

IMPOSSIBILITY, IMPRACTICABILITY, AND FRUSTRATION

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ABSTRACT

Three fundamental concepts underlie the principles that should govern unexpected-circumstances cases. (1) A contract consists not only of the writing in which it is partly embodied, but also includes, among other things, certain kinds of tacit assumptions. (2) These assumptions may be either event-centered or magnitude-centered. (3) The problems presented by unexpected-circumstances cases should be viewed in significant part through a remedial lens. The principles that rest on these concepts can be broadly summarized as follows. A shared nonevaluative tacit assumption that a given circumstance will persist, occur, or not occur during the contract time should provide a basis for judicial relief where the assumption would have affected the promisor's obligations had it been made explicit. If the promisor was neither at fault for the occurrence of the unexpected circumstance, nor in control of the conditions that led to the occurrence, she should not be liable for expectation damages. The promisor should, however, be liable for restitutionary damages, because it would be unjust to allow the promisor to both be excused from performance and retain any benefits that she received under the contract. Alternatively, the promisor should be liable for reliance damages where she is at fault for the creation of the unexpected circumstance, but the fault is minor; where the promisor is in control of the conditions that led to the occurrence of the unexpected circumstances; or where an objective of the contract was to reserve for the promisor the promisee's time, labor, or productive capacity. A seller should also be entitled to judicial relief if as a result of a dramatic and unexpected rise in her costs, performance would result in a financial loss that is significantly greater than the risk of loss that the parties would reasonably have expected that the seller

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I thank Shawn Bayern, Robert Cooter, Jesse Fried, Rob MacCoun, Barak Medina, and Ariel Porat for their extremely valuable comments on earlier drafts of this article, and Jennifer Beerline, Alan Galloway, and Elaine Meckenstock for their wonderful comments, editorial assistance, and research assistance.

had undertaken. If, under such circumstances, the market value of the contracted-for commodity has risen in tandem with the seller's costs, the buyer should be entitled to the profit he would have made if a reasonably foreseeable increase in the seller's cost of performance, and a corresponding increase in the market value of the commodity, had occurred. In appropriate cases, courts should take into account gains and losses to both parties that proximately resulted from, or were made possible by, the occurrence of the unexpected circumstance.

INTRODUCTION

- 1 Perhaps the most intractable problems in contract law concern when and how judicial relief should be granted in contracts cases on the basis of impossibility, impracticability, or frustration (which I will refer to collectively as *unexpected-circumstances cases*). As stated by James White and Robert Summers (2006, §3–10), “The doctrines of impossibility [and] commercial impracticability . . . comprise unclimbed peaks of contract doctrine. Clearly, all of the famous early and mid-twentieth century mountaineers, Corbin, Williston, Farnsworth and many lesser persons have made assaults on this topic but none has succeeded in conquering the very summit.”
- 2 In part, the intractability of the problems in this area results from their inherent difficulty. Intuitively, there seems to be a tension between the concept of relief based on unexpected circumstances, on the one hand, and such basic ideas of contract law as risk-shifting, the security of transactions, and rewards for knowledge, skill, and diligence, on the other. However, the inherent difficulty of the problems presented by unexpected-circumstances cases has been compounded by a tendency to rest analysis in this area on one or more of three premises: (1) the only issue in unexpected-circumstances cases is whether a promisor's nonperformance is excused by the circumstances; (2) whether relief is warranted on the basis of unexpected circumstances should be determined by the application of a single-stranded test; and (3) that test should focus exclusively on the parties' expectations *ex ante*, at the moment of contract formation, and should not take into account *ex post* considerations—that is, gains and losses to both parties that either arose under the contract prior to the occurrence of the unexpected

circumstances, or resulted proximately from or were made possible by the occurrence.²

I will show that all three premises are incorrect. The substantive and remedial issues in unexpected-circumstances cases are much more complex than a choice between excuse and no excuse. Resolution of these issues requires a set of principles whose complexity matches that of the problems involved. These principles should take ex post considerations into account.

The set of principles that should govern unexpected-circumstances cases is as follows:

1. Judicial relief normally should be granted if the parties shared a tacit incorrect assumption that the nonoccurrence of some circumstance during the life of the contract was certain rather than problematic, and the incorrectness of that assumption would have provided a basis for judicial relief if the assumption had been explicit rather than tacit. I will call this *the shared-assumption test*.
2. Judicial relief also normally should be granted if as a result of a dramatic and unexpected general rise in prices, and therefore costs, performance would result in a loss to a promisor that is significantly greater than the risk the parties reasonably would have expected the promisor to have taken. I will call this *the bounded-risk test*. In a sense, this test is only a special case of the shared-assumption test—the shared assumption being that under the circumstances neither party will bear an unbounded risk. However, the bounded-risk test requires special treatment because it rests on special kinds of circumstances and implicates a special kind of remedy. The application of both tests to unexpected-circumstances cases rests in significant part on a methodological and a psychological proposition. The methodological proposition is that the tacit assumptions of contracting parties, like other implied contractual terms, are normally best determined by considering what similarly situated parties would likely have assumed. The psychological proposition is that actors are

2 As a practical matter, unexpected-circumstance cases frequently do not simply involve the occurrence of a new event. Rather, they often involve the failure of existing circumstances to persist in a manner that the parties expected, or the failure of a regularly recurring event, such as the freezing of a lake in the winter, to occur. Accordingly, an unexpected circumstance often can be described either as a new circumstance or as a failure of an existing circumstance to persist or recur. For ease of exposition, I will use the terms *occurrence* and *unexpected circumstance* to include all three categories, unless the context indicates otherwise, and I will use the term *circumstance* and *event* more or less interchangeably.

loss-averse; that is, an actor perceives a diminution of his existing resources or endowments as a greater harm than a failed opportunity to augment his endowments by an equal amount.³ To put this in contractual terms, a contracting party typically disvalues out-of-pocket losses more than he disvalues an equal amount of forgone gains.

3. Where relief is based on the shared-assumption test, the promisor normally should not be liable for expectation damages. In certain cases falling under this test, however, the promisor should be liable for reliance damages.
4. Where judicial relief is based on the bounded-risk test, the promisor normally should not be liable for full expectation damages, but should be liable for a modified form of expectation damages.
5. Under either test, in determining whether to grant relief and what relief to grant, the courts may properly take into account ex post considerations.

5 Part 1 of this article develops the shared-assumption test and the relief appropriate under that test. Part 2 develops the bounded-risk test and the relief appropriate when that test applies. Part 3 considers and rejects a well-known test, proposed by Richard Posner and Andrew Rosenfield (1977), that would make unexpected-circumstances cases turn on which party was the cheapest insurer of the risk that the unexpected circumstances would occur. Finally, Part 4 develops the role of ex post considerations in unexpected-circumstances cases. Throughout, I will consider the continuities and discontinuities between the issues raised by unexpected-circumstances cases and the closely related issues raised by cases involving mutual mistake.

6 A note on terminology: in this article, the term *promisor* will be used to mean a party who seeks judicial relief against full enforcement of her promise, and the terms *promisor* and *adversely affected party* will be used more or less interchangeably.⁴ The terms *impossibility* and *impracticability* will be used primarily to refer to cases in which a *seller* is adversely affected by the occurrence of an unexpected circumstance because that occurrence either makes her performance impossible or significantly increases her cost

3 See, e.g., Thaler 1992, 63-78; Kahneman, Knetsch & Thaler 1990; Tversky & Kahneman 1990.

4 Here, and in the balance of this article, unless the context indicates otherwise I use feminine pronouns to refer to promisors and masculine pronouns to refer to promisees.

of performance. In contrast, the term *frustration* will be used primarily to refer to cases in which a *buyer* is adversely affected by the occurrence of an unexpected circumstance because the occurrence significantly diminishes the value of the seller's performance to the buyer.

1. THE SHARED-ASSUMPTION TEST

1.1. Tacit Assumptions

All contracts are based on numerous assumptions. Sometimes an assumption that underlies a contract is made explicit in the contract. If a contract is explicitly based on an assumption that turns out to have been incorrect, normally the effect of the assumption would be treated under the category of interpretation. Consider *Krell v. Henry*,⁵ one of the famous coronation cases. Edward VII was to be crowned in Westminster Abby on June 26, 1902, and the coronation procession was to be held on June 26 and June 27. Krell, who had a flat in London, had left England in March 1902. Before he left, Krell instructed his solicitor to let the flat on such terms, and for such period, up to six months, as the solicitor thought proper. On June 17, Henry noticed an announcement on the exterior of Krell's flat that windows to overlook the coronation procession were to be let. Henry then entered into an agreement, confirmed in writing on June 20, to take the flat for the days, but not the nights, of June 26 and June 27, for £75, and put down £25 as a deposit. Very shortly thereafter, Edward became ill, and on June 24 his physicians decided that he required surgery. As a result, the coronation and procession were postponed. Henry did not pay the £50 remaining under the agreement, and Krell sued for that amount. The court held for Henry. In the leading opinion, Lord Justice Vaughan Williams said, "I think it cannot reasonably be supposed to have been in the contemplation of the contracting parties when the contract was made, that the coronation would not be held on the proclaimed days . . . or along the proclaimed route."⁶

Now suppose the contract in *Krell v. Henry* had explicitly stated, "This agreement is made on the assumption that the coronation procession will

5 [1903] 2 K.B. 740.

6 *Id.* at 750. Some of these facts are based on Wladis 1987, 1609-1610.

take place in six days, as scheduled.” In that event, an analysis based on unexpected circumstances would have been unnecessary. Instead, Henry would have prevailed as a matter of interpretation. In the actual case, the relevant assumption was tacit, rather than explicit. In contrast to explicit shared assumptions, whose effect normally falls within the domain of interpretation, tacit shared assumptions are at the heart of unexpected-circumstances cases.

- 9 The concept of a tacit assumption has been explicated as follows by Lon Fuller (Fuller & Eisenberg 2005, 732–733):

Words like “intention,” “assumption,” “expectation” and “understanding” all seem to imply a conscious state involving an awareness of alternatives and a deliberate choice among them. It is, however, plain that there is a psychological state that can be described as a “tacit assumption,” which does not involve a consciousness of alternatives. The absent-minded professor stepping from his office into the hall as he reads a book “assumes” that the floor of the hall will be there to receive him. His conduct is conditioned and directed by this assumption, even though the possibility that the floor has been removed does not “occur” to him, that is, is not present in his conscious mental processes.

- 10 A more colloquial expression that captures the concept of a tacit assumption is “taken for granted.”⁷ As that expression indicates, tacit assumptions are as real as explicit assumptions. Tacit assumptions are not made explicit, even where they are the basis of a contract, precisely because they are taken for granted. They are so deeply embedded in the minds of the parties that it simply doesn’t occur to them to make these assumptions explicit, any more than it occurs to Fuller’s professor to think to himself every time he is about to walk through a door, “Remember to check my assumption that the floor is still there.”

- 11 Of course, if actors had infinite time and would bear no costs, they could ransack their minds to identify all of the shared tacit assumptions on which their contract is based and make each assumption explicit. But actors do not have infinite time and they do have costs. The principle of bounded rationality is applicable here. As stated by Oliver Williamson (1987, 75–76), this principle “has been defined by Herbert Simon as follows: ‘*The capacity of the*

7 Cf. McTurnan 1963, 51 (employing the formulation, “an unquestioning faith in the existence of a fact”).

human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world. . . . [The principle] refers both to neurophysiological limits on the capacity to receive, store, retrieve, and process information without error and to definitional limits inherent in language.”

So, for example, if the cost of searching for information were zero, then an actor contemplating a decision would make a comprehensive search for all relevant information. In reality, however, searching for information does involve costs, in the form of time, energy, and often money. Most actors either don't want to expend the resources required for comprehensive search or recognize that comprehensive search would not be achievable at any realistic cost. Accordingly, human rationality is normally bounded by limits on information search and information processing. Under one model of information search, developed by George Stigler (1961), an actor invests in search until the expected cost of further search equals the expected marginal return from further search. Under this model, an actor's decision to terminate search is rational even though it turns out that a further search would have produced information that would have affected the actor's eventual choice. Although the actor would have wanted to know that information, he is rationally ignorant of it.

The concept of limited search of the outside world also applies to the process of identifying and making explicit all of an actor's tacit assumptions that bear on a prospective contract, because the incremental time and costs of doing so would be disproportionate to the expected incremental gain. Just as a contracting party acts rationally in terminating the exterior process of searching the outside world for every piece of relevant information, so too does he act rationally in terminating the interior process of searching his mind for every relevant tacit assumption. In any event, normally it would be almost impossible to conduct a complete interior search of this kind. As Randy Barnett (2003, 1027) points out:

[When we add] to the infinity of knowledge about the present world the inherent uncertainty of future events . . . we immediately can see that the seductive idea that a contract can . . . articulate every contingency that might arise before, during, or after performance is sheer fantasy. For this reason, contracts must be silent on an untold number of items. And many of these silent as-

sumptions that underlie every agreement are as basic as the assumption that the sun will rise tomorrow. They are simply too basic to merit mention.

14 In short, in contracting, as in other parts of life, some things go without saying. And a central characteristic of things that go without saying is—they are not said. Instead, as Barnett states, these things are simply too basic to merit attention.

15 Modern contract law recognizes that a contract is “the total legal obligation which results from the parties’ agreement,”⁸ which in turn means “the bargain of the parties in fact as found in their language or by implication from other circumstances.”⁹ Among these circumstances are shared tacit assumptions that the parties regard as certain rather than problematic, and on which their contract is based. Shared tacit assumptions of this type are just as much a part of a contract as explicit terms, so that where the risk of an unexpected circumstance would have been shifted away from the promisor if the assumption had been made explicit, an otherwise identical shared tacit assumption should operate in the same way.

16 This approach to shared tacit assumptions is an application of the usual hypothetical-contract methodology, under which unspecified terms are usually determined on the basis of what the contracting parties probably would have agreed to if they had addressed the relevant issue. So in *Krell v. Henry* we can be pretty confident that: (i) actors in the positions of the contracting parties would have shared the tacit assumption that the coronation would take place in six days scheduled; (ii) the contract was made on the basis of that assumption; (iii) Henry was not assuming the risk that the assumption was incorrect—was not gambling, and was not being paid to gamble, on whether the coronation would take place; and (iv) due to the phenomenon of loss-aversion, the impact on Henry of a £75 out-of-pocket loss would be greater than the impact on Krell of a £75 forgone gain.

8 U.C.C. §1-201(12).

A revised version of Article 1 of the *Uniform Commercial Code* was adopted by the National Conference of Commissioners on Uniform State Laws and the American Law Institute in 2001. About half the states have adopted the revised version; many major commercial states have not. The citations to Article 1 herein are to the pre-2001 version of that article. However, as regards the language from Article 1 quoted in the text, the differences between the two versions are only grammatical.

9 *Id.* §1-201(3).

1.2. Exceptions and Clarifications Under the Shared-Assumption Test

Not every shared tacit assumption about the future will justify judicial relief where the assumption turns out to be incorrect. I turn now to four major exceptions: (1) cases in which the parties recognize that their assumption is problematic, and the role of foreseeability; (2) cases in which the risk is explicitly or implicitly allocated to the adversely affected party; (3) cases in which the assumption is not shared or is evaluative; and (4) cases in which the impact of the unexpected circumstances is not material.

1.2.1. Cases in which the Parties Recognize that Their Assumption Is Problematic, and the Role of Foreseeability

To begin with, tacit assumptions should not serve as the basis for judicial relief in unexpected-circumstances cases if the parties recognized that although the relevant circumstance was highly unlikely to occur, the probability of the occurrence was not negligible. In such a case, the known uncertainty of the assumption, although slight, will normally have figured into the parties' decision to contract, the amount of the contract price, or both. As stated by Lee McTurnan (1963, 16), in the context of mutual mistake, "when parties contract aware of an uncertainty, the natural inference is that they estimated the probabilities and fixed the price accordingly."

This does not mean that an assumption must be objectively nonproblematic to justify judicial relief under the shared-assumption test. Every assumption concerning the future—including, for example, the assumption that the sun will rise tomorrow—is objectively problematic. The question is whether the contracting parties tacitly assumed that the future was not problematic in the relevant respect. So in *Krell v. Henry* it is pretty clear that the parties tacitly assumed that whether the coronation procession would occur in six days, as scheduled, was not problematic. This assumption, therefore, should have and did provide a basis for judicial relief, even though objectively the assumption was problematic.

One index to whether the parties tacitly assumed that the occurrence of a given circumstance in the future was certain rather than problematic is whether the occurrence was reasonably foreseeable—that is, foreseeable as likely, or at least not unlikely, to occur.¹⁰ Foreseeability is a complex concept,

10 See Note, *The Fetish of Impossibility in the Law of Contracts*, 53 *Colum. L. Rev.* 94, 98 n. 23 (1953)

and its meanings can vary with the context. In the context of an unexpected-circumstance case, whether a circumstance was reasonably foreseeable should depend on (i) the degree of difficulty that the contracting parties would have had in foreseeing the circumstance and (ii) the likelihood that the parties did foresee the circumstance, given the information the parties actually knew and the salience of the possibility that the circumstance would occur.

21 The period of the contract is also relevant. Contracts extend over a given duration. Call this the *contract time*. The longer the contract time, the more likely that a variety of circumstances that bear on the contract will occur during that time. For example, if a party rents a theater for twenty years, it is reasonably foreseeable that the theater may be destroyed during the contract time by some catastrophic event. In contrast, if the same party rents the same theater for the next evening, destruction of the theater by a catastrophic event during the contract time may not be reasonably foreseeable.

22 That the occurrence of a given circumstance during the contract time was reasonably foreseeable when the contract was made suggests that the parties did not assume that the occurrence was certain. Conversely, that the occurrence of a given circumstance during the contract time was not reasonably foreseeable suggests that the parties tacitly assumed it was certain that the circumstance would or would not occur during that time. But reasonable foreseeability normally should be only an index, not the test. The test should be what the parties tacitly assumed. As a practical matter, that question will usually be resolved on the basis of the fact-finder's common-sense intuition concerning what tacit assumptions would probably have been held by similarly situated parties. Reasonable foreseeability should play a very important but usually not decisive role in that determination.¹¹ Parties who are highly sophisticated, or who are engaged in large-scale contractual enterprises, might regard the nonoccurrence of a given circumstance during the contract time as problematic rather than certain even though the circumstance had a

(foreseeability is properly used "as a factor probative of assumption of the risk of impossibility"). For cases holding that judicial relief on the basis of unexpected circumstances is available only if the circumstances are unforeseeable, see, e.g., *E. Air Lines, Inc. v. McDonnell Douglas Corp.*, 532 F.2d 957 (5th Cir. 1976); *Barclay's Bus. Credit, Inc. v. Inter Urban Broad. of Cincinnati, Inc.*, No. 90 Civ. 2272, 1991 WL 258751 (S.D.N.Y. Nov. 27, 1991); *Iodice v. Bradco Cleaners*, 1993 Mass. App. Div. 54 (1993).

11 See, e.g., *Madeirense Do Brasil, S.A. v. Stulman-Ernrick Lumber Co.*, 147 F.2d 399 (2d Cir. 1945).

very low probability of occurring. In contrast, unsophisticated parties, or parties engaged in very small-scale enterprises, might tacitly assume that whether a given circumstance would occur or not during the contract time was certain rather than problematic, although objectively the likelihood whether the circumstance would or would not occur was problematic rather than certain. Lon Fuller (Fuller & Eisenberg 2005, 769) has illustrated this point as follows:

[W]here parties have entered into a contract, an unexpected obstacle to performance may operate disruptively in varying degrees depending on the context. To one who has contracted to carry goods by truck over a road traversing a mountain pass, a landslide filling the pass may be a very disruptive and unexpected event. But one who contracts to build a road through the mountains might view the same event, occurring during the course of construction, as a temporary set-back and a challenge to her resourcefulness.

Although reasonable foreseeability should usually be significant rather than decisive, there is one class of cases in which reasonable foreseeability should be determinative. These are cases in which if a reasonably foreseeable circumstance should occur, it would affect a large class of sellers who deal in a relatively standardized commodity, and the occurrence of the circumstance is so well foreshadowed that a premium for taking the risk of the occurrence is impounded into the market price. In such a case it should be no defense to an individual seller who has received the risk premium that was impounded into her price, that she did not personally perceive that the event was foreshadowed.¹²

For example, in *Transatlantic Financing Corp. v. United States*,¹³ Transatlantic and the United States had executed a voyage charter on October 2, 1956, during the international crisis that resulted from Egypt's seizure of

12 See U.C.C. §2-615 cmt. 8 (2002): "[T]he exemptions of this section [for excuse by reason of impracticability] do not apply when the contingency in question is sufficiently foreshadowed at the time of contracting to be included among the business risks which are fairly to be regarded as part of the dickered terms, either consciously or as a matter of reasonable, commercial interpretation from the circumstances."

Substantial amendments to Article 2 of the *Uniform Commercial Code* were adopted by the National Conference of Commissioners on Uniform State Laws and the American Law Institute in 2003. So far no state has adopted these amendments, and no state is likely to do so. Accordingly, citations to Article 2 herein are to the pre-2003 version of that Article.

13 363 F.2d 312 (D.C. Cir. 1966).

the Suez Canal several months earlier. The charter indicated the termini of the voyage—Galveston, Texas to Bandar Shapur, Iran—but not the route. The regular route between these points was via the Canal. On October 27, Transatlantic’s vessel, the *Christos*, sailed from Galveston on a course that would have taken her through the Canal. On October 29, Israel invaded Egypt; on October 31, Great Britain and France invaded the Canal Zone; and on November 2, Egypt closed the Canal. As a result, the *Christos* was forced to make a longer and more expensive voyage around the Cape of Good Hope, and Transatlantic claimed that it was entitled to additional compensation for its extra costs. The court denied the claim. In the course of its opinion, the court stated that “if anything, the circumstances surrounding this contract indicate that the risk of the Canal’s closure may be deemed to have been allocated to Transatlantic. We know or may safely assume that the parties were aware, as were most commercial men with interests affected by the Suez situation . . . that the Canal might become a dangerous area. No doubt the tension affected freight rates.”¹⁴ The conclusion that the tension affected freight rates should have been the end of the court’s analysis. The only meaning that can be given to this conclusion is that carriers, including Transatlantic, had increased their rates by including a premium for the risk that the Canal route might be unavailable. Accordingly, the United States had paid Transatlantic a premium to cover just the risk that occurred. Transatlantic could not both take the premium and deny coverage.

1.2.2. *Cases in Which the Risk Is Explicitly or Implicitly Allocated to the Adversely Affected Party*

25 Next, an unexpected circumstance that would otherwise justify judicial relief should not do so if the risk that the circumstance will occur is contractually assigned to the adversely affected party. This is not a limitation on the shared-assumption test but merely a corollary. That test allocates away from the adversely affected party the risk that a certain kind of unexpected circumstance will occur if the parties share a tacit assumption that the circumstance will not occur. The test does not allocate the risk in that manner if the contract provides otherwise, explicitly or implicitly. This exception is straightforward, but its application can sometimes be difficult, particularly when the allocation of risk is implicit, or inferred from the circumstances, rather than explicit.

14 *Id.* at 318.

1.2.2.1. Implicit contractual allocation to the adversely affected party.

Just as a shared assumption may be either explicit or tacit, so too may be an allocation of a risk to the adversely affected. *United States v. Wegematic Corp.*¹⁵ is a leading example of such a tacit allocation. In June 1956 the Federal Reserve Board had invited electronics manufacturers to submit proposals for a digital-computing system. Wegematic submitted a proposal for the provision of a new computer, the ALWAC 800 Wegematic “characterized the machine as ‘a truly revolutionary system utilizing all of the latest technical advances,’ and featured that ‘maintenance problems are minimized by the use of highly reliable magnetic cores.’”¹⁶ In September the Board ordered the ALWAC 800s for delivery on June 30, 1957. The order provided that in the event Wegematic failed to comply with any provision of the contract, the Board could procure the services described in the contract from other sources and hold Wegematic responsible for any excess cost. Wegematic accepted the order.

After several notifications of delay, in mid-October 1957 Wegematic announced that due to engineering difficulties it had “become impracticable to deliver the ALWAC 800 Computing System at this time.”¹⁷ The Board then procured an IBM 650 computer, which served substantially the same purpose as the ALWAC 800, but at a higher price, and sued Wegematic for damages. Wegematic defended on the ground that “delivery had been made impossible by ‘basic engineering difficulties’ whose correction would have taken between one and two years and would have cost a million to a million and a half dollars, with success likely but not certain.”¹⁸ The difficulties “may have stemmed from the magnetic cores, used instead of transistors . . . , which did not have sufficient uniformity at this stage of their development.”¹⁹

At the trial, the Federal Reserve Board recovered \$179,450 for the excess cost of the IBM equipment. The Second Circuit, in an opinion by Judge Friendly, affirmed, largely on the ground that the risk that the promised computer could not be manufactured had been implicitly assumed by Wegematic:

15 360 F.2d 674 (2d Cir. 1966).

16 *Id.* at 674.

17 *Id.*

18 *Id.*

19 *Id.*

We see no basis for thinking that when an electronics system is promoted by its manufacturer as a revolutionary breakthrough, the risk of the revolution's occurrence falls on the purchaser; the reasonable supposition is that it has already occurred or, at least, that the manufacturer is assuring the purchaser that it will be found to have when the machine is assembled. . . . If a manufacturer wishes to be relieved of the risk that what looks good on paper may not prove so good in hardware, the appropriate exculpatory language is well known and often used.²⁰

1.2.2.2. Custom and Trade Usage; Inference from the Circumstances.

29 The risk of unexpected circumstances may also be implicitly allocated to the adversely affected party by custom or trade usage²¹ or by an inference from the circumstances. For example, suppose that A normally uses a contractual provision that allocates away from A the risk that a certain contingency will occur. If A makes a contract that does not include such a provision, there is a strong inference that A has accepted the risk that the contingency will occur.

30 This point is illustrated by *Barbarossa & Sons, Inc. v. Iten Chevrolet, Inc.*²² Iten contracted to supply Barbarossa with a large truck for use in Barbarossa's business and then ordered the truck from its supplier, GM. Iten usually made contracts with customers on an order form that included an escape clause, under which Iten's obligation to supply a vehicle was made contingent on its ability to obtain the vehicle from the manufacturer. In contracting with Barbarossa, however, Iten did not use its usual order form; the contract had no escape clause and did not refer to GM as the source of supply. Subsequently, GM canceled Iten's order for Barbarossa's truck, apparently because GM was experiencing components shortages. When Iten failed to deliver the truck, Barbarossa purchased another brand of truck from a third party and sued Iten for damages. Iten defended on the ground

20 *Id.* at 676-677.

21 See U.C.C. §2-615 cmt. 8 ("The provisions of this section [on excuse by reason of impracticability] are made subject to assumption of greater liability by agreement and such agreement is to be found not only in the expressed terms of the contract but in the circumstances surrounding the contracting, in trade usage and the like."); *Transatlantic Finan. Corp. v. United States*, 363 F.2d 312 (D.C. Cir. 1966) ("Proof that the risk of a contingency's occurrence has been allocated . . . may be found in the surrounding circumstances, including custom and usages of the trade"); Corbin 2001, 98.

22 265 N.W.2d 655 (Minn. 1978).

that GM's cancellation of the order and refusal to manufacture the truck made performance impracticable. The court held for Barbarossa, pointing out that Iten had not included its usual escape clause in the contract.

An implicit allocation of risk is also evidenced by a price that impounds the risk, as in the *Transatlantic* case.

1.2.3. Cases in which the Assumption Is Not Shared or Is Evaluative

The shared-assumption test applies only if the relevant assumption is shared—that is, only if both contracting parties hold the assumption. For example, suppose that A, a contractor, agrees to construct a home for B on a parcel of land that B has contracted to purchase from a third party. B, who is not engaged in the business of construction, is likely to tacitly assume that it will be feasible to build the home on the parcel. A, a professional contractor, is likely to be aware that he may encounter unexpected soil conditions that would materially increase his costs. If A does encounter such conditions, he should not be able to obtain judicial relief under the shared-assumption test.²³

A rule that both parties must share a tacit assumption if the assumption is to be the basis for judicial relief on the ground of unexpected circumstances has a salutary information-forcing effect. In the subsoil hypothetical, for example, A knows or should know the risk of unexpected subsoil conditions, and B does not. Accordingly, if A wishes either to be excused if such conditions materialize or to put the risk of such conditions on B, A should bring the risk to B's attention and explicitly contract around it. The requirement that the tacit assumption will provide relief only if it is shared gives A an incentive to do just that. This is generally the scenario in the real world of construction contracts. Under the legal rule that governs such constructs, the contractor bears the risk of unexpected subsoil conditions unless he contracts around the risk.²⁴ However, the most commonly used form contract for construction projects requires an equitable adjustment of the price in such cases. (American Institute of Architects 1997, Art. 4.3.4).

Frequently, assumptions made by contracting parties are unshared—for example, one party assumes that prices will go up, and the other assumes

23 However, if the increase in costs is very substantial, A may be entitled to judicial relief under the bounded-risk test. See Part 2, *infra*.

24 See, e.g., *Rowe v. Town of Peabody*, 93 N.E. 604 (Mass. 1911).

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that prices will go down. Such cases do not present any special problems; the parties are simply bargaining on the basis of conscious and different evaluations of states of the world that they understand are problematic rather than on the basis of assumptions they both believe are certain. Indeed, such *evaluative assumptions*—assumptions that are based on conscious evaluations of future probabilities—will not be relevant even if shared by both parties. For example, suppose Team A trades an injured player, Green, to Team B, and both teams assume that Green will take a year to recover because that's the normal recovery time, although they also both realize that recovery times vary widely. In fact, Green heals quickly and is ready to play within a month. The parties' shared evaluative assumption should not and will not be a ground of judicial relief to Team A.²⁵

1.2.4. Cases in which the Impact of the Unexpected Circumstance Is Not Material

35 Finally, a tacit assumption should not provide the basis for judicial relief if the impact of the unexpected circumstance is not material. The impact may be immaterial for a variety of reasons. For example, the unexpected circumstance may concern only a minor aspect of the contract, such as an inability to use a designated carrier to ship goods when comparable carriers were available at the same price, or may concern only an immaterial amount, as where a comparable carrier would charge more, but only slightly more. Or, the promisor may be able to mitigate his financial loss. For example, suppose that A is planning to marry B. A leases a two-bedroom apartment from Landlord for the purpose of beginning married life, as she so informs Landlord. B dies prior to the marriage and before the term of the lease is to begin. A should not be awarded judicial relief. Even though the lease was made on the basis of the tacit assumption that A and B would get married, A can avoid most or all of her financial loss by assigning the lease or subletting the apartment.²⁶

25 On evaluative assumptions, see Eisenberg 2003, 1581-1584.

26 This position is embodied in *Restatement (Second)* §265 illus. 5 (1981):

A contracts to sell and B to buy a machine to be delivered to B in the United States. B, as A knows, intends to export the machine to a particular country for resale. Before delivery to B, a government regulation prohibits export of the machine to that country. B refuses to take or pay for the machine. If B can reasonably make other disposition of the machine, even though at some loss, his principal purpose of putting the machine to commercial use is not substantially

1.3. The Role of Fault and the Nature of Judicial Relief Under the Shared-Assumption Test

Today, judicial relief in both mutual-mistake cases (that is, cases in which the parties shared a mistaken assumption about the existing world) and most unexpected-circumstances cases is based on the existence of shared tacit assumptions that turn out to be incorrect.²⁷ But since mutual-mistake and most unexpected-circumstances cases are governed by a common test, why should, and why does, contract law separate these two doctrinal categories?

One answer to this question is that actors commonly take for granted that the present world has certain characteristics, but less commonly take for granted that the future world will have certain characteristics. As a result, contracting parties are more likely to share a tacit assumption that a fact of the present world is certain than to share a tacit assumption concerning the certainty of some aspect of the future world. In a related context, Barak Medina has pointed out that:

[Psychological research, shows] that people prefer to bet on a risk which has not been realized yet rather than to bet on a risk whose realization is not yet known to them. For instance, [Heath and Tversky: 1991 and Rothbart and Snyder: 1970] report that people are more willing to bet on the next week's price of a certain share than they are on the (unknown to them) price of the same share last week. According to these results, people are more willing to

frustrated. B's duty to take and pay for the machine is not discharged, and B is liable to A for breach of contract.

See also, e.g., *Swift v. Canadian Co. v. Banet*, 224 F.2d 36, 38 (3d Cir. 1955) (United States buyer of lamb pelts was to take title to the pelts in Canada, and supervening regulation prohibited importation of the pelts into the United States. The buyer's defense of frustration was rejected on the ground that "Even if the goods could not be imported into the United States . . . the rest of the world was free to the buyer, so far as we know, as destination for the shipment"); *Amtorg Trading Corp. v. Miehle Printing Press & Mfg. Co.*, 206 F.2d 103 (2d Cir. 1953) (seller allowed to retain damages from buyer-exporter's down payment on printing presses, even though the government had adopted a regulation that barred buyer's intended exportation of printing presses to Russia without an export license, and the license was refused); *Coker Int'l v. Burlington Indus.*, 747 F. Supp. 1168 (D.S.C. 1990), *aff'd*, No. 90-2494, 1991 WL 97487 (4th Cir. June 11, 1991) (purchaser of used looms intended for resale to Peru was not entitled to return of deposit after Peruvian regulation blocked intended shipment); *Pierson & Co. v. Mitsui & Co.*, 181 N.Y.S. 273 (N.Y. Gen. Term 1920) (buyer of steel plates held liable despite its inability to secure a license to export the steel plates to Japan as it had intended); Weiskopf 1996, 256-257 (citing these cases).

27 See *Restatement Second* §§ 152, 261.

bear a risk about future events than they are about the nature of an event that already happened but whose result is unknown to them.²⁸

38 Accordingly, courts might appropriately be somewhat more reluctant to give relief in unexpected-circumstances cases than in mutual-mistake cases.

39 However, there are also deeper and more complex reasons for the doctrinal separation. There are certain recurring practical differences between mutual-mistake and unexpected-circumstances cases. Although these practical differences do not rise to the level of water-tight distinctions, they nevertheless have significant theoretical and doctrinal implications.²⁹ One of these practical differences concerns the role of fault, which in turn may impact the nature of judicial relief under the shared-assumption test.

1.3.1. *Fault in Mutual-mistake and Unexpected-circumstances Cases*

40 In mutual-mistake cases, the adversely affected party will rarely be at fault for having caused the actual facts of the present world to differ from the facts that the parties tacitly assumed.³⁰ In contrast, in unexpected-circumstances cases the adversely affected party may well be at fault for the occurrence of the relevant circumstance. For example, a recurring kind of unexpected-circumstance case concerns the destruction of the contract's subject-matter—say, by fire. In such cases, the destruction may well have resulted from the fault of the party who was in possession of the subject-matter when the destruction occurred. Accordingly, although in theory fault on the part of the adversely affected party might figure in either mutual-mistake or unexpected-circumstance cases, in practice fault is unlikely to figure in the former type of case and often likely to figure in the latter.

41 *Restatement Second* highlights this difference between mutual-mistake cases and unexpected-circumstances cases. Under Section 157, a mistaken

28 Message from Barak Medina to Melvin Eisenberg, December 11, 2006.

29 The differences between mutual-mistake and unexpected-circumstances cases that are discussed in this article are based on recurring characteristics of cases in each category rather than on characteristics that necessarily inhere in cases in each category. In the occasional situation in which a mutual-mistake case has a characteristic more typically associated with unexpected-circumstances cases, the principles developed in this article to deal with the latter cases should normally be extended by analogy and applied accordingly.

30 Of course, one party may be at fault for misrepresenting or failing to disclose a fact, but such cases are not mutual-mistake cases, because they do not involve shared tacit assumptions.

party's fault normally will not bar him from coming within the shelter of mutual-mistake doctrine:

A mistaken party's fault in failing to know or discover the facts before making the contract does not bar him from avoidance or reformation under the rules stated in this Chapter, unless his fault amounts to a failure to act in good faith and in accordance with reasonable standards of fair dealing.

In contrast, the provisions of *Restatement Second* that afford judicial relief based on the occurrence of an unexpected circumstance explicitly apply only where the adversely affected party is not at fault for having caused the relevant event. For example, Section 261 provides that:

Where, after a contract is made, a party's performance is made impracticable *without his fault* by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.³¹

1.3.2. *Effect of Promisor's Fault; Degrees of Fault; Reliance Damages*

Suppose an unexpected circumstance, that would otherwise provide an excuse to the promisor, was caused by her fault. For example, in the landmark case of *Taylor v. Caldwell*,³² the defendant agreed to lease a hall to the plaintiff for four nights, but before the first of these nights the hall burned down. The plaintiff sued to recover damages for the defendant's failure to provide the hall. Suppose the fire in *Taylor v. Caldwell* resulted from the owner having carelessly discarded an unextinguished cigar. Certainly the promisor's fault should be given some effect. Under *Restatement Second*, the promisor's fault operates in a binary fashion, like an on/off switch, to bar the promisor from employing an unexpected-circumstances excuse that she would otherwise be entitled to invoke. However, there is another way to view this problem—that fault should operate on a continuum, like a dimmer switch. A promisor's fault in causing the unexpected circumstance may be slight or severe. At one extreme, the fault may consist of intentional or

31 (Emphasis added.) See also *id.* at §266(1) (existing impracticability) and §265 (discharge by supervening frustration).

32 3 B. & S. 826, 122 Eng. Rep. 309 (1863).

reckless conduct. At the other extreme, the fault may consist only of minor negligence. The location of the promisor's conduct on the fault continuum should affect the promisee's measure of damages. Where a promisor would be excused by reason of unexpected circumstances but for her fault, if her fault is minor a reasonable accommodation is to require the promisor to pay reliance damages—the costs that the promisee incurred in reliance on the promise—but not expectation damages. The promisor should be required to pay reliance damages because she is at fault, and her fault has caused the promisee to be worse off than he was before the promise was made. However, the promisor should be excused from paying expectation damages, because but for her fault she would be excused from liability, the fault is minor, and the promisee will have no loss in the usual sense of that term—that is, no diminution in his pre-contract wealth—after he is compensated for his costs by reliance damages.

44

This remedial approach is exemplified by a series of four important decisions by the Massachusetts Supreme Court. The decisions all arose out of a contract between John Bowen Co., a general contractor, and the Massachusetts Department of Health, acting with the approval of the State Public Building Commission, for the construction of the Lemuel Shattuck Hospital in Boston.³³ The series began with *Gifford v. Commissioner of Public Health*,³⁴ which concerned the validity of the contract. This case did not involve unexpected circumstances, but it set the stage for the other three decisions. Under a Massachusetts statute, contracts like the one at issue had to be put out to bid and awarded to the lowest qualified bidder. The contract was awarded to Bowen, but another bidder, Slotnik, challenged the award. The Massachusetts Supreme Court held that in setting out the components of its bid Bowen had failed to fully comply with the statute, and that if Bowen had fully complied, Slotnik would have been the lowest qualified bidder.³⁵ Accordingly, the court canceled the award of the contract to Bowen.

33 The hospital is alternatively named in the four decisions as “a chronic diseases hospital in Boston” and the “Chronic Diseases Hospital and Nursing Home.”

34 105 N.E.2d 476 (Mass. 1952).

35 Under the statute, each general contractor's bid had to be divided into two items. Item 1 covered the work that the general contractor would perform. Item 2 covered the work that subcontractors would perform and had to include the names of the subcontractors chosen and the amounts of their bids. On Item 1, Slotnik's bid was lower than Bowen's by \$21,784. On Item 2, Bowen's bid was lower than Slotnik's by \$21,942.75—even though Slotnik and

The next three decisions in the series involved suits against Bowen by subcontractors who had entered into contracts with Bowen before Bowen's contract with the Department of Health was canceled by *Gifford*.

The first of these decisions, *M. Ahern Co. v. John Bowen Co.*,³⁶ was an action by a plumbing subcontractor, Ahern, for unpaid labor and materials furnished before Bowen's contract was canceled. The court began by pointing out that although Bowen was not liable for Ahern's expectation damages, by reason of the unexpected circumstance that Bowen's contract with the Department of Health had been canceled, that was not the end of the case. The courts have not been deterred "from giving recovery in cases of excusable impossibility for such performance as has been received."³⁷ This was nothing new; it is hornbook law that even where unexpected circumstances excuse expectation damages, they do not excuse restitution for the value of a benefit conferred. But the court then made two important moves.

First, the court moved away from grounding recovery in such cases on the basis of "the principle of unjust enrichment which underlies restitution."³⁸ Instead, the court said, "Our decisions have spoken of 'an implication [from the contract] that what was *furnished* was to be paid for'"³⁹ even though the defendant had not been benefited in the normal sense of that term. Presumably the court made this first move because Ahern's unpaid-for work

Bowen named the same twenty-six subcontractors and received the same bids from those subcontractors. There were two reasons for the discrepancy. First, Bowen had reduced the painting subcontractor's bid by \$20,000, the projected cost of fabric wall covering. Bowen claimed that it had merely shifted the \$20,000 to Item 1. Second, Albre Marble & Tile Co. had submitted two bids, one for the installation of marble and one for the installation of tile, and each bid stated that "If a performance bond will be required, add $\frac{3}{4}$ of 1% of the above proposal to the contract sum." Since the Public Building Commission's form for bids by general contractors provided that the awarding authority could require subcontractors to furnish a performance bond, Slotnik added $\frac{3}{4}$ of 1% to Albre's bids. Bowen did not, on the grounds that Bowen itself would be providing a performance bond, so that a performance bond from Albre would be unnecessary and that as a matter of custom the Public Building Commission had never required performance bonds from subcontractors. The court held that Bowen should not have deleted the \$20,000 from Item 2, and should have added $\frac{3}{4}$ of 1% to Albre's two sub-bids, in which case Bowen's bid would have been higher than Slotnik's. *Id.* at 481.

36 133 N.E.2d 484 (Mass. 1956).

37 *Id.* at 485.

38 *Id.*

39 *Id.* (emphasis added).

had conferred a benefit on Massachusetts, rather than on Bowen.

48 The court then made its second important move. It not only rejected unjust-enrichment theory as the basis of recovery for what was furnished in suits like that brought by Ahern, but also held that “[i]t is no longer necessary to find implications of a contract to support recovery.”⁴⁰ Instead, the court said, recovery was to be based on “what the court holds to be *fair and just* in the unanticipated circumstances.”⁴¹ In *Ahern* itself, the court concluded, what was fair and just turned at least in part on the role that Bowen had played in causing performance of the contract to be impossible:

This is not a case where the defendant stands fully apart, as the plaintiff does, from the circumstances which caused the unexpected destruction of the subject matter of the contract. The defendant did those things with respect to the subbids discussed in *Gifford v. Commissioner of Public Health* . . . which caused its bid to appear the lowest, although in fact it was not. The *Gifford* decision has held that what the defendant did was not properly done. Even though we assume, as the defendant urges here, that it acted in good faith, and in respects as to which the prescribed course was not clear, the fact is that its actions, in a field where it had a choice, had a significant part in bringing about the subsequent critical events—the awarding to it of an apparent contract which turned out to be void and the ensuing decision of this court. In the circumstances it is plain that this is not a case of *fully* excusable impossibility.⁴²

49 Accordingly, the court sustained an award to Ahern of the value of the labor and materials.

50 The next decision in the Lemuel Shattuck series was *Boston Plate & Window Glass Co. v. John Bowen Co.*⁴³ In this case, Boston Plate, a subcontractor that had entered into contracts with Bowen to furnish glass, glazing, and miscellaneous nonferrous metal work for the hospital, sued Bowen for expectation damages for breach of those contracts. Bowen argued that it was not liable on the contracts because the decision in *Gifford* rendered

40 *Id.* at 486.

41 *Id.* (emphasis added).

42 *Id.* (emphasis added).

43 141 N.E.2d 715 (Mass. 1957).

performance of the contracts impossible. The court agreed. "It is apparent that the validity of the general contract was tacitly assumed by both parties. Therefore, since the validity of the general contract was essential to the performance of the subcontracts, its validity was a condition to the continued existence of obligations under the subcontracts."⁴⁴

To summarize the story so far, even where the occurrence of an unexpected circumstance excuses the promisor from liability for expectation damages, the promisor will not be excused from liability for what the promisee furnished under the contract before the occurrence of the unexpected circumstance. The concept of "furnished," for this purpose, is elastic, and depends in whole or in part on what is fair and just under the circumstances.

This story leaves open the treatment of costs that a promisee has incurred where the promisee had not furnished anything before the occurrence of the unexpected circumstance. That issue was the subject of the last decision in the Lemuel Shattuck series, *Albre Marble & Tile v. John Bowen Co.*⁴⁵ Albre had contracts with Bowen for the installation of marble and tile for the hospital. Albre sued Bowen in four counts. The first and second counts sought expectation damages for Bowen's breach of those contracts. Bowen pleaded impossibility, and these two counts were dismissed on summary judgment. Albre's third and fourth counts sought to recover the value of its work and labor under its contracts, which consisted of the "preparation of samples, shop drawings, tests and affidavits,"⁴⁶ rather than labor or materials furnished in the construction of the hospital. To put this differently, Albre sought reliance damages in its third and fourth counts. Accordingly, a major issue in the case was whether and when a promisee could recover reliance damages against a promisor who was excused from paying expectation damages by reason of unexpected circumstances. The court concluded that even though Bowen was not sufficiently at fault to be liable for expectation damages, it was sufficiently at fault to be liable for reliance damages:

Although the matter of denial of reliance expenditures in impossibility situations seems to have been discussed but little in judicial opinions, it

⁴⁴ *Id.* at 717.

⁴⁵ 155 N.E.2d 437 (Mass. 1959).

⁴⁶ *Id.* at 439.

has, however, been the subject of critical comment by scholars. See Fuller and Perdue, *The Reliance Interest in Contract Damages*, 46 Yale L.J. 52, 373, 379–383. . . . In England the recent frustrated contracts legislation provides that the court may grant recovery for expenditures in reliance on the contract or in preparation to perform it where it appears ‘*just to do so having regard to all the circumstances of the case*’ (emphasis supplied). 6 & 7 George VI, c. 40.

. . . [T]his is not a case of mere impossibility by reason of a supervening act. . . . Although the defendant’s conduct was not so culpable as to render it liable for breach of contract . . . nevertheless, it was a contributing factor to a loss sustained by the plaintiff which as between the plaintiff and the defendant the latter ought to bear to the extent herein permitted.⁴⁷

53 In short, the governing principle, exemplified by the Lemuel Shattuck series, should be that where the occurrence of an unexpected circumstance would warrant judicial relief except that the promisor is proven to have been at fault, and the fault was minor, the promisor normally should be relieved from liability for expectation damages, but not for reliance damages.

54 Suppose, however, that the promisor is not proven to be at fault. Even then, reliance damages for the promisee may be justified where the promisor had control over the conditions that led to the occurrence of the unexpected circumstance. Liability for reliance damages in such cases may be justified on one of two grounds.

55 To begin with, if the promisor had such control there will often be a significant likelihood that the promisor was at fault for the occurrence, even though the promisee cannot prove that fault.

56 Alternatively, liability in such cases can be based on the ground that responsibility follows from control, because control implies some ability to take steps to prevent the loss from occurring. There are ample precedents for this approach. For example, workers’ compensation law, which makes an employer liable for accidents to employees even without a showing of fault, is at least partly justified on the ground that the employer is responsible for workplace accidents because it is in control of the workplace. Product liability law, which makes a manufacturer liable for injuries caused by

⁴⁷ *Id.* at 440–441.

product defects even without a showing of fault, is at least partly justified on the ground that the manufacturer is responsible for injuries caused by defective products because it is in control of the production process. The law of agency, which makes an employer vicariously liable for tortious injuries caused by an employee acting within the scope of his employment if the employer had the right to control the manner and means of the employee's performance, is at least partly justified on the ground that the employer is responsible for such injuries because of its control.

The facts (although not the decision) in *Taylor v. Caldwell* illustrate how the control principle should be applied.⁴⁸ On May 27, 1861, the owners of the hall had agreed to allow the lessee to use the hall for four days, the first of which was June 17, to give a series of concerts and fêtes, in exchange for £100 per day. Prior to June 17, the hall was destroyed by fire. The lessee claimed damages for expenses it had incurred in advertising and in preparing for the concerts. The court said, "we must take it on the evidence [that the destruction of the hall] was without the fault of either party,"⁴⁹ and held that the owners were excused. That result was correct as far as expectation damages but seems doubtful as far as reliance damages. The owners were in control of the hall and, therefore, had at least some ability to prevent a fire; the lessee did not. Although the owners were not *proven* to be at fault, given their control over the premises they bore some responsibility to ensure its safety, and it would have been appropriate to make the owners responsible for the lessee's costs on that basis.

1.3.3. *Reliance Damages in the Absence of Fault or Control*

What should be the remedial consequences, under the shared-assumption test, if the test is satisfied and the promisor was neither at fault for the occurrence of the unexpected circumstance nor in control of the conditions that led to the occurrence? Clearly, the promisor should not be liable for expectation damages; that is the minimum significance of the conclusion that judicial relief is appropriate under the shared-assumption test. Clearly, too, the promisor will be liable for restitutionary damages, because it would be

48 122 Eng. Rep. 309 (Q.B. 1863).

49 *Id.* at 312.

unjust to allow the promisor both to be excused from performance and to retain any benefits that she received under the contract. The more difficult issue is whether reliance damages should be granted against the promisor even in the absence of fault or control.

59 One possible approach is that the promisee should be able to recover reliance damages in all such cases. That approach would be inappropriate. Very often, perhaps typically, if the parties had addressed the relevant circumstance *ex ante*, they would have treated the occurrence of the circumstance as a condition to the promisor's obligation to perform. A good example is *Krell v. Henry*, the coronation case discussed above.⁵⁰ If the parties had addressed the issue directly, Krell, the lessor, almost certainly would not have promised that the coronation procession would take place in six days, as scheduled. Instead, the contract almost certainly would have provided that the occurrence of the procession as scheduled was a condition to Henry's obligation to pay for the rooms. When a contract is subject to a condition that is not fulfilled, normally neither party has a right to either expectation or reliance damages, because both parties take the risk of nonfulfillment. For example, if A Corporation and B Corporation enter into a contract to merge, subject to the condition that the Internal Revenue Service rules that the merger is tax-free, and the IRS rules that the merger is taxable, A and B must each absorb its own merger-related costs. Similarly, reliance damages should normally not be awarded in cases, like *Krell v. Henry*, in which judicial relief is based on a shared tacit assumption that if made explicit would best be interpreted as a condition, because the same remedial treatment should be given to the tacit assumption as would be given if the assumption had been explicit.

60 Although it would be inappropriate to make the promisor liable for reliance damages in all cases in which relief from expectation damages should be granted on the basis of the shared-assumption test, reliance damages are appropriate in some cases. One example consists of cases in which the promisor is at fault for the creation of the unexpected circumstance, but the fault is minor; another consists of cases in which the promisor is in control of the conditions that led to the occurrence of the unexpected circumstance.

61 Reliance damages also would normally be appropriate in frustration cases in which the promisee has incurred costs in reliance on the contract

50 See *supra* text at notes 5-6.

prior to the occurrence of the frustrating event, and an objective of the contract was to induce the promisee to incur those costs because the promisor wanted to reserve the promisee's time or labor. For example, in *Krell v. Henry*, Lord Justice Williams set out a hypothetical in which a cabman was engaged to take a person to Epsom on Derby Day "at a suitable enhanced price for such a journey,"⁵¹ but then Derby was called off. Williams concluded that the cabman would be entitled to the agreed upon fare. That conclusion was wrong in general—and inconsistent with *Krell v. Henry* in particular—because it seems clear that the contract in the hypothetical was made on the tacit assumption that the Derby would take place and, therefore, the cabman should not be entitled to expectation damages.

However, suppose that as a result of the contract the cabman had turned down another booking, unrelated to the Derby, for the same day, and after the Derby was called off the cabman was unable to get a substitute booking. Here the purpose of the cab-hirer would have been to reserve the cab, and he should compensate the cabman for the latter's cost for maintaining the reservation, that is, the cost of forgoing an opportunity to contract for a fare at the regular price. The same reasoning would apply to a hypothetical variation of *Krell v. Henry* in which a person reserved a hotel room at an advanced rate to view the coronation procession, and after the coronation was cancelled, the hotel was unable to fill the room even at its regular rate.⁵² This reasoning also applies to a hypothetical formulated by Joseph Perillo (1996, 6–7) in which a dressmaker sews up a specially designed wedding dress for a prospective bride, and the wedding is then called off by the prospective groom.

There may be other cases in which the adversely affected party should be liable for reliance damages. Indeed, there may be occasional cases in which, if the parties had addressed the issue, they would have provided that if the occurrence of a given unexpected circumstance justified judicial relief, the

51 [1903] 2 K.B. 740, 750.

52 In contrast to frustration cases, in which normally the promisor is a buyer, in impossibility and impracticability cases normally the promisor is a seller. Unlike buyers, who will often have a specific interest in inducing a seller to incur certain costs in reliance on the contract, as in the cabman and wedding-dress hypotheticals, a seller will typically be indifferent to whether and how the buyer relies, at least if the reliance does not affect the seller's damages for breach. However, if a seller in an impossibility or impracticability case does have a specific interest in inducing a buyer to incur certain costs in reliance on the contract, the seller may appropriately be made liable for the buyer's reliance damages.

relief should take the form of equalizing their out-of-pocket costs in reliance on the contract. Inevitably, the courts must have a certain amount of discretion at the remedial stage; this may be seen as a consequence of the hypothetical-contract methodology.

2. THE BOUNDED-RISK TEST

2.1. The Test

64 Many unexpected-circumstances cases turn on the occurrence of a discrete event, and can be resolved by applying the shared-assumption test. Other cases, however, do not turn on such an occurrence. Often a dramatic and unexpected increase in the promisor's cost of performance should support judicial relief even if the increase is not tied to a discrete event, because in many and perhaps most contracts, the parties do not expect that the promisor has undertaken an enormous financial risk.

65 A special test is needed to address these cases. Under this test, which I will call the *bounded-risk test*, a promisor should be entitled to judicial relief if as a result of a dramatic and unexpected rise in costs, performance would result in a financial loss significantly greater than the risk of loss that the parties would reasonably have expected the promisor to have undertaken. The bounded-risk test may be viewed as either a free-standing test or a special application of the shared-assumption test, where the shared assumption concerned the amount of risk assumed by the promisor. More generally, for purposes of unexpected-circumstances cases a circumstance can be defined not only by its characteristics but also by its magnitude, that is, its dollar cost. An annual inflation of 5 percent is one kind of circumstance; an annual inflation of 200 percent is another. As Paul Joskow (1977, 154–161) has pointed out:

It may facilitate the contracting process . . . if it is understood or implied in the contract that when events such as [wars, embargoes, changes in government rules and regulations, destruction of key supply facilities, or hyperinflation] occur *and* lead to dramatic increases in the cost of performance or the impossibility of performance that the contract will simply be discharged or renegotiated. . . .

For example, if we had two similar occurrences, let's say embargoes, the seller would have to perform if the price rise were small, but would not be

required to perform if the resulting cost increase were very large. Such asymmetric treatment of differing consequences from similar events only appears to make sense if we expand our notion of possible contingencies to include elements identified by both event and consequence, and assume that, given a particular type of occurrence, the size of the consequence and the probability of the consequence occurring are negatively correlated. That is to say, given the set of possible embargoes, those with small consequences are much more probable than those with large consequences. Then we could appeal to the notions of bounded rationality . . . and argue that the low-probability events are outside of the boundary and not legally part of the contract.⁵³

Whether viewed as a free-standing test or as a special application of the shared assumption test, the bounded-risk test requires independent development, partly because the test does not focus on a discrete event and partly because the test carries special remedial considerations in its wake.

2.2. Comparison with Mutual Mistake

Bounded-risk cases reflect still another way in which mutual-mistake and unexpected-circumstances cases tend to differ in practice in a manner that gives rise to important differences in theory and doctrine. Under the shared-assumption test, the major difference between mutual-mistake and unexpected-circumstances cases concerns the role of fault. Under the bounded-risk test, the major difference between the two kinds of cases concerns the relative structure of the parties' positions. In mutual-mistake cases the buyer is characteristically the adversely affected party, while in unexpected-circumstances cases the seller is characteristically the adversely affected party.

53 The effect of the magnitude of the impact of an event, as opposed to the nature of the event, is also recognized in *Restatement Second* §261 cmt. d (1981):

Performance may be impracticable because extreme and unreasonable difficulty, expense, injury, or loss to one of the parties will be involved. A severe shortage of raw materials or of supplies due to war, embargo, local crop failure, unforeseen shutdown of major sources of supply, or the like, which either causes a marked increase in cost or prevents performance altogether, may bring the case within the rule stated in this section. . . . A mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction, *unless well beyond the normal range*, does not amount to impracticability since it is this sort of risk that a fixed-price contract is intended to cover. (Emphasis added.)

68 The implications of this structural difference are highly significant. In the typical mutual-mistake case, in which the buyer is the adversely affected party, the contract price sets an upper boundary on the buyer's loss. Even in atypical mutual-mistake cases, in which the seller is the adversely affected party, normally the seller will have no loss at all in the normal sense of that term, but will merely forgo a windfall. In contrast, in the typical unexpected-circumstances case, in which the seller is the adversely affected party, if the contract is enforced there may be little or no bounds on the seller's potential loss.

69 Here is why this is so. In the typical mutual-mistake case, a buyer claims that she will take a loss if she does not obtain relief, because as a result of a mistaken shared tacit assumption the commodity that she has agreed to purchase lacks some or all of its expected value.⁵⁴ For example, in *Lenawee County Board of Health v. Messerly*,⁵⁵ the Messerlys sold Carl and Nancy Pickles an income-producing investment property consisting of a three-unit apartment building located on a 600-square-foot parcel. Five or six days after the purchase, Mr. and Mrs. Pickles discovered raw sewage seeping out of the ground. Tests conducted by a sanitation expert indicated that the sewage system was inadequate because, unknown to the Messerlys, their predecessor-in-interest had installed a septic tank on the property without a permit and in violation of the Health Code. Subsequently, the County Board of Health condemned the property and obtained a permanent injunction proscribing habitation until the property was brought into conformance with the Health Code. However, it was impossible to remedy the illegal septic system within the confines of the 600-square-foot parcel, because the Health Code required 750 square feet of property for a septic tank for a one-family-dwelling and 2,500 square feet for a three-family dwelling. As a result, the only way the apartment building could be put to residential use was to pump and haul the sewage, which would cost double the income generated by the building. Accordingly, the value of the supposed income-producing property was negative, because the property could not possibly produce income that exceeded or even equaled the sewage costs. In cases

54 I use the term *commodity* in its broadest sense to mean anything that can be purchased and sold.

55 331 N.W.2d 203 (Mich. 1982).

like *Messerly*⁵⁶ the buyer will have a significant or even total loss unless judicial relief is granted on the basis of mutual mistake. However, the loss is normally limited to the amount of the purchase price.

Where the *seller* is the adversely affected party in a mutual-mistake case, typically he will have no loss at all in the normal sense of that term. Rather, the issue in such cases is how to allocate a windfall—an unexpected and unbargained-for element of value. For example, in *In re Seizure of \$82,000 More or Less*,⁵⁷ agents of the Drug Enforcement Administration (DEA) had found \$24,000 in drug proceeds wrapped in plastic bags in the battery case of a Volkswagen. The car and the money were forfeited to the U.S. government pursuant to statute, and the car was then sold by the government to the Chappells. The Chappells noticed a fuel problem and took the car to a mechanic, who found \$82,000 wrapped in plastic bags in the fuel tank. The DEA seized the \$82,000, and the Chappells disputed the seizure. This was a windfall case. The Volkswagen had an unexpected element of value—the hidden money in the gas tank. Whether the court allocated the \$82,000 to the government or to the Chappells, the other party would not be worse off than it expected to be at the time the contract was made. If the \$82,000 was

56 For comparable cases, see, e.g., *Dover Pool & Racquet Club v. Brooking*, 322 N.E.2d 168, 169–171, 174 (Mass. 1975) (Dover had contracted to purchase from Brooking a fifty-acre parcel of land, located partly in the Town of Medfield, to use as a tennis- and swimclub. The parties had previously inquired into the relevant zoning laws, which allowed such a use. Unknown to the parties, after Dover made its inquiries, but just before the contract was signed, the Town of Medfield published a notice of public hearing on a zoning-law amendment that would require a special permit for Dover’s planned use. The court held that Dover could rescind the contract.); *Bar-Del, Inc. v. Oz, Inc.*, 850 S.W.2d 855, 856–857 (Ky. Ct. App. 1993) (Buyer had contracted to purchase a tavern from Seller. Unknown to the parties, the property was not zoned for tavern use even though the Seller had operated the tavern for many years. The court held that Buyer could rescind.); *In re Macrose Industries*, 186 B.R. 789, 793 (E.D.N.Y. 1995) (Buyer had contracted to purchase a parcel of real estate from Seller, subject to obtaining all the municipal approvals that were necessary to realize the buyer’s plans for the property. The contract gave Buyer one year to secure these approvals. Subsequently, Buyer discovered that the process of obtaining one of the required permits could take up to two years. The court held that the buyer could rescind.); *Reilley v. Richards*, 632 N.E.2d 507, 508–509 (Ohio 1994) (Buyer had contracted to purchase a parcel of real estate upon which to build a house. Subsequently, Buyer discovered that part of the property was located in a flood-hazard area, and as a result was unfit for construction. The court held that the buyer could rescind.).

In *Messerly* itself, the court held that the buyer would have been excused except for the inclusion of an as-is provision in the contract.

57 119 F. Supp. 2d 1013 (W.D. Mo. 2000).

allocated to the government, the Chappells would still have the car that they expected to get at the price that they agreed to pay. If—as occurred—the \$82,000 was allocated to the Chappells, the government would still have the amount that it expected to get in exchange for the car that it agreed to sell.

71 In summary, in mutual-mistake cases the buyer is typically the adversely affected party and as in *Lenawee*, the buyer's loss is limited to the purchase price. If the seller is the adversely affected party, typically neither party will have a loss, although one party will forgo a windfall, as the government did in the drug-money case.

72 Some unexpected-circumstances cases, like most mutual-mistake cases, involve adversely affected buyers. Such cases are usually treated under the doctrine of frustration. Typically, the buyer claims that the commodity she agreed to purchase has lost most or all of its value because of the occurrence of an unexpected circumstance. Like the buyer in a mutual-mistake case, the buyer in a frustration case faces a loss—sometimes a total loss—if judicial relief is not awarded. Again, however, the loss is limited to the contract price. For example, in *Krell v. Henry*, the rooms that the lessee had rented to watch the coronation procession had no value to him when the coronation was canceled. However, if judicial relief had not been granted, the lessee's loss, although total, would have been limited to the contract price.

73 Characteristically, however, unexpected-circumstances cases involve a seller who is adversely affected by an unexpected and drastic increase in the cost of performance.⁵⁸ Cases in which the seller's cost of performance unexpectedly rises above the contract price often, perhaps usually, involve a cost increase that is market-wide. In such cases, the increase normally will raise not only the seller's costs but also the buyer's value for, and the market value of, the contracted-for commodity. Therefore, in the absence of judicial relief to the seller, the buyer's expectation damages, based on the difference between the contract price and the market price, can rise to a very high level that is not bounded by the contract price, and often would

58 This difference between mutual-mistake and unexpected-circumstances cases, like the other differences discussed in this article, is based on typical cases in each of the two categories rather than on characteristics that necessarily inhere in such cases. The rare case in which a mutual mistake drastically increases the seller's cost of performance should be treated like the counterpart unexpected-circumstances case.

give the buyer a windfall.⁵⁹

For example, suppose that Packer agrees to sell 10,000 pounds of N nuts, a delicacy, to Distributor at a price of \$1.00/pound. Packer expects to purchase the nuts from farmers at 50¢/pound. Distributor operates at a 100 percent gross margin and expects to resell the nuts to retailers at \$2.00/pound, for a total profit of \$10,000. Because of a blight, the quantity of N nuts available on the market falls dramatically, and the price of N nuts to packers rockets to \$6.00/pound. The demand for N nuts is relatively inelastic. The price charged by packers to distributors rises to \$7.00/pound, and the price charged by distributors to retailers rises to \$14.00/pound. If Packer does not perform and is not entitled to judicial relief, she will incur damages of \$60,000 (based on the difference between the \$1.00/pound contract price and the \$7.00/pound market price to distributors). Distributor, in turn, will reap a windfall profit of \$130,000 (based on damages of \$60,000 plus the \$70,000 difference between the \$7.00/pound market price to distributors and the \$14.00/pound charged by distributors), compared with its *ex ante* expected profit of \$10,000.

The same kind of issues can arise where the seller is a producer rather than a middleman. For example, suppose that Manufacturer, who produces plastic pipe, agrees to sell 100,000 feet of 1" diameter pipe to Distributor at 50¢/foot, with delivery over six months beginning six months after the contract date. Manufacturer's projected cost of performance is 45¢/foot, including 35¢/foot for petrochemical products. Distributor expects to re-

59 Trimarchi (1991, 65), upon which Part 2 draws, has analyzed this issue in formal terms as follows:

Consider a contract in which a promisor (hereafter "the seller") agrees to supply the promisee (hereafter "the buyer") with certain goods or services for a price p . The seller's cost of performance, estimated at the time of the contract, is c (production cost, if the seller is a manufacturer, or purchasing cost, if the seller is a middleman). The value of the goods or services to the buyer, expressed in monetary terms, is V . It may be assumed that $V > p > c$. Assume that over time the cost of performance rises to c^*

Assume that V remains fixed, while performance costs increase. If . . . $c^* > V$, and the remedy of specific performance is not given, the seller may breach the contract and pay expectation damages $V-p$.

In this case the seller sustains a loss with respect to his initial forecast, equal to $V - c$. This amount, which normally is not exorbitant, represents the limit of the seller's risk.

This limit no longer exists if V increases as a result of the same factors which increased the cost of performance. If V increases to more than c^* , the seller will incur a loss equal to the increase in costs, irrespective of its amount.

sell the pipe to retailers at 60¢/foot, for a profit of \$10,000. The price of the petrochemical products used in the manufacture of plastic pipe doubles to 70¢/foot due to an unexpected surge in worldwide demand, so that Manufacturer's cost of performance would be 80¢/foot. As a result of the increase in costs, the market price to distributors rises to 90¢/foot, and the price charged by distributors rises to \$1.10/foot. If Manufacturer does not perform and is not entitled to judicial relief, it will be liable for damages of \$40,000 (based on the difference between the 50¢/foot contract price and the 90¢/foot market price to distributors). Distributor, in turn, will reap a windfall profit of \$60,000 (based on damages of \$40,000 plus the \$20,000 difference between the 90¢/foot market price to distributors and the \$1.10/foot price charged by distributors), compared with Distributor's ex ante expected profit of \$10,000.

76 Of course, the profits that the distributors in the hypotheticals would reap if judicial relief was withheld would not be windfalls if the parties reasonably believed that the sellers were taking the risk of enormous losses because, for example, the buyers were bargaining for the chance of enormous profits. However, in these and most comparable cases that conclusion seems unlikely. As Pietro Trimarchi (1991, 71) has pointed out:

[I]t is unreasonable to assume that the parties would normally be willing to gamble on uncertainties about disastrous events. . . . It seems likely that the parties would normally be more inclined to avoid [such a] gamble and to change their overall plans in the event of exceptional unforeseen changes in market conditions; accordingly, a legal rule allowing discharge or amendment of the contract would presumably more often correspond to their preferences.⁶⁰

77 The bounded-risk test is congruent with the moral obligation that a promise entails. As stated by Thomas Scanlon (1990, 214), "Saying 'I promise to . . . ?' normally binds one to do the thing promised, but it does not bind unconditionally or absolutely. . . . It does not bind absolutely because, while a promise binds one against reconsidering one's intention simply on grounds of one's own convenience, it does not bind one to do the thing promised whatever the cost to oneself and others."

60 Cf. Farber (1983, 335–336) (impracticability doctrine protects promisors against catastrophic losses); Narasimhan 1986, 1147 (neither party to a contract accepts unlimited risks).

The bounded-risk test is also efficient, as Trimarchi pointed out the test reflects the agreement that the parties would probably have reached if they had specifically addressed the issue. The underlying methodology in bounded-risk cases is the same as the underlying methodology in typical shared-assumption cases. In both types of cases, the objective is to construct the term the parties probably would have agreed upon if they had addressed the issue. However, the application of that methodology differs significantly in the two types of case. Typical shared-assumption cases are *event-oriented*, in the sense that the issue is whether the occurrence of a discrete event entitles the adversely affected party to judicial relief. If it does, then usually the relief should consist of an excuse of that party's obligation to perform, although in some cases the relief may consist only of excusing liability for expectation damages. In contrast, the typical bounded-risk case is *magnitude-oriented*, in the sense that the issue is whether the adversely affected party's dramatically increased cost of performance entitles it to judicial relief.

In such cases, determining what the parties would have agreed to if they had addressed the issue is a more complex enterprise than in event-oriented cases. Normally, each party to a contract will expressly or impliedly take some risk. The issue is how much risk?

Assuming that the seller and the buyer had approximately the same wealth, utility for money, and attitude to risk, the seller can reasonably be expected to have accepted the risk of a moderate or reasonably predictable increase in costs, because a purpose of many contracts for sale is to shift the risk of such increases to the seller, and gains and losses within normal bounds are unlikely to significantly affect the wealth of either party. In some cases, it can be inferred from the circumstances that the seller was taking the risk of a very large loss due to market-wide cost increases. The most obvious case is that in which one or both parties are speculators. Within limits, the acceptance of such a risk may also be inferred from the fact that a contract is for a period of many years, because the longer the term of a contract, the more it becomes reasonably foreseeable that a very large increase in costs may occur during that term.⁶¹ Price-escalation provisions in a long-term contract

61 As Trimarchi (1991, 71) observes:

[The] taking of a risk in return for a fixed fee may in some cases be assumed from the nature of the contract, particularly its term, even though there may not

may also suggest that the seller made an evaluative choice among various types of such provisions and was taking the risk that her choice would turn out badly.

81 In the normal case, however, a seller would not be willing to accept an extremely large risk, or perhaps more accurately, would charge the buyer a steep premium to accept such a risk, because if the loss materialized it would significantly decrease the seller's wealth. The buyer, on his part, would be unlikely to want to pay the premium that the seller would demand for exposure to such a loss, especially where the buyer's damages would essentially amount to a windfall rather than compensation for a loss in the normal sense of that term.

82 Although the bounded-risk test is not explicitly articulated in contract law, it has significant support in the doctrine of impracticability. That doctrine is reserved for cases where the seller's performance is possible, because where performance is not possible, the doctrine of impossibility suffices. The bounded-risk test fleshes out the meaning of the doctrine of impracticability. Indeed, it is difficult to see how that doctrine could sensibly be interpreted if it did not center on a very large increase in a seller's costs, the risk of which was not explicitly or implicitly assumed by the seller. So, for example, in *Vernon v. Los Angeles*,⁶² the California Supreme Court stated that "a thing is impracticable when it can only be done at an excessive and unreasonable cost."⁶³ That statement was endorsed in *Transatlantic*.⁶⁴ In *Misahara Construction Co. v. Transit-Mixed Concrete Corp.*,⁶⁵ the Massachusetts Supreme Court stated that "certain risks are so unusual and have

be any specific wording to such effect. For instance, it is quite normal to enter into a short term commitment to supply goods or services without worrying about the possibility that wholly unforeseeable events may intervene to render performance impracticable. However, where a commitment is entered into for many years it is reasonable to assume that the supplier will have considered the possibility of drastic changes in his costs. Accordingly, in the latter case, a fixed price clause can be reasonably interpreted as an indication that the supplier is willing to take a larger risk.

62 290 P.2d 841 (Cal. 1955).

63 *Id.* at 847, quoting *Mineral Park Land v. Howard*, 156 P. 458, 460 (1916).

64 363 F.2d 312 (D.C. Cir. 1966).

65 310 N.E.2d 363, 367 (Mass. 1974).

such severe consequences that they must have been beyond the scope of the assignment of risks inherent in the contract, that is, beyond the agreement made by the parties. To require performance in that case would be to grant the promisee an advantage for which he could not be said to have bargained in making the contract.”⁶⁶ Similarly, the Comment to *Restatement Second* § 261 (“Discharge by Supervening Impracticability”) states that “Performance may be impracticable *because extreme and unreasonable difficulty [or] expense . . . to one of the parties will be involved. . . .* A mere change in the degree of difficulty or expense due to such causes as increased wages, prices of raw materials, or costs of construction *unless well beyond the normal range*, does not amount to impracticability since it is this sort of risk that a fixed-price contract is intended to cover.”⁶⁷

Restatement Second § 351 (“Unforeseeability and Related Limitations on Damages”) also endorses a version of the bounded-risk test, although in a somewhat different context. Sections 351(1) and (2) set out the principle of *Hadley v. Baxendale*. Section 351(3) then adopts a much different principle: “A court may limit damages [*even*] for *foreseeable loss* by excluding recovery for loss of profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation.”⁶⁸

The bounded-risk test is exemplified by *Moyer v. Little Falls*.⁶⁹ Earl Moyer had entered into a contract with the city of Little Falls to dispose of the city’s refuse for five years, beginning April 1, 1984, in exchange for annual payments by the city of \$97,700. Moyer planned on dumping the refuse in the Rose Valley Landfill, which was located near the city. At the time the contract

66 See also, e.g., *L.N. Jackson & Co. v. Royal Norwegian Gov’t*, 177 F.2d 694, 702 (2d Cir. 1949) (“it cannot be believed that the contractee would have demanded or the contractor would have assumed’ the risks which it entails”) (L. Hand, J., dissenting, quoting *North German Lloyd v. Guar. Trust Co.*, 244 U.S. 12, 22 (1917)); *Corbin* 1937,465 (“In dealing with the concept of impossibility . . . the courts have given increasing consideration to the extent of the risk that a promisor should be regarded as having undertaken”).

67 (Emphasis added). See also *Kan. City, Mo. v. Kan. City, Kan.*, 393 F.Supp. 1, 6 (W.D. Mo. 1975), where the court rejected the proposition that “no increase in expense, regardless of its cause or magnitude, will operate to excuse performance.”

68 (Emphasis added).

69 510 N.Y.S.2d 813 (Sup. Ct. 1986).

was made, the estimated amount of the city's annual refuse was 8,000 cubic feet, and the rate for dumping refuse at the Rose Valley Landfill was \$1.50 per cubic yard. In December 1985, that landfill was closed by order of New York state. The only other landfill approved by the state and available to Moyer was the Mohawk Valley Sanitary Landfill. Over the eleven-month period after the Rose Valley Landfill was closed, Mohawk Valley Landfill increased its rate for dumped refuse from \$2.50 per cubic yard to \$10.00 per cubic yard, and Moyer's dumping costs increased 666 percent. Moyer stopped performing the contract, and Little Falls brought suit. The court concluded that Mohawk's rate increases consisted of gouging that had been made possible by the state's action in giving Mohawk a monopoly position and held that "the 666 percent increase was not and could not have been within the contemplation of the parties. Such a massive cost escalation is 'excessive' as a matter of law and future performance by plaintiff must be excused."⁷⁰

85 In short, as these authorities illustrate, the bounded-risk test normally applies to excuse a seller from full expectation damages where, absent judicial relief, the seller's loss from increased costs would greatly exceed the risk that the parties would reasonably have expected the seller to have taken on.

2.3. Nature of Relief

86 Assuming that judicial relief is appropriate under the bounded-risk test, the next issue is what form the relief should take. In typical cases that fall within the shared-assumption test, normally the promisor should be excused either entirely or from expectation damages. That is not true in cases that fall within the bounded-risk test. The remedy under that test should follow from the underlying theory of relief. This theory is that if the parties had addressed the issue, the seller would have accepted the risk of cost increases up to a certain point but not beyond. Accordingly, the buyer should be entitled to expectation damages measured by the difference between the contract price and a hypothetical price based on the increased costs the seller could reasonably have been expected to bear.

87 To put this differently, when judicial relief is based on the bounded-risk test, a seller should not be made better off, due to a very large increase in her costs, than she would have been if her costs had risen only moderately.

70 *Id.* at 815.

If the seller's costs had risen only moderately, the buyer would have been entitled to expectation damages for nonperformance. There is no good reason why the buyer should forgo all expectation damages because the seller's costs rose excessively. Therefore, in cases where the bounded-risk test is applicable and the buyer's value for, and the market value of, the contracted-for commodity rise in tandem with the seller's costs, the buyer should be entitled to the expectation damages that would have been awarded if there had been a reasonably foreseeable increase in the seller's cost of performance and a corresponding increase in the market value of the commodity. What constitutes a reasonably foreseeable increase in the seller's cost of performance should be historically based; more specifically, it should be the maximum percentage increase in the cost of the relevant inputs over a comparable stretch of time during a reasonable past period. In most cases, consideration of price movements during the prior ten to twenty years probably would suffice.⁷¹

The easiest kind of situation in which to apply the bounded-risk test consists of cases, like the nut and plastic-pipe hypotheticals, in which the buyer is purchasing for resale. In such cases the buyer's only expectation is to make a profit, and if the buyer is awarded the maximum profit that he would have reasonably expected *ex ante*, this expectation will be fulfilled. A more difficult case is presented where the buyer is an end-user. For example, suppose that in the plastic-pipe hypothetical the buyer was an end-user who planned to use the plastic pipe in the construction of a new plant. In that case, the buyer's expectation would have been to acquire a certain amount of pipe at a certain price and failure to give the buyer

71 In a comment on an earlier draft of this article, Shawn Bayern pointed out that: [there is] another advantage of [this] remedial approach . . . for bounded-risk cases. In particular, [the] proposed scheme is advantageous because it avoids a harsh discontinuity (between large damages for the promisee and no damages for the promisee) and, as a result, can reduce the cost of settlement between the parties: the precise relationship between the cost changes that have actually occurred and "reasonable" cost increases is taken off the table in many cases, such that this precise relationship need not be litigated. As a result, the parties disagree about less and should more readily be able to settle their dispute. (There is a similar, related point: what I call "harsh discontinuities" tend to increase the cost of errors in adjudications, because they can—at least in theory—amplify small differences in courts' assessment of what is reasonable into large differences in damages. By contrast, without such discontinuities, parties can better predict the potential damages they face, and this probably encourages settlement.)

Message from Shawn Bayern to Melvin Eisenberg, November 16, 2006.

full expectation damages might seem to frustrate that expectation. However, the buyer's reasonable expectation would not be frustrated if he could not reasonably have expected the seller to take an unbounded risk. Even in end-user cases, therefore, the remedy should be the difference between the contract price, and a hypothetical price based on maximum historical percentage price increases for the relevant inputs. It might be objected that this remedy would saddle the buyer with an opportunity cost, on the theory that if the buyer had made a contract with another supplier, he would have been able to acquire the contracted-for commodity at the contract price. However, the bounded-risk test should apply only when a cost increase is market-wide. As a result, the costs of all sellers of the relevant commodity would have increased in the same way, and all sellers would have the same defense, so that the buyer would have done no better if he had contracted with another seller.

89 Generally speaking, the bounded-risk test and the associated remedial consequence seem to comport with business practice. Russell Weintraub (1992, 41) conducted a survey of general counsels in which he asked the following question:

Company A has contracted to sell B a fixed quantity of fuel oil per month at a fixed price for 10 years. An unprecedented OPEC oil embargo causes the cost of the oil to A to far exceed the price that B has agreed to pay. A's loss over the 10 years of the contract would be so large as to require liquidation of A. B can pass on the added cost of oil to its customers without suffering a competitive disadvantage. A refuses to deliver the oil at the contract price and B sues A for the difference between the contract price of the oil and the much higher price that B must pay to obtain oil from other sources. What result should the court reach?

90 In response, 35 percent of the general counsels stated that B should receive a judgment for the difference between the contract price and the market price, but 14 percent stated that A should be excused from performance, and 46 percent stated that the contract price should be adjusted to avoid ruinous loss to A but give B a significant savings over current market price.⁷²

72 George Triantis has argued that contract law should not allow defenses based on unexpected circumstances (Triantis 1992). Triantis's argument is based on the claim that when formulating

contracts, parties allocate *all* possible risks. The claim proceeds as follows: Admittedly many specific risks—in particular, unforeseen risks—are not explicitly allocated by contracting parties. However, even those risks are implicitly allocated within broader risks that are explicitly allocated. Therefore, if a promisor agrees to render a certain performance, all risks affecting the promisor's ability to render that performance that are not specified in the contract are contractually allocated to her. Accordingly, "judicial reallocation of risk through contract doctrine such as commercial impracticability is an interference with freedom of contract that cannot be justified on grounds of economic efficiency" (480). (See *also* Trebilcock 1993, 127-130; *but see* 144-145.)

Triantis's claim that contracting parties allocate all risks flies in the face of both ordinary experience (see, e.g., Narasimhan 1986) and experimental evidence, and Triantis offers neither experiential nor experimental evidence to support his claim. Instead, Triantis rests his claim entirely on a long and highly complex model of decision theory as applied to the allocation of unknown risks under conditions of uncertainty. However, Triantis here mistakes a normative theory for a descriptive theory. Triantis assumes that decision theory, on which his claim rests, is a descriptive theory about how *real* actors *actually* make decisions. It isn't. Rather, decision theory is a normative or prescriptive theory about how *rational* actors *should* make decisions. Within the last thirty or forty years, psychologists (and increasingly, economists) have experimentally and theoretically established that real actors routinely and systematically deviate from the prescriptive dictates of decision theory. (See, e.g., Kahneman, Slovic, & Tversky 1982; Kahneman & Tversky 2000; Kahneman 2003; Simon 1957.) Triantis's claim that contracting actors allocate all risks, therefore, is contradicted not only by ordinary experience but by a mass of experimental evidence. This evidence shows the existence of systematic cognitive problems affecting decision-making, such as bounded rationality, which limits the future scenarios that actors can be realistically expected to envision; overoptimism; and defects in capability, including systematic underweighting of future benefits and costs as compared to present benefits and costs and systematic underestimation of low-probability risks. (See Eisenberg 1995, 213-225.)

Triantis acknowledges the existence of these cognitive problems, but he argues that they apply to contracting across the board, so that the "selective focus" of unexpected-circumstances doctrine is "anomalous." (Triantis 1992, 474.) In fact, however, cognitive problems—particularly, the capacity to imagine future risks and to accurately assess their probability—are a disproportionately large factor in unexpected-circumstances cases. There is a huge cognitive difference between deciding how many apples to buy at what price, on the one hand, and imagining and accurately assessing a future that could unfold in hundreds of different ways, on the other.

A second basic flaw in Triantis's argument is that it rests on the unarticulated premise that a contract consists only of the parties' explicit expressions. This is incorrect. As stated in the *Uniform Commercial Code*, a contract consists of the bargain of the parties in fact, which includes not only explicit expressions but also—among other things—the parties' tacit assumptions. (See text at notes 7-8, *supra*.) Therefore, if a contract allocates all risks, that is because, and only because, many risks will be allocated by the portion of the contract that is comprised of the parties' shared tacit assumptions. And this, of course, is precisely the point of the shared-assumption test—that even when a writing does not afford relief based upon the occurrence of an unexpected circumstance, the parties' tacit assumptions will often make relief contractually appropriate.

Triantis's claim also ignores the issue of economic magnitude. It cannot reasonably be assumed that parties allocate to a promisor the risk of every unexpected circumstance without regard to the economic magnitude of the risk, because normally a promisee would not pay the price a promisor would demand to bear such a risk. This is the essence of the bounded-

3. THE ROLE OF INSURANCE CONSIDERATIONS

91 At least at the margin, insurance considerations may figure in unexpected-circumstances cases. In particular, if market insurance or hedge instruments that cover a given risk are readily available, and there is a customary practice in a business sector to purchase such insurance or instruments, a promisor who decides not to do so may fairly be deemed to have assumed the risk that would have been insured or hedged under the customary practice.

92 In an influential article, Posner and Rosenfield (1977, 88–92) went one step further and argued that the risk of an unexpected circumstance should always fall on the party who is the cheaper insurer against the risk. To put this differently, Posner and Rosenfield argued that the determinative test for judicial relief in unexpected-circumstances cases should be which party was the cheaper insurer. The argument, in a slightly paraphrased form, proceeds as follows:

93 Discharge of a contractual obligation should be allowed on the ground of impossibility, impracticability, or frustration where the promisee is the superior (more efficient or cheaper) risk bearer. One party is a superior risk bearer if he is in a better position to prevent the relevant risk from materializing. In such a case, efficiency requires that party to bear a loss resulting from the materialization of the risk. But prevention is only one way of dealing with risk; the other is insurance. If the promisor is the cheaper insurer, her inability to prevent the risk from materializing should not discharge her from a contractual obligation. The factors relevant to determining which party to a contract is the cheaper insurer are risk-appraisal costs and transaction costs. Risk-appraisal costs are the costs of determining the probability of a loss and the magnitude of the loss if it occurs. Transaction costs are the costs involved in eliminating or minimizing the risk by pooling it with other risks, that is, by diversifying the risk away. This can be done either through the purchase of market insurance or through self-insurance.

94 Before examining this argument directly, it is necessary to clarify two issues.

risk test. Under both the shared-assumption and bounded-risk tests, judicial relief is not, as Triantis characterizes it, a reallocation of risk but rather a recognition of the allocation of risk based on the parties' tacit assumptions and what the parties probably would have agreed to if they had addressed the relevant issue.

First, Posner and Rosenfield state that in every unexpected-circumstances case, “the basic problem is the same: to decide who should bear the loss resulting from an event that has rendered performance by one party impracticable.”⁷³ The use of the term “loss” in this context is somewhat misleading. The traditional objective of remedies in areas of private law other than contracts is to compensate a wrongfully injured party by restoring him to the position that he was in before the injury. Such a regime makes injured parties whole for diminutions in pre-transaction wealth which are losses in the normal sense of that term. Although the remedial regime in contract law is also commonly characterized as compensatory,⁷⁴ the classic contract-law remedy of expectation damages is not designed to restore the injured party to the position that he was in before the injury. Instead, this remedy is designed to put the promisee forward to a position as good as he would have been in if the promisor had performed. As stated by Fuller and Perdue (1936–1937, 53), “[in contract law] we ‘compensate’ the plaintiff by giving him something he never had. This seems on the face of things a queer kind of ‘compensation.’”⁷⁵ It is therefore somewhat misleading to put the issue in unexpected-circumstances cases in terms of “who should bear the loss,” because often there is no loss, in the normal sense of a diminution in pre-contract wealth, but only a failure to achieve an expected gain.

Second, although Posner and Rosenfield’s argument mentions market insurance, that is not the kind of insurance that underlies their argument. Market insurance is often or usually unavailable to cover the expectations and liabilities that unexpected-circumstances cases involve. Furthermore, many or most unexpected-circumstances cases involve either events that

73 Posner & Rosenfield at 86.

74 See, e.g., *Hawkins v. McGee*, 146 A. 641, 643 (N.H. 1929) (“By ‘damages,’ as that term is used in the law of contract, is intended compensation for a breach.”); *Restatement (Second) of Contracts* ch. 16, Introductory Note, 100 (1981) (“The traditional goal of the law of contract remedies has . . . [been] compensation of the promisee for the loss resulting from breach.”).

75 That the classic contract-law remedies are not compensatory is not a strike against them. Whether a given remedial regime is desirable in any area of law does not depend on whether the regime is compensatory. Instead, it depends on what remedial regime is best justified, in that area, by considerations of policy and fairness. In the area of contracts—or more accurately, in the area of bargain contracts—the remedial regime that is best justified by considerations of policy and fairness is one that implements the expectation principle for breach of bargain promises. See Eisenberg 2005.

are too special to be covered by normal market insurance, such as the illness of a king on a given day or the drying up of a particular stream, or events that are too widespread to be covered by normal market insurance. As to the latter case, Trimarchi (1991, 66–67) points out that:

The principle of insurance (in its widest sense) lies basically in aggregating a number of homogeneous and uncorrelated risks, that are sufficient for the statistical regularity of events to make the overall losses in a given timespan predictable with a reasonable degree of accuracy. This reduces risk (defined as the probable variation of actual experience from expected experience). . . .

An important requisite for any given risk to be efficiently insurable is, therefore, that it can be assessed in terms of statistical findings. This however is not feasible in the case of such exceptional events as wars, international crises, national political crises, and the like, [which affect society as a whole, or large portions of it, and] the occurrence of which is so spasmodic as to defy statistical calculation over a reasonable timespan.

97 Presumably because of the unavailability of market insurance in many or most unexpected-circumstances cases, Posner and Rosenfield attempt to treat self-insurance as more or less interchangeable with market insurance. It isn't. Self-insurance, in its paradigmatic form, is not insurance at all. Insurance involves the transfer of a risk from one independent entity to another, usually through a market transaction. In paradigmatic self-insurance transactions, in contrast, an entity simply sets aside a reserve to cover future risks (or sets up a captive insurer, which in economic terms is virtually the same thing). But Posner and Rosenfield do not even touch upon paradigmatic self-insurance—understandably, since identifying the “cheapest reserve-creator” would be a nonsensical task. Instead, they argue, explicitly or implicitly, that what they call “self-insurance” can be effected in one of four other ways: charging a premium for bearing the relevant risk, hedging a risk by entering into a forward contract, diversifying, or increasing the scale of the firm, which allows more diversification and facilitates the bearing of risk.

98 Once Posner and Rosenfield's argument is clarified it cannot be sustained, because: (1) the argument is premised on an unspoken and critical, but incorrect, factual predicate, (2) the test that Posner and Rosenfield urge would not be administrable, and (3) making liability turn on the elements

that Posner and Rosenfield refer to as “self-insurance” would provide incentives for inefficient behavior and would require courts to decide cases on unacceptable grounds.⁷⁶

3.1. The Incorrect Factual Predicate

Posner and Rosenfield’s argument turns on the proposition that one party to a contract will be better than the other at appraising the probability that a risk will materialize, determining the magnitude of the loss if the risk does materialize, or both. The unspoken but critical predicate of this proposition is that contracting parties *will* appraise the probability and magnitude of the relevant risks in unexpected-circumstances cases. This predicate is incorrect. Most unexpected-circumstances cases arise because the parties tacitly assume that a given kind of circumstance will not occur during the contract time. In such cases the parties do not consider or even foresee, let alone appraise, the risk that the unexpected circumstance will occur. Indeed, if the parties do foresee the relevant risk, judicial relief normally should not be granted. Accordingly, it is more or less irrelevant for present purposes which party can better appraise the probability or magnitude of an unexpected circumstance, because most unexpected-circumstances cases arise precisely because neither party has thought about engaging in such an appraisal.

3.2. Administrability

Next, Posner and Rosenfield’s test would be virtually impossible to apply in practice. Indeed, Posner and Rosenfield themselves are unsure how to apply their test. Concerning one of their hypotheticals, they conclude that “We are *inclined* to view A as the superior risk bearer in these circumstances and thus to discharge B”⁷⁷ (Posner & Rosenfield 1977, 93.) Concerning two of the actual cases they analyze, they conclude that “both cases *may* have been

76 In addition, although Posner and Rosenfield’s argument pivots on the proposition that risk is a cost, they fail to carry out the logic of that proposition by recognizing that although firms are willing to accept the costs of moderate risks, most firms do not want to accept the costs of extreme risks. Because efficiency is based in part on effectuating party preferences, firms that cannot rely on the law of large numbers and are not pure speculators will have a strong preference against either taking or insuring extreme risks of loss.

77 Emphasis added in this and all following quotes from the Posner & Rosenfield article.

correctly decided from an economic standpoint” (102.) Another group of cases “*seem* correctly decided when evaluated from the standpoint of economics” (105). Another result “*seems* correct” (106). Another is “difficult to analyze because the two key parameters seem to point in opposite directions” but “is *probably* correct” (108). Of still another case they say, “Unfortunately, it is unclear a priori which would be the more efficient rule” (103). And more generally, Posner and Rosenfield admit that “[i]n many individual, and perhaps some classes of, cases, economic analysis—at least of the casual sort employed by the judges and lawyers in contract cases—will fail to yield a definite answer, *or even a guess*, as to which party is the superior risk bearer” (110).

101 Michael Trebilcock has excoriated Posner and Rosenfield’s argument in general, and their attempt to rationalize various cases on the basis of their model in particular (Trebilcock 1988, 247–252.) Take, for example, *Transatlantic*,⁷⁸ in which the carrier claimed that it had a right to increased compensation because as a result of the closing of the Suez Canal, the carrier unexpectedly had to transport the cargo via the longer Cape route. The court denied the claim. Posner and Rosenfield (1977, 104) attempt to explain the case on the ground that “[t]he shipowner is the superior risk bearer because he is better able to estimate the magnitude of the . . . loss and the probability of the unexpected event,” and shipowners who own several ships and ply different routes can spread the risks of delay on any particular route, even without purchasing market insurance. Trebilcock (1988, 251) properly characterizes this rationalization as spurious. “On the particular facts, surely the U.S. government [the shipper] was much better placed than the carrier to appraise the risks of the outbreak of war in the Middle East. Surely it was also better equipped than the carrier to evaluate the consequences of delayed arrival of the goods. And surely it was better placed than the carrier to self-insure or otherwise diversify the risk of canal closure.”

102 Posner and Rosenfield try to defend against critiques of this sort by arguing that the decision in *Transatlantic* should and did “turn on the characteristics of shippers as a class” (1977, 104). But as Trebilcock observes (1988, 251–252), “what empirical intuitions or generalizations can confidently be

78 *Transatlantic Financing Corp. v. United States*, 363 F.2d 312 (D.C. Cir. 1966).

offered—or at least are likely to be accessible to a court—as to whether shippers as a class or carriers as a class can better determine the probability of given contingencies and evaluate the consequences of interrupted or aborted performance” or, for that matter as to “which class of actors can more cheaply self-insure, market-insure, or otherwise diversify the risks in question?” Posner and Rosenfield’s class-based defense of their argument also raises the difficult and perhaps impossible issue of how to define the relevant class. In a case like *Transatlantic*, is the relevant class large-scale ocean carriers, ocean carriers, carriers, ship owners, transportation companies, large-scale sellers of homogenous services, or something else entirely?

3.3. Self-Insurance

Recall that Posner and Rosenfield identify four types of “self-insurance”: charging a premium for taking the relevant risk, hedging, diversifying, and attaining a large scale. What Posner and Rosenfield mean by charging a premium and by hedging in this context is not completely clear: they could be referring either to actually charging a premium or hedging or to a superior ability to charge a premium or to hedge. If Posner and Rosenfield are referring to cases in which one of the parties actually charged a premium for bearing or actually hedged the relevant risk, then the cases do not involve unexpected circumstances. If Posner and Rosenfield are referring to a superior ability to charge a premium or to hedge, their argument fares no better. The capacity to charge a premium cannot differentiate two parties to a contract because either party can demand a premium for carrying a risk—the seller by demanding an increase in the price and the buyer by demanding a reduction. Much the same is true of hedging. Normally, if one party could hedge—most typically, by entering the futures market—so could the other. Furthermore, hedging is a relatively restricted technique, which generally is available only for standardized commodities, and even then often for only relatively short periods of time.

The argument for “self-insurance” based on diversification and scale also fails. Diversification and scale have business benefits and costs that are independent of the possibility that an unexpected-circumstances case will arise. These business benefits and costs swamp the expected benefits and costs of dealing with unexpected-circumstances cases, which are few and far between

and usually involve much smaller stakes than firm-wide business decisions on diversification and scale. Therefore, a firm's decisions on how much to diversify and what scale to attain normally will be made on the basis of benefits and costs other than the prospect that an unexpected-circumstances case may arise. Presumably those decisions are rational, so that every firm attempts to adopt its efficient degree of diversification and scale given the nature of its business, its resources, the competitive climate, and so forth. Accordingly, a rule under which liability in unexpected-circumstances cases was imposed on the party who is more diversified, has a larger scale, or both, would inefficiently penalize a firm for having efficiently achieved diversification and large scale. To put this differently, under Posner and Rosenfield's argument efficiency and success would breed liability.

105 Finally, as Trebilcock (1988, 258) has tellingly pointed out, imposing liability on a party to a contract on the basis of the party's attainment of significant diversification and scale would violate basic concepts of justice. "By treating the nature and quality of particular interactions between two parties as irrelevant to determinations of liability, the insurance rationale risks degenerating into a relatively arbitrary selection of an insurer or 'deep pocket,' and thus a largely random form of judicially administered wealth redistribution."

106 In short, the cheapest-insurer rationale is deeply flawed, and comports with neither efficiency, corrective justice, nor distributive justice.

4. THE ROLE OF EX POST CONSIDERATIONS

107 An important issue in many unexpected-circumstances cases is whether the courts should base their decisions solely on the basis of the ex ante expectations and assumptions held by the parties at the time the contract is made or, in appropriate cases, should also take into account ex post considerations—that is, gains and losses to both parties that either arose under the contract prior to the occurrence of the unexpected circumstance or proximately resulted from, or were made possible by, the occurrence.

108 Here again, there is a practical difference between mutual-mistake and unexpected-circumstances cases that has important theoretical and doctrinal implications. Mutual-mistake cases concern the present world at the time of the contract. As a result, usually the mistake is discovered very soon after the contract is made and is remediable by rescission.

In contrast, unexpected circumstances often occur well after the contract is made. By then the eggs have been scrambled, and it is often too late to solve the problem simply by rescission. Instead, more complex adjustments may be required, and in making those adjustments the courts should have power to take ex post considerations into account in appropriate cases. This power is not a license to reallocate gains and losses on the basis of distributional considerations. Rather, the power is a recognition of the reality presented by many unexpected-circumstances cases and must be exercised within the general framework of the parties' enterprise.

Indeed, an ex post approach to unexpected-circumstances cases is not necessarily inconsistent with an ex ante approach. If contracting parties had addressed the problem of unexpected circumstances ex ante, they might very well have agreed that if unexpected circumstances arise that justify judicial relief, the court should resolve the issue in the fairest possible way taking all relevant considerations into account, rather than specifying the outcome under every possible contingency. A comparable approach was adopted by the parties in *Ocean Tramp Tankers Corp. v. V/O Sovfracht [The Eugenia]*,⁷⁹ another Suez Canal case. The charter in this case was negotiated at a time when "the agents of both sides realised that there was a risk that the Suez Canal might be closed, and each agent suggested terms to meet the possibility. But they came to no agreement, and in the end they concluded the bargain . . . without any express clause to deal with the matter. That meant that, if the canal were to be closed, they would 'leave it to the lawyers to sort out.'"⁸⁰

One type of case in which ex post considerations should be taken into account arises where the unexpected circumstance makes a seller's performance valueless to the buyer but simultaneously creates an opportunity for the seller to make an equivalent profit on another contract that could only be made because the unexpected circumstance had occurred. For example, in *Krell v. Henry*⁸¹ the cancellation of the coronation made the contract valueless to Henry, the lessee. However, after the original coronation was canceled, a new coronation procession was scheduled, which took place

79 [1964] 2 Q.B. 226 (1963).

80 *Id.* at 234 (opinion of Lord Denning).

81 [1903] 2 K.B. 740 (1903).

along the same route. As a result, the lessor had the opportunity to make an equivalent profit, which he could only make because the original procession had been canceled. An appropriate disposition of *Krell v. Henry* would take that ex post consideration into account.

112 Another type of case in which ex post considerations should be taken into account arises where an unexpected circumstance makes it more expensive for a seller to perform the contract at issue but simultaneously increases the profits that the seller will make on other contracts. *Missouri Public Service Co. v. Peabody Coal Co.*⁸² is a good example. Missouri Public Service, a public-utility company, entered into a ten-year contract with Peabody Coal under which Peabody agreed to supply the coal that Missouri Public Service would require at a new coal-burning power plant, at a base price of \$5.40 per net ton. The base price was subject to both specific price-adjustment provisions for changes in designated costs and a general inflation-escalator provision based on the Industrial Commodities Index.

113 Performance under the contract was profitable for Peabody during the first two years. Thereafter, Peabody's production costs began to outpace the price-adjustment and inflation-escalator provisions, and in 1974 Peabody requested modification of the latter provision. For the most part, Public Service rejected Peabody's request. Peabody thereupon threatened to stop shipping coal, and Public Service sued for specific performance. Peabody defended on the ground that it was suffering excessive economic loss under the contract because although the Industrial Commodities Index had been an accurate measure of inflation in the years prior to the contract, it had ceased to be an effective measure due to the 1973 oil embargo, runaway inflation, and the enactment of costly new mine-safety regulations. In response, Public Service showed that since performance of the contract had begun, Peabody had experienced an approximate three-fold increase in the value of its coal reserves, presumably brought about by the same causes that resulted in losses to Peabody under its contract with Public Service. The court awarded specific performance, relying in part on that ex post consideration:

[A] claim made by Peabody alleged to bring it within the doctrine of "commercial impracticability", is the Arab oil embargo. . . . Peabody failed to demonstrate that this embargo affected its ability to secure oil or petroleum prod-

82 583 S.W.2d 721 (Mo. Ct. App. 1979).

ucts necessary to its mining production albeit at inflated cost. In fact . . . this embargo can reasonably be said to have, at least indirectly, contributed to the marked appreciation to the value of Peabody's coal reserves by forcing the market value of that alternative source of energy upward in this country.⁸³

In the two categories of cases just discussed, ex post considerations either support complete judicial relief, as in *Krell v. Henry*, or militate against any judicial relief, as in *Peabody*. In some cases, however, ex post considerations suggest an adjustment of the contract. For example, in *City of Vernon v. City of Los Angeles*,⁸⁴ the cities of Los Angeles and Vernon had contracts under which Los Angeles agreed to dispose of Vernon's sewage. As a result of a lawsuit brought by the State of California, Los Angeles had to build expensive new processing facilities for the sewage that flowed through its system. Los Angeles asked Vernon to shoulder its proportionate share of the cost of the new facilities. Vernon refused, and Los Angeles claimed that it was excused from further performance of the contracts because of the greatly increased costs of processing sewage due to the need for the new facilities. The court held that Los Angeles was excused for the most part but that "certain described 'facilities and rights' created under the contracts (such as the gauging stations and relief sewer provided for by [one of the contracts] can and should be salvaged."⁸⁵

The power of the courts to take ex post considerations into account is supported by other authorities as well. For example, in *M. Ahern Co. v. John Bowen Co.*,⁸⁶ the court rejected the concept that recovery for work furnished on a project was based on ex ante implication from the contract, and held instead that whether such a recovery should be granted depends "in each case in accordance with what the court holds to be fair and just in the unanticipated circumstances."⁸⁷ Similarly, *Restatement (Second) §272(2)* provides that if the rules concerning impracticability and frustration, together with the rules on remedies, "will not avoid injustice, the court may

83 *Id.* at 728.

84 *Vernon v. Los Angeles*, 290 P.2d 841, 847 (Cal. 1955).

85 *Id.* at 847.

86 133 N.E.2d 484 (Mass. 1956).

87 *Id.* at 486. See also *Turner Entertainment Co. v. Degeto Film GmbH*, 25 F.2d 1512 (11th Cir. 1994).

grant relief on such terms as justice requires.” To the same effect is Official Comment 6 to UCC § 2–615, which provides that “[i]n situations in which neither sense nor justice is served by either answer when the issue is posed in flat terms of ‘excuse’ or ‘no excuse’ [in unexpected-circumstances cases]’ adjustment under the various provisions of this Article is necessary.”

5. CONCLUSION

116 Three fundamental concepts underlie the set of principles that should govern unexpected-circumstances cases: a contract consists not only of the writing in which it is partly embodied but also includes, among other things, certain kinds of tacit assumptions; these assumptions may be either event-centered or magnitude-centered; and the problems presented by unexpected-circumstances cases should be viewed in significant part through a remedial lens.

117 The principles that rest on these concepts involve two tests for judicial relief, a repertoire of remedies, and judicial power to take ex post considerations into account. Putting aside certain qualifications, these principles can be summarized as follows.

118 Under the shared-assumption test, a shared nonevaluative tacit assumption that a given circumstance will either persist, occur, or not occur during the contract time should provide a basis for judicial relief where the assumption would have affected the promisor’s obligations if it had been made explicit. Normally, the same remedial treatment should be given where a tacit assumption fails as where a counterpart explicit assumption would have failed. Very often, perhaps typically, in such cases, if the parties had addressed the relevant circumstance ex ante they would have treated the occurrence of the relevant circumstance as a condition to the promisor’s obligation to perform. If an assumption takes the form of an express condition, normally neither party would have a right to damages for nonfulfillment of a condition, because both parties take the risk of nonfulfillment of an express condition.

119 Accordingly, if the shared-assumption test is applicable and the promisor was neither at fault for the occurrence of the unexpected circumstance nor in control of the conditions that led to the occurrence, she should not be liable for expectation damages. The promisor should, however, be liable

for restitutionary damages, because it would be unjust to allow the promisor both to be excused from performance and to retain any benefits that she received under the contract. Even in the absence of a conventional benefit conferred by the promisee, the promisor should be liable for reliance damages where the promisor is at fault for the creation of the unexpected circumstance but the fault is minor, where the promisor is in control of the conditions that led to the occurrence of the unexpected circumstance, and in frustration cases in which an objective of the contract was to induce the promisee to incur out-of-pocket or opportunity costs because the promisor wanted to reserve the promisee's time, labor, or productive capacity.

Under the alternative bounded-risk test, a seller should be entitled to judicial relief if as a result of a dramatic and unexpected rise in costs, performance would result in a financial loss that is significantly greater than the risk of loss that the parties would reasonably have expected the seller had undertaken. If the buyer's value for, and the market value of, the contracted-for commodity have risen in tandem with the seller's costs, the buyer should be entitled to modified expectation damages, equal to the profit the buyer would have made if a historically based increase in the seller's cost of performance, and a corresponding increase in the market value of the commodity, had occurred.

Finally, in appropriate unexpected-circumstances cases, courts should take into account *ex post* considerations—that is, gains and losses to both parties that either arose under the contract prior to the occurrence of the unexpected circumstance or proximately resulted from, or were made possible by, the occurrence. One type of case in which *ex post* considerations should be taken into account arises where the unexpected circumstance makes a seller's performance valueless to the buyer but simultaneously creates an opportunity for the seller to make an equivalent profit on a substitute contract. Another such case arises where the unexpected circumstance makes it more expensive for a seller to perform the contract at issue but simultaneously increases the profits that the seller will make on other transactions. In these two categories, *ex post* considerations either support complete judicial relief or militate against any judicial relief. In some cases, perhaps rare, *ex post* considerations may suggest that the contract be judicially adjusted.

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