

# THE CASE AGAINST COMPENSATION IN CONSUMER CONTRACTS

*Robert E. Scott\**

## *I. Introduction*

- Compensation is the governing principle in contract law remedies. The principle shapes the doctrines that specify the consequences of breach, particularly the default rules providing for expectation damages.
- Yet, the compensation principle has tenuous historical, economic and empirical support, and compensation plays little role in the contracts between commercial parties and consumers.
- A consumer buyer's right to walk away from an executory contract (i.e., to breach) is a subset of a family of termination rights that serve important risk management functions.
- Where a buyer can terminate her obligation to purchase a good, she effectively holds a call option on the good defined by an option price and an exercise price. The option price is the buyer's sunk investment, which may be specified in the contract as a nonrefundable deposit or as a termination fee *or may be specified in the form of the legal default rule that determines prospective damages liability*. The exercise price is the additional sum needed to acquire the good.
- Sellers often sell insurance to their buyers in the form of these *embedded options*. In light of the heterogeneity among optimal option prices, I make the case against having an expectation damages default rule to begin with. Instead, in the case of consumer buyers,

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\* Alfred McCormack Professor of Law, Columbia Law School.

I propose that parties be induced to agree explicitly with respect to all termination rights, including breach damages, by a default rule that provides consumer buyers a termination option at no cost.

## ***II. Historical Roots of Compensation in Contract Remedies***

- Although now firmly entrenched in contract doctrine, the contemporary understanding of the compensation principle is a recent development in contract law. Well into the 19<sup>th</sup> century, contract enforcement was heterogeneous: The common law courts provided separate remedies for discrete contracting categories.
- Beginning in the 19<sup>th</sup> century, however, the courts began to collapse these categories under an expanding compensation principle that they had adopted from tort law. Thereafter, the compensation notion gradually mutated to include full expectancy damages and this broad conception of compensation spread to each of the previously discrete transactions.
- The dominance of the compensation principle is now unquestioned, but an examination of its historical roots suggests that the elevation of compensation to a universally applicable norm results more from path dependence than from a sustained and systematic appreciation of the merits of the rules governing contract damages.

## ***III. Consumer Termination Practices***

- The irrelevance of compensation is reflected in the patterns of consumer contracts in practice. These contracts reveal systematic attempts to contract away from the compensation principle, with varying degrees of success.
- Options to return goods without charge are frequently given to buyers for free. Such

“free” options are remarkably common in both commercial and consumer contracts. They are particularly interesting because these contracts make no attempt to compensate the seller for losses it suffers when the buyer walks away from the contemplated exchange. These return options provide free insurance to buyers.

- The parties are more likely to agree to embedded options and at lower option prices where the seller has superior ability to bear exogenous risks and enjoys private information about and control over the contract good (and where the buyer has relatively little control). One might think of the Circuit City return policy -- free return within 30 days, no questions asked-- as a salient example.
- Given the heterogeneity of sellers, buyers and the subject matter of exchanges, the “price” of these termination options vary widely. These prices can be expected to deviate greatly from the compensation that matters in contract damages: the amount necessary to put the seller in the position she would have been in if the exchange were completed.

#### ***IV. The Lost Volume Seller—A Case in Point***

- The theory of embedded options implies that optimal contract damages have little to do with compensation. Moreover, optimal damages are as context dependent as the price of goods in sales contracts. Therefore, the wisdom of having any default in consumer cases needs to be reconsidered.
- Consider the paradigmatic lost volume case in which the buyer’s termination deprives the seller of a sale, so that the seller’s economic loss may systematically exceed market damages.
- In these cases, scholarly debate has focused on how much of the seller’s selling costs or

overhead were “consumed” by the breaching buyer and whether the default measure of damages ought to be the full profit lost by the seller (which may be overcompensatory) or incidental damages (which may be undercompensatory).

- The focus on lost volume and selling costs is a red herring. Whether a given volume seller would have chosen to write an option to a buyer and at what price the option would be offered simply cannot be determined a priori. And, in any event, the termination provision is unlikely to have much to do with compensating the seller for the lost sale.
- Given that merchant sellers typically draft consumer contracts, the legal rule should focus the incentive on the seller, the drafter of the contract, to bargain explicitly for termination options. I propose, therefore, that absent an agreement respecting termination rights, the courts give consumer buyers free options: the right to walk away from the executory exchange, but to specifically hold the merchant seller to the deal.
- The free option consumer default is similar to the indefiniteness rule that courts apply when parties fail to provide a contract price for services for which there is no established market price. The indefiniteness rule might be understood as a kind of global bargain-forcing default, one that uses the threat of non-enforceability to encourage parties to specify the solution to certain contingencies themselves.
- This solution also resembles the proposals for “asymmetric paternalism” suggested by behavioral law and economics scholars. These proposals argue for a “penalty default” on the merchant seller in circumstances where consumers choices are likely to be impaired by cognitive biases. The merchant is thus induced to make the termination policy salient to the consumer, much as the price of the goods themselves is made salient.