Measuring Contract Damages--Policy and the Advantageous Breach

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Introduction

To an extraordinary degree, the principles and supplementary rules used in determining contract damages are clear in application, consistent in operation and fair in result. Of course the system is not a geometry and occasionally the process of measuring damages becomes confused. Such an instance follows:

O leases Blackacre to L (usually for the purpose of exploiting some natural resource). Among other things the agreement provides that L will either explore, improve, or restore Blackacre. L deliberately defaults, and O brings an action for damages. As it happens the cost of exploration, improvement, or restoration far exceeds the value of any demonstrable benefit to be gained thereby. What is the proper measure of damages—the cost of completion or the appreciation in value of Blackacre which would result from completion?

The basic principle governing the award of contract damages is to put the injured party in as good a position as he would have been had the promise been kept. What about O? What does "in as good a position as he would have been" mean in this context? May notions of freedom and stability of contract be reconciled with an award measured by the difference in value? Are damages measured by the cost of completion punitive? Lastly, what is fair?

A summary of four leading cases will help sharpen these questions. Of these the earliest is Groves v. John Wunder Co. S.J. Groves & Sons Company owned a tract of suburban real estate zoned as heavy industrial property. The principal value of this land lay in the deposit of sand and gravel which it carried, and to excavate and screen this gravel the Groves Company maintained a plant on the premises. In August 1927, Groves entered into an involved contract with the John Wunder Company which operated a similar plant nearby. In substance Groves leased the property to Wunder for a period of seven years. The agreement provided that Wunder would remove sand and gravel and then, using the overburden stripped away in the process, leave the tract at a uniform grade substantially the same as that of a roadway passing through the premises. Wunder paid Groves $105,000. During the period of the lease, Wunder removed only the richest and best of the gravel and upon termination deliberately surrendered the premises with the ground rugged and uneven and not at the grade agreed upon.

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1 11 W. Williston, Contracts § 1338 (3d ed. W. Jaeger 1968); 5 A. Corbin, Contracts § 992 (1964). A much relied upon analysis distinguishes three principal purposes pursued in awarding contract damages: (1) to prevent unjust enrichment, (2) to put the promisee in as good a position as he was in before the promise was made, and (3) to put the promisee in as good a position as he would have occupied had the promisor performed. Fuller & Purdue, The Reliance Interest in Contract Damages, 46 Yale L.J. 52, 53-54 (1936). Under this analysis the third purpose may be considered basic to the extent that it sets the limit of recovery in cases of conflict. See id. at 75-80.

2 205 Minn. 163, 286 N.W. 235 (1939).
Had the land been graded as agreed, its value would have been $12,600. On the other hand, to complete the grading almost 300,000 cubic yards of overburden would have to be removed bringing the cost to about $60,000. The Supreme Court of Minnesota held that the cost of completion was the proper measure of damages.

In contrast, the Supreme Court of Oklahoma held in *Peevyhouse v. Garland Coal & Mining Co.*,³ on a very similar fact pattern, that the difference in value was the proper measure of damages. Peevyhouse, a farmer, had leased the mineral rights to a part of his farm to the defendant strip mining company. In addition to payment, the mining company promised to restore the land upon completion of its operations. As in *Groves*, the defendant paid but deliberately defaulted on its promise of restoration. The difference between the value of the land as surrendered and its value if restored was found to be $300. The cost of restoration was placed at about $29,000.

A variation of this issue is found in a series of oil exploration cases. The facts of *Fite v. Miller*⁴ present the problem in sharp focus. In exchange for one half interest in a mineral lease held by Fite in a small parcel of land, Miller paid $1,000 and obligated himself to drill a test well. The drilling was to begin immediately after Miller completed a well on his own land just to the north. At the time of the agreement, prospects for discovering oil looked bright; however, Miller's well to the north proved to be a dry hole as did other wells in the vicinity. Miller refused to drill, and Fite brought an action seeking damages for breach of contract. Uncontradicted expert testimony and geological data established beyond dispute that drilling to the contract depth would have been a vain and useless act. Although the cost of drilling was in dispute, Miller admitted to a figure of $6,400. A statute provided that damages for breach of contract were to be measured by the amount of loss that the plaintiff sustained plus the profits of which he was deprived.⁵ The Supreme Court of Louisiana held that although anticipated profits were exceedingly remote and purely speculative, the loss sustained was to be measured by the cost of drilling.⁶

*Riddle v. Lanier*⁷ involved a similar exchange—assignment of mineral leases in return for an obligation to drill a test well. The contract depth was 3,500 feet unless oil or gas in commercial quantities was found at some lesser depth or unless an impenetrable substance was discovered making further drilling impractical. Having struck neither oil nor impenetrable substance, the defendant willfully abandoned the hole at 1,830 feet. On the evidence the jury found that had the well been drilled to 3,500 feet the plaintiff's leases would have been worthless. Although the cost of completing the well was found to be $15,000, the Com-

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³ 382 P.2d 109 (Okla. 1962).
⁴ 196 La. 876, 200 So. 285 (1940).
⁵ Id. at 882, 200 So. at 287. The substance of this statute should be compared with Restatement of Contracts § 329 (1932) which provides:

Where a right of action for breach exists, compensatory damages will be given for the net amount of the losses caused and gains prevented by the defendant's breach, in excess of savings made possible, if established in accordance with the rules stated in §§ 330-346.

⁶ But see Restatement of Contracts § 346, illustration 3 (1932).
⁷ 136 Tex. 130, 145 S.W.2d 1094 (Comm'n App. 1941).
mission of Appeals of Texas held that the plaintiff could not recover substantial damages.

As might be expected there are many sound arguments on both sides of this issue. A dialogue of point and counterpoint follows.

**PLAINTIFF:** The law of contract damages should not reward default. Damages should be measured to discourage not induce breach.\(^8\)

**DEFENDANT:** The cost-of-completion measure urged by the plaintiff is a sanction tantamount to specific performance.\(^9\) Just as equity will not require performance of a vain, useless, or wasteful thing,\(^10\) the law should not encourage or expect its performance.

**PLAINTIFF:** As a practical matter unless the obligee insists on the performance due him, the threat of damages so measured will not force performance. In the ordinary course this situation will precipitate negotiation and compromise.\(^11\)

**DEFENDANT:** Whether payment to the plaintiff is made to satisfy a compromise agreement or judgement, the exaction is punitive to the extent it exceeds fair compensation for the harm sustained.\(^12\)

**PLAINTIFF:** Fair compensation is the equivalent of performance.\(^13\) It is by no means clear that the difference in value is equivalent to performance. In what sense are damages "punitive" which place the defendant in no worse position than the performance of his promise? As the bargain was made free of mutual mistake and no intervening cause has rendered performance impossible, the harshness, if any, of an

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8 "That the decision below handsomely rewards bad faith and deliberate breach of contract is obvious. That is not allowable." Groves v. John Wunder Co., 205 Minn. 163, 165, 286 N.W. 235, 236 (1939). "Therefore, though it may be assumed that the impulse to assuage disappointment is one shared by those who make and influence the law, this impulse can hardly be regarded as the key which solves the whole problem of the protection accorded by the law to the expectation interest." Fuller & Purdue, supra note 1, at 58.


10 See Abell v. Safe Deposit & Trust Co., 192 Md. 438, 64 A.2d 722 (1949) (would not require corporation to maintain $1,000,000 mortgage to secure bonds worth $13,000); Smith v. Myers, 130 Md. 64, 99 A. 938 (1917) (would not require removal of $1,500 building from disputed portion of $12 lot); Murtfeldt v. New York, W.S. & B. Ry. Co., 102 N.Y. 703, 7 N.E. 404 (1886) (would not require construction of railroad underpass of no use to plaintiff); Restatement of Contracts § 367, illustration 6 (1932).

11 34 Ill. L. Rev. 501, 504 (1939).

12 "Punitive damages are not recoverable for breach of contract." Restatement of Contracts § 342 (1932). "All damages are in some degree punitive and preventive; but they are not so called unless they exceed just compensation measured by the harm suffered." Id. comment a.

13 "In the law of Contract, the term 'damages' is used to mean compensation in money as a substitute for and the equivalent of the promised performance." 5 A. Corbin, Contracts § 990, at 3 (1964) (emphasis supplied).
award based on cost of completion can stem solely from the fact that defendant made a bad bargain.\footnote{14}{24 MINN. L. REV. 114, 116 (1939).}

**Defendant:** In any event, a recovery in excess of the difference in value is clearly a windfall because the very disparity between cost and value that raises this issue makes it unrealistic to imagine that plaintiff seeks funds to spend for completion.\footnote{15}{Avery v. Fredericksen & Westbrook, 67 Cal. App. 2d 334, 341, 154 P.2d 41, 45 (1944); see Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109, 112 (Oka. 1962); Groves v. John Wunder Co., 205 Minn. 163, 176, 286 N.W. 235, 241 (1939) (dissecting opinion).}

**Plaintiff:** On the other hand, damages measured by the difference in value allow the defendant to reap full benefit from the bargain and yet discharge a substantial obligation for next to nothing. The defendant seeks to preserve a windfall.\footnote{16}{Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109, 116 (Oka. 1962); see Fite v. Miller, 196 La. 876, 890, 200 So. 285, 290 (1940).}

**Defendant:** The plaintiff suggests that a recovery limited to the difference in value will result in unjust enrichment, yet fails to show that the enrichment would be at his expense.\footnote{17}{“A person who has been unjustly enriched at the expense of another is required to make restitution to the other.” RESTATEMENT OF RESTITUTION § 1 (1937).} His action is for compensatory damages which are due him under the contract. He has not shown, nor can he show, that his loss exceeds the value of this right of action. In addition to these arguments the parties will rely on certain doctrines applied to resolve a similar issue as to the measure of damages which arises in construction contract litigation. This issue is commonly presented in an action by the builder to recover payment. Although he has breached, he has, nevertheless, substantially performed the contract. As substantial performance is the implied condition of payment in such contracts,\footnote{18}{Jacob & Youngs v. Kent, 230 N.Y. 239, 241-44, 129 N.E. 889, 890-91 (1921); 3A A. CORBIN, CONTRACTS § 701, at 314 (1964). The doctrine is based on the distinction between dependent and independent promises. See 5 W. WILLISTON, CONTRACTS § 805 (3d ed. W. Jaeger 1961). Even an express promise to replace defective work may be considered independent of the promise to pay. Jacob & Youngs v. Kent, 230 N.Y. 656, 130 N.E. 933 (1921) (motion for reargument).} payment less damages for the breach is due. Two of the doctrines, the “economic benefit” rule and the “economic waste” rule, compete for adoption. Both are exceptions to the general rule that damages are to be measured by the cost of completion.\footnote{19}{See 11 W. WILLISTON, CONTRACTS § 1363, at 344-45 (3d ed. W. Jaeger 1968).} Plaintiff will seek application of the economic waste rule which requires the difference-in-value measure only in those cases where completion in accordance with the contract would involve unreasonable destruction of completed work.\footnote{20}{Bucholz v. Riemenschneider, 165 Wis. 312, 156 N.W. 946 (1916); RESTATEMENT OF CONTRACTS § 946, comment b (1932).} He will point out that the improvement, restoration or exploration involves no destruction. Defendant will urge adoption of the economic benefit rule which excepts from the
general cost-of-completion measure all cases in which the cost is disproportionate to the benefit to be gained by completion.\textsuperscript{21}

Plaintiff may rely upon yet another doctrine, the main purpose rule, to modify the exceptions described by the economic waste and benefit rules. The apparent source of this rule is the qualification that a contractor whose breach frustrates the purpose of the contract has not substantially performed and may not therefore recover under the contract.\textsuperscript{22} In the present context frustration of purpose requires that damages be measured by the cost of completion whenever performance as promised is essential to the main purpose of the contract.\textsuperscript{23} In the extreme case this rule is both understandable and easy to apply. For example, suppose that after his unsuccessful attempt to recover the cost of restoration, Peevyhouse decided to repair the strip mining excavation at his own expense. To carry out his objective, he enters into a contract with Ace Excavating for an agreed price of $25,000. Ace begins the restoration but midway abandons the job for a more profitable venture. It seems clear that Peevyhouse should recover the cost of completion less any unpaid portion of the contract price.\textsuperscript{24} Ace's breach frustrated the main purpose of the contract. However, the rule is very difficult to apply to more complex arrangements,\textsuperscript{25} and further, it is not at all clear that the fine distinctions it provokes have anything to do with the basic issue.

A case which brings principles and established rules of law into head-on conflict is similar in one respect to a case upon which the authorities are silent. No amount of pure reasoning will suffice either to resolve the conflict or fill the gap. In each case a sound decision will turn on policy considerations.\textsuperscript{26} Legal decisions are made in terms of rules because rules afford a level of clarity, stability and predictability that cannot be achieved through the most adept articulation of supporting policies. In most cases these three qualities overwhelm in importance any arguable nuances of underlying policy, and the rule acquires a fixed position within a scheme of law.

The present issue brings into conflict principles and rules which form the law of contract damages. It shatters the apparent stability of this well-settled scheme of law and calls for an adjustment.\textsuperscript{27} Recourse to underlying policy provides a

\textsuperscript{21} "The owner is entitled to the money which will permit him to complete, unless the cost of completion is grossly and unfairly out of proportion to the good to be attained. When that is true, the measure is the difference in value." Jacob & Youngs v. Kent, 230 N.Y. 239, 244, 129 N.E. 889, 891 (1921).


\textsuperscript{23} See Peevyhouse v. Garland Coal & Mining Co., 382 P.2d 109, 114 (Okla. 1962).

\textsuperscript{24} Id.

\textsuperscript{25} Although the court [in Peevyhouse] presented no evidence as to the purpose of the parties in entering the contract, it assumed that the main consideration was the profitable mining of coal. While from the defendant's point of view the court's assumption may have been correct, the facts indicate that it was plaintiff's main purpose to realize a profit from the mining operation without permanent injury to his property. 49 IOWA L. REV. 597, 601 (1964). "The objective of this contract of present importance was improvement of real estate." Groves v. John Wunder Co., 205 Minn. 163, 170, 286 N.W. 235, 238 (1939). "But that is not what plaintiff's predecessor in interest contracted for." Id. at 184, 286 N.W. at 244 (dissenting opinion).


sound basis for decision. At least two writers in the field have suggested that the middle ground between difference in value and cost of completion may contain a more just result. The alternative framed by existing principles and rules warrants close scrutiny. The dilemma may prove illusory.

II. The Market Function of the Advantageous Breach

Sometimes financial advantage lies in the breach rather than the performance of a contractual duty. Perhaps a man ought to keep his promises but our law of contract damages will occasionally make default the more attractive alternative. In general, when the law induces a breach, default rather than performance will produce the more efficient allocation of our community resources. The obligee may be disgruntled, the public indifferent, but the analyst will perceive a social end.

The breaking point at which discouragement yields to encouragement (to breach) is clearly a function of the measure of contract damages. At each stage of an executory contract it is possible to draw an optimum line beyond which breach and reallocation will produce the greater efficiency. If we narrow our view to the execution and product of the contract, that optimum line will be a function of cost and value. In some areas of contract law the rules for measuring damages place the breaking point close to the optimum. In other areas different policies prevail.

For instance, the breaking point is normally close to the optimum in contracts for the sale of goods. Consider a contract for the sale of widgets between Seller and Buyer. The terms are 100 widgets at $1.00 each. Seller's profit (including reasonable overhead) on this fixed price item is 20¢ per widget. Another party, Intervenor, offers Buyer 100 sub-widgets at 90¢ each. Intervenor's profit will be 10¢ per sub-widget at this price. By breaching, Buyer will save $10 but be liable under U.C.C. § 2-708(2) for $20 in damages. Even if Intervenor is willing to forgo his profit and sell at 80¢ each, Buyer is not induced to breach. As long as Intervenor is not able to acquire and handle widgets more economically than Seller, he cannot without taking a loss himself induce Buyer to breach his contract. If he is more efficient, he may of course by narrowing his profit margin make default the more attractive alternative for Buyer. In the event that Intervenor is unwilling to reduce his profit, a preferable reallocation may be discouraged. The measure of damages in this instance operates to insure that all induced rearrangements will be preferable.

28 Id. at 66-71; Farnsworth, Legal Remedies for Breach of Contract, 70 Colum. L. Rev. 1145, 1175 (1970).
30 If the measure of damages provided in subsection (1) [market price less unpaid contract price] is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer. . . . Uniform Commercial Code § 2-708 (2). See generally Distribu-Dor, Inc. v. Karadonis, 11 Cal. App. 3d 463, 90 Cal. Rptr. 231 (1970); Anchorage Cen. D. Co. v. Van Wormer & Rodrigues, Inc., 443 P.2d 596 (Alaska 1968).
31 "If recovery for breach of contract were limited to protection of restitution and reliance interests, a party could frequently profit through repudiation of one agreement and entry into another offering him a larger share of a smaller joint gain." Birmingham, supra note 29, at 285.
Section 2-706 of the Uniform Commercial Code provides another illustration of breaking-point policy. Consider a contract for the sale of a single "super widget" to be manufactured by Seller for Buyer at a price of $1,000. Buyer ordered this unique item for a project which has since fallen through, and there is no other earthly use for a super widget. To date Seller has expended $500 in labor and materials on the partially constructed widget which requires an additional expenditure of $300 to complete. Whether he completes manufacture or not, the super widget's only value is $100 as scrap. In this situation it is more advantageous for Buyer to repudiate than await tender. In the normal course Seller will exercise his option under U.C.C. § 2-704(2)32 to cease manufacture and sell the scrap for $100. Damages measured under U.C.C. § 2-706(1)33 will be computed as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>contract price</td>
<td>$1000</td>
</tr>
<tr>
<td>less: proceeds of resale</td>
<td>$100</td>
</tr>
<tr>
<td></td>
<td>$900</td>
</tr>
<tr>
<td>less: savings realized</td>
<td>$300</td>
</tr>
<tr>
<td></td>
<td>$600</td>
</tr>
</tbody>
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Suppose that Buyer’s project had not fallen through. Rather, an adverse market has diminished his original expectations making the completed super widget worth less than the contract price. Buyer's breaking point will occur when he values the completed widget at $400. At this point the $600 loss he would realize by acquiring a $400 widget for $1,000 equals the damages which would result from repudiation. Seller has expended $500 in labor and materials. To complete the widget at a cost of $800 he will have to expend another three hundred dollar's worth of these resources. A three hundred dollar investment to appreciate the value of the incompleted widget (worth $100 as scrap) to the value of a completed widget (worth $400 to Buyer) is a marginally sound allocation of resources. If Buyer values the completed widget at less than $400, breach will be advantageous and at the same time the three hundred dollar investment to complete manufacture will be wasteful to the extent that it will appreciate the value of the widget by a correspondingly smaller amount. In addition to the elements of damages considered, the Uniform Commercial Code also places the burden of transactional costs arising from the breach on the

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32 Where the goods are unfinished an aggrieved seller may in the exercise of reasonable commercial judgement for the purposes of avoiding loss and of effective realization either complete manufacture and wholly identify the goods to the contract or cease manufacture and resell for scrap or salvage value or proceed in any other reasonable manner.

Uniform Commercial Code § 2-704 (2).

33 The seller may resell the goods concerned or the undelivered balance thereof. Where the resale is made in good faith and in a commercially reasonable manner the seller may recover the difference between the resale price and the contract price together with any incidental damages allowed under the provisions of this Article . . . , but less expenses saved in consequence of the buyer's breach.

Uniform Commercial Code § 2-706 (1).
defaulting party—a rule which serves to place the breaking point still closer to a true optimum.

The rule requiring mitigation of damages produces within the limits of its application a similar result in labor contracts. On the whole, if we indulge in the assumption that a competitive market will produce the most efficient allocation of resources, it becomes clear that once the promisor has placed the promisee in as good a position as he would have occupied by performance, a rearrangement induced by a desire to maximize profit or minimize loss will result in the preferable allocation of resources. However, whether a particular measure of damages designed to place the promisee “in as good a position” will also place the breaking point near the optimum is a question for specific analysis.

Policies other than promoting efficient reallocation of resources may be analyzed in terms of the breaking point. Certain doctrines commonly applied in the area of building or construction contracts serve to avoid a breaking point created by a particular measure of damages. Much of the litigation involves a plaintiff builder in default bringing an action to recover for his work. Normally, the threshold question is whether the builder has substantially performed. If he has, he is entitled to recover payment under the contract. However, if his deviation from the contract specifications is too great or frustrates the purpose of the contract, he has not met the implied condition of payment, and the question of recovery under quasi-contract is raised. Although few decisions necessarily turn on the character of the plaintiff’s breach, courts frequently consider the willfulness of a breach in resolving the questions of substantial performance and recovery under quasi-contract.

As a general rule, if the breach is willful, recovery is denied under both the contract and quasi-contract. This general rule is subject to a spectrum of variations in which such standards as intentional, deliberate, or not in good faith are employed in place of willful. In theory, if not in practice, even under the least stringent variation, a builder who freely chose to cut corners would be denied relief. Even if the builder could realize savings greatly in excess of the diminution in value of the completed structure, he is not induced to breach. There is authority which rejects the rule of willfulness as applied to recovery under quasi-contract. When this is the case, the breaking point remains a function of the measure of recovery.

When a plaintiff contractor is in substantial default he may recover the amount by which the benefit he has conferred upon the defendant exceeds the

35 See Birmingham, supra note 29, at 291.
36 See id. at 284-86.
38 See generally 3A. A. Corbin, Contracts §§ 701, 704, 705, 706 (1960); 5A. A. Corbin, Contracts § 1124 (1964).
40 Id. at 328.
41 Id. at 329; 5A. A. Corbin, Contracts § 1123 (1964).
42 See generally Restatement of Contracts § 275, illustration 6 (1932); Id. § 357, comment e.
injury caused by his own breach. The benefit conferred is determined by the "amount that the part performance has added to [the defendant's] wealth," and the injury is "measured in accordance with the usual rules for determining damages for a breach." This "net benefit" measure is, however, subject to the limitation that in no case shall the plaintiff's recovery exceed a ratable portion of the full contract price. Professor Corbin offers the following example:

[A] landowner secured by his contract the erection for $2000 of a building worth $3000, and the plaintiff, in erecting the building, fails to comply with the contract in matters going to the essence of the contract, and the building erected as it is erected, is worth $2500, the plaintiff is not entitled to recover $2500; all that he is entitled to recover is twenty-five thirtieths of $2000.

Just what policy this ratable portion limitation serves is not at all clear. Professor Corbin offers the moralistic view that "the plaintiff is the wrongdoer, and must not be able to profit by his own wrong." The example above implies a rule that may easily fail to produce this result. Suppose that the building in the example would cost $2900 to construct in accordance with the contract specifications, and further, that the plaintiff's costs in erecting the building as he did were $2500. Under the ratable portion rule, plaintiff is limited to a recovery of 25/30 x $2000 or $1666.67. Unless the net benefit is less than $1666.67, this will be plaintiff's recovery. In this case benefit was conferred in the form of a building valued at $2500. Net benefit will be determined by subtracting the amount of the defendant's injury from this figure. As previously indicated, there are two usual rules for measuring the defendant's loss. The difference in value in this case is $500 which when subtracted yields a net benefit of $2000. On the other hand, if we assume a cost of correction of $800 (twice the difference between the cost under the contract and the actual cost), the net benefit is $1700. In either case the recovery will be the smaller ratable portion of the full contract price. Plaintiff's total loss on this transaction is $833.33, a figure which should be compared with the $900 loss he would have sustained had he performed according to the contract. Unless recovery is denied for "willful breach," this measure of restitution renders the contract defective in the sense that it is financially advantageous to breach upon formation. Yet, under the assumed facts this contract provided for a sound allocation of resources, a $2900 investment in labor and materials to produce a building worth $3000. The essence of the problem is this: paying $1666.67 for a $2500 building does not net out to be as good as paying $2000 for a $3000 building. It's difficult to imagine a purpose which is served by this fairly complex measure of recovery.

The policy that a wrongdoer should not profit by his wrongful act has, however, emerged in considerations less confused of purpose than the measure of recovery under quasi-contract described above. For example, in Healy v.

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44 Restatement of Contracts § 357 (1932).
45 5A A. Corbin, Contracts § 1124, at 13 (1964).
46 Id.
47 Restatement of Contracts § 357 (1932).
48 5A A. Corbin, Contracts § 1124, at 12 n.12 (1964).
49 Id. at 12.
Fallon," a builder who had substantially complied with the contract realized a savings by mistakenly using wider clapboard than was stipulated. Neither the usefulness nor the value of the house was diminished by this slight breach. The court observed that the difference in cost to the contractor was less than $50 and approved a deduction of that amount from the contract price. In Jacob & Youngs v. Kent the difference-in-value measure resulted in a recovery of the full contract price. The court was careful to observe that the brand of pipe substituted in violation of the specifications was of equivalent market value and cost.

There are other cases in which a particular measure of damages might render a contract defective from the outset. The rules that cope with this problem are in conflict. The Restatement of Contracts gives the following illustration of the economic waste rule:

A contracts to construct a monumental fountain in B's yard for $5000, but abandons the work after the foundation has been laid and $2800 has been paid by B. The contemplated fountain is so ugly that it would decrease the number of possible buyers of the place. The cost of completing the fountain would be $4000. B can get judgment for $1800, the cost of completion less the part of the price unpaid.

Although the illustration is designed to show the function of the economic waste rule, the main purpose rule provides the same result. By changing the facts slightly we may distinguish the application of these two rules. Assume that the construction of this fountain was part of a contract to build a mansion for which A has paid the full contract price. The builder having completed the mansion in accordance with the contract abandons his work on the fountain as in the Restatement illustration. Because the cost of completion, $4000, is disproportionate to the benefit to be gained by completion, the economic benefit rule requires a difference in value measure which will yield nominal damages. On these facts the main purpose rule provides no relief for the would-be owner of an ugly fountain. But, because no unreasonable economic waste is necessary to complete the fountain, the economic waste rule provides as before for the cost of completion.

It is difficult to perceive a sound reason for distinguishing these cases in the matter of damages. Although with reference to the housing market, neither contract provided for a sound allocation of resources, the economic benefit and main purpose rules leave the first contract sound yet render the second defective from the outset. Without the main purpose rule, the economic benefit rule would at least be consistent in promoting reallocations preferable in terms of the market. On the other hand, the economic waste rule allows an owner to contract for what he desires despite the circumstance that cost disproportionately exceeds

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50 69 Conn. 228, 37 A. 495 (1897).
51 Id. at 232-34, 37 A. at 496-97 (1897).
52 230 N.Y. 239, 129 N.E. 889 (1921).
53 Id. at 241, 129 N.E. at 890.
54 Restatement of Contracts § 346, illustration 4, at 576-77 (1932).
55 See id. comment b.
benefit. However, the policies of freedom and stability of contract manifest in this rule are subject to a strange limitation. What reasonable policy could possibly favor expending $4000 to obtain no benefit yet disfavor a $4000 destruction to achieve a substantial but nevertheless disproportionate benefit? It seems fair to characterize these doctrines as makeshift rules. While the policies that underlie the law of contract damages surely compete, the balance struck in these rules is difficult to understand. There is little to recommend the uncritical adoption of any one of these rules to resolve the issue framed in the introduction.

III. Conclusion

Men very rarely bargain for promises. The real exchange in a bilateral contract is of legal obligations. Setting aside those promises which may be specifically enforced, the nature of a contractual obligation is disjunctive: perform or respond in damages. Although contracting parties consciously seek legal obligations, the process of reaching an agreement focuses attention on the promises rather than the law which makes them enforceable. Normally, it would be both vain and capricious to resolve the issue framed in the introduction by seeking to carry out the "intent of the contract." An exceptional circumstance is described by Professor Farnsworth by varying the facts of Groves v. John Wunder Co. as follows:

Had the sum to be paid for the lease originally been $165,000 with no provision for restorative work, and had the parties subsequently modified the agreement to reduce the price to $105,000 and include the restorative work, this conclusion [recovery of $60,000] would be difficult to dispute. However, where it is not clear that both parties have considered the disparity between cost and value in making their bargain, courts are understandably reluctant to fully enforce a grossly wasteful promise. If freedom and stability of contract are to prevail when the intention to waste is clear, the issue remains unresolved only in those cases where mutual assent to the waste inherent in performance is not apparent.

Each of the contracts in the four cases summarized in the introduction was an arrangement for the joint exploitation of land. The common issue brings the policy of promoting preferable reallocations of our resources and the policies of freedom and stability of contract into sharp conflict. One way to balance these policies is to distinguish such joint exploitation arrangements from consumer contracts in which one party seeks satisfaction and not profit. Where the cost of performance is disproportionate to the benefit to be gained, the ability to contract to satisfy personal desires is more important than the ability to make a joint exploitation bargain an inflexible allocation of resources. From this aspect, the policy of encouraging preferable reallocations should prevail in each of the four cases. This does not mean, however, that the damages ought to be measured by the difference in value. As a practical matter the parties may reallocate by

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56 205 Minn. 163, 286 N.W. 235 (1939). See text accompanying note 2 supra.
57 Farnsworth, supra note 28, at 1172.
negotiation under a cost-of-completion measure. Although the defendant's ability to perform at a cost less than the market price available to the plaintiff might coerce him to perform rather than breach and reimburse this price, surely any measure of damages which might fall short of the cost of completion would adequately serve the policy of reallocation. This approach leaves the measure of damages free to serve other competing policies.

In addition to carrying out the clear intent of the contract, there are other policies which may be served by focusing on a view of the exchange at the time of contract formation. Certainly, the law ought to discourage the formation of contracts which are apparently defective from the outset. And, it may prove sound for the burden of any rule designed to discourage wasteful promises to fall on the party who seeks to escape the full effect of his promise. Further, to avoid discouraging desirable arrangements, the full consequence of the rule should be apparent from the outset. These considerations lead to the following rule:

If at the time the contract was made, the defendant contemplated a cost of performance which exceeded every reasonable expectation of benefit, the plaintiff may recover, in addition to the difference in value, the excess of which the defendant knew or had reason to know.

The recovery must of course be limited by the actual cost of completion. A good reason for placing this burden on the defendant is to disappoint any possible expectation of profitable breach.

Consideration of one last policy may serve to fix the measure of damages. In measuring contract damages, penalties are to be avoided. Professor Hartzler describes the policy which supports this principle as follows:

If damages are awarded to secure expectation interest in order to encourage the making of contract promises, to introduce damage measuring law which goes beyond the value of expectations may introduce a deterrent to the very contract making behavior to be encouraged. The function of a penalty is to discourage such conduct. One might say that the existence of penalty measures in the law of contracts would serve to discourage breaches of contract. But, once such a law is established it exists before the fact—before the making of all contracts in the future. Then the conduct discouraged well may be the very making of contract promises . . . .

This policy which at first glance appears to militate against any measure of damages in excess of the difference in value is nevertheless perfectly compatible with the proposed rule of recovery. Rarely would anyone be discouraged from entering a contract by the prospect of having to pay in damages the amount he contemplates expending to perform. A rule to implement this policy would limit any recovery over the difference in value to the cost contemplated by the defendant at the time the contract was made.

58 Id. at 1174.
Applying these rules to the facts of Groves v. John Wunder Co.\(^6\) raises questions not considered by the court. First, it is not at all clear that the defendant company anticipated removing only the best gravel. Changing market conditions or a closer inspection of the quality of the gravel may have made it financially unwise to carry out an original business decision. It would appear from the terms of the contract that the defendant did not expect to carry away any of the overburden but merely to use that which was stripped away to grade the property after sufficient gravel was processed. Whether the defendant knew or had reason to know that his contemplated grading costs would exceed the increase in value of the land is the critical question under these rules. Assume on the basis that the defendant owned and operated a similar plant in the area that he had reason to know of the increased value which would result from grading. The question is reduced to a determination of the costs which he anticipated at the outset. Under the proposed rules there is little likelihood of a $60,000 recovery.

In Peevyhouse v. Garland Coal & Mining Co.,\(^6\) on the other hand, the facts were clear enough for the dissenting opinion to conclude that the defendant company could have anticipated the actual cost of restoration.\(^6\) Again, in this case it is probable that the defendant was aware of land values and the effect of restoration. In both cases the damages would probably amount to the contemplated cost which is the maximum under the rule to effect the policy against penalties.

The oil exploration cases, Fite v. Miller\(^6\) and Riddle v. Lanier\(^6\) present a different problem. In Fite it is clear that the defendant had no reason to know of a disparity between cost and benefit at the time the contract was made. Under the proposed rules the plaintiff may in such a case recover as little as the difference in value and as much as the defendant's contemplated costs. In this case the two rules fail to fix an amount of recovery and provide instead a range of permissible amounts consistent with the underlying policies.

Breach of a wasteful promise is a preferable reallocation of resources. The benefit arising from default is the difference between the value of the resources released and the value of the performance promised. So much of this benefit as exceeds the disparity between cost and benefit fairly within the knowledge of the defendant at the time the contract was made is truly unanticipated. As the cost of completion varies so will this unanticipated benefit. The effect of limiting recovery to the lower of the actual cost and contemplated cost of completion is to give the defendant the benefit but not the burden of the risk of cost which he assumed. The reasons for this limitation are: (1) to induce the breach, and (2) to avoid penalty. The range of permissible recoveries represents that portion of the unanticipated benefit which may, consistent with underlying policy, be equitably divided between the parties to the contract.

For example, in Riddle these rules direct consideration of the possibility

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\(^{60}\) 205 Minn. 163, 286 N.W. 235 (1939).
\(^{61}\) 382 P.2d 109 (Okla. 1962).
\(^{62}\) Id. at 115.
\(^{63}\) 196 La. 876, 200 So. 285 (1940).
\(^{64}\) 136 Tex. 130, 145 S.W.2d 1094 (Comm'n App. 1941).
that the defendant had anticipated a cost of drilling from 1,830 to 3,500 feet which exceeded every reasonable expectation of benefit based on the probability of discovering oil below 1,830 feet in that area. Any excess of which he had reason to know would of course raise the plaintiff's minimum recovery and thereby narrow the range of permissible recoveries.

Professor Birmingham has suggested that a court faced with a case like Groves or Peevyhouse might grant specific performance—a remedy with the important virtue of simplicity. Such a decree would place the parties in a position from which they might bargain and divide the unanticipated gain caused by default. This remedy would treat both these cases in the same way by placing the parties in a commercially unrealistic position. If the question of cost and value had been raised just before each of these contracts was formed, it would surely have stimulated further negotiation. We may assume that in this event the parties would have arrived at a fair bargain. However, once the bargain is struck and performance begun, it would be the extraordinary case in which a decree of specific performance would produce the same fair bargain. The rules proposed here, although complex, have the virtue of focusing on the circumstances of formation where the equities of such cases lie.

These rules are suggested as possible ways to implement policies which existing doctrines fail to serve. The underlying policies may be balanced in other ways and the rules designed to achieve desired ends may vary in method. What is most important is that the process is clearly thought out.

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65 Birmingham, supra note 27, at 69-70.