performance). Note how incurred expenditures do not include those that could have been avoided under mitigation principles.

61. *See Cont'l Water*, 918 F.2d at 694 (noting that since the breach occurred after the overhead expenses had been incurred, the jury would not have been entitled to subtract the overhead if there had been a set contract price). Note how mitigation generally cannot apply to prebreach overhead, as it has already been incurred at the time of breach.

million (\$4 million—\$2 million), and this would cover the overhead expenses plus an allowance for profit.⁶²

Returning to his set-return versus open-return contract comparison, Judge Posner intriguingly stated that the overhead treatment under the two contract types is “symmetrical.”⁶³ Unfortunately, he did not elaborate more on that thought, but it appears that he was focused primarily on how the recovery in either scenario can turn on whether the overhead was truly “fixed,” taking into account whether the aggrieved party could recoup or avoid the overhead.⁶⁴ Notwithstanding some similarity in that regard, Judge Posner’s analysis stopped short of a full comparison of the results under the two contract types. And as shown below, such fuller comparison highlights several inexplicable inconsistencies under the two different price scenarios.

First, although it is true that the determination of whether overhead is truly fixed can be relevant under either contract type, for open-return contracts it is relevant only for prebreach overhead, since all precontract and postbreach expenditures (variable or fixed) generally are disallowed. In stark contrast, the truly fixed determination becomes relevant only for postbreach overhead on the set-return contract since all precontract and prebreach expenditures (variable or fixed) are recoverable.

Expanding on the precontract category, recall how the aggrieved party generally recovers all such costs on a set-return contract since (i) only saved costs get subtracted from the contract price and (ii) precontract costs (fixed or variable), by definition, cannot be saved via mitigation after the breach.⁶⁵ In contrast, as demonstrated above, precontract expenditures would generally get wiped out under the *Dempsey* approach for an open-return contract, regardless of whether the costs could have been avoided.⁶⁶

A final way to see the dramatic inconsistency is to compare the divergent results for the set-return and open-return contracts under the *Dempsey/Continental Water* approach in the table set forth below. Note how only two categories of expenditures are treated the same under the two contract types: prebreach variables (recoverable) and postbreach variables (not recoverable under mitigation). In contrast, precontract variables and all fixed overhead (i.e., precontract, prebreach, and postbreach) are treated differently and more harshly for the open-return contract.

62. *Id.* Note how the alternate formula of lost profits plus expenses incurred provides the same \$2 million result (i.e., \$1 million + \$1 million).

63. *Id.*

64. *Id.*

65. See *supra* note 55 and accompanying text for a discussion of recoverable expenditures by the aggrieved party. Posner also discussed prebreach overhead in *Continental Water*, where because the breach occurred after the overhead was incurred the overhead expenses were not subtracted from the contract price since it was too late for the aggrieved party to make a substitute contract to cover those already incurred costs. *Cont'l Water*, 918 F.2d at 694. As noted earlier, such expenditures might be denied upon a satisfactory showing that the aggrieved party would have taken a loss on the contract, but that is a separate point.

66. As discussed above, aggrieved parties might sometimes succeed in recovering under some reliance theory or pushing back the contract formation date. This requires, however, an additional showing not required for the set-return contract.

<i>Expenditure Type</i>	<i>Set-Return Contract</i>	<i>Open-Return Contract</i>
Precontract: Fixed or Variable	Recoverable	Not Recoverable
Prebreach Fixed	Recoverable	Not Recoverable
Prebreach Variable	Recoverable	Recoverable
Postbreach Variable	Not Recoverable	Not Recoverable
Postbreach Fixed	Recoverable	Not Recoverable

Having now uncovered the inconsistent treatment of fixed overhead and precontract expenditures, we now question why recovery of these sunk costs should turn on whether the aggrieved party's return on the contract is set or open. Setting aside administrative costs for the moment, we see no satisfactory theoretical explanation for the sharp distinction. In fact, there is a strong theoretical reason for allowing recovery of precontract expenditures: to eliminate a potential disincentive for parties to make precontract investments. Default rules limiting the aggrieved party's ability to recover precontract expenditures upon breach would deter parties from making these efficient expenditures before executing a contract.⁶⁷

One might attempt to support the *Dempsey/Continental Water* approach, however, under a "reliance" theory of contract damages: that is, that the aggrieved party should recover its expenditures only to the extent they were incurred in detrimental reliance on the contract.⁶⁸ But even if one believes in this controversial viewpoint as a general matter, it founders as a satisfactory explanation for the disparate treatment of set-return versus open-return contracts. That is, as shown above, prebreach expenditures are recoverable on set-return contracts irrespective of whether they were incurred in detrimental reliance on the contract. At a deeper related level, the generally accepted recovery of precontract expenditures on set-return contracts evidences rejection of the notion that the aggrieved party's contract recovery should be properly limited to detrimental reliance.

A second theoretic justification based on the uncertainty of the revenue stream under an open-return contract also fails upon closer examination. Although the aggrieved party *might* have failed to recoup all of his expenditures absent the breaching party's breach, it is also true that the aggrieved party might have recouped all costs and then some (i.e., made a profit). And, as will be discussed in greater detail in the risky return section, a more reasonable presumption should be that aggrieved parties, on average, would recoup all costs and a profit on their successfully obtained deals.⁶⁹ If not, why expose your funds to the risk of loss instead of just investing in United States treasury debt instruments and receive back all your capital plus the "safe" risk-free interest rate? Furthermore, why penalize the aggrieved party for the lack of an actual revenue stream when the breaching party was the one who prevented the actual gain from realization over time? In this regard, the rules generally should allow for full cost

67. For a discussion of the efficiency of precontract expenditures, see *infra* Part IV.A.3.

68. The reliance theory would explain why prebreach overhead is recoverable only in the case of a substitute deal and precontract expenditures are not recoverable at all.

69. See *infra* Part IV.B for a discussion regarding expected payouts on risky ventures.

recovery, subject to reduction upon a sufficient showing by the breaching party that the aggrieved party would not have recouped some or all of their costs in a particular case.⁷⁰ Finally, recall how successful litigants can recoup certain precontract costs despite the lack of a fixed contractual revenue stream under the *Red Owl* line, where there is no contract at all.⁷¹

Given the lack of any strong theoretic support for the inconsistent treatment, we now consider whether practical concerns justify the disparate treatment, and find administrative concerns similarly lacking in this regard. At first blush, recovery of precontract expenses and overhead might seem easier to administer on a set-return contract, since the indirect recovery does not require a determination of the actual amounts (i.e., the indirect recovery occurs when the costs are *not* taken into account as an offset against the contract price). As discussed below, however, this fails to account for the offsetting administrative difficulties under the *Dempsey* approach, where sunk costs are not universally allowed on the open-return contract. In addition, the attempted justification loses force upon recognition that the set-return contract scenario requires consideration of component expenditures in determining which saved costs should be subtracted from the set contract price recovery.

To understand the administrative difficulties inherent in calculating damages under the *Dempsey* Rule, where fixed overhead is generally denied, recall Judge Posner's treatment of prebreach overhead. Under Posner's approach, overhead is sometimes allowed as a direct expenditure on the open-return contract, depending on whether the aggrieved party could have recovered the overhead through another deal or avoided it via an overhead cutback. So in addition to determining the amount of overhead in these cases, we now need to analyze whether the aggrieved party could have found a substitute deal or cutback the overhead. Interestingly in this regard, Judge Posner suggests that we might want to place a low burden of proof on the aggrieved party to show the substituted deal or cutback ability in order to "simplify litigation."⁷²

A second administrative difficulty arises from the line the *Dempsey* approach draws between precontract and postcontract expenditures. Having drawn such a line, we now need to determine which prebreach expenditures fall into which category. In this regard, recall the earlier discussion regarding the possible backing up of the

70. This is in fact our proposal for cost recoupment. See *infra* Part IV.A for a discussion of the benefits of a default rule allowing the aggrieved party to recover precontractual expenditures; see also *L. Albert & Son v. Armstrong Rubber Co.*, 178 F.2d 182, 191 (2d Cir. 1949); RESTATEMENT (SECOND) OF CONTRACTS § 349 (1981) (explaining similar concept under current law regarding the possible reduction of expenses incurred after the contract formation).

71. See *supra* notes 35–39 for a discussion of how the *Red Owl* court employed the doctrine of promissory estoppel to award the aggrieved party damages where the contract was never finalized.

72. *Autotrol Corp. v. Cont'l Water Sys. Corp.*, 918 F.2d 689, 695 (7th Cir. 1990). To the extent that Judge Posner's approach would take pressure off those alternate inquiries, note how we have moved closer to our preferred regime that would allow just the sunk cost recovery without any further inquiry. Further note that although we support Judge Posner's movement towards greater recovery as a matter of bottom-line result, we do not believe that one needs to justify such movement on grounds of simplifying litigation. Rather, as discussed above, we believe it is conceptually correct to provide the recovery, and that the only issue under consideration is whether administrative concerns should override the theoretically correct movement towards allowing the recovery. From that perspective, Judge Posner's approach lends further support to our view since he seemingly supports a greater recovery of such amounts on administrative grounds apart from our theoretic arguments.

contract date to an earlier point in time (e.g., the signing of a preliminary agreement).⁷³ Similarly, consideration needs to be given as to whether precontract expenditures should be recoverable under promissory estoppel or some other reliance-based theory. Like the overhead discussion above, we now need to consider not only the amount of the precontract expenditures but also the difficult question of the proper trigger time for recovery.⁷⁴ And once again, we seem to lack a convincing explanation for why aggrieved parties should be subjected to harsher burdens when they successfully finalize the deal.

Finally, determining damages under set-return contracts requires a similar consideration of component costs, including overhead, since “saved” costs get subtracted from the set contract price recovery. For instance, as per Posner’s *Continental Water* opinion, consideration must be given as to whether “overhead” is truly fixed or just another saved variable cost that gets subtracted out from the set contract price.⁷⁵ More generally, disputes arise over which of the aggrieved party’s future component costs were “saved” by the breaching party’s breach.

In sum, current law contains an unjustified disparate treatment of sunk costs. Precontract expenditures and prebreach overhead are recoverable on set-return contracts without any further showing by the aggrieved party, yet they are not generally recoverable on an open-return contract: prebreach overhead requires an additional showing of a substituted deal whereas precontract expenditures (fixed or variable) are not recoverable at all. As discussed above, this inconsistency lacks any compelling theoretic or practical justification.⁷⁶ And, as will be discussed below in Part III.B, the inconsistency extends to a reasonable profit estimate as well.

III. THE CONSEQUENCES OF UNDERCOMPENSATORY AND OVERCOMPENSATORY DAMAGES

It has long been recognized in economic theory that default remedies can be tailored to create efficient outcomes because a promisor’s willingness to breach will

73. See *supra* notes 51–52 and accompanying text regarding backing up of contract dates to an earlier point in time.

74. This is not to say that undertaking such inquiry could not be justified if such line drawing was theoretically correct. But again, given that the theoretically correct treatment supports allowance of these sunk costs irrespective of the prebreach time frame, the focus here is whether the (theoretically-incorrect) line drawing can be justified on grounds of administrative ease. With that perspective in mind, the administratively difficult line drawing in question is subject to serious critique.

75. *Cont’l Water*, 918 F.2d at 692–95.

76. The open-return and set-return scenarios cannot be completely synchronized since the aggrieved party properly needs to present evidence of its costs when it is suing for a direct recovery of them under the open-return contract, whereas the indirect recovery on the set-return contract makes such an initial showing unnecessary. But that’s an unobjectionable evidentiary difference necessitated by the different contexts. The objectionable theoretic difference arises when an aggrieved party is denied a recovery even upon proper evidence of such incurred costs in the open-return context. As a somewhat related point, note how a breaching party should be allowed to counter an aggrieved party’s initial showing of costs in the open-return context by proving that such costs should not be recovered under a *Hadley*-type standard. See *infra* note 147 for a discussion of the expansion of damage awards for open-return contracts and the application of the *Hadley*-type limitation.

depend in large part on the consequences of the breach.⁷⁷ Many economic theorists believe awarding expectation damages provides the precise incentive to make the efficient breach idea work (i.e., the promisor will not breach unless he can pay enough money to make the promisee indifferent to the breach and still be better off than if he had performed and paid no damages).⁷⁸ Damages set below expectancy would fail to deter non-efficient breaches because the promisor may breach even if he would not benefit more from the breach than the promisee would suffer from the breach. Conversely, damages higher than expectancy—such as disgorgement—would deter some efficient breaches because the breaching party would not reap the benefits from the breach.

A. *Undercompensation, Penalty Default Rules, and Non-Efficient Breaches*

As shown above, the *Dempsey*-type approach can undercompensate the aggrieved party where the contract price is not readily determinable. Since the breaching party can avoid having to cover the aggrieved party's precontract and prebreach overhead expenditures, the aggrieved party can be left with a loss on the contract despite the lack of any showing that the contract would have generated such a loss absent the breaching party's breach.⁷⁹ This is disturbing from a distributional perspective⁸⁰ given contract law's goal of protecting the benefit of the bargain to the aggrieved party.

77. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.10, at 119–20 (7th ed. 2007) (asserting that the promisor may break a promise for economic gain); Robert L. Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 292 (1970) (arguing that a default remedy for breach of contract that protects the expectation interest promotes economic efficiency by promoting the optimal allocation of resources); Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443, 1468 (1980) (stating that economic efficiency would be promoted by the availability of supercompensatory damages).

78. A breach is considered "Pareto efficient" or "Pareto optimal" if there is "no change from that situation that can make someone better off without making someone else worse off." Mark Pettit, Jr., *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HASTINGS L.J. 417, 432 (1987) (quoting A.M. POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7 n.4 (1983)). A breach is considered "Kaldor-Hicks efficient" "if and only if under the redistribution the winners win enough so that they could compensate the losers. . . . [but] does not require that the winners actually compensate the losers." *Id.* at 433 (quoting Jules Coleman, *Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CALIF. L. REV. 221, 239 (1980)).

79. This is in addition to losing out on any potential profits. Although the aggrieved party might receive some interest on its recovery, the interest rate typically is low and the interest generally starts accumulating after the time of expenditure. See *infra* Part IV.B for a discussion regarding the risky rate of return percentage; see also *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 751 (7th Cir. 1988) ("Not all breaches of contract are . . . efficient. Some are opportunistic; the promisor . . . exploits the inadequacies of purely compensatory remedies (the major inadequacies being that pre- and postjudgment interest rates are frequently below market levels when the risk of nonpayment is taken into account and that the winning party cannot recover his attorney fees)."). Additionally, some jurisdictions do award reasonable attorney fees. See, e.g., *Autotrol Corp. v. Cont'l Water Sys. Corp.*, 918 F.2d 689, 695 (7th Cir. 1990) (affirming that Texas does award reasonable attorney fees). A more comprehensive discussion of attorney fees is beyond the scope of this Article.

80. The focus here is on distributional concerns (e.g., the sharing of resources between the aggrieved party and the breaching party) as opposed to the efficiency points (e.g., increasing total resources) discussed below.

Moving beyond this basic distributional analysis, consider next whether the undercompensatory *Dempsey* approach finds support from the notion of “penalty default” rules. In their highly influential article, Ian Ayres and Robert Gertner argue that some “default” legal rules (i.e., rules that the parties can modify via an overriding agreement) should be structured to intentionally penalize one or more of the parties.⁸¹ For instance, a default rule shortchanging the party with better information might be desirable in order to induce such party to disclose such information in an attempted negotiated modification to the default rule. As one such example, Ayres and Gertner flag the *Hadley* rule,⁸² which denies the aggrieved party recovery for out of the ordinary expenditures absent proper disclosure as part of the negotiating process.⁸³ But the penalty default notion does not seem to support the *Dempsey*-type approach, which much more broadly undercompensates the aggrieved party by denying recovery for precontract expenditures regardless of their typicality or disclosure.⁸⁴ If anything, the penalty default analysis might seem to suggest an overcompensatory damage regime here, intentionally penalizing the *breaching party* in order to induce that party to come to the negotiating table before breaching the contract.⁸⁵ As will be discussed in the next Section, there are good reasons to not go too far in such overcompensation direction,⁸⁶ but it is sufficient for

81. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989).

82. *Hadley v. Baxendale*, (1854) 9 Ex. 341.

83. Ayres & Gertner, *supra* note 81, at 101–02.

84. Note that the *Hadley* rule could, and probably should, be maintained as part of any reversal of the *Dempsey*-type approach. See *infra* note 147 for a discussion on how a *Hadley*-type limitation should be an available defense for the breaching party. And connecting back to the last Section on the sunk cost anomaly, it is hard to see why a penalty default rule against the aggrieved party makes sense where only the contract price is not readily determinable. Drawing upon *Hadley*, it might seem to make some sense at first blush in order to induce disclosure of the expenditures that the aggrieved party is trying to recoup. Deeper analysis, however, undercuts that explanation. First, as noted right above, the *Hadley* limitation could, and probably should, apply to any relaxation of the *Dempsey* approach. Second, as shown in Part II.B *supra*, the aggrieved party does get coverage for some expenditures on open-return contracts under the *Dempsey* approach (postcontract variables), again subject to the *Hadley* limitation. And so, it is not clear, then, why only precontract expenditures should automatically get wiped out on grounds of forcing disclosure even when they can pass the *Hadley* test. Third, as to the set-return contract comparison, recall how the aggrieved party’s saved costs reduce the breaching party’s exposure on the contract. As such, if we are so concerned about the breaching party properly assessing its exposure on breach, why not have a similar default rule assuming a high amount of saved costs in order to induce the aggrieved party to disclose its actual costs on the contract?

85. The default rules arguably do not matter from an efficiency standpoint if there is costless renegotiation at the time of breach. Assume, for instance, the following: (i) the legal default rule deprives the aggrieved party of any damages on breach and (ii) the breaching party’s breach would generate a \$10 benefit to the breaching party and a \$15 loss to the aggrieved party. Even with the penalty rule working against the aggrieved party, the breaching party still has an incentive to renegotiate with the aggrieved party since the breaching party would realize only a \$10 benefit from the breach, whereas the aggrieved party should be willing to pay the breaching party more than \$10 not to breach (up to \$14.99). See Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 632 (1988) (discussing role of renegotiating costs in incentivizing parties to breach or perform). With this in mind, the relevance seems to be more about distribution (sharing of the pie) than efficiency (increasing the size of the pie). But see *infra* note 89 for a discussion on how, arguably, the default rules create efficient outcomes because the decision to breach is dependent upon the consequences of the breach.

86. As discussed in greater detail in the next Section, negotiations reversing default rules can be costly, especially where the default rules contain some uncertainty. See *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d

purposes of this Section to conclude that any “penalty default” rule should certainly not run against the *aggrieved party* and in favor of the breaching party.

A related point concerns the notion of opportunistic versus efficient breach. An efficient breach results where the breaching party’s benefit from such breach exceeds the aggrieved party’s loss from deprivation of the breached contract.⁸⁷ Much commentary supports such efficient breaches since they increase overall societal resources.⁸⁸ With this in mind, the problems with the undercompensatory *Dempsey* approach are more pronounced, as the breaching party now has an incentive to breach even where its benefits from the breach are less than the aggrieved party’s detriment since the breaching party need not internalize some or all of the aggrieved party’s losses.⁸⁹ In this regard, Ayres and Gertner’s cautionary warning to proceed with care on penalty default rules rings particularly true here: “One-sided penalties can create incentives for opportunism.”⁹⁰

In sum, the undercompensatory *Dempsey* approach is problematic, as it not only fails to provide the benefit of the bargain to the aggrieved party but also can encourage non-efficient breaches. Also, the “penalty default” rule concept cuts against, rather than in favor of, such a general undercompensatory regime for contract breaches.

742, 750 (7th Cir. 1988) (“If [the breaching party] is forced to pay more than [the aggrieved party’s actual losses] an efficient breach may be deterred, and the law doesn’t want to bring about such a result.”); Craswell, *supra* note 85, at 632 (stating that “the assumption of costless transactions must be relaxed”).

87. See, e.g., POSNER, *supra* note 77, § 4.10, at 119–20 (explaining that an efficient breach occurs when a party to a contract decides to breach the contract because damages are less than the benefit from avoiding the obligation under the contract).

88. See, e.g., Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 558 (1977) (“As long as the compensation [for breach] adequately mirrors the value of performance, the damage rule is ‘efficient.’ It induces a result superior to performance, since one party receives the same benefits as performance while the other is able to do even better.”); Ian R. Macneil, *Efficient Breach of Contract: Circles in the Sky*, 68 VA. L. REV. 947, 948 (1982) (“[E]fficiency theory suggests that promisors who breach increase society’s welfare if their benefit exceeds the losses of the promisees.” (alteration in original)).

89. See *Patton*, 841 F.2d at 751 (“Not all breaches of contract are . . . efficient. Some are opportunistic; the promisor . . . exploits the inadequacies of purely compensatory remedies”); Craswell, *supra* note 85, at 634 (stating that smaller damages may give the seller an incentive “to breach”). Since the *Dempsey* Rule is just a default rule, one might ask why parties do not simply modify it if it does not reflect the most efficient result. The answer relates to the discussion below in Parts III.B and IV.A.1 regarding the costly nature of negotiation. Also, note how one could make a similar critique of the movement to impose a “default” disgorgement remedy.

90. Ayres & Gertner, *supra* note 81, at 98. As a further critique, consider Craswell’s intriguing distributional point on overcompensatory penalty rules in the other direction. After noting how aggrieved parties pay for such overcompensation via an upward pricing adjustment on the deal, he questions why we would want to work into the rules such a bet/investment. Craswell, *supra* note 85, at 638. A similar critique could be made about undercompensatory rules: that is, an undercompensatory regime might translate into a reduced initial price for the aggrieved party. If so, arguably the aggrieved party is not harmed since, on an ex ante basis, the aggrieved party gets compensated. But even if this is so, one could then question why we would want to work such an outside exchange into the underlying contract. Furthermore, any actual pricing adjustment might be less than under the assumption of a perfect pricing adjustment.

B. Doctrinal Responses to Undercompensation and Their Potential for Overcompensation

Recognizing the possibility for opportunistic and non-efficient breaches where contract damages systemically undercompensate aggrieved parties, several scholars and courts have identified an additional interest that contract damages should protect—the disgorgement interest.⁹¹ Alternatively, some courts have resolved the undercompensation problem by liberally awarding expectation damages despite the uncertainty of lost profits. Although both solutions—disgorgement and awarding speculative lost profits—resolve the problems of undercompensation and opportunistic breaches, they each create reciprocal problems of overcompensation and deterrence of efficient breaches.

1. Limitations of Disgorgement as a Contract Remedy

Damages in private law are generally measured by the loss that an injured party suffered as a result of a wrong, rather than by the gain realized by the wrongdoer.⁹² A disgorgement remedy, however, bases damages on the value of the gain that was made possible by the wrong.⁹³ Such a remedy has long been recognized as a form of recovery in various areas of the law, most notably in the law of fiduciary obligations and property interests.⁹⁴ As an example, a fiduciary who wrongfully obtains a personal gain through the use of his position of trust must disgorge that gain to his beneficiary regardless of any actual loss suffered by the beneficiary.⁹⁵ Among the stated justifications for requiring disgorgement is that a wrongdoer should not benefit from his wrong, that disgorgement gives effect to the injured parties implicit expectations, and that disgorgement provides proper incentives.⁹⁶

Although not traditionally awarded for breaches of contract, such a disgorgement remedy has been recognized in the proposed amendments to the *Restatement (Third) of*

91. Although it has been believed that until recently contract law did not protect the disgorgement interest, there have been periodic expressions of support for the remedy. *See, e.g.*, Laurin v. DeCarolis Constr. Co., 363 N.E.2d 675, 678–79 (Mass. 1977) (holding that purchaser of land was entitled to disgorgement of profits that contractor had derived from removing and selling trees from the property after the contract had been signed under theory of deprivation of a contract interest as opposed to a property interest); John P. Dawson, *Restitution or Damages?*, 20 OHIO ST. L.J. 175, 186–87 (1959) (stating that the established principle of equity courts in land contract cases, which allows land contract purchaser to sue a defaulting vendor in equity and recover money proceeds of vendor’s wrongful resale, should be more widely employed as a contract damage remedy); Melvin A. Eisenberg, *The Disgorgement Interest in Contract Law*, 105 MICH. L. REV. 559, 578–79 (2006) (stating that since the 1950s, secondary literature periodically expressed support for the disgorgement interest based solely on the question of validity of the breaching promisor to retain his gains from breach).

92. Eisenberg, *supra* note 91, at 562–63.

93. *Id.* at 563.

94. *Id.* at 563–64.

95. *Id.* at 563.

96. *See* RESTATEMENT (THIRD) OF AGENCY § 8.05 cmt. b, illus. 4 (2006) (stating that an agent who wrongfully possesses property of a principal is not entitled to recover compensation for improvements the agent makes to the property); RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 1 cmt. b, illus. 5 (Discussion Draft 2000) (providing an example of a disgorgement remedy where trespasser benefits from an intentional trespass).

*Restitution and Unjust Enrichment.*⁹⁷ Under a disgorgement remedy, the breaching party would be required to disgorge any direct and foreseeable gains resulting from the breach.⁹⁸ The disgorgement interest has been referred to as the mirror image of the expectancy interest.⁹⁹ Perfect expectancy damages would put the *aggrieved party* in the position he would have been in had the contract been performed, making the *aggrieved party* indifferent between performance and *receiving* damages.¹⁰⁰ Conversely, perfect disgorgement damages would put the *breaching party* in the position he would have been in had the contract been performed, making the *breaching party* indifferent between performance and *paying* damages.¹⁰¹

Unlike the expectancy remedy, the disgorgement remedy is meant to be applied sparingly to protect the aggrieved party's contract interest where performance cannot be easily valued, the breaching party acts opportunistically, and disgorgement would not result in an "inappropriate windfall to the promisee, or would otherwise be inequitable."¹⁰² The proposed Restatement provision recognizing disgorgement as a remedy for breaches of contract explains that the claim "is infrequently available, because a breach of contract that satisfies the cumulative test[] . . . is distinctly rare."¹⁰³ However, the disgorgement remedy has been used as a proxy for expectancy damages in the same way that reliance has been used when expectancy damages are too difficult to reasonably ascertain.¹⁰⁴ The remedy has also been used where specific performance

97. RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 39 (Tentative Draft No. 4, 2005) [hereinafter RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft)] ("If a breach of contract is both material and opportunistic, the injured promisee has a claim in restitutio [sic] to the profit realized by the defaulting promisor as a result of the breach. Liability in restitution with disgorgement of profit is an alternative to liability for contract damages measured by injury to the promisee.") The proposed disgorgement remedy is guided by a test of remoteness and does not necessarily require forfeiture of the entire profit. *Id.* cmt. f. An illustration in the proposed Restatement (Third) demonstrates the calculation of disgorgement damages. Suppose Farmer sells Buyer his entire crop of carrots for the coming season at a price of \$500 per ton. Farmer's carrots have unique qualities not obtainable elsewhere. Bad weather results in reduced harvest and higher prices. Farmer delivers twenty tons of carrots to Buyer, then sells ten tons to a competing buyer at \$800 per ton. Buyer is entitled to recover \$3,000 from Farmer under a disgorgement remedy. It is irrelevant that buyer's provable contract damages (measured by the contract-market differential) might be less than \$3,000. *See generally id.* cmt. i, illus. 15.

98. *Id.* cmt. f.

99. *See* Eisenberg, *supra* note 91, at 561.

100. *Id.*

101. *Id.*

102. RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39(3)(b). The disgorgement section is meant to apply to situations where the promised performance has no "full equivalent" on the market (i.e., breach of a promise to maintain a confidence, to refrain from competition, or other prohibited conduct). *Id.* cmts. b, d. Further, it is meant to apply to opportunistic breaches, meaning a breach involving a deliberate choice by the breaching party to improve the terms of the transaction by exploiting the vulnerability of the aggrieved party whose contractual expectations may not be adequately protected by a contract remedy limited to provable damages. *Id.* cmt. d.

103. *Id.* cmt. a.; *see also id.* reporter's note g. (stating that "[c]ourts should not in effect put the defendant at work for the plaintiff, involuntarily, for mere breach of contract, even though this is sometimes warranted for more serious forms of wrongdoing such as fraud or breach of a fiduciary duty" (quoting 1 GEORGE E. PALMER, THE LAW OF RESTITUTION § 4.9, at 451 (1978))).

104. In cases where lost profits are speculative and reliance damages are undercompensatory or difficult to value, courts may award disgorgement as a surrogate for expectancy damages. *See* Eisenberg, *supra* note

or injunctive relief may have been appropriate, but the breaching party's wrongful actions put those remedies out of reach.¹⁰⁵

Even its advocates recognize, however, that there are at least two main problems with awarding disgorgement as a form of contract damages. First, a disgorgement award runs counter to the compensatory nature of contract damages, as opposed to the punitive nature of fiduciary obligation or tort damages.¹⁰⁶ The normative goal of contract damages is to put the aggrieved party in as good a position as he would have been had the contract been performed.¹⁰⁷ Accordingly, damages are generally measured by the aggrieved party's losses rather than the breaching party's gains.¹⁰⁸ Under a disgorgement theory, however, damages are measured by the gains to the breaching party rather than the losses to the aggrieved party.¹⁰⁹ This form of compensation runs the risk of being overcompensatory. The aggrieved party would be permitted to recover the breaching party's profits from breach, even if they exceed the expected value of the breaching party's performance, so long as it did not result in an "inappropriate windfall."¹¹⁰ Recall the earlier discussion of the *Rocky* variant in the Introduction, assuming in the first instance that the Coliseum asserts only a claim for Dempsey's take from his first fight against Tunney. Allowing the Coliseum to disgorge Dempsey's

91, at 577. "For example, where A gives B a noncompete agreement and then proceeds to compete, if B's losses from the competition are difficult to measure directly, A's profits can be used as an indirect measure of the losses." *Id.* (emphasis omitted). In certain categories of cases, "protection of the disgorgement interest is the best or only way to provide efficient incentives and to effectuate bargain contracts." *Id.*

105. See RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39 cmt. c (stating that the fact that specific performance or injunctive relief might have previously been available is significant indication of propriety of disgorgement relief). As example, suppose a publisher owned the copyright of a book and prints hardcover copies. The publisher then licensed to another publisher the rights to publish the paperback edition of the book after October 1985. In breach of this agreement, the paperback publisher prematurely printed and sold paperback copies in September, and the book rose to the top of the paperback best-seller list. In *U.S. Naval Institute v. Charter Communications, Inc.*, the Second Circuit held that the aggrieved party was entitled to lost profits on the sales it would have made to purchasers who would have purchased the hardcover edition in September if the paperback version was not available. *U.S. Naval Inst. v. Charter Commc'ns, Inc.*, 936 F.2d 692 (2d Cir. 1991). However, the court held that the aggrieved party was not entitled to disgorgement of the paperback publisher's profits because the general principle of contract law is that the aggrieved party's damages should be measured by the aggrieved party's losses, not the breaching party's gains. *Id.* at 69. Supporters of the disgorgement remedy for contract interests assert that disgorgement should have been awarded because the aggrieved party would have almost certainly been entitled to enjoin the breaching party from publishing the paperback edition if the aggrieved party had time to obtain an injunction before the wrongful publication. See generally Eisenberg, *supra* note 91, at 585–87.

106. A standard presumption of contract law is that relief should be compensatory, as the obligation imposed by contract (as compared to fiduciary obligation or tort) lies in a choice between performance and payment of damages. Accordingly, damages for breach of contract should not be dependent on the aggrieved party's state of mind—it should be irrelevant whether the breaching party breached for a good reason or a bad reason. RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39 cmt. a.

107. See *Hawkins v. McGee*, 146 A. 641, 643 (N.H. 1929).

108. See, e.g., *Acme Mills & Elevator Co., v. Johnson*, 133 S.W. 784, 785 (Ky. 1911) (holding that contract damages should be measured by the harm to the aggrieved party, rather than the gain to the breaching party).

109. Eisenberg, *supra* note 91, at 562–63.

110. See *supra* notes 95–102 and accompanying text for a discussion of how the disgorgement interest functions.

take seems clearly excessive and very disproportionate to the Coliseum's loss from the cancelled local club fight.

Moving beyond the theoretical problems of measuring contract damages by the breaching party's gains, such a form of damages is administratively difficult. Not only might the amount of the breaching party's surplus be difficult to calculate, it would also be difficult to determine how much of the surplus should be attributed to the breach.¹¹¹ Our Dempsey variant based on *Rocky* again provides a good illustration of the problem. It is not clear that the Coliseum's disgorgement claim necessarily would be limited to Dempsey's take from the first Tunney fight. Like in *Rocky*, assume now that Tunney grants Dempsey a rematch, which Dempsey wins. Absent Dempsey's breach to take the first fight, Tunney would not have felt compelled to grant Dempsey the rematch that crowned Dempsey as champion. As such, why would the disgorgement remedy not also include Dempsey's take from the second Tunney fight, all his subsequent championship defenses, and any champion endorsement revenue?

In response to the problems highlighted above, some disgorgement proponents would deny recovery where it provides an "inappropriate windfall,"¹¹² or where the profits were not a "direct and foreseeable consequence of the decision to breach."¹¹³ But such limitations then require a complicated determination as to the propriety of such denial in any case. This more nuanced approach also adds uncertainty, which is problematic for reasons discussed below. Finally, aggrieved parties are still left without an adequate remedy in cases applying the limitation.

Second, the concept of a disgorgement remedy is inherently at odds with the theory of efficient breach.¹¹⁴ Under the theory of efficient breach, a promisor who discovers that his performance is worth more to a substitute promisee should be able to break his promise, provided that he compensates the original promisee for any actual losses. If he is forced to pay more than that in the form of disgorgement (or punitive damages) an efficient breach might be deterred, and as one court reasoned "the law doesn't want to bring about that result."¹¹⁵

111. For an in depth discussion of the difficulties in calculating the profits realized as a result of breach, see E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339, 1350, 1370 (1985).

112. RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39(3)(b).

113. *Id.* cmt. f. The disgorgement profit has been defined to include only the "marginal gain to the breaching party that is the direct and foreseeable consequence of the decision to breach. As in other applications of the disgorgement remedy, the decision how far to follow consequential damages gains (such as profits from reinvestment) is guided by a test of remoteness." *Id.*

114. See, e.g., HOWARD O. HUNTER, MODERN LAW OF CONTRACTS § 1:44 (2011) (recognizing that this provision appears to be at odds with the theory of efficient breach); Caprice L. Roberts, *Restitutionary Disgorgement as a Moral Compass for Breach of Contract*, 77 U. CIN. L. REV. 991, 1009 (2009) (explaining that disgorgement removes the incentives for the promisor to breach, even where such breach would increase social welfare).

115. *Patton v. Mid-Continent Sys., Inc.*, 841 F.2d 742, 750 (7th Cir. 1988); see also *J. Yanan & Assoc., Inc. v. Integrity Ins. Co.*, 771 F.2d 1025, 1034 (7th Cir. 1985) (stating that when a contract is breached to take advantage of a more profitable alternative, compensatory damages suffice because the point of damages is to make a breach so expensive that it will only be undertaken if the benefits outweigh costs, but not so expensive that even a beneficial switch will not be undertaken).

Advocates of the disgorgement remedy have criticized the theory of “efficient breach” asserting that the doctrine rests on false factual predicates.¹¹⁶ First, expectation damages make the aggrieved party indifferent between performance and damages. Often expectation damages do not make the aggrieved party whole because of unrecoverable consequential damages and the cost of litigation or other dispute resolution. And second, at the time of breach, the breaching party knows the value that the aggrieved party puts on performance. Disgorgement advocates are not disturbed by the fact that disgorgement discourages efficient unilateral breaches because they believe that such a penalty default rule provides incentives for parties to renegotiate for an efficient termination when it would be more profitable to breach than perform.¹¹⁷ An efficient termination is possible when the amount of money that the breaching party is willing to pay to escape performance is greater than the amount of money the aggrieved party is willing to accept in lieu of performance.¹¹⁸ Also, the efficient result may be achieved by full performance under the initial contract and then a subsequent contract between the initial contracting party and the third party who values performance more.

The flaw in this reasoning is that it assumes transaction costs (such as renegotiation costs of the initial or subsequent contract) are sufficiently low that parties will reach efficient outcomes. However, where information is not perfect—for example, where it is unclear whether a disgorgement remedy will be available at all or, if it is awarded, how much the surplus will be—the costs of renegotiation may be so high that an efficient termination will not result.¹¹⁹ Further, transaction costs are inherently high between contracting parties because of the bilateral monopoly situation and the stalemate bluff.¹²⁰

116. See generally Eisenberg, *supra* note 91, at 571–73.

117. The drafters of the Restatement preferred renegotiation to breach: “To take without asking, having calculated that one’s anticipated liability in damages is less than the price one would have to pay to purchase the rights in question, is precisely the conduct that the law of restitution condemns.” RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39 cmt. i. The idea of efficient renegotiation was explored by Judge Posner over two decades ago:

It is true that if the [copyright] infringer makes greater profits than the copyright owner lost . . . the owner is allowed to capture the additional profit even though it does not represent a loss to him. It may seem wrong to penalize the infringer for his superior efficiency and give the owner a windfall. But it discourages infringement. By preventing infringers from obtaining any net profit it makes any would-be infringer negotiate directly with the owner of a copyright.

Taylor v. Meirick, 712 F.2d 1112, 1120 (7th Cir. 1983).

118. Eisenberg, *supra* note 91, at 572 (citing Paul G. Mahoney, *Contract Remedies and Option Pricing*, 24 J. LEGAL STUD. 139, 141 (1995)). Several economic theorists have argued that under the Coase Theorem any remedy would be equally efficient because parties will renegotiate to reach the “Pareto efficient” results absent transaction or bargaining costs. See generally R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960) (introducing the Coase Theorem); POLINSKY, *supra* note 78, at 7 n.4 (explaining the Coase Theorem).

119. See Craswell, *supra* note 85, at 632 (explaining that because transaction costs will not be low unless the parties know the legal rule with a fair degree of certainty, courts should concern themselves not so much with the substance of the legal rule as with its certainty and predictability). Cf. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 618 (2003) (concluding that the “effective domain of state-supplied contract law” limits party options, and creates standards that, in a complex world, are often “unsatisfactory”).

120. Further analysis of transaction costs impeding efficient breaches or terminations is beyond the scope of this Article. For an in-depth discussion of such costs, see Craswell, *supra* note 85, at 636–40; see also

2. Problems of Awarding Uncertain Lost Profits

As an alternative solution to the undercompensation problem, some courts “are opening the door to proof of lost anticipated profits” and awarding expectancy damages regardless of their speculative nature.¹²¹ Generally, courts only award damages when they can be calculated with a reasonable degree of certainty. However, in situations where the aggrieved party would not be afforded adequate relief in the absence of expectancy damages, some courts have permitted juries to award lost profits based on controversial projections and appraisals if there is some reasonable basis for the opinion.¹²²

In *Fera v. Village Plaza Inc.*,¹²³ the issue of speculative lost profits as damages for the breach of a ten-year lease for a new book and bottle shop was heavily contested.¹²⁴ After hearing several days of testimony, with proofs ranging from no profits (and even a possible loss) to the aggrieved party’s own testimony of \$270,000, the jury awarded lost profits in the amount of \$200,000.¹²⁵ In denying a new trial, the court explained that where injury is found damages should not be precluded for lack of precise proof: “We do not, in the assessment of damages, require a mathematical precision in situations of injury where, from the very nature of the circumstances precision is unattainable. Particularly is this true where it is the [breaching party’s] own act or neglect that has caused the imprecision.”¹²⁶ The problem with this approach, as with the disgorgement remedy, is that it often leads to overcompensation and potentially discourages efficient breaches. Overcompensation occurs not only because damage

Juliet Kotritsky, *Uncertainty, Reliance, Preliminary Negotiations and the Holdup Problem*, 61 SMU L. REV. 1377, 1410–38 (2008).

121. Stewart Macaulay, *The Reliance Interest and the World Outside the Law Schools’ Doors*, 1991 WIS. L. REV. 247, 264 (1991) (“Insofar as we think contracts law should reflect business expectations and reinforce a sense of security, denying any remedy for breach of uncertain obligations or limiting recovery to out-of-pocket expenses may fail to serve this purpose.”).

122. *Id.*; see also *Am. Nat’l Bank & Trust Co. of Chicago v. Reg’l Transp. Auth.*, 125 F.3d 420, 437 (7th Cir. 1997) (stating that “a jury has wide discretion in determining damages, as long as it has a reasonable basis” (quoting *Dressler Indus., Inc. v. Gradall Co.*, 965 F.2d 1442, 1447 (7th Cir. 1992))); *Interclaim Holdings Ltd., v. Ness, Motley, Loadholt, Richardson & Poole*, 2004 WL 725287, at *11 (N.D. Ill. 2004) (stating that “where the existence of damages is established, the evidence need only tend to show a basis for the computation of damages with a fair degree of probability” (quoting *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, 152 F.3d 658, 664 (7th Cir. 1998))); *Godwin v. Ace Iron & Metal Co.*, 137 N.W.2d 151, 156 (Mich. 1965) (stating that the court “can not resist the conclusion that it is better to run a slight risk of giving somewhat more than actual compensation, than to adopt a rule which, under the circumstances of the case, will, in all reasonable probability, preclude the injured party from the recovery of a large proportion of the damages he has actually sustained from the injury, though the amount thus excluded can not be estimated with accuracy by a fixed and certain rule” (quoting *Allison v. Chandler*, 11 Mich. 542, 553 (1863))).

123. 242 N.W.2d 372 (Mich. 1976).

124. *Fera*, 242 N.W.2d at 374–76.

125. *Id.* at 375.

126. *Id.* at 376 (internal quotation marks omitted) (quoting *Godwin*, 137 N.W.2d at 156). Several years later, another court awarded lost profits for a new business that never commenced because of the breach of a lease agreement, reasoning, “it would be grossly unfair to deny [the aggrieved party] meaningful recovery for lack of a sufficient ‘track record’ where the [aggrieved party] has been prevented from establishing such a record by [the breaching party’s] actions.” *Chung v. Kaonohi Ctr. Co.*, 618 P.2d 283, 291 (Haw. 1980).

awards are based on controversial evidence of lost profits but also because some profit awards are not reduced for saved human capital or other saved work efforts going forward.¹²⁷

In sum, the most efficient remedies are those that come closest to exact compensation.¹²⁸ Where damages are difficult to calculate, there is a choice between adopting default rules that would either significantly undercompensate or potentially overcompensate aggrieved parties. In crafting default rules, overcompensation seems preferable to undercompensation because it would create incentives for renegotiation rather than for opportunistic breaches. However, the current solutions of awarding disgorgement or speculative lost profits may stray too far from the compensatory nature of contract damages. Accordingly, courts have been reluctant to award these types of damages which have been called “punitive” in nature and have instead severely undercompensated aggrieved parties for breaches of open-return contracts.¹²⁹ Further, default rules should provide clear legal standards because contracting parties benefit from certainty and predictability.¹³⁰ The requirements for disgorgement as a remedy for breaches of contract, however, are far from clear and provide little normative guidance to contracting parties (i.e., it is difficult to determine whether there would be an “inappropriate windfall” or other “inequity”).¹³¹

IV. THE RESPONSE

Instead of the extremes of either severely undercompensating the aggrieved party where the lost revenue stream is uncertain or awarding disgorgement of all profits regardless of whether compensatory or punitive, we suggest a more fine-tuned approach. Our approach would effectively reverse the current default presumption (no recovery for precontract expenditures, overhead, or profit) to allow recovery of pre- and postcontract expenditures, a reasonable allocation of overhead, and a risky rate of return. Reversing the Dempsey Rule is appropriate given that the lack of an actual revenue stream on the contract was brought about by the breaching party’s actions.¹³²

Our proposal is essentially an extension of the well-established presumption that the aggrieved party would have at least recovered his expenditures made in preparation

127. See *supra* Part II.B for a detailed discussion of backing out saved costs.

128. See Craswell, *supra* note 85, at 62–63 (suggesting that the economic case for overcompensation is somewhat problematic, except when these remedies are being used to more closely approximate true compensation).

129. See Farnsworth, *supra* note 111, at 1369 (“In no jurisdiction do courts generally apply the disgorgement principle. The decisions containing such statements are widely scattered, do not cite each other, and show no coherent pattern. Even advocates of the disgorgement principle concede that judicial recognition has been rare.”).

130. See *supra* note 77 and *infra* note 141 and accompanying text for a discussion of the inherent benefits of rules which provide certainty and predictability for contracting parties.

131. RESTATEMENT (THIRD) OF RESTITUTION (Tentative Draft) § 39(3)(b). See *supra* notes 98–105 and accompanying text for a discussion of the limited and uncertain application of disgorgement as a contract remedy.

132. See *supra* Part III.B.2 for a discussion of the justifications supporting awards of uncertain lost profits.

and part performance of the contract if the contract had not been breached. As one court reasoned over a century ago:

Ordinarily, the performance of agreements results in advantage to both parties over and above that with which they part in the course of its performance; otherwise there would soon be an end of contracting. And it seems to us, upon general principles of justice, that, if he who, by repudiation, has prevented performance, asserts that the other party would not even have regained his outlay, the wrongdoer ought at least to be put upon his proof.¹³³

So, where lost profits are difficult to ascertain, the aggrieved party is generally permitted to recover postcontract variable expenditures made in preparation and part performance of the contract, subject to the right of the breaching party to reduce the damage award to the extent he can show that the aggrieved party would have lost money on the contract (i.e., proof of a losing contract).¹³⁴

In this Part we will demonstrate why this reasoning should be extended to include all expenditures (pre- and postcontract; fixed and variable), and also to presume a risky rate of return on the capital investment.¹³⁵ In other words, where the breaching party

133. *Holt v. United Sec. Life Ins. & Trust Co.*, 72 A. 301, 306 (1909) (stating that where profits prevented by repudiation of an agreement cannot be recovered, “expenditures fairly incurred [by the injured party] in preparation for performance or in part performance . . . form a proper subject for consideration, where the . . . expenditures [were made] in anticipation of the “advantage[s] that will come to him from completed performance”).

134. For example, in *L. Albert & Son v. Armstrong Rubber Co.*, the court reasoned:

It is often very hard to learn what the value of the performance would have been; and it is a common expedient, and a just one, in such situations to put the peril of the answer upon that party who by his wrong has made the issue relevant to the rights of the other. On principle therefore the proper solution would seem to be that the promisee may recover his outlay in preparation for the performance, subject to the privilege of the promisor to reduce it by as much as he can show that the promisee would have lost, if the contract had been performed.

178 F.2d 182, 189 (2d Cir. 1949) (citation omitted).

135. There is controversy among scholars over whether expectancy or reliance should be the key to awarding contract damages—some suggest that reliance is a proxy for expectations, some assert that expectations is a proxy for reliance. See, e.g., W. David Slawson, *Why Expectation Damages for Breach of Contract Must Be the Norm: A Refutation of the Fuller and Perdue “Three Interests” Thesis*, 81 NEB. L. REV. 839 (2003) (arguing that expectancy should be the norm for awarding contract damages, while refuting the argument that awarding expectation damages generally results in the same amount of recovery as reliance damages). Our proposal is consistent with either view. In perfect markets there would be no difference between reliance and expectancy because the aggrieved party’s loss in foregoing to enter another contract would be identical to the expectation value of the contract. See L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 62 (1936) (explaining that where reliance interest embraces a person’s lost opportunity to enter similar contracts with another person, reliance and expectation interests merge); see also Christopher W. Frost, *Reconsidering the Reliance Interest*, 44 ST. LOUIS U. L.J. 1361, 1366–68 (2000) (explaining that reliance and expectancy measures begin to merge when considering lost opportunity and that, taken literally, reliance becomes indistinguishable from expectancy). Under expectancy damages, the aggrieved party would be entitled to recover lost profits plus expenses incurred prior to breach. Now, taking reliance on its own terms, the aggrieved party would be entitled to recover expenses incurred in preparation for performance, and we can include an amount close to lost profits as a proxy for lost opportunities on the use of the expenditures. The rationale for permitting recovery for lost opportunities is that the aggrieved party would have been able to allocate resources differently and probably would have been

repudiates and prevents the aggrieved party from realizing actual profits under the contract it should be presumed in favor of the aggrieved party that he would have recovered over the life of the contract a gain, sufficient not only to recover his investment (including precontract and fixed costs) but also yield a risky rate of return on that investment.¹³⁶ To the extent the aggrieved party would not have regained this outlay plus a profit, the burden should be on the breaching party to set forth such evidence (i.e., evidence of a losing contract).

The proposal is not motivated at all by a desire to “punish” the “bad breacher,” as evidenced by the fact that the presumption is rebuttable either down (by the breaching party) or up (by the aggrieved party). Also, unlike the disgorgement remedy, the presumption does not purport to take away the breaching party’s profits to the extent they exceed a reasonable default estimation of the aggrieved party’s actual loss. Rather, the proposal is motivated by a desire to more accurately reflect business expectations, encourage precontract expenditures, and reinforce a sense of security where expectancy damages are uncertain.¹³⁷

A. *Reverse Dempsey on Precontract Expenses and Overhead*

Adopting a default rule permitting the aggrieved party to recover precontract expenditures and allocable overhead would resolve the promissory estoppel and sunk cost anomalies, reduce the instances of undercompensation and inefficient breaches, and encourage parties to make precontract investments. The justifications for limiting recovery of reliance expenditures to postcontract variable expenses rest on false pretenses and are unpersuasive in light of these countervailing benefits.

1. Resolve Promissory Estoppel and Sunk Cost Anomalies

Altering the current default rule for open-return contracts would help resolve the two anomalies discussed in Part II: First, that the aggrieved party may actually be worse off where he successfully finalizes a contract than where negotiations break down and he never lands the deal; and second, that the aggrieved party is generally entitled to a recovery of precontract and fixed costs under a set-return contract but is denied such recovery under an open-return contract. Extending the presumption of recoverable costs to include precontract and fixed costs under open-return contracts would add consistency and predictability to contract damage awards. Further, the justifications for limiting recovery under the Dempsey Rule lose force when one

successful pursuing another profitable deal if it were not using its resources to pursue the deal with the breaching party.

136. See, e.g., *Beefy Trail, Inc. v. Beefy King Int’l, Inc.*, 267 So. 2d 853, 860 (Dist. Ct. App. Fl. 1972) (Owen, J., concurring and dissenting) (“The proof that full performance would have resulted in a loss to the plaintiff is a matter of defense; there is no burden on [the aggrieved party] to prove that there would not have been any loss.”).

137. See Macaulay, *supra* note 121, at 264 (“Insofar as we think contracts law should reflect business expectations and reinforce a sense of security, denying any remedy for breach of uncertain obligations or limiting recovery to out-of-pocket expenses may fail to serve this purpose.”); Ofer Grosskopf & Barak Medina, *Regulating Contract Formation: Precontractual Reliance, Sunk Costs and Market Structure*, 39 CONN. L. REV. 1977, 1986 (2007) (arguing that negotiating party may be motivated to invest in precontractual reliance through expectation of investment yields, as well as competition factors).

considers that the aggrieved party would be entitled to recover those expenditures on successful deals with determinable revenue, and possibly on some unsuccessful deals with reliance on a promise.

Under the theory of promissory estoppel, as demonstrated by the *Dempsey* variation of the *Red Owl* case, an aggrieved party may be entitled to recover precontract expenditures made in reliance on a promise if a final contract is never executed.¹³⁸ However, where a promisee executes a final contract with an indeterminable revenue stream, the Dempsey Rule would generally preclude recovery of precontract expenditures, even if they were incurred in reliance on promises made during the course of negotiations or as part of a preliminary agreement.

There does not seem to be any rational basis for permitting recovery for expenditures incurred based on a promise where a final contract is never consummated but limiting recovery where a contract is executed and then breached. To the contrary, such an inconsistent approach potentially leads to counter-intuitive results whereby the aggrieved party's recovery may actually be less where he sues on the contract than where he is forced to sue under an alternative theory of liability because the contract is never finalized. Rather than unknowingly wiping out an investing party under general integration principles when a final contract is executed, the default rule should be reversed to permit recovery of precontract expenditures, unless the contract provides otherwise. To the extent the parties intend to limit the aggrieved party's recovery of precontract expenditures upon breach, they should include an explicit waiver or liquidated damages clause in the contract.

Reversing the Dempsey Rule would not only resolve the inconsistencies between recovery for broken promises versus breached open-return contracts but also between breached set-return versus open-return contracts. As discussed, precontract expenditures and fixed overhead are implicitly included in contract damages for set-return contracts because they are not deducted on grounds that they were not incurred in reliance on the contract.¹³⁹ Such damages are measured by the contract price less any expenses saved by the aggrieved party by not having to perform. However, precontract expenditures and fixed overhead are excluded from recovery under open-return contracts because the aggrieved party is only entitled to recoup the expenditures incurred after formation of the contract.¹⁴⁰

Consider now whether the justifications offered to support the Dempsey Rule are strong enough to warrant toleration for these anomalous results. The main stated rationale for not allowing recovery of precontract expenditures rests on causation

138. See *supra* Part II.A and accompanying notes for a discussion of the incongruity between the Dempsey Rule and the *Red Owl* case.

139. See *supra* Part II.B and accompanying notes for a discussion of disparate treatment of sunk costs in set-return and open-return contracts. See also *Vitex Mfg. Corp. v. Caribtex Corp.*, 377 F.2d 795, 798–99 (3d Cir. 1967) (determining that there should not be any deduction from profits where overhead is fixed and nonperformance of the contract did not produce overhead cost savings).

140. See RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) (permitting recovery of expenditures incurred in preparation and part performance of the contract). See also *supra* Part II for a discussion of the promissory estoppel and sunk cost anomalies.

defects (i.e., the expenditures were not caused by the breached contract).¹⁴¹ It is axiomatic that a party cannot make expenditures in reliance on a non-existent contract.¹⁴² Another stated reason for the limitation is that a promisee who takes risks prior to forming a binding contract should suffer the resultant consequences.¹⁴³

These justifications fail to consider that although the promisee cannot rely on the contract when making precontract expenditures, he can rely on prior dealings, negotiations, preliminary agreements, and the prospects of obtaining a contract. Although the promisee takes enormous risk in making precontract expenditures, he does so expecting to recoup his expenditures on successful deals. Precontract reliance expenditures become sunk costs at the time of contract formation, but create value if a contract (even an open-return contract) is ultimately formed.¹⁴⁴ An assessment of the efficiency of the investment should be calculated based on the risk that a contract will not be reached, not based on the risk that a contract will be reached, then breached, and lost profits will be “too speculative” to recover.¹⁴⁵ In other words, the risk the promisee is undertaking when making precontract expenditures is the risk that the deal may never be finalized, not the risk that he will get the contract and the promisor will breach. In addition, as discussed in Part II.B, aggrieved parties get back all of their costs on set-return contracts without regard to reliance.

Similar to precontract expenses, fixed overhead expenditures are generally not awarded because those costs were not incurred in reliance on the contract (i.e., those expenditures would have been incurred even if the contract had never been consummated). However, this justification ignores the possibility that some of those overhead investments could have been directed at other prospective deals if they were not being allocated to the repudiated one.¹⁴⁶ Further, like precontract expenditures, the

141. See 22 AM. JUR. 2D *Damages* § 420 (2010) (explaining that the aggrieved party is generally precluded from recovering precontract costs under a reliance theory because such damages measure the aggrieved party’s cost of reliance on the breached contract). See also *supra* note 32 for a list of cases where recovery of precontract expenditures was denied.

142. See *Moore v. Lewis*, 366 N.E.2d 594, 599–600 (Ill. App. Ct. 1977) (denying recovery of expenditures allegedly made on a promise to issue a contract to sell a mortgage because at the time the expenditures were made there was no contract on which the promisee could rely); *Am. Oil Co. v. Lovelace*, 143 S.E. 293, 295 (Va. 1928) (reasoning that work done prior to the contract was done at the aggrieved party’s own risk).

143. The *Dempsey* court reasoned: “Any obligations assumed by the plaintiff prior to [the date of the final agreement] are not chargeable to the defendant” as the plaintiff took the risk that these expenditures would be wasted if the defendant never signed the contract. *Chicago Coliseum Club v. Dempsey*, 265 Ill. App. 542, 551 (1932).

144. After a promisee makes a precontractual investment and the parties decide to negotiate the final contract, the initial investment becomes a sunk cost. During negotiations, if the promisor refuses to compensate the promisee for the investment the promisee could terminate discussions and receive nothing or continue discussions and recover some of the costs. Any threat by the promisee to terminate discussion would be irrational, as the initial expenditures would not be recoverable and would therefore put the promisor (who has not made any precontract expenditures) in a superior bargaining position. See Grosskopf & Medina, *supra* note 137, at 1986.

145. See *id.* (demonstrating that negotiating parties will be willing to invest in precontract reliance that does not increase their profits if it increases their prospects of obtaining the contract).

146. See *Autotrol Corp. v. Cont’l Water Sys. Corp.*, 918 F.2d 689 (7th Cir. 1990) (allowing manufacturer to recover a portion of its general overhead that was allocable to its performance of a joint

aggrieved party is willing to invest in fixed overhead costs because he expects to recover these costs on successful deals. Finally, although it is true that in order to allow recovery for precontract expenditures or fixed overhead under an open-return contract (as opposed to a set-return contract) each recoverable cost must be separately determined because it is not built into the ordinary damage remedy, this additional burden should not preclude recovery as demonstrated in Part II.B.

Although a few courts (and some academics)¹⁴⁷ have possibly recognized the potentially anomalous results of denying recovery of precontract expenditures and have permitted recovery in limited circumstances, the default rule of denying recovery under open-return contracts remains the same.¹⁴⁸ The limited number of courts which have permitted recovery seem to require some type of preliminary agreement or definite promise and significant reliance on that agreement or promise.¹⁴⁹ By going further to

potential venture agreement after a patent holder's breach of the agreement). See also *supra* Part II.A for a discussion of why damages may be higher for broken promises without a contract than with a finalized deal.

147. There has been some academic discourse advocating the expansion of damage awards for open-return contracts. Two decades ago, Michael Kelly proposed replacing the *Dempsey* presumption that the aggrieved party would have recouped only its postcontract costs had there been no breach with a presumption that would include recoupment of precontract costs: that is, a presumption that the aggrieved party would have broken even. Michael B. Kelly, *The Phantom Reliance Interest in Contract Damages*, 1992 WIS. L. REV. 1755 (1992). However, this argument loses some of its force because it is not carried out far enough. As will be discussed in Part IV.B, investors do not make investments today on the expectation that they will receive back at a later point in time just the same dollar amounts. See David W. Barnes, *The Net Expectation Interest in Contract Damages*, 48 EMORY L.J. 1137, 1206 n.247 (1999) (people enter into contracts expecting to earn more than zero profits). A few years later, Gregory Crespi advocated for recovery of documented precontract expenditures under a reliance theory of damages so long as it was within the reasonable contemplation of the parties at the time of contract formation that those expenditures would likely be wasted in the event of breach. See Gregory S. Crespi, *Recovering Pre-Contractual Expenditures as an Element of Reliance Damages*, 49 SMU L. REV. 43, 49–50 (1995). Under his reliance-based approach, expenditures would be recoverable as a proxy for lost opportunity costs postcontract. *Id.* at 50–51. Although we agree with this approach to the extent it allows recovery of precontract costs, there are several limitations. First, the proposal is premised on recovery for postcontractual foregone opportunities, which many courts reject. See Crespi, *supra* at 51 (noting that American courts are hostile to the recovery of precontractual expenditures). Although our proposal is not dependent on an acceptance of liability for foregone opportunities, it does fit into that concept more easily than Crespi's approach. We would permit recovery for the aggrieved party's capital investment and return thereon based on the reasonable assumption that but for this deal, the aggrieved party would have invested in another risky deal with that expected payout. Second, from an evidentiary standpoint it is difficult for the aggrieved party to prove which expenses were within the reasonable contemplation of the parties at the time of contract formation. Although we agree with a *Hadley*-type limitation, we propose that the limitation be used as a defense available to the breaching party rather than as an additional element for the aggrieved party to establish before setting forth a prima facie case for recovery. It appears that Crespi is proposing that the aggrieved party bear the burden of proving that the breaching party understood at the time of contracting that those expenditures would be wasted in the event of breach because he mentions that, in addition to this standard, recovery would still be subject to the "usual avoidability, foreseeability, and reasonable certainty limitations on damages." Crespi, *supra* at 64 (citations omitted). Finally, the proposal is limited to recovery of precontract expenditures and does not include recovery for fixed overhead or a risky rate of return on the investment. (Both Kelly and Crespi's scholarship have been recognized in one of the leading contract treatises. See CORBIN ON CONTRACTS, *supra* note 30, § 57.3.)

148. Grosskopf & Medina, *supra* note 137, at 1992–93 (noting that courts are only willing to impose precontract liability absent consent in cases of unjust enrichment, misrepresentations, or specific promises).

149. See, e.g., *DPJ Co. Ltd. P'ship v. FDIC*, 30 F.3d 247, 249 (1st Cir. 1994) (permitting damages for a bank's repudiation of a line of credit in the amount of reliance expenditures, including those made after the commitment letter was issued by the bank but before the line of credit was extended, because the aggrieved party had to take steps in reliance on the commitment letter in order to meet the loan conditions).

eliminate the Dempsey Rule and allowing recovery of such expenditures on all successful deals, we avoid the difficult exercise of determining whether there was presigning reliance, how definite the preliminary agreement was when the expenditures were incurred, and whether integration principles should bar recovery. Further, we would add consistency and predictability for contracting parties because under the murkiness of current damage awards for open-return contracts it is unclear when a court would decide to grant recovery for precontract expenditures. Economic theorists have demonstrated that these types of ad hoc determinations without clear standards lead to inefficiencies because transaction costs will be high unless the parties know the legal rule with a fair degree of certainty: “[C]ourts should concern themselves not so much with the substance of the legal rule as with its certainty and predictability.”¹⁵⁰

In short, the justifications for limiting recovery under the Dempsey Rule rest on false factual pretenses and further lose force when one considers that the aggrieved party would be entitled to recover those expenditures on successful deals with determinable revenue, and possibly on some unsuccessful deals with reliance on a promise. Accordingly, the rule should be reversed to add consistency to awards of contract damages.

2. Reduce Problems of Undercompensation and Non-Efficient Breaches

Another reason for reversing the Dempsey Rule is that it systemically undercompensates the aggrieved party where the revenue stream is speculative. Such undercompensation occurs because the aggrieved party is automatically denied recovery of his precontract expenditures and fixed costs, without a showing that those costs would not have been recoverable if the contract had been fully performed (i.e., proof of a losing contract). The current solutions to this undercompensation problem (i.e., disgorgement and recovery of uncertain lost profits) cut too far in the other direction and run the reverse risks of being overcompensatory. Further, it is unclear that courts would move away from the compensatory nature of contract damages to allow disgorgement, as such awards may be punitive in nature.

The main risk inherent in an undercompensatory damage regime is that it may create incentives for opportunistic behavior and non-efficient breaches. As demonstrated, economic theorists believe awarding compensatory damages provides the precise incentives to make the breach idea work.¹⁵¹ A party will only be inclined to breach if he can pay enough money to his contract partner to fully compensate him for his losses and still be better off than if he had performed and not paid damages. In a situation where damages are undercompensatory, a party would have an incentive to breach, even where his benefits from the breach are less than his contract partner’s losses, because the breaching party would not internalize all of the losses. The Dempsey Rule runs this risk, as a party contemplating breach of an open-return contract would need to consider only his contract partner’s postcontract variable costs and not his fixed costs or other precontract expenditures.

150. Craswell, *supra* note 85, at 632.

151. See *supra* note 78 and the surrounding text for a discussion of why expectancy damages yield the optimal levels of performance and breach.

Reversing the Dempsey Rule to allow recovery of precontract expenditures and fixed overhead would respond, at least in part, to the undercompensation problem. As one scholar who advocated for recovery of precontract expenditures explained: “[A]llowing compensation for at least certain kinds of pre-contractual expenditures will, in practice, bring us closer to the goal of making disappointed promisees whole, since such compensation will augment . . . damages awards that otherwise now systematically undercompensate promisees.”¹⁵² Such increased recovery for open-return contracts would bring damage awards closer to the optimal level from an efficiency standpoint (i.e., put the aggrieved party in the same position as if the contract had been fulfilled) without going too far in the other direction.¹⁵³

3. Encourage Precontract Expenditures and Investments

Another problem with a damage rule that excludes recovery for precontract expenditures is that it discourages relation-specific investments during negotiations.¹⁵⁴ Instead, such a rule provides incentives for contracting parties to strategically delay investments until execution of the final contract, despite the potential inefficiencies. Reversing the Dempsey Rule would encourage parties to make efficient precontract investments because the investing party would be entitled to recover the costs upon breach, even if lost profits are speculative.

Several academics have demonstrated the potential benefits of making precontract investments in the exploration of potentially profitable ventures. For example, Schwartz and Scott explain that commercial parties can maximize expected surplus by making sunk cost investments into deals that are promising but whose success is uncertain and are too complex to describe in formal contracts.¹⁵⁵ They also reveal two gains that can be realized by making investments before a contract is finalized, accelerating the realization of returns if the project turns out to be successful and illuminating how to best structure the project to make it profitable.¹⁵⁶

152. See Crespi, *supra* note 147, at 50.

153. See HUNTER, *supra* note 114, § 14:25.

154. See *supra* note 53 for a discussion of relation-specific investments.

155. In advocating for recovery of precontract expenditures made in reliance on preliminary agreements, Schwartz and Scott developed a model to explain why parties would conclude only preliminary agreements, make sunk cost investments when success is uncertain, and sue each other over deals that could never have been finalized. See Schwartz & Scott, *supra* note 26, at 662–65. After analyzing a sample of 105 cases litigated between 1999 and 2003 that directly involved the issue of precontractual reliance, Schwartz and Scott revealed four patterns of commercial behavior: (1) thirty cases raised the issue of reliance in the absence of any agreement and twenty-six cases found no liability; (2) twenty-seven cases involved the issue of reliance where parties had agreed on some terms but indicated that they did not intend to be bound, and no liability was found; (3) thirty-six cases turned on whether the preliminary agreement was sufficiently complete to be binding, even though the parties contemplated final memorialization, and such agreements were enforced so long as a formal writing was not necessary; and (4) twelve cases turned on whether there was a preliminary agreement to negotiate further in good faith. *Id.* at 671–73.

156. *Id.* at 703.

In order to encourage certain precontract investments, many scholars have advocated for recovery of such expenditures if negotiations break down before a final contract is executed.¹⁵⁷ As one court explained:

Giving legal recognition to preliminary binding commitments serves a valuable function It permits [parties] to make plans in reliance upon their preliminary agreements and present market conditions. Without such legal recognition, parties would be obliged to expend enormous sums negotiating every detail of final contract documentation before knowing whether they have an agreement.¹⁵⁸

If these are the policies driving recovery where a final contract is not executed, then, *a fortiori*, these expenditures should be recoverable when a final contract is reached, even if profits are indeterminable. Without expanding recovery, parties may be reluctant to make efficient relation-specific investments when negotiating open-return contracts.¹⁵⁹

Although some skeptics may be concerned that our proposal would cause imprudent reliance expenditures,¹⁶⁰ that concern is tempered by a number of factors. First, despite the expanded scope of recovery under our approach, it is unlikely that higher costs recovery alone would lead to over-reliance because of the inherently undercompensatory nature of contract damages. Under the American system, even expectancy-based damages where a contract price is known do not fully compensate a victim of breach because of the absence of attorneys' fees and other litigation costs, as well as a victim's inability to prove all elements of loss (particularly noneconomic loss or consequential damages).¹⁶¹ Second, the relying party would only be entitled to recover reliance expenditures if the other party breaches the contract; to the extent the contract is never awarded or is never breached, the relying party would bear the costs of those expenditures (absent an alternative theory of liability). Third, the award of damages would be limited by the traditional defenses to damage awards, such as reasonableness and foreseeability.¹⁶² To

157. See, e.g., Bebchuk & Ben-Shahar, *supra* note 43, at 457 (concluding that an intermediate liability approach to reliance liability is the best way to regulate precontractual investment). Ben-Shahar proposed a controversial no-retraction principle that radically altered the distinction between agreement and no agreement, and could create promisor liability based on negotiations. Omri Ben-Shahar, *Contracts Without Consent: Exploring a New Basis for Contractual Liability*, 152 U. PA. L. REV. 1829, 1838–44 (2004). In response, Johnston suggested a bargaining model to compliment the no-retraction model because promising should remain cheap early on and become more costly later in the process in order to encourage negotiations and only efficient and consented transactions. Jason Scott Johnston, *Investment, Information, and Promissory Liability*, 152 U. PA. L. REV. 1923, 1926, 1944–46 (2004).

158. *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491, 499 (S.D.N.Y. 1987).

159. Our proposal goes further than the models developed for recovery of expenditures in the absence of a final contract. Rather than limiting damages to expenditures incurred after a preliminary agreement was consummated, we would allow damages for all reasonable expenditures made in furtherance of the contract. Also, we would allow recovery even in situations where expenditures were incurred in the absence of a preliminary agreement providing for simultaneous investments.

160. Pettit, *supra* note 78, at 443.

161. See Johnston, *supra* note 157, at 1930 (stating that “expectation-based damages do not fully compensate victims of breach”).

162. For example, the *Hadley* court developed a rule limiting damages under which the aggrieved party would only be permitted to recover damages that arise naturally from the breach (i.e., direct damages) or those that may “reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract” (i.e., foreseeable consequential damages). *Hadley v. Baxendale*, (1854) 9 Ex. 341, 355.

the extent the relying party makes imprudent, unreasonable, or unforeseeable expenditures, the breaching party would be able to raise that as a defense to avoid or limit liability.¹⁶³ Finally, as discussed, our default rule is only a presumption for expanded recovery of all reliance expenditures (including precontract and fixed costs), and it could be rebutted by the breaching party upon a proper showing of a losing contract.

Accordingly, reversing the Dempsey Rule would have the advantages of adding consistency to damage awards, discouraging non-efficient breaches or other opportunistic behavior, and encouraging precontractual reliance expenditures. The concerns of increased liability pale in comparison to these benefits and the risks inherent in alternative solutions such as disgorgement and awards of uncertain lost profits.

B. “[Y]ou’re going to get your money back plus a profit”¹⁶⁴

This Section briefly sketches another way in which current law systematically shortchanges aggrieved parties on open-return contracts.¹⁶⁵ For reasons briefly explained below, the aggrieved party should recover not only his expenditures but also a profitable rate of return thereon running from the time of outlay until repayment. Current law, however, typically provides aggrieved parties an insufficient interest rate, which starts to accrue significantly after the time of outlay.

Our analysis begins by highlighting how an aggrieved party’s outlays constitute investments in a venture. Under well-accepted investment principles, investors typically receive *on average* a positive rate of return on their investment starting from the time of outlay. Under time-value of money principles, the “present value” of a future dollar is less than a current dollar. This results since the current dollar could, for example, be deposited in the bank, thereby generating a positive rate of return. Similarly, the later recovery of an earlier-incurred expenditure, without more, does not fully compensate the aggrieved party given the aggrieved party’s deprivation of the opportunity to make the normal rate of return elsewhere. Importantly, this holds true even if the expected value of the investment exactly matches the investment amount *at the time of investment*.

A simple investment in a risk-free treasury bill illustrates these principles.¹⁶⁶ Although the “T-bill’s” expected present value matches its purchase price at the acquisition time, the investor receives a return of its principal *plus* interest running from the time of expenditure until repayment. In an unfortunate deviation, current law

163. See RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981) (“Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.”).

164. Michael Crittenden & Serena Ng, *Fed is Confident of AIG Payback, but Skeptics Remain*, WALL ST. J., May 27, 2010, at C3 (quoting Robert Benmosche, AIG CEO, statement to Congressional Oversight Panel regarding bailout funds).

165. Our companion article, *Risky Returns as Contract Damages*, which is still in progress, provides a more expansive development of these points.

166. We begin with the investment generally considered to be “risk-free” to isolate the initial time-value of money and present value points in their most basic form. We then integrate risky investments into the analysis below in this Section.

generally does not provide an aggrieved party interest until after the expenditure date: oftentimes starting only upon the later breach date (or possibly even later than that on litigation commencement or the judgment date).¹⁶⁷

Furthermore, for risky investments, the average positive rate of return must exceed the risk-free interest rate to compensate the investor for the possibility of loss. Otherwise, a rational investor would have chosen the safe, risk-free investment, rather than the risky equity venture.¹⁶⁸ Investors in equity ventures, like investors in junk bonds, should receive a higher rate of return over time for taking on the risk, assuming that the loss contingency does not occur. The loss contingencies for equity ventures (as opposed to junk bond investments) are the risk of not obtaining the deal or the risk of failed business operations upon obtaining it (as opposed to the risk of bankruptcy). In other words, the aggrieved party's rate of return typically should increase commensurate with the *venture's* riskiness, rather than the breaching party's bankruptcy risk, since the aggrieved party typically makes an owner-like investment in the venture.¹⁶⁹

Critics may believe that the profit provision might seem too generous to aggrieved parties, since the risky venture might have been a losing one. Careful examination of this objection, however, reveals its weakness. Our proposal would provide aggrieved parties the average rate of return on comparable risky deals rather than the higher return on above-average deals. This return seems only fair given that it is the breaching party who prevented an actual determination as to whether the deal in question would have been an above-average deal with returns in excess of our average benchmark. Further, our proposal takes the form of a rebuttable presumption: breaching parties could reduce or even eliminate the average risky return percentage upon a proper showing that the

167. For a general discussion of the delayed provision of prejudgment interest, see Michael Knoll, *A Primer on Prejudgment Interest*, 75 TEX. L. REV. 293, 353–54 (1996). For a specific representative example, see CAL. CIV. CODE § 3287(b) (West 2011) (providing that interest begins only on the date that the action was filed). See also Kelly, *supra* note 147, at 1775 nn.60–63. For an example of interest beginning to accrue on the litigation commencement date, see *Cyberchron Corp. v. Calldata Sys. Dev.*, 47 F.3d 39, 43 (2d Cir. 1995). Note that although Professor Kelly initially highlights the interest shortcomings, he then proposes only a recoupment of the expenditure without an additional profit recovery, which might explain why his proposal has not received full recognition. Kelly, *supra* note 147. Although running interest from a variety of different dates adds some possible complexity, the additional complexity does not seem to be problematic enough to create undercompensation, along with all the problems noted in Part II.A.

168. Consider for example the typical reluctance to bet one's savings on simple 50/50 coin toss. This relates to the diminishing marginal utility of money. See, e.g., Richard Posner, *Common-Law Economic Torts: An Economic and Legal Analysis*, 48 ARIZ. L. REV. 735, 738 n.6 (2006) ("Risk aversion is an implication of diminishing marginal utility of income. Most people would prefer to pay \$20 to avoid a .001 probability of a \$10,000 loss than to take their chances on the loss, even though the expected cost of the loss is only \$10 (\$10,000 x .001). The reason is that the expected disutility of such a loss is much greater than the expected cost because inframarginal dollars are worth more than marginal ones. It is the same reason that most people would not put up \$1 million for a 50 percent chance of winning \$2 million.").

169. As per the previous textual sentence, a second related material difference from the junk bond example is that the contingency that properly should cause the aggrieved party to lose out on its heightened return is the failure of the business over time (for reasons other than the breaching party's breach) rather than the bankruptcy of the breaching party.

venture would have been one of the below-average deals.¹⁷⁰ In contrast, current law implicitly, and incorrectly, presumes that the deal would have been subpar.

As a second and somewhat related objection, providing profits from the time of outlay might seem overly generous for precontract outlays since the aggrieved party was taking the risk of failing to obtain the deal. But as noted, that risk becomes irrelevant once the aggrieved party successfully navigates through that hurdle. Focusing now on the profit element, if anything, aggrieved parties should receive a higher than average rate of return for the precontract expenditures. This results since the average rate of return includes the below-average returns on failed efforts to land deals. As such, the average rate of return on precontract expenditures in successful deals must be higher than the average rate of return on all precontract investments.

In short, aggrieved “investors” generally should receive compensation at a higher “risky” rate of return running from the time of outlay, rather than a lower risk-free rate of return running from the time of breach or even later under current law.

V. CONCLUSION

Having revealed two inexplicable inconsistencies in damage awards under the current regime (i.e., divergences in recovery under promissory estoppel versus open-return contracts and under set-return versus open-return contracts), we suggest reversing the Dempsey Rule to allow a presumptive recovery of precontract expenditures and fixed overhead along with a risky rate of return thereon. Our solution is essentially an extension of the current presumption that the aggrieved party would have at least recovered his postcontract variable expenditures if the contract had not been breached. We would expand the presumption to also include precontract and fixed costs as well as a risky rate of return on the capital investment. The aggrieved party should recover these amounts, even absent a showing of reliance for two main reasons: First, because the aggrieved party would otherwise be entitled to such recovery under a set-return contract; and second, because the aggrieved party was deprived the opportunity to invest his money elsewhere during the period of exposure. To the extent the aggrieved party would not have regained this outlay plus the risky return, the burden should be on the breaching party to set forth such evidence. Our increased presumptive recovery is appropriate given that the lack of an actual revenue stream on the contract was brought about by the breaching party’s actions. Further, our approach more accurately reflects the typical *ex ante* expectations of investors and contracting partners—most rational parties pursue and enter into contracts expecting to do more than merely recoup their postcontract variable expenditures and earn zero profits.

Reversing the Dempsey Rule and expanding the presumptive recovery for breaches of open-return contracts might be critiqued from two different directions. On the one hand, our proposed recovery may seem undercompensatory since the breaching party’s breach could have deprived the aggrieved party of a supranormal rate of return

170. Regarding the breaching party showing a loss on contract, see, for example, *L. Albert & Son v. Armstrong Rubber Co.*, 178 F.2d 182 (2d Cir. 1949). Further note how our proposed “default” rule could be adjusted *ex ante* by the parties in their original agreement. See *supra* Part III.A for a discussion of penalty default rules.

on their capital or labor well into the future. On the other hand, our proposal might seem overcompensatory in that the aggrieved party's risky venture could have failed to generate any profits at all, or possibly even operated at a loss. But rather than undercutting our proposal, the competing directions of these critiques, taken together, demonstrate the moderating appeal of our proposal. These dueling critiques highlight that our proposal provides a superior default rule on average than other possibilities, as our recovery is keyed to the venture's *ex ante* expected payout over time on the aggrieved party's investment. As such, our proposal provides a superior starting point for litigation by utilizing a moderate average recovery subject to adjustment in appropriate cases. Under our approach, we would presume that Jack Dempsey should cover the promoter's costs plus a risky profit return without going overboard and taking away all of his hard-fought revenue.

There are two main ways to adjust our proposed "default" rule. First, our proposed recovery could be adjusted in litigation upon a proper showing by either party, either up (by the aggrieved party) or down (by the breaching party). For instance, the aggrieved party should receive a higher recovery upon a proper showing that his particular case involved a supranormal return. In similar fashion, the recovery should be reduced upon a proper showing by the breaching party that his particular case involved below-average profit potential. We believe that our regime therefore places the evidentiary burdens on the appropriate parties. In contrast, current rules, which require the aggrieved party to prove the revenue stream with sufficient certainty, can leave the aggrieved party with less than the normally expected payout absent any showing that the venture really was a subpar deal. This result is problematic, especially where the breaching party caused the failure of an actual revenue stream. Similarly, the current starting presumption that the venture would have generated a subpar return can lead to opportunistic breaches by encouraging the non-investing party to discount the harm to the aggrieved party when deciding whether to breach.

Our proposal is also a default rule in the second sense that it would apply only absent an enforceable contractual provision to the contrary regarding damages for breach. Absent such a specific overriding agreement, a rule providing the aggrieved party with a return of its investment along with a risky rate of return for the time invested seems like a more reasonable presumption of the parties' intentions at the time of contracting, assuming that one is not planning an opportunistic breach. And if one party is contemplating a breach and believes that he should be able to do so without fully compensating the other side, our proposal would force him to disclose such intentions at the time of contracting. In contrast, the current default rules can give a breaching party the ability to wipe out an aggrieved party's recovery of his precontract investments under general integration principles without any disclosure at contracting.