

COMMENTS

OUTGROWING IMPOSSIBILITY: EXAMINING THE IMPOSSIBILITY DOCTRINE IN THE WAKE OF HURRICANE KATRINA

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[E]ach party to a contract has notice that the other will understand his words according to the usage of the normal speaker of English under the circumstances, and therefore cannot complain if his words are taken in that sense.¹

INTRODUCTION

This classic Holmesian statement of the formalist theory of contract interpretation begs several questions. This Comment will tackle just one: how is silence interpreted according to “the usage of a normal speaker of English”? Is silence to be interpreted as an assumption of risk by one party, or carelessness that the judiciary must fix? Is silence active or passive, aware or negligent, in the English language? The doctrine of impossibility requires the judicial system to answer these questions when performance under a contract is rendered impossible by an event that the contract did not address; the cost of the impossibility is allocated based on this *ex post* interpretation.²

This Comment describes a fundamental problem with the contract doctrine of impossibility: it is no longer well suited to address precisely the type of problems that it was created to solve. Unfortunately, it has taken the occurrence of several terrifyingly destructive events—Hurricane Andrew in 1992,³ the Northridge Earthquake in 1994,⁴ the September 11 attacks in 2001, and most recently Hurricane Katrina in 2005⁵—to highlight the problems of dealing with risk allocation *ex post*, as the contract doctrine of impossibility proposes.⁶

There is potential for an enormous silver lining in the tragedy of Katrina: The Gulf Coast, and the nation as a whole, must seize the opportunity to assess its choices, rethink its safety nets, and develop plans to manage risk and limit

¹ Oliver Wendell Holmes, *The Theory of Legal Interpretation*, 12 HARV. L. REV. 417, 419 (1899).

² The “impossibility-of-performance doctrine” is “[t]he principle that a party may be released from a contract on the ground that uncontrollable circumstances have rendered performance impossible.” BLACK’S LAW DICTIONARY 772 (8th ed. 2004).

³ Prior to Hurricane Katrina, Hurricane Andrew in 1992 was the most expensive natural disaster in U.S. history, costing nearly \$25 billion in today’s dollars. *See, e.g.*, Theo Francis, *Hurricane Katrina’s Toll: Insured Losses Could Reach Up to \$26 Billion*, WALL ST. J., Aug. 30, 2005, at A2.

⁴ *See, e.g.*, David M. Cutler & Richard J. Zeckhauser, *Reinsurance for Catastrophes and Cataclysms*, in THE FINANCING OF CATASTROPHE RISK 233, 239 (Kenneth A. Froot ed., 1999).

⁵ *See, e.g.*, FRANCES FRAGOS TOWNSEND ET AL., THE FEDERAL RESPONSE TO HURRICANE KATRINA: LESSONS LEARNED 1–2 (2006), <http://www.whitehouse.gov/reports/katrina-lessons-learned.pdf>.

⁶ *See infra* Part II (discussing the nature of the analyses implicated by the U.C.C. and the superior risk bearer tests).

future loss. This Comment proposes that these assessments should focus on insurance law, rather than contract law, as the vehicle for efficient risk allocation and management.⁷

Part I traces the development of the impossibility doctrine from its origins in Roman Civil Law all the way to its modern expressions. Part II focuses on the Uniform Commercial Code (U.C.C.) and the superior risk bearer models, examining their particular methods and assumptions outside the historical context. In Part III, the theories developed in Part II are applied to a hypothetical Katrina-affected contract. In applying those theories, this Comment critiques the theories as well. Part IV describes how insurance law may offer solutions to the problems encountered in the application of traditional contract law doctrines. Finally, this Comment offers conclusions relating the critiques set forth in Part III and the proposal described in Part IV.

I. THE HISTORY OF THE IMPOSSIBILITY DOCTRINE

Contracts may be understood, in a very basic way, as risk allocation devices.⁸ A perfect contract allocates all risks in an efficient manner.⁹ However, when parties fail to allocate all risks of nonperformance in their contract, and an unforeseen situation affecting timely performance arises, the doctrine of impossibility, later codified under the heading of commercial impracticability in the U.C.C.,¹⁰ may come into play. To best understand how Katrina-affected contracts are treated—and how they *ought* to be treated—this Comment will pursue a brief survey of how contract law has traditionally handled risk allocation and unforeseen circumstances.

⁷ See *infra* Part IV (proposing state insurance and reinsurance regimes similar to those in Florida and California).

⁸ See Gerhard Wagner, *In Defense of the Impossibility Defense*, 27 *LOY. U. CHI. L.J.* 55, 61 (1995). If the exchange contemplated in the contract could be effectuated immediately, a contract would be unnecessary. However, since not all performance is immediate, and in fact, parties often desire for performance to occur in the future, contracts are required to allocate the risks that time inevitably creates. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 105 (6th ed. 2002).

⁹ Wagner, *supra* note 8, at 61. Efficiency is most commonly understood by reference to the Kaldor-Hicks model which states that “a move is efficient whenever the winners win more than the losers lose, [and] if the winners compensated the losers to their satisfaction, the winners would still be better off than they were before the [transaction].” Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 *YALE L.J.* 1211, 1221 (1991) (describing Kaldor-Hicks or Potential Pareto Superiority).

¹⁰ U.C.C. § 2-615 (1998).

A. *Roman Civil Law and the Doctrine of Impossibility*

Problems relating to unallocated risk have plagued the interpretation of contracts since people began forging agreements for the purpose of mutual benefit. Indeed, analyses of Roman civil law indicate that this sort of problem arose frequently.¹¹

The most common form of unallocated risk occurred in the context of personal performance contracts. In these cases, only a certain individual—or a certain class of individuals—could perform the service described in the contract.¹² When death, disability, or some other unforeseen circumstance prevented the personal performance envisioned by the contract, the parties were left to grapple with the consequences of incomplete risk allocation.¹³ In response to these cases, courts developed a method of interpretation to deal with the class of contractual obligations—*obligatio de certo corpore*¹⁴—that required personal performance.¹⁵ In cases where an obligation of this class exists, the promisor is excused from performance when the object of the contract “has perished, neither by his act, nor his neglect, and before he is in default, unless by some stipulation he has taken on himself the risk of the particular misfortune which has occurred.”¹⁶ Thus, civil law allowed for a very narrow impossibility defense. The promisor was excused from performance only when the object of the contract was a living thing that had ceased to exist at the time of performance.

B. *Impossibility in British and Early American Common Law*

Building on Roman civil law, British common law expanded the scope of the impossibility defense to cover all manner of contracts, including those outside the *obligatio de certo corpore* class. This expansion came at the expense of the positivist notion of contracts, which finds an absolute obligation

¹¹ See, e.g., *Taylor v. Caldwell*, 122 Eng. Rep. 309 (K.B. 1863); *Paradine v. Jane*, 82 Eng. Rep. 897 (K.B. 1647).

¹² According to Judge Blackburn’s summary of relevant civil law in *Taylor*, these contracts often involved the sale of slaves. *Taylor*, 122 Eng. Rep. at 312–13. When the slave died before the transaction was completed, performance became impossible and was subsequently excused. *Id.* at 313.

¹³ *Id.*

¹⁴ *Id.* at 312.

¹⁵ *Id.* at 313.

¹⁶ *Id.* (discussing Pothier’s treaty on obligations under civil law).

of performance absent an express allocation of risk to the contrary.¹⁷ The positivist approach was famously articulated in *Paradine v. Jane*, in which an English court found that the promisor's performance—in the form of rent—was not excused despite the fact that the promisor had been exiled from the rental property as the result of war.¹⁸ The court noted that “when the party by his own contract creates a duty or charge upon himself, he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, because he might have provided against it by his contract.”¹⁹

However, even in this hard-line approach, we can detect an early form of the modern impossibility doctrine. In the above language, the court stipulated that performance is required only if it is possible.²⁰ A similarly narrow interpretation of the impossibility doctrine appears over a century later in *Steers v. Leonard*.²¹ There, the Minnesota court was unwilling to excuse performance of a construction contract despite several failed attempts at constructing the contemplated structure.²² As in the *Paradine* decision, the availability of the impossibility defense was not completely foreclosed but rather limited: “If a man bind himself, by a positive, express contract, to do an act in itself possible, he must perform his engagement, *unless prevented by the act of God, the law, or the other party to the contract.*”²³

It should be noted that in the context of British and early American common law, excuse of performance is equivalent to excuse from liability.²⁴ If the promisor is excused from performance by reason of impossibility, he is not only freed from his specific contractual obligation, but also from his obligation to pay any typical breach damages to the promisee.²⁵

¹⁷ *Id.*; see also GRANT GILMORE, *THE DEATH OF CONTRACT* 80 (1974). But *c.f. infra* Part II.A (some commentators see modern iterations of the doctrine of impossibility returning to positivist notions embodied in the Roman civil law and early British decisions).

¹⁸ 82 Eng. Rep. 897, 897 (K.B. 1647).

¹⁹ *Id.* The court contrasts the duties imposed by law with the duties assumed via contract; the former are more leniently enforced because they are *not* assumed voluntarily. *Id.* at 897–98.

²⁰ The *Paradine* court required performance of the promisor only “if he may.” *Id.* at 897 (emphasis added). In this case, performance was possible since exile did not affect the promisor's ability to pay his dues to his landlord. *Id.*

²¹ 20 Minn. 494 (1874).

²² *Id.* at 506–08. The Court cited a series of contemporary decisions holding builders to their performance requirements despite accidental casualties suffered in the building process. *Id.* at 503–06.

²³ *Id.* (emphasis added). For an example of a contract in which performance was excused based on this narrow definition of impossibility, see *Howell v. Coupland*, in which a potato farmer was excused from delivering his crop because of a disease that destroyed it. 1 Q.B.D. 258 (1876).

²⁴ See ROBERT E. SCOTT & JODY S. KRAUS, *CONTRACT LAW AND THEORY* 835 (3d ed. 2002).

²⁵ *Id.*

C. *Modern Iterations of the Impossibility Doctrine*

One might argue that the early forms of the impossibility doctrine²⁶ are not motivated by economic concerns but rather by assumed limitations in the court's ability to enforce contracts under which performance is impossible.²⁷ In contrast, the impossibility doctrine in its modern form is motivated by "the challenge of interpreting parties' agreements: The fundamental question . . . is whether the parties (explicitly or implicitly) allocated the risk of the contingency that has materialized, irrespective of whether it makes performance impossible."²⁸ Rather than determining whether performance is completely impossible, courts focus on whether the difficulty of performance was contemplated by the parties during the negotiation of the contract.²⁹ When the promisee appears to be the bearer of the risk, courts read the contract to include an implied condition the occurrence of which excuses the promisor's performance.³⁰ In contrast, when the promisor appears to have borne the risk of the unexpected event, his performance is not excused.³¹

According to Professor Charny, the modern doctrine of impossibility places the judge in the position of "construct[ing] a 'hypothetical bargain'" between the parties to the original contract.³² He noted that judges face several options in constructing these bargains: will they consider the parties narrowly or broadly? What kind of preferences will each party to the hypothetical bargain have?³³ At the very least, this analysis of modern impossibility suggests that the judiciary has carved out for itself a much larger role in interpreting contracts than it once had when it was applying bright-line positivist theory. Many legal scholars have expressed frustration at the arbitrary decisions that this increased judicial involvement has occasioned.³⁴

²⁶ See *supra* Parts I.A–B.

²⁷ See SCOTT & KRAUS, *supra* note 24, at 835.

²⁸ *Id.*

²⁹ See Aaron J. Wright, Note, *Rendered Impracticable: Behavioral Economics and the Impracticability Doctrine*, 26 CARDOZO L. REV. 2183, 2198–99 (2005).

³⁰ *Id.* at 2188. The promisor is not forced to pay damages because a successful impossibility defense means that his failure to perform does not constitute a breach of contract. *Id.*

³¹ This approach has been codified. See RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981); see also § 262 (providing for use of the impossibility defense in contracts involving personal performance).

³² See David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1815–16 (1991).

³³ *Id.* at 1816–17.

³⁴ See, e.g., Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 84 (1977) ("Conventional legal scholars who have dealt with the discharge cases have indicated a pervasive dissatisfaction with the prevailing doctrinal articulations.").

Like the common law, the U.C.C.'s version of the doctrine of impossibility, found in section 2-615 under the heading of "Excuse by Failure of Presupposed Condition,"³⁵ also provides plenty of room for judicial interpretation.³⁶ The comments accompanying section 2-615, as well as the case law following it, indicate a much expanded scope of applicability as compared with the very limited range of cases indicated by *Paradine* and *Steels*.³⁷ For example, increased cost of performance is not totally precluded as a basis for excusing performance.³⁸ This flexibility indicates a more nuanced understanding of the economic consequences of the impossibility doctrine. The U.C.C., like the Second Restatement of Contracts and modern common law, recognizes that a somewhat expanded impossibility defense may increase contractual efficiency.

The modern versions of the impossibility doctrine, as they appear in contemporary case law, the Second Restatement of Contracts, and the U.C.C., are, for purposes of this Comment, synonymous.³⁹ They expand the original scope of the doctrine by widening the class of cases to which it may apply. The modern impossibility doctrine avails itself in cases where performance is not necessarily impossible but economically inefficient.

II. MODERN THEORIES OF IMPOSSIBILITY: THE U.C.C. AND SUPERIOR RISK BEARER TESTS

Two distinct models of impossibility have emerged in the modern case law and scholarly literature. While both of these models represent a general expansion of the doctrine of impossibility, they employ different tests and thus merit separate consideration.⁴⁰ On one side of the debate are the U.C.C. drafters and proponents, who hinge their theory of impossibility on a

³⁵ Section 2-615, in relevant part, reads: "Delay in delivery or non delivery . . . is not a breach of [seller's] duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the nonoccurrence of which was a basic assumption on which the contract was made . . ." U.C.C. §2-615(a) (1998).

³⁶ Professor Gilmore laments this judicial involvement: "With such magnificently open-ended drafting we need not fear that the further development of the law will be in any way inhibited." GILMORE, *supra* note 17, at 83.

³⁷ See *supra* Part I.B.

³⁸ U.C.C. § 2-615 cmt. 4.

³⁹ Many scholarly works on the topic of impossibility use "impossibility" and "impracticability" interchangeably. See, e.g., Posner & Rosenfield, *supra* note 34, at 83.

⁴⁰ To be sure, there are significant overlaps between the two models. These overlaps are reflected in the similar criticisms leveled at each model. Compare *supra* Part III.A.5, with *supra* Part B.4.

determination of foreseeability.⁴¹ Judge Posner and his law and economics colleagues provide an alternative approach in the form of the superior risk bearer model.⁴² This model, rather than seeking to divine what was in the minds of the parties to the contract at the time of negotiation, assigns the costs associated with performance or nonperformance to the party who was the superior risk bearer at the time the contract was executed.⁴³

Evaluation of modern legal models often occurs in the context of efficiency considerations: A good model achieves efficient results.⁴⁴ This type of analysis is nowhere more common, or more appropriate, than in the area of contract law.⁴⁵ Accordingly, this Comment will examine the two major schools of thought on the impossibility doctrine in this context.⁴⁶

A. *The U.C.C. Section 2-615 Commercial Impracticability Model*

The U.C.C.'s theory of impracticability turns on a determination of foreseeability.⁴⁷ Performance is excused only when the circumstances making performance impossible or impracticable were unforeseeable, and the risk of the occurrence of those circumstances was not specifically allocated by the contract.⁴⁸ This formulation requires the court to assess whether the parties *should* have allocated the risk of the event that rendered performance impracticable.⁴⁹ If the risk was foreseeable, meaning the parties should have contemplated it in the process of negotiation, the contract will be read to have allocated the risk to the seller, and performance will not be excused.⁵⁰ If

⁴¹ See *infra* Parts II.A, III.A.2.

⁴² See *infra* Parts II.B, III.B.

⁴³ See *infra* Parts II.B, III.B.

⁴⁴ Posner & Rosenfield, *supra* note 34, at 88–89.

⁴⁵ Posner and Rosenfield posit that this is the case because efficiency is more important in the contracts context. If contract rules are inefficient, it is likely that parties will bargain specifically around them. *Id.* at 89; see also *supra* note 9 (defining Kaldor-Hicks efficiency).

⁴⁶ See Paul L. Joskow, *Commercial Impossibility, the Uranium Market and the Westinghouse Case*, 6 J. LEGAL STUD. 119, 153 (1977).

⁴⁷ See, e.g., Wright, *supra* note 29, at 2198–99 (noting that the foreseeability test in the U.C.C. formulation of impossibility resembles a contemplation doctrine that “forc[es] the judiciary ex post to make a determination of the future occurrences parties should have reasonably included in their contract negotiations”). But see *Transatlantic Fin. Corp. v. United States*, 363 F.2d 312, 315 (D.C. Cir. 1966) (“The doctrine of impossibility of performance has gradually been freed from the earlier fiction and unrealistic strictures of such tests as the ‘implied term’ and the parties’ ‘contemplation.’”).

⁴⁸ U.C.C. § 2-615 (1998).

⁴⁹ See § 2-615 cmt. 8.

⁵⁰ See, e.g., *United States v. Wegematic Corp.*, 360 F.2d 674, 676 (2d Cir. 1966) (holding that where a seller promised to furnish the buyer with a “revolutionary breakthrough” in the form of an electronics system, the seller assumed the risk that a revolutionary breakthrough would in fact not occur).

specific performance is impossible, the seller will be forced to pay breach damages.⁵¹ On the other hand, if the risk is deemed unforeseeable, the seller will be excused from performance.⁵² An interesting quirk of the U.C.C. version of impracticability is that it is only available to sellers of goods.⁵³

Paul Joskow, one of the lead proponents of the U.C.C. approach, describes it as a “weaker” doctrine of impracticability as compared to the original version announced in *Paradine*,⁵⁴ but he defends this relaxation as appropriate given the nature of modern commercial transactions.⁵⁵ In Joskow’s view, the U.C.C. rule provides incentives for parties to acquire and incorporate information into their contracts at a reasonable level while ensuring that in truly extreme situations, contracts will be discharged.⁵⁶ This approach provides contracting parties with a reasonable set of default rules that they may rely on:

It may facilitate the contracting process, however, if it is understood or implied in the contract that when [catastrophic and unforeseeable] events . . . 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. If parties wanted to provide otherwise, they could write it into the contract explicitly. The key to such a rule of discharge working well is to provide an appropriate and well understood list of occurrences and an

⁵¹ See *id.* at 676 (in which the contract included a provision authorizing the buyer to collect liquidated damages in the case of nonperformance).

⁵² *Id.*

⁵³ The U.C.C. by definition only applies to contracts relating to the sale of goods; it does not cover the provision of services. However, it is unclear why the impracticability defense is unavailable to the buyer; this is in contrast to the common law approach that makes the impossibility defense available to all parties, regardless of their status. Posner and Rosenfield speculate that the U.C.C.’s limited impracticability doctrine resulted from “a cautious reaction . . . to the then undecided state of the common law with regard to buyers’ claims of impossibility.” Posner & Rosenfield, *supra* note 34, at 109. But see Benjamin N. Henszey, *UCC Section 2-615—Does “Impracticable” Mean Impossible?*, 10 UCC L.J. 107, 108 n.4 (1977) (explaining that comment 9 to U.C.C. § 2-615 indicates that the impracticability defense is also available to buyers).

⁵⁴ Joskow, *supra* note 46, at 153 (proclaiming that this “weaker” form of the original impossibility doctrine “was largely an effort to give *force majeure* [sic] relief to small businessmen who were not well represented and did not have the proper exemption clauses written into their contracts”) (citing William D. Hawkland, *The Energy Crisis and § 2-615 of the Uniform Commercial Code*, 70 COM. L.J. 75, 77 (1974)).

⁵⁵ *Id.*; *accord* *Transatlantic Fin. Corp. v. United States*, 363 F.2d 312, 315 (D.C. Cir. 1966) (“The doctrine ultimately represents the ever-shifting line, drawn by courts hopefully responsive to commercial practices and mores . . .”); *Wegematic*, 360 F.2d at 677 (“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.”).

⁵⁶ Joskow, *supra* note 46, at 154.

appropriate and well-defined standard for calculating what a dramatic increase in cost is.⁵⁷

There are other commentators, however, who view the U.C.C. approach as not nearly so moderate—especially in light of how the U.C.C. case law has developed.⁵⁸ Some courts have treated the question of impracticability very narrowly.⁵⁹ Richard Duesenberg contends that the trend the courts have set indicates that parties should follow a simple rule when deciding whether to rely on the availability of an impracticability defense: “Do not count on it.”⁶⁰

B. *The Superior Risk Bearer Model*

This model, developed by Judge Posner and Andrew Rosenfield, and widely adopted in law and economics circles, asks what the parties *could* have done—not what they *would* have done—to anticipate and prepare for the event that made performance impossible or impracticable.⁶¹

The superior risk bearer, according to Posner and Rosenfield, is the party to the contract who is the “more efficient bearer of the particular risk in question, in the particular circumstances of the transaction.”⁶² To determine which party is the superior risk bearer, Posner and Rosenfield ask two general questions: First, was either party in a position to prevent the occurrence of the event triggering the impracticability defense?⁶³ Second, was either party in a better position to insure against the risk?⁶⁴ The cost of insurance is based on two factors: (1) the cost of measuring the risk and (2) the transaction costs associated with insuring the risk.⁶⁵ The first step in insuring against a risk,

⁵⁷ *Id.*

⁵⁸ *See, e.g.,* Richard W. Duesenberg, *Sales, Bulk Transfers, and Documents of Title*, 31 BUS. LAW 1533 (1976); Henszey, *supra* note 53, at 108.

⁵⁹ These narrow interpretations appear in two variations. Some courts interpret foreseeability very narrowly, such that almost any condition is foreseeable and thus outside the scope of U.C.C. section 2-615. *See, e.g., Transatlantic*, 363 F.2d at 318–20 (holding that the risk of closure of the Suez Canal was foreseeable and that the seller appeared to have assumed the risk). Another variation arises when courts question the actual burden caused by the occurrence of a problematic condition. *See, e.g., Eastern Airlines, Inc. v. Gulf Oil Corp.*, 415 F. Supp. 429, 441 (1975) (holding that Gulf failed to prove how a change in oil prices negatively impacted its operations: “Under no theory of law can it be held that Gulf is guaranteed preservation of its intra-company profits The burden is upon Gulf to show what its real costs are, not its ‘costs’ inflated by its internal profits . . .”).

⁶⁰ Duesenberg, *supra* note 58, at 1552.

⁶¹ Posner & Rosenfield, *supra* note 34, at 90.

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *Id.* at 91.

namely measuring it, requires the party to assess both the magnitude and the probability of the risk.⁶⁶ The second part of the insurance cost calculation relates to transaction costs incidental to acquiring insurance.⁶⁷ Parties have two choices in seeking insurance: They may self-insure by pooling similar risks from a number of contracts, or they may seek private market insurance.⁶⁸ Thus, the superior risk bearer may be described in two distinct ways:⁶⁹ (1) the party that is in a position to prevent the risk from materializing,⁷⁰ or (2) the party who is best able to insure against the risk by determining the dimensions of the risk at a low cost and pooling that risk efficiently.⁷¹

This model will not allow the superior risk bearer to discharge the contract.⁷² On the other hand, if the superior risk bearer is seeking to enforce the contract against the other party, the court will discharge the other party from its obligations.⁷³ Where both parties are equally well suited (or poorly suited) to bear the risk that materialized, Posner and Rosenfield preach a tough-love approach: enforce the contract.⁷⁴ The theoretical grounds for this decision are unclear,⁷⁵ but the conclusion may be supported by interpreting the superior risk bearer model as one that favors contract enforcement on autonomy or welfare-enhancing grounds or both.⁷⁶

⁶⁶ It is not difficult to imagine scenarios where a party may have information about the magnitude of a risk but remains unable to accurately and efficiently estimate the probability of its occurrence or vice versa. Posner and Rosenfield provide an unsatisfactory solution to this sort of problem: "When the two key parameters of the economic analysis point in opposite directions, the analysis is indeterminate on a general level and must proceed to an estimation of their relative empirical importance." *Id.* at 102; *see infra* Parts III.B.3–4 for a more detailed discussion of this problem.

⁶⁷ Posner & Rosenfield, *supra* note 34, at 91–92.

⁶⁸ *Id.* The larger the amount of similar, but uncorrelated, risks in a given portfolio, the cheaper self-insurance will be. *See id.* For example, a hospital deciding whether to purchase medical malpractice insurance from the market or to self-insure will be more likely to self-insure the greater the number of doctors—and consequently, the number of risks—it has. *See id.*

⁶⁹ *Id.* at 90–92. To be sure, the ideal risk bearer is the party that fits both of the descriptions set forth. However, it is analytically useful to separate the two requirements of this model. *Id.*

⁷⁰ *Id.* at 90.

⁷¹ *Id.* at 90–92. Of course, it may be the case that a party fulfills both of these conditions, thus making it the optimal risk bearer. But, as the case law and Posner's & Rosenfield's hypotheticals illustrate, a party may be deemed the *superior* risk bearer despite not having the comparative advantage in *both* of the categories described. *Id.* at 93–98.

⁷² *Id.* at 90.

⁷³ *Id.* at 92.

⁷⁴ *Id.* at 110–11.

⁷⁵ *Id.*

⁷⁶ The argument for enforcing contracts on autonomy grounds is that independent, rational parties enter into contracts of their own free will. Failure to enforce such contracts would undermine each party's autonomy. *See, e.g.,* CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 2 (1981).

C. *The Information Problem*

Economists and law and economics scholars often make assumptions to develop basic models. Common assumptions include rationality, perfect information, and zero transaction costs.⁷⁷ While making these assumptions is useful in constructing basic models, it is important to understand how these assumptions affect the resulting models and what adjustments might be required to translate models into real-world efficient law.⁷⁸ The recently developed field of behavioral economics, which identifies patterns of human behavior and incorporates those patterns into economic models, has been instrumental in revealing the gaps between imperfect assumptions and reality, particularly with regard to the assumption of rationality.⁷⁹

Neither of the theories of impossibility described above explicitly describes its assumptions regarding the level of information available to contracting parties.⁸⁰ Joskow and U.C.C. supporters prefer to decide ex post how much information was available to the contracting parties via the foreseeability test.⁸¹ As critics have been quick to point out, this type of ex post determination poses serious factual and logical issues.⁸² The superior risk bearer test, while avoiding problems related to ex post judgments, also makes unrealistic assumptions about levels of information.⁸³ Posner and Rosenfield acknowledge that parties may be in a situation where they are equally poorly situated to prevent or insure against risk.⁸⁴ But their solutions—allocating the cost of nonperformance based on “estimation[s] of . . . relative empirical importance” or simply enforcing the contract⁸⁵—are unsatisfactory.

Catastrophic events, such as the September 11 attacks and Hurricane Katrina, highlight the problems with these theories: Reliable information regarding the magnitude and the probability of the risk—elements that are

⁷⁷ ROBIN PAUL MALLOY, *LAW IN A MARKET CONTEXT: AN INTRODUCTION TO MARKET CONCEPTS IN LEGAL REASONING* 27 (2004).

⁷⁸ See generally *id.* at 41–50.

⁷⁹ See Wright, *supra* note 29, at 2203–04 (noting that overoptimism, the confirmation bias, and the hindsight bias all lead people to act irrationally).

⁸⁰ See *supra* Parts II.A–B.

⁸¹ See *infra* Part III.A.2.

⁸² A foreseeability test may encourage parties *not* to allocate risk in the hopes that the court will rule in their favor and discharge their performance if the risk materializes. See *infra* Part III.A.5.

⁸³ See John Eloffson, Note, *The Dilemma of Changed Circumstances in Contract Law: An Economic Analysis of the Foreseeability and Superior Risk Bearer Tests*, 30 COLUM. J.L. & SOC. PROBS. 1, 9–10 (1996).

⁸⁴ See discussion *infra* Part III.B.3.A.

⁸⁵ See Posner & Rosenfield, *supra* note 34, at 102.

important to both tests—was not available to contracting parties.⁸⁶ No terrorist event of September 11's magnitude had occurred in the history of this country, and no hurricane had hit New Orleans with Katrina's force.⁸⁷ How do we determine whether the parties *should* have foreseen the risk, or whether they *could* have insured against it, if there was limited reliable information at the time of contracting? The next Part will examine these questions in detail.⁸⁸

III. CAN MODERN THEORIES BE APPLIED TO MODERN CATASTROPHIC EVENTS?

The answer to the above question is “yes.” Both the U.C.C. and superior risk bearer approaches may be applied to resolve contract issues arising out of the devastation wrought by Hurricane Katrina and other similarly catastrophic events. This Comment evaluates this application, rather than accepting it blindly, and asks whether either of these theories achieves the right results.⁸⁹ If so, do they achieve the correct result while staying true to their tenets, or must they be stretched, contorted, or defiled in the process? For a variety of reasons, neither approach is particularly satisfactory when applied to Katrina-type events.⁹⁰ This Part will analyze each test closely and determine the precise reasons for their respective flaws.

The analysis will proceed in two steps: First, each model will be applied to a hypothetical Katrina-affected contract.⁹¹ Next, this Comment will ask three questions of each model. Are there parts of the model that were difficult to apply?⁹² Did the model require information that would be unavailable to the parties?⁹³ Did the model make assumptions that were inappropriate given the circumstances that gave rise to a claim of impossibility?⁹⁴

⁸⁶ See *infra* Parts III.A.5, B.4.

⁸⁷ In both cases, some might suggest that cues could have been taken from similar earlier events. In the case of September 11, previous bombings of the World Trade Center could have provided local businesses with a sense of the risk of future terrorist attacks. Likewise, Hurricane Camille of 1969 could have provided New Orleans businesses a sense of the risks of a major natural disaster.

⁸⁸ See *infra* Part III (placing these criticisms in the context of a relevant hypothetical).

⁸⁹ This Comment defines the right result by reference to the ultimate goal of efficiency. Thus, the right result is the result that is most efficient (or least inefficient, depending on your perspective). See *supra* text accompanying note 44.

⁹⁰ This Comment measures satisfactoriness in terms of efficiency. For a discussion of why efficiency is an appropriate context in which to evaluate contract law, see *supra* notes 44–46 and accompanying text.

⁹¹ See *generally infra* Parts III.A–B.

⁹² See *infra* Parts III.A.5, B.4.

⁹³ See *infra* Parts III.A.5, B.4.

⁹⁴ See *infra* Parts III.A.5, B.4; see also *supra* Part II.C.

For the purpose of this exercise, let us assume that a New Orleans-based closely held corporation, Cajun Corp., entered into a supply contract with a publicly held non-Gulf Coast firm, X Corp.,⁹⁵ for the provision of widgets. Cajun Corp.'s widget factory was completely destroyed by Hurricane Katrina. All of Cajun Corp.'s employees were forced to flee the Gulf Coast, and their plans for the future are unknown. Although there are other widget manufacturers in the market, Cajun Corp.'s widgets were unique, and thus substitution of alternative widgets would be an inappropriate remedy. Furthermore, X Corp. has indicated that it would be unwilling to accept a shipment of widgets other than widgets made by Cajun Corp.⁹⁶ The contract between Cajun Corp. and X Corp. has no *force majeure* clause, nor does it mention what would occur in the case of a hurricane damaging Cajun Corp.'s facilities.⁹⁷ Finally, Cajun Corp. and X Corp. agreed that their contract would be governed by the common law and statutes of the state in which X Corp.'s primary place of business is located.⁹⁸ After applying the theories to this scenario, this Comment will assess the problems encountered and highlight how several critiques of these theories become especially relevant when the theories are applied to cases of genuine impossibility.

A. *The U.C.C. Approach to Impossibility and Cajun Corp.*

U.C.C. section 2-615 requires a party seeking discharge of a contract to prove that (1) an underlying condition of the contract failed, (2) failure was

⁹⁵ In other words, a firm *not* directly affected by Hurricane Katrina.

⁹⁶ The absence of perfect market substitutes is not as far-fetched a condition as one might think: The \$500 million American shrimp industry suffered just such a situation after Hurricane Katrina. See Cameron McWhirter, *Ailing Shrimpers Dealt a Tough Blow*, ATLANTA J.-CONST., Sept. 6, 2005, at C1. Damaged ships, fleeing shrimpers, and decimated processing plants sent shrimp companies and restaurants searching for imperfect substitutes. See Romina Maurino, *Canadian Firms Assess Impact on Gulf Coast Operations*, OTTAWA CITIZEN, Sept. 3, 2005, at D3 (noting that seafood producer Connors Bros.' Income Fund "has begun alternative sourcing of canned shrimp to meet customer demands"); Randi F. Marshall & Mark Harrington, *Hurricane Sets Fishing Industry Adrift*, NEWSDAY, Sept. 8, 2005, at A46 (describing a New York restaurant owner who is "trying to determine who will provide the high quality she wants but can no longer get").

⁹⁷ *Force majeure* clauses excuse performance when it is rendered impossible by an act of God or some equally uncontrollable event. BLACK'S LAW DICTIONARY 674 (8th ed. 2004). Unfortunately, data on the use of *force majeure* clauses are sparse. See Wagner, *supra* note 8, at 62 (noting that despite a dearth of empirical evidence on the use of *force majeure* clauses, case law indicates that they are common in the commercial arena). Most academic examples involving the impossibility doctrine also omit discussion of *force majeure* clauses for the sake of simplicity. See, e.g., Posner & Rosenfield, *supra* note 34, at 92–95.

⁹⁸ Louisiana is the only state that has not adopted Article 2 of the U.C.C.; instead, Louisiana contracts are governed by the Louisiana Code, which includes a version of the impossibility doctrine that, for purposes of this Comment, does not significantly differ from the U.C.C. version. See LA. CIV. CODE ANN. arts. 1873–78 (2006). This Comment therefore assumes, for simplicity's sake, that the Louisiana Civil Code does not apply.

unforeseeable, (3) the risk of failure was neither contemplated nor allocated by the contract, and (4) performance is impracticable as a result of the failed condition.⁹⁹

In the context of our example, Cajun Corp. would be entitled to a discharge of the contract if it could prove that (1) the nonoccurrence of a Category 3 hurricane impacting the New Orleans area was an underlying condition of the contract with X Corp., (2) the occurrence of Hurricane Katrina was an unforeseeable event, (3) the risks associated with a Category 3 hurricane were neither contemplated nor allocated in the contract, and (4) the occurrence of Hurricane Katrina has made Cajun Corp.'s performance impracticable.¹⁰⁰

1. Nonoccurrence of the Condition Was an Underlying Assumption of the Contract

a. The U.C.C. Test

Analysis of this question strongly implicates the second and third parts of the U.C.C. test, which ask, respectively, whether the occurrence of the condition was foreseeable at the time of the contract and whether the parties allocated the risk of nonoccurrence at the time of contract.¹⁰¹ In other words, to determine whether the parties assumed the nonoccurrence of an event when drafting the contract, we must assess whether they actually contemplated—or should have contemplated—a certain risk. The analysis of the first U.C.C. factor requires circular logic—a problem that will be addressed in detail below.¹⁰²

Case law indicates that there are a significant number of scenarios that satisfy the underlying assumption test.¹⁰³ In the comments to section 2-615, the drafters provide a nonexhaustive list¹⁰⁴ of occurrences that may lead to satisfaction of this requirement:

⁹⁹ See Joskow, *supra* note 46, at 156–59; see also U.C.C. § 2-615(a) (1998). Another condition, implicit in comment five, and noted in Joskow's article, is that the seller must have made all reasonable attempts to assure himself that the source of supply will not fail. § 2-615 cmt. 5; see also Joskow, *supra* note 46, at 161.

¹⁰⁰ § 2-615.

¹⁰¹ Joskow, *supra* note 46, at 156 (“The definition of the appropriate occurrences to fall under this requirement depends primarily on the associate requirements of ‘foreseeability’ and ‘assumption of risk’ which help to define the appropriate boundary.”).

¹⁰² See *infra* Part III.A.5 for elaboration on this point.

¹⁰³ See Joskow, *supra* note 46, at 156.

¹⁰⁴ Much has been made in the scholarship about section 2-615 of the fact that this list is in fact “non-exhaustive.” See, e.g., Henszey, *supra* note 53, at 109.

[A] severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a marked increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section.¹⁰⁵

In addition, cases that involve “fires, incapacity of key personnel, [and] changes in government rules and regulations” also seem to satisfy this first requirement.¹⁰⁶

b. The Cajun Corp. Example

Hurricanes are not specifically mentioned in section 2-615 or the accompanying comments, but it seems that they are among the events that this section contemplated because they are events with “low probabilities and [have] consequences that are difficult to predict and insure against.”¹⁰⁷ Thus, Hurricane Katrina, a Category 3 hurricane, appears to qualify as a condition the nonoccurrence of which was an underlying assumption of Cajun Corp.’s contract with X Corp. Therefore, the analysis must proceed to the remaining requirements under the U.C.C. test.

2. Occurrence of the Condition Was Not Foreseeable When the Contract Was Executed

a. The U.C.C. Test

The second element of the U.C.C. test is perhaps the most crucial: was the occurrence of the condition, the nonoccurrence of which was an underlying assumption of the contract, unforeseeable at the time the contract was executed?¹⁰⁸ As Joskow points out, almost every condition is in some way foreseeable.¹⁰⁹ Even a seemingly unprecedented event, such as the terrorist attacks of September 11, is in some way foreseeable;¹¹⁰ after all, the World

¹⁰⁵ § 2-615 cmt. 4.

¹⁰⁶ Joskow, *supra* note 46, at 156.

¹⁰⁷ *Id.* The difficulty of insuring against hurricane damage is debatable and will be addressed in the criticism of this test. See *infra* Part III.A.5.

¹⁰⁸ § 2-615.

¹⁰⁹ Joskow, *supra* note 46, at 157.

¹¹⁰ See, e.g., Jeffrey W. Stempel, *The Insurance Aftermath of September 11: Myriad Claims, Multiple Lines, Arguments Over Occurrence Counting, War Risk Exclusions, the Future of Terrorism Coverage, and*

Trade Center had been attacked in 1993.¹¹¹ Would it be unreasonable to expect businesses in and around the World Trade Center to anticipate the possibility of future attacks when they entered into contracts pre-September 11?¹¹²

U.C.C. proponents respond to the problem of total foreseeability by applying the concept of bounded rationality when determining whether conditions are foreseeable.¹¹³ Bounded rationality is an alternative to the traditional economic assumption of total rationality,¹¹⁴ which assumes that all economic actors will appropriately weigh and incorporate all available information in any decision-making process in which they engage. In contrast, the theory of bounded rationality recognizes that economic actors *cannot* always take advantage of all available information when making decisions.¹¹⁵ This does not mean that human beings make decisions arbitrarily. Rather, human beings are *aware* of the limitations that the bounded rationality theory highlights and often attempt to correct their imperfect memories, knowledge, and computational powers by using lists, rules of thumb, and mental shortcuts.¹¹⁶

When the theory of bounded rationality is applied to the determination of foreseeability required in U.C.C. section 2-615, the problem of total foreseeability is eliminated.¹¹⁷ Since economic actors may not take all available information into account or may misinterpret available information when making decisions, they cannot foresee certain risks materializing.¹¹⁸ Thus, the task of U.C.C. interpreters is to determine whether a certain

New Issues of Government Role, 37 TORT & INS. L.J. 817 (2002) (“[A] jury could find the risk to nonpassengers from inadequate security to be foreseeable. After all, Tom Clancy foresaw it in a best-seller.”).

¹¹¹ Robert D. McFadden, *Blast Hits Trade Center, Bomb Suspected; 5 Killed, Thousands Flee Smoke in Towers*, N.Y. TIMES, Feb. 27, 1993, at 1.

¹¹² Stempel, *supra* note 110, at 817.

¹¹³ See Joskow, *supra* note 46, at 157.

¹¹⁴ See generally HERBERT A. SIMON, *MODELS OF MAN: SOCIAL AND RATIONAL* (Garland Publ'g, Inc. 1987) (1957).

¹¹⁵ *Id.*

¹¹⁶ Christine Jolls et al., *A Behavioral Approach to Law and Economics*, in *BEHAVIORAL LAW & ECONOMICS* 13, 14 (Cass R. Sunstein ed., 2000). Lists, rules of thumb, and mental shortcuts are all examples of heuristics, which are devices that humans use “to make quick and low-cost inferences, usually in uncertain decision-making environments.” Wright, *supra* note 29, at 2202. However, “even with these remedies, and in some cases because of these remedies, human behavior differs in systematic ways from that predicted by the standard economic model of unbounded rationality.” Jolls et al., *supra*, at 14.

¹¹⁷ See Wright, *supra* note 29, at 2199–200.

¹¹⁸ *Id.* at 2200.

condition was foreseeable for parties operating under the constraints of bounded rationality.¹¹⁹

The bounded rationality approach to determining foreseeability requires the court to ask what the parties contemplated at the time of the contract negotiations.¹²⁰ Did the negotiation include discussion of a reasonable set of risks?¹²¹ Or did the parties neglect to consider some commonplace risks that, despite their bounded rationality, should have been recognized and discussed?¹²² These questions are considered specifically with respect to the party seeking to discharge the contract.

b. The Cajun Corp. Example

The analysis of the second element of the U.C.C. test suggests two questions relating to the transaction between Cajun Corp. and X Corp:¹²³ Did either party contemplate the risk of hurricane damage affecting their contract at the time of negotiation? If not, *should* the parties have contemplated that risk in crafting their bargaining positions? According to accounts of many large and small businesses in the wake of Hurricane Katrina, the risk of a catastrophic event was largely ignored as a cost of doing business in the Gulf Coast.¹²⁴ Although some businesses did have contingency plans for smaller-scale events, most were unprepared for a catastrophe of Katrina's proportions.¹²⁵ Thus, it is likely that hurricane damage was not contemplated during contract negotiations. This negative answer implicates the normative analysis. Should Cajun Corp. or X Corp. or both have contemplated the risk of hurricane damage in their contract negotiations?

This question in turn requires a separate determination: how "bounded" are the parties' respective rationalities?¹²⁶ In other words, were the risks of a

¹¹⁹ Joskow, *supra* note 46, at 157.

¹²⁰ *Id.*

¹²¹ *See id.* at 158.

¹²² *See id.*

¹²³ *See supra* text accompanying notes 122–23.

¹²⁴ *See, e.g.,* Ilana DeBare, *Picking Up the Pieces; Small Businesses Face Big Challenges After a Disaster, But Help Is Out There*, S.F. CHRON., Sept. 10, 2005, at C1 (noting that a small business owner in the New Orleans area did not know whether the fee he paid a disaster-management company would be covered under his business insurance).

¹²⁵ *See, e.g.,* Brian Fonseca & Carmen Nobel, *Katrina's Wrath*, EWEEK, Sept. 19, 2005, at 22, 22–23 (“[E]ven [for] those [businesses] with well-designed and practical disaster recovery plans, the task of bringing their organizations back online has proved more daunting than they feared.”).

¹²⁶ *See supra* notes 120–22 and accompanying text.

hurricane so glaring that the parties should have reasonably contemplated them? On the one hand, there was plenty of information available to suggest that New Orleans was extremely vulnerable to a serious hurricane.¹²⁷ The Army Corps of Engineers published several reports to that effect years prior to Hurricane Katrina.¹²⁸ New Orleans and Louisiana officials had also discussed levee-strengthening initiatives for years.¹²⁹ Hurricanes that ravaged other parts of the Gulf Coast, particularly Florida, had caused millions of dollars of damage.¹³⁰ Finally, Hurricanes Betsy and Camille in the 1960s foreshadowed the type of damage would result if a major hurricane hit New Orleans.¹³¹ On the other hand, this information might fall into the category of information that cannot be processed and incorporated in decision making by actors constrained by bounded rationality.¹³² U.C.C. proponents may suggest that contracting parties underestimate the risk of natural disasters due to the availability heuristic¹³³ or an optimistic bias.¹³⁴

¹²⁷ The White House's report on Hurricane Katrina, in a section entitled "Worst Scenario," reads:

A catastrophic hurricane striking Southeast Louisiana has been considered a worst-case scenario that the region and many experts had known and feared for years According to the [U.S. Army Corps of Engineers], New Orleans would be inundated by over twenty feet of water if a [severe] hurricane took a "critical path" towards the city.

TOWNSEND ET AL., *supra* note 5, at 24.

¹²⁸ See, e.g., NEW ORLEANS DIST., U.S. ARMY CORPS OF ENG'RS, COMPREHENSIVE HURRICANE PROTECTION PLAN FOR COASTAL LOUISIANA 5 (2000) (showing a map that details the potential devastation to the New Orleans area that would be caused by a slow-moving category 4 or category 5 hurricane); see also Peter Carey, *Floods Unavoidable, Army Engineers Say*, MIAMI HERALD, Sept. 2, 2005, at 22A.

¹²⁹ See S. Con. Res. 30, Reg. Sess. (La. 1999) (encouraging Congress "to authorize and to urge the governor of the state of Louisiana to support the development of the 'Comprehensive Hurricane Protection Plan for Coastal Louisiana' by the U.S. Army Corps of Engineers to provide continuous hurricane protection from Morgan City to the Mississippi border").

¹³⁰ TOWNSEND ET AL., *supra* note 5, at 6.

¹³¹ *Id.* at 24.

As an omen of things to come, Hurricane Betsy's storm surge and high winds hit Lake Pontchartrain just north of New Orleans, overtopping levees and flooding the city In total, seventy-five people were killed and over 160,000 homes were flooded. Only four years later, Hurricane Camille . . . caused an estimated 335 deaths, destroyed or damaged 22,008 homes, and injured thousands in Louisiana, Mississippi, and Virginia.

Id.

¹³² See *supra* note 115 and accompanying text.

¹³³ The availability heuristic refers to a tendency to estimate the risk of an incident in proportion to one's exposure to that incident. Cass R. Sunstein, *Introduction* to BEHAVIORAL LAW & ECONOMICS, *supra* note 116, at 1, 5. For example, after reading an article about a gruesome murder, the reader may view the risk of being murdered as more serious than, for example, the risk of being fatally injured in a car accident. *Id.*

¹³⁴ People are, by nature, optimistic; this means that they systematically underestimate the risk of negative events befalling them personally. *Id.* at 4. Interestingly, the optimistic bias does not lead people to

The U.C.C. test does not offer a clear way to resolve this issue. It is unclear whether Cajun Corp. *should have* taken the risk of severe hurricane damage into account when negotiating its contract with X Corp.¹³⁵ Thus, we cannot conclusively determine whether Cajun Corp.'s contract would satisfy the foreseeability requirement of the U.C.C. test. Proponents of the U.C.C. doctrine would likely find that the risk of a severe hurricane was not foreseeable (after all, the test is supposed to protect businesses from bearing risks they are not suited to calculate).¹³⁶ This result, however, does not feel right for two reasons, one factual and one methodological. The factual problem is that there is overwhelming evidence that the risk a major hurricane would pose to New Orleans residents and businesses was known and publicized long before Hurricane Katrina made landfall.¹³⁷ Even if we accept, as we should, the argument of bounded rationality, it is unclear that the law should encourage such an expansive view of that theory. Second, as critics of the U.C.C. point out, judges are most likely ill-equipped to determine now, in the wake of Hurricane Katrina, what parties *should have* foreseen, because of their own bounded rationality.¹³⁸

3. *Risk of Failure of Condition Was Not Allocated by Contract*

a. *The U.C.C. Test*

As previously noted, this U.C.C. element is intimately related to the first two.¹³⁹ Allocation of the risk of failure of a condition during contract negotiation is crucial in three important respects.¹⁴⁰ First, allocation of risk indicates that occurrence of the condition was “contemplated,” as required by the foreseeability test.¹⁴¹ Furthermore, the risk was sufficiently large to allocate, thus reinforcing the notion that it was foreseeable. Finally, allocation

underestimate the risks of events occurring *in general*; rather, it leads them to underestimate the risk of an event *affecting them*. *Id.*

¹³⁵ Bounded rationality, in addition to suggesting that parties may not be able to foresee a large set of events, also suggests that judges may have difficulty assessing an event's foreseeability, as required by the U.C.C. test. See Wright, *supra* note 29, at 2211–13. Judges may be affected by the hindsight bias, a tendency to use current knowledge to judge past events, even when those events occurred in the absence of current knowledge. *Id.* This problem will be discussed in greater detail in the text accompanying notes 177–80.

¹³⁶ See *supra* text accompanying notes 104–05 (discussing the set of events that are typically considered unforeseeable).

¹³⁷ See *supra* note 127 and accompanying text.

¹³⁸ For further discussion of these problems, see *infra* text accompanying notes 157–61.

¹³⁹ See *supra* Part III.A.1; see also *infra* text accompanying notes 167–69.

¹⁴⁰ See Eloffson, *supra* note 83, at 5.

¹⁴¹ See Joskow, *supra* note 46, at 156.

of the risk indicates that the nonoccurrence of the condition was *not* an underlying assumption of the contract. If the risk was *not* allocated in the contract, it suggests at least one of the following: (1) the risk was not contemplated during negotiation of the contract, (2) the risk was unforeseeable, or (3) the parties contemplated the risk during negotiation but assumed the risk would not materialize.¹⁴²

The U.C.C. adopts an expansive view of what constitutes risk allocation.¹⁴³ The contract need not expressly allocate a risk for a court to find that the risk indeed had been previously allocated.¹⁴⁴ When a particular condition “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,” the U.C.C. assumes that the risk of this condition has been allocated.¹⁴⁵

b. The Cajun Corp. Example

The contract between Cajun Corp. and X Corp. does not expressly mention the risk of severe hurricane damage.¹⁴⁶ There is no *force majeure* clause that allocates general risk.¹⁴⁷ According to the comments to section 2-615 of the U.C.C., the next step in the analysis is to determine whether the risk of a severe hurricane falls into the category of “sufficiently foreshadowed” risks.¹⁴⁸ Again, this analysis implicates the question: what is the boundary of bounded rationality? The U.C.C. does not provide a good answer to this question.¹⁴⁹

¹⁴² There is an important caveat to this statement: With regard to the first two points, some risks are contemplated, but they are so indeterminate that they are ignored in the final contract. They may be ignored because they are unforeseeable *or* because the parties are unable to agree on a particular allocation.

¹⁴³ See U.C.C. § 2-615 cmt. 8 (1998); see also Joskow, *supra* note 46, at 158.

¹⁴⁴ U.C.C. § 2-615 cmt. 8 (1998).

¹⁴⁵ *Id.* This is true regardless of whether the contract expressly allocates the risk of the condition. *Id.*

¹⁴⁶ See *supra* text accompanying note 97.

¹⁴⁷ See *supra* note 97 and accompanying text. *Force majeure* clauses raise an interesting question with respect to this U.C.C. requirement that is beyond the scope of this Comment: do they only cover foreseeable risks that the parties do not want to bother defining, or can they be construed to embrace *all* risks, regardless of foreseeability?

¹⁴⁸ § 2-615 cmt. 8.

¹⁴⁹ See *supra* Part III.A.2. This criticism is developed *infra* Part III.A.5.

4. Occurrence of Condition Has Made Performance Impracticable

a. The U.C.C. Test

Discharge cannot be granted if the party seeking it can still perform under the contract without suffering unreasonable difficulty.¹⁵⁰ This requirement is designed to ensure that parties are not released from their contractual obligations simply because they suffered a small glitch during performance; to meet the standard set out by this requirement, performance must be impracticable.¹⁵¹

Impracticability has proved to be an elusive concept. It has two components: (1) the magnitude of the cost increase and (2) the reason for the cost increase. For performance to be excused, the cost of performance must be “marked[ly]”¹⁵² higher, and the increase must be the result of a sufficiently unforeseeable event.¹⁵³ Neither the comments to section 2-615 nor modern cases provide much guidance regarding the type of cost increase that merits discharge. However, the U.C.C. is slightly more helpful when it comes to determining whether the event that gave rise to the cost increase was “within the contemplation” of section 2-615.¹⁵⁴ Market collapse, by itself, does not qualify.¹⁵⁵ However, when performance is affected by “war, embargo, local crop failure, [or] unforeseen shutdown of major sources of supply,” the U.C.C. appears willing to discharge the contract.¹⁵⁶ Thus, parties may claim that their performance is truly impracticable only when they suffer marked cost increases due to unforeseeable events.¹⁵⁷

b. The Cajun Corp. Example

To prove that its performance has become impracticable, Cajun Corp. must prove that it has suffered marked cost increases because of the occurrence of

¹⁵⁰ § 2-615(a).

¹⁵¹ *Id.*

¹⁵² § 2-615 cmt. 4.

¹⁵³ *Id.*

¹⁵⁴ § 2-615 cmt. 8.

¹⁵⁵ § 2-615 cmt. 4. With regard to market collapse, comment 4 elaborates that “[market collapse] is exactly the type of business risk which business contracts made at fixed prices are intended to cover.” *Id.* It is unclear from this statement whether non-fixed-price contracts could be discharged as the result of a market collapse.

¹⁵⁶ *Id.*

¹⁵⁷ See *supra* Parts III.A.1–2.

an unforeseeable event.¹⁵⁸ The first requirement is easily met. Cajun Corp. must reconstruct its entire factory¹⁵⁹ and hire a new workforce¹⁶⁰ before beginning production of X Corp.'s widget order. These costs represent a marked increase over what Cajun Corp. would have paid to produce the widgets had Hurricane Katrina not affected New Orleans. The second requirement of this element implicates the earlier discussion of foreseeability.¹⁶¹ While this Comment has strong reservations regarding categorizing Hurricane Katrina as an unforeseeable event, it is likely that U.C.C. proponents would see it as such.¹⁶² Thus, Cajun Corp. would likely satisfy the requirement of impracticability set forth in section 2-615.

5. *Summary and Criticism of the U.C.C. Approach*

For its performance to be excused under U.C.C. section 2-615, Cajun Corp. must show that the nonoccurrence of a Category 3 hurricane—an unforeseeable event—was an underlying condition of its contract with X Corp., the risk of such a hurricane was not allocated in the contract, and the hurricane made performance under the contract impracticable.¹⁶³ Each of these factors appears to be satisfied by the U.C.C. test.¹⁶⁴ Thus, under the U.C.C. approach to impracticability, Cajun Corp.'s performance under the contract with X Corp. would be excused. The U.C.C. would allocate the risk of an “unforeseeable” event such as Hurricane Katrina to the buyer.¹⁶⁵

The U.C.C. approach is vulnerable to three major criticisms.¹⁶⁶ The first criticism is a stylistic one. The requirements of the test are largely interdependent, rendering the analysis circular: how may a judge determine whether the nonoccurrence of a condition was an underlying assumption of the contract (the first element of the U.C.C. test) without delving into the analysis

¹⁵⁸ See § 2-615 cmt. 4.

¹⁵⁹ Purchasing substitute widgets from another manufacturer is not an option because of the terms of the contract. See *supra* Part III; see also Christopher J. Bruce, *An Economic Analysis of the Impossibility Doctrine*, 11 J. LEGAL STUD. 311, 311 (1982) (noting that in a situation where a factory burned down, the cost of rebuilding the factory could render performance uneconomical).

¹⁶⁰ See *supra* Part III. Hiring a new workforce may be extremely costly since it may involve enticing former employees back to the New Orleans area with high salaries.

¹⁶¹ See *supra* Part III.A.2.

¹⁶² See *supra* Part III.A.2.

¹⁶³ See *supra* Parts III.A.1–4.

¹⁶⁴ See *supra* Parts III.A.1–4.

¹⁶⁵ If Cajun Corp. were the buyer and had been unable to perform under the contract, i.e., pay X Corp., then the result would be unclear under the U.C.C. See *supra* note 53 and accompanying text.

¹⁶⁶ See *supra* Parts III.A.1–4.

of foreseeability (the second element)?¹⁶⁷ Similarly, the risk allocation analysis (the third element) hinges on whether the risk was foreseeable (the second element).¹⁶⁸ An analysis of any of the first three elements of the U.C.C. test implicates other elements of the test; this overlap means that circular logic is required to apply the U.C.C. test. The first three elements should be collapsed into a general foreseeability inquiry. If this inquiry finds that the event in question was unforeseeable, then the judge ought to determine whether performance has been rendered truly impracticable.¹⁶⁹

The second criticism of the U.C.C. approach is the most important one. The method of determining foreseeability is flawed, mainly because there *is no* discernible method. The comments to section 2-615 provide some examples of events that would be considered unforeseeable for the purposes of this test.¹⁷⁰ Additionally, comment 4 notes that “increased cost” and “collapse in the market” are each, in and of themselves, insufficient to prove the occurrence of an unforeseeable event.¹⁷¹ Finally, comment 2 warns us that the “present section deliberately refrains from any effort at an exhaustive expression of contingencies and is to be interpreted in all cases sought to be brought within its scope in terms of its underlying reason and purpose.”¹⁷² Unfortunately for the U.C.C. interpreter, not only does this section “refrain[] from any effort at an exhaustive expression of contingencies,” but it also refrains from providing guidance—exhaustive or otherwise—regarding the analysis appropriate to determining whether an event is foreseeable.¹⁷³ Section 2-615 does not address the assumptions that are appropriate regarding the contracting parties. As such, it does not shed light on the question that has become the chorus of this Part: what does bounded rationality mean in the context of this doctrine?¹⁷⁴ Since the rationality of the parties is unknown, how can foreseeability be determined? This criticism may be simply stated: The U.C.C. test provides no reference or discernible context for the foreseeability inquiry it proposes.¹⁷⁵

¹⁶⁷ See *supra* Part III.A.1.

¹⁶⁸ See *supra* Part III.A.3.

¹⁶⁹ See *supra* Part III.A.4.

¹⁷⁰ See U.C.C. § 2-615 cmts. 4–5 (1998).

¹⁷¹ § 2-615 cmt. 4.

¹⁷² § 2-615 cmt. 2.

¹⁷³ This Comment does not suggest that defining foreseeability is simple. However, the difficulty of the task does not excuse the poor drafting of the U.C.C. section, in which disparate examples are substituted for a meaningful analysis of the concept of foreseeability.

¹⁷⁴ See *supra* Parts III.A.2–4.

¹⁷⁵ U.C.C. proponents generally adopt a very expansive view of bounded rationality; in other words, they believe that humans are very limited in their ability to “formulat[e] and solv[e] complex problems and . . .

The third and final criticism of the U.C.C. approach to impracticability is that it cannot be efficiently applied.¹⁷⁶ By its own terms, the U.C.C. test requires “the judiciary ex post to make a determination of the future occurrences parties should have reasonably included in their contract negotiations.”¹⁷⁷ This ex post determination invokes the problem of hindsight bias.¹⁷⁸ Depending on how the impracticability-invoking event is framed, the judge may either underestimate or overestimate its foreseeability.¹⁷⁹ Thus, even if both the U.C.C. test’s circularity was remedied and the foreseeability test was more clearly defined, there are good reasons to suspect that it cannot be accurately applied.

Although some of these criticisms are general in nature, they are offered to suggest that in the context of disaster-affected contracts, the U.C.C. approach is not useful because it is based on the assumption that information is gathered and used in ways that do not mirror reality. Information predicting the likelihood of natural disasters and their impact on a region is distorted to an extraordinary degree by government action.¹⁸⁰ As a result, it is unclear whether natural disasters should rightfully be classified as foreseeable or unforeseeable events. Since this determination is central to the U.C.C. test, this Comment concludes that the U.C.C. approach is poorly designed for dealing with disaster-affected contracts.

B. The Superior Risk Bearer Approach to Impossibility

This section will apply the superior risk bearer model of impossibility to Cajun Corp.’s hypothetical contract with X Corp. Posner and Rosenfield note that a party may be the superior risk bearer for one of two reasons: “First, he may be in a better position to prevent the risk from materializing

process . . . information.” Oliver E. Williamson, *The Economies of Organization: The Transaction Cost Approach*, 87 AM. J. OF SOCIOLOGY 548, 553 (1981). See generally Joskow, *supra* note 46. Even if this position was somehow substantiated in the language of the Code, it would be an unfortunate position from a policy perspective. It is unwise to encourage and reward behavior that limits the amount of correct information incorporated in the decision-making process. Admittedly, human beings will never be able to make the right decisions all the time. However, where change is possible, contracting parties should be encouraged to incorporate *more*, not less, information into the terms of their agreements. See generally Posner & Rosenfield, *supra* note 34.

¹⁷⁶ See Wright, *supra* note 29, at 2211–12.

¹⁷⁷ *Id.* at 2198–99.

¹⁷⁸ See *supra* note 135.

¹⁷⁹ See *supra* note 135.

¹⁸⁰ The same kind of distortion occurs with respect to information on terrorist events. See RICHARD A. POSNER, *CATASTROPHE* 176 (2004).

[Second], [t]he promisor may be the superior insurer.”¹⁸¹ The following sections will develop this analysis in greater depth, asking which party is the superior risk bearer and whether this approach makes sense as applied to disaster-affected contracts.

1. *Determining the Party in the Best Position to Prevent the Risk*

a. *The Superior Risk Bearer Test*

The first way in which a party may qualify as the superior risk bearer is if that party is in the best position to prevent a given risk from materializing.¹⁸² If a party is able to prevent a risk from materializing at a cost less than the cost suffered if the risk actually materialized, then that party is in the best position to prevent the risk and must pay the consequences if the risk materializes.¹⁸³ This rule makes sense: it requires parties to act efficiently by eliminating loss when possible. If they do not act efficiently—i.e., they do not prevent the risk from materializing—then they ought to be punished.

b. *The Cajun Corp. Example*

In the context of the Cajun Corp. example, the risk in question is that of a Category 3 hurricane making landfall in New Orleans. Neither Cajun Corp. nor X Corp. is in a position to prevent this risk from materializing. Thus, neither Cajun Corp. nor X Corp. may be defined as the superior risk bearer on the basis of this factor.

2. *Determining the Party Best Able to Insure Against Risk*

a. *The Superior Risk Bearer Test*

“The factors relevant to determining which party to the contract is the cheaper insurer are (1) risk-appraisal costs and (2) transaction costs.”¹⁸⁴ Risk-appraisal has two dimensions: probability and magnitude.¹⁸⁵ To completely

¹⁸¹ Posner & Rosenfield, *supra* note 34, at 90.

¹⁸² *Id.*

¹⁸³ *Id.* If the party’s cost of preventing the risk from materializing is greater than or equal to the cost suffered if the risk materialized, it would be better for the parties to do nothing. If the risk never materialized, the parties would be well off for not having spent the money; if the risk materializes, the parties will pay a smaller or equal cost relative to the cost of prevention.

¹⁸⁴ *Id.* at 91.

¹⁸⁵ *Id.*

appraise a risk, a party must know the magnitude of potential loss and the likelihood that the risk will materialize.¹⁸⁶ Each of the components of risk-appraisal has different financial costs. For example, information on the magnitude of a loss may be abundant, and likely cheap, while information on the probability of loss may be extremely difficult to find and thus costly.¹⁸⁷

Transaction costs related to obtaining insurance are the second relevant factor in determining the best insurer.¹⁸⁸ A party seeking to insure against a risk has two options at its disposal: either self-insure or purchase an insurance policy.¹⁸⁹ Both methods of insurance have the same underlying goal of “minimizing the risk through pooling it with other uncertain events,” and both require the party to incur transaction costs.¹⁹⁰ Thus, the party in the best position to insure against the risk is the party that can minimize both risk-appraisal and transaction costs.¹⁹¹

b. The Cajun Corp. Example

The superior risk bearer test requires Cajun Corp. to prove that it was *not* the best insurer to qualify for excuse of performance.¹⁹² This means that Cajun Corp. must prove that it was not in the best position to (1) appraise the risk of the occurrence of a Category 3 hurricane, (2) minimize transaction costs associated with pooling the risk of a Category 3 hurricane, or (3) both.¹⁹³

To prove that it was not in the best position to appraise risk, Cajun Corp. must show that it had inferior access to information regarding (1) the magnitude of loss resulting from a hurricane, (2) the probability that a hurricane would occur, or (3) both.¹⁹⁴ With regard to the costs associated with estimating the magnitude of loss, both parties presumably had access to Army Corps of Engineers reports, as well as other information across a broad range

¹⁸⁶ *Id.*

¹⁸⁷ This may be the situation for Cajun Corp. It might be very cheap, even free for Cajun Corp. to obtain information on the magnitude of loss in the case of a Category 3 hurricane (Cajun Corp. executives could run a quick internet search, for example). However, the availability of accurate information on the probability that such a hurricane would occur and thereby affect the contract with X Corp. is likely to be extremely expensive if it exists.

¹⁸⁸ Posner & Rosenfield, *supra* note 34, at 91.

¹⁸⁹ *Id.* at 91–92.

¹⁹⁰ *Id.* (noting that, when available, self-insurance is generally cheaper than market insurance).

¹⁹¹ *Id.* at 91.

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

of media relating to the magnitude of potential loss that a serious hurricane hitting New Orleans could cause.¹⁹⁵ Cajun Corp., however, had an advantage in gathering information relating to magnitude of loss by virtue of its location. Cajun Corp. employees and managers were more likely to read newspaper articles, watch TV news specials, and pay attention to legislative action and political statements regarding hurricane prediction than the employees and managers of X Corp., who lived outside of the Gulf Coast. This type of exposure means that it would likely have been cheaper for Cajun Corp. to gather information on the magnitude of potential loss than it would have been for X Corp.¹⁹⁶ However, X Corp. was in the best position to determine the loss it would suffer if Cajun Corp. was unable to perform.¹⁹⁷ Posner and Rosenfield suggest that weighing these competing advantages is the judge's task.¹⁹⁸

But was either party in a position to gather information about the probability that a hurricane of Katrina's strength would affect New Orleans? The answer to this question is far less clear. It seems that there was no available information as to when a hurricane of Katrina's magnitude would affect New Orleans;¹⁹⁹ rather, the only information available was regarding the dimensions of the damage that could result from such a hurricane.²⁰⁰ The

¹⁹⁵ Access to information is not specifically mentioned in this Comment's Cajun Corp. example.

¹⁹⁶ As Benjamin Franklin said, "[T]ime is money." Benjamin Franklin, *Advice to a Young Tradesman*, in BENJAMIN FRANKLIN AND JONATHAN EDWARDS: SELECTIONS FROM THEIR WRITINGS (Carl Van Doren ed., 1920). One of the major costs of acquiring information is time spent. The longer someone has to spend locating a piece of information (even if the information itself is free), the more costly the information. This conclusion rests on the assumption that time has value. Economists typically explain this assumption in the context of opportunity cost: According to this example, when someone is not spending time tracking down information, they are instead able to engage in another activity generating Z dollars of income. By tracking down information, the person in our example is forfeiting the opportunity to make Z dollars. See MALLOY, *supra* note 77, at 45 & n.52 (discussing opportunity cost in the context of employment decisions).

¹⁹⁷ This assumption follows from the analysis that Posner and Rosenfield conducted in their first example, noting that the relevant loss calculation is the loss that failure of performance would create for the parties involved. See Posner & Rosenfield, *supra* note 34, at 92–93. Cajun Corp.'s loss would be limited to the cost of the contract; however, X Corp.'s loss might be greater if Cajun Corp.'s product was integral to X Corp.'s operations. *Id.* The buyer is typically in the best position to estimate the loss it would suffer if it was unable to receive the goods secured by the contract. *Id.*

¹⁹⁸ *Id.*

¹⁹⁹ The only exceptions to this were the reports issued by the National Oceanic and Atmospheric Administration (NOAA) in the days immediately prior to Katrina, when the storm was developing in the Gulf of Mexico. See TOWNSEND ET AL., *supra* note 5, at 22–31. These last-minute reports, however, would not be considered to determine the lowest-cost insurer because the superior risk bearer test focuses on the conditions of the parties ex ante, or before the contract was finalized. See Posner & Rosenfield, *supra* note 34, at 90–92.

²⁰⁰ Positing that it was simply a matter of time probably does not satisfy the superior risk bearer test, although Posner and Rosenfield have not elaborated on this point. Notice that the analysis here resembles the

analysis is incomplete: Although it appears the Cajun Corp. was in the best position to appraise the potential loss caused by Hurricane Katrina, neither party had specific information regarding the likelihood that an event like Hurricane Katrina would occur during the term of their contract.²⁰¹ This means that, as to Cajun Corp. and X Corp., it is unclear which party, if any, was in the best position to appraise the risk of a hurricane of Katrina's strength affecting New Orleans.

Setting aside this troublesome result for the moment,²⁰² the superior risk bearer model requires a further determination: which party was in the best position to minimize transaction costs relating to obtaining insurance against the risk of a Katrina-like event?²⁰³ Since the risk of a severe hurricane eludes exact appraisal, it is unclear that this stage of the analysis can even be reached. After all, how can one insure against an undetermined risk? Again, Posner and Rosenfield do not offer much guidance. If a precise risk appraisal is not required, then the parties could have either self-insured or purchased market insurance.²⁰⁴ Posner and Rosenfield's analysis suggests that Cajun Corp. could have self-insured: "[A party] may be able to eliminate the risk of such contingencies simply by charging a higher price—in effect, an insurance premium—to all of its customers."²⁰⁵ Alternatively, Cajun Corp. may have chosen to purchase an insurance policy, thus shifting its risk to the insurance company, which in turn pools that risk with a large set of other risks.²⁰⁶ Both of these options are not terribly attractive; self-insuring might render Cajun Corp. uncompetitive, while purchasing market insurance is costly and might not provide complete coverage.²⁰⁷

X Corp. also may self-insure or purchase market insurance. Depending on X Corp.'s business structure, it may or may not be able to self-insure. Like

"foreseeability" analysis implicated by the U.C.C. See *supra* Part III.A.2. Is "risk appraisal" per the superior risk bearer formulation equivalent to "foreseeability" in the U.C.C. model? See *infra* Part III.B.4. (noting that an inability to appraise risk does not render an event unforeseeable).

²⁰¹ The term of the contract matters when applying the superior risk bearer test. The longer the term of the contract, the more likely it is that parties have access to information regarding the probability of a given risk.

²⁰² See *infra* Part III.B.4 (discussing criticisms of the superior risk bearer model).

²⁰³ See Posner & Rosenfield, *supra* note 34, at 91.

²⁰⁴ *Id.* at 93.

²⁰⁵ *Id.* (this suggestion is made in the context of the authors' first example).

²⁰⁶ *Id.*

²⁰⁷ *Id.* In the first Posner and Rosenfield example, the risk in question is fire damage. *Id.* at 92–93. The reality for Gulf Coast businesses is that comprehensive hurricane and business interruption insurance is not necessarily available at reasonable cost. See *infra* Part IV.A (discussing incomplete insurance markets).

Cajun Corp., X Corp. could also potentially raise the cost of its goods or services and set aside the excess revenue for insurance purposes. However, passing on indirect costs of business to consumers may not be practical.²⁰⁸ X Corp.'s better option appears to be to purchase market business interruption insurance; since X Corp. is a publicly held corporation, it most likely has the means and the incentives to purchase such a policy, especially if the widgets it buys from Cajun Corp. are central to its own production process.²⁰⁹ To summarize, Cajun Corp. is in a better position to self-insure, while X Corp. is better suited to purchase market insurance. The best insurer, from a transaction cost perspective, would be the party with the lowest cost of insurance; since Cajun Corp. is a closely held corporation with a very niche market, self-insuring through a price premium is probably more burdensome than purchasing market insurance would be for X Corp.²¹⁰ Thus, X Corp. is the party best suited to minimize transaction costs associated with acquiring insurance.

3. *Determining the Superior Risk Bearer*

a. *The Superior Risk Bearer Test*

This model instructs us that the superior risk bearer is either the party in a position to prevent a risk from materializing or the party best suited to insure against the risk.²¹¹ Unfortunately, reality often presents “doubtful cases”;²¹² Posner and Rosenfield acknowledge that there is often no clear-cut superior risk bearer.²¹³ They provide the following advice: “When the two key parameters of the economic analysis point in opposite directions, the analysis is indeterminate on a general level and must proceed to an estimation of their

²⁰⁸ See Posner & Rosenfield, *supra* note 34, at 93.

²⁰⁹ There is a suggestion that there is a presumption against publicly held corporations, i.e., that they are likely to be in the best position to insure. *Id.* (A party is more likely to be found the superior risk bearer if it is a public corporation and the other party is a close corporation because “the owners of [a public corporation] could eliminate the risk of the loss . . . by combining their shares in [the superior risk bearer] with shares of other companies.”).

²¹⁰ *Id.* at 93–94 (“It is generally more difficult for the owners of a closely held corporation to diversify away the risks associated with their holdings in the corporation, for often those holdings represent a large fraction of their net assets.”). *But see id.* at 94 n.28 (noting that courts have not applied the public–private distinction in impossibility cases).

²¹¹ See *supra* Parts III.B.1–2.

²¹² See Posner & Rosenfield, *supra* note 34, at 110.

²¹³ *Id.*

relative empirical importance.”²¹⁴ Estimation of relative empirical importance, as Posner and Rosenfield further acknowledge, is simply fact-based analysis.²¹⁵ In other words, in the many cases where no clear-cut superior risk bearer emerges, a relative empirical analysis would eliminate any semblance of a rule. However, Posner and Rosenfield return to this issue; later in their landmark article, they suggest that doubtful cases ought to be handled with a strict liability rule:

The choice in doubtful cases between treating nonperformance as breach or as discharge is similar to the choice in tort law between strict liability and no liability for unavoidable accidents. Pending definitive empirical study, we are inclined to consider the strict-liability solution better in the contract context.²¹⁶

The rationale behind this strict liability rule is that, in the authors’ view, it is likely to yield the right result *most* of the time.²¹⁷ They posit that the promisor, or the performing party, is likely to be the superior risk bearer; therefore, enforcing the contract is likely to allocate the risk to the superior risk bearer.²¹⁸ Furthermore, a strict liability approach fits in with the nature of contracting: Parties choose to enter into agreements of their own accord and on behalf of their own best interests and should be held to those freely assumed obligations.²¹⁹ Finally, Posner and Rosenfield explain that a strict liability rule encourages parties to allocate risk in their contract to avoid unfavorable litigation when the risk materializes.²²⁰

b. The Cajun Corp. Example

The best insurer analysis of Cajun Corp. and X Corp. is “indeterminate.”²²¹ The probability of the risk materializing—one of the two components of risk appraisal—is unknown.²²² Furthermore, it is unclear which party was in the best position to minimize transaction costs relating to the acquisition of

²¹⁴ *Id.* at 102. When Posner and Rosenfield refer to “economic analysis,” they are referring to the risk-appraisal portion of the superior risk bearer test, which considers the ability to determine the magnitude of the loss and the probability that the loss would occur. *Id.*

²¹⁵ *Id.* at 103.

²¹⁶ *Id.* at 110.

²¹⁷ *Id.* at 110–11.

²¹⁸ *Id.*

²¹⁹ *Id.* at 111; see also Wright, *supra* note 29, at 2197.

²²⁰ Wright, *supra* note 29, at 2197.

²²¹ See Posner & Rosenfield, *supra* note 34, at 102.

²²² See *supra* Part III.B.2.b.

insurance.²²³ Thus, the Cajun Corp. and X Corp. contract presents a “doubtful case”²²⁴ that merits strict liability treatment.²²⁵ The contract would be enforced against Cajun Corp.

4. *Summary and Criticism of the Superior Risk Bearer Test*

The superior risk bearer test determines whether excuse of performance is appropriate based on whether the party claiming excuse was the superior risk bearer.²²⁶ Under this theory, contracts are only discharged when the party seeking discharge is not the superior risk bearer and the party opposing discharge is the superior risk bearer.²²⁷ Contracts are not discharged when the party seeking discharge is the superior risk bearer or when there is no clearly discernible superior risk bearer.²²⁸

Daniel Ostas summarizes the criticisms to the superior risk bearer model:

As a matter of abstract economic logic, the efficient-insurer hypothesis makes some sense. But in its pragmatic implementation, it becomes problematic Hence, traditional [economic analysis of the law] appears to have identified a factor in excuse cases, but that factor is not sufficiently robust to guide the courts.²²⁹

Nowhere is this criticism more applicable than in the case of disaster-affected contracts. From a model-design perspective, the superior risk bearer test is clear and parsimonious; it uses well-defined parameters to arrive at a simple but important conclusion.²³⁰ Furthermore, it avoids the hindsight bias problems that the U.C.C. approach raises.²³¹ However, the preciseness of the test is its downfall,²³² especially in the context of disaster-affected contracts such as the one between Cajun Corp. and X Corp.

²²³ See *supra* Part III.B.2.b.

²²⁴ See Posner & Rosenfield, *supra* note 34, at 110.

²²⁵ See *supra* Part III.B.3.a.

²²⁶ See *supra* Part II.B.

²²⁷ See *supra* Part II.B.

²²⁸ See *supra* Part II.B.

²²⁹ Daniel T. Ostas, *Postmodern Economic Analysis of Law: Extending the Pragmatic Visions of Richard A. Posner*, 36 AM. BUS. L.J. 193, 234–35 (1998).

²³⁰ See Sheldon W. Halpern, *Application of the Doctrine of Commercial Impracticability: Searching for the “Wisdom of Solomon,”* 135 U. PA. L. REV. 1123, 1165 (1987).

²³¹ *Id.* at 1159 (“An efficiency-based approach [such as the superior risk bearer test] to excuse does indeed eliminate the fictions of both imputed intent and basic assumptions.”); see also Wright, *supra* note 29, at 2210–11.

²³² Halpern, *supra* note 230, at 1160–61.

The theory's first failed assumption is that information required in the risk-appraisal process is available to at least one of the parties at reasonable cost.²³³ As the Cajun Corp. example illustrates, that assumption is simply not always valid.²³⁴ There was no information available at the time of contract regarding the probability that a severe hurricane would hit New Orleans during the 2005 hurricane season.²³⁵ It seems that government officials were aware of the possibility of a severe hurricane hitting New Orleans at some point but that point was not defined sufficiently in advance to guide contract negotiations.²³⁶ There is evidence to suggest that at least some officials felt a certain sense of urgency in needing to prepare New Orleans for such an eventuality.²³⁷ But the probability of the risk materializing in the 2005 hurricane season was unknown. Thus, although Hurricane Katrina may have been a "foreseeable" event under the analysis of the U.C.C. test,²³⁸ since its probability was undefined at the time of contract, the risk-appraisal analysis is incomplete. The incompleteness of the risk analysis means that the contract will likely be enforced under the strict liability fallback regime of the superior risk bearer test.

This result is deeply unsatisfying. If the maxim of *pacta sunt servanda* ("agreements must be kept")²³⁹ is correct, then it should be applied in all cases: All obligations freely assumed must be satisfied, no matter the cost, impracticality, or inconvenience that such performance entails. However, if society recognizes that the realities of commerce require flexibility, then a rule reflecting this realization should be developed.²⁴⁰ It is simply not good enough to develop a rule that works some of the time and when it does not, to revert to the rule that was expressly rejected as too strong.²⁴¹

²³³ See *supra* Part III.B.2.

²³⁴ See *supra* Part III.B.2.

²³⁵ The NOAA did issue statements predicting that the 2005 hurricane season would be particularly severe. See TOWNSEND ET AL., *supra* note 5, at 22. While the NOAA did fear that major hurricanes would hit, they were unable to predict with any sort of reliability *where* those hurricanes would make landfall. *Id.*

²³⁶ *Id.* at 24–25.

²³⁷ *Id.*

²³⁸ This is the position that this Comment has taken, see *supra* Part III.A, but U.C.C. proponents may not agree with this assessment.

²³⁹ BLACK'S LAW DICTIONARY 1140 (8th ed. 2004). This phrase summarizes the strictest form of the impossibility doctrine, which does not discharge contracts regardless of the circumstances. *Id.*

²⁴⁰ See *supra* Parts I.B–C (discussing the relaxation of the *pacta sunt servanda* rule in modern theories of impossibility).

²⁴¹ This is not a criticism that all commentators share. See, e.g., Wright, *supra* note 29, at 2211.

The second failed assumption of the superior risk bearer test is that insurance is always available. As a theoretical matter, some form of insurance is always available because parties may self-insure.²⁴² However, self-insurance, especially when it is not the norm, may render a business uncompetitive; for smaller businesses, self-insurance is practically unavailable.²⁴³ Market insurance is not always available either; the superior risk bearer test seems to assume that insurance markets are complete. This is not the case, in particular in the case of hurricane and related forms of insurance. When neither party is in a better position to minimize transaction costs relating to obtaining insurance, the superior risk bearer analysis is incomplete. The strict liability rule is triggered, and the same unsatisfying result is reached.

IV. PROPOSAL: GULF COAST-WIDE INSURANCE AND REINSURANCE

Modern approaches to contractual impossibility and impracticability, when applied to disaster-affected contracts, leave much to be desired.²⁴⁴ They suffer from significant substantive and methodological problems.²⁴⁵ The substantive problems are largely the product of incorrect assumptions about information: that parties will collect and weigh information in ways that are either unrealistic or inefficient or both.²⁴⁶ Methodologically, both approaches involve some form of ex post determination of ex ante conditions that gives rise to a host of errors.²⁴⁷

This Comment suggests that where disaster-affected contracts are concerned, viable solutions may be found not in the convoluted analyses of contract law, but rather in the law and economics of insurance. There are too many indeterminate variables implicated in the contract law approach. We cannot accurately know what parties thought when they negotiated a contract, what they should have thought, or what they could have thought.²⁴⁸ This is especially true regarding the forecasting of natural disasters. Individual biases, when supported by custom and cues from the government,²⁴⁹ confuse the

²⁴² Posner & Rosenfield, *supra* note 34, at 93.

²⁴³ *See supra* Part III.B.2.

²⁴⁴ *See supra* Parts III.A.5, B.4.

²⁴⁵ *See supra* Parts III.A.5, B.4.

²⁴⁶ *See supra* Parts II.C, III.A.5, B.4.

²⁴⁷ *See generally supra* Part III.

²⁴⁸ *See supra* Part III.

²⁴⁹ *See infra* note 259 and accompanying text.

appropriate integration of information regarding the risk of natural disaster in contract negotiations.

It is high time that businesses get the right message—from the government, from the market, and from each other—about the risk of natural disasters. Cognitive errors are hallmarks of human behavior; they cannot be readily changed.²⁵⁰ However, what can be changed are the signals issued by government and market entities. The vehicle for this change ought to be insurance reform.

A. *The Basics of Insurance*

1. *Why Do People Buy Insurance?*

Insurance is “[a] contract by which one party (the *insurer*) undertakes to indemnify another party (the *insured*) against risk of loss, damage, or liability arising from the occurrence of some specified contingency.”²⁵¹ When a party purchases insurance, that party is exchanging an uncertain cost (the cost of a risk materializing) for a certain cost (the cost of the insurance premium).²⁵² Posner and Rosenfield explain that “[b]ecause of the administrative expenses of insurance, the certain cost (that is, the insurance premium) is always higher, often much higher, than the uncertain costs that it avoids—the expected cost of the fire, of the automobile accident, or whatever.”²⁵³ Then why do people buy insurance? The standard answer is that risk in itself has a cost beyond the cost of the risk materializing. People are risk averse, and thus are willing to pay a premium to avoid risk.²⁵⁴

2. *Forms of Insurance*

Insurance markets have developed enormously in the last few decades in tandem with economic expansion.²⁵⁵ There are many forms of insurance, ranging from commercial insurance that insures parties against loss caused by a breach of contract,²⁵⁶ to bumbershoot insurance that provides “coverage for

²⁵⁰ See *supra* note 115 and accompanying text.

²⁵¹ BLACK'S LAW DICTIONARY 814 (8th ed. 2004).

²⁵² Posner & Rosenfield, *supra* note 34, at 91.

²⁵³ *Id.*

²⁵⁴ *Id.*

²⁵⁵ See, e.g., Stempel, *supra* note 110, at 843 n.95.

²⁵⁶ BLACK'S LAW DICTIONARY 815 (8th ed. 2004).

ocean marine risks,”²⁵⁷ to terrorism insurance, a relatively new line of insurance.²⁵⁸

There are several forms of insurance that are particularly relevant to this Comment’s discussion. One form is flood insurance that is “often sold privately but subsidized by the federal government.”²⁵⁹ A significant portion of the damage to New Orleans was caused by flooding.²⁶⁰ Another relevant form of insurance is hurricane insurance.²⁶¹ Finally, business interruption insurance covers “one or more kinds of loss from the interruption of an ongoing business, such as a loss of profits while the business is shut down to repair fire damage.”²⁶² Typically, these forms of insurance only cover direct loss resulting from the risk they cover, thus raising the issue of what constitutes direct loss.²⁶³ Courts have defined direct loss differently, leading to different interpretations of insurance coverage.²⁶⁴

²⁵⁷ *Id.*

²⁵⁸ *Id.* at 819.

²⁵⁹ *Id.* at 817.

²⁶⁰ This raises a number of problems for homeowners; there are still unresolved questions regarding whether homeowner’s insurance covers flood damage. See Alec Russell, *Now for the Clean-up and the Fight to Claim Insurance*, DAILY TELEGRAPH (London), Sept. 26, 2005, at 16.

²⁶¹ Hurricane insurance, when it is part of a homeowner’s insurance policy, is typically subject to an “ordinance or law” limitation. See Hugh L. Wood, Jr., Comment, *The Insurance Fallout Following Hurricane Andrew: Whether Insurance Companies Are Legally Obligated to Pay for Building Code Upgrades Despite the “Ordinance or Law” Exclusion Contained in Most Homeowners Policies*, 48 U. MIAMI L. REV. 949, 949–50 (1994).

²⁶² BLACK’S LAW DICTIONARY 815 (8th ed. 2004). Business interruption claims arising from September 11 ranged from five to twenty-one million dollars. See Lucien J. Dhooge, *A Previously Unimaginable Risk Potential: September 11 and the Insurance Industry*, 40 AM. BUS. L.J. 687, 704 (2003).

²⁶³ See, e.g., Dhooge, *supra* note 262, at 690–91.

²⁶⁴ Some courts define direct loss broadly:

[I]n a suit on a policy insuring for “direct loss” caused by the named peril, a proper definition of proximate cause would be “that cause which in a natural and continuous sequence unbroken by any new and intervening cause, produces a loss, and without which the loss would not have occurred.

Federal Ins. Co. v. Bock, 382 S.W.2d 305, 307 (Tex. Civ. App. 1964) (citing Provident Life & Accident Ins. Co. v. Holt, 27 S.W.2d 556 (Tex. Civ. App. 1930)). But see *Abady v. Hanover Fire Ins. Co.*, 266 F.2d 362, 364 (4th Cir. 1959) (holders of a fire insurance policy sought to recover costs due to frozen pipe and the court held that the loss was *not* directly attributable to wind damage and denied the claim).

3. *The Dynamics of the Insurance and Reinsurance Industries*

An insurance market has two tiers: a direct insurance tier and a reinsurance tier.²⁶⁵ In many cases, insurance companies selling policies to individuals will insure themselves by resorting to the reinsurance market.²⁶⁶ An insurance market is complete when any party that seeks insurance for a particular risk is able to purchase a policy that covers that risk.²⁶⁷ Conversely, a market is incomplete when individuals seeking to insure against a risk are unable to purchase an appropriate policy.²⁶⁸

In 1968, the federal government passed the National Flood Insurance Act.²⁶⁹ This Act created a federally subsidized National Flood Insurance Program (NFIP).²⁷⁰ Reports show that the NFIP was woefully undersubscribed.²⁷¹ Further government regulation was required in the wake of recent severe natural disasters when private insurers attempted to transform complete or nearly complete markets into incomplete ones.²⁷² For example, Florida officials had to step in after Hurricane Andrew to stop insurers from slashing coverage in the state.²⁷³ Some commentators view the increasingly active role of government in the provision of insurance and other disaster relief services as a strong message to the American people: “The critical point here is that the rush of new risk-management policies after 1960 reflected a

²⁶⁵ *E.g.*, 1 ERIC MILLS HOLMES & MARK S. RHODES, HOLMES’S APPLEMAN ON INSURANCE § 1.4 n.4 (2d ed. 1996) (“In a reinsurance treaty, the reinsured contracts to cede all or part of its risks to the reinsurer. The reinsurer contracts to accept the risks in return for a portion of the premiums.”).

²⁶⁶ Kenneth A. Froot, *Introduction to THE FINANCING OF CATASTROPHIC RISK*, *supra* note 4, at 1, 2. Reinsurers are “separately capitalized insurers” who service the insurance industry by allowing insurers to “pool [their] exposure for large events.” *Id.*

²⁶⁷ *See, e.g.*, Arthur Hau, *A Note on Insurance Coverage in Incomplete Markets*, 66 S. ECON. J. 433, 433 (1999).

²⁶⁸ *Id.* (“[M]arket incompleteness means that individuals face some risks that are uninsurable due to the absence of corresponding insurance markets, possibly as a result of moral hazard or adverse selection.”).

²⁶⁹ National Flood Insurance Act of 1968, Pub. L. No. 90-448, 82 Stat. 572 (codified as amended at 42 U.S.C. §§ 4001–129 (2000)).

²⁷⁰ David A. Moss, *Courting Disaster? The Transformation of Federal Disaster Policy Since 1803*, in *THE FINANCING OF CATASTROPHE RISK*, *supra* note 4, at 307, 318–19. At the time of the Act’s adoption, most general property insurance policies did not cover flood damage because the private insurance industry felt it could not pool the risk efficiently. *Id.* at 319. In its original form, the National Flood Insurance Program (NFIP) charged “premiums [that] corresponded to actual risk. Exceptions were made for structures erected before an area’s identification as a flood zone, in which case subsidized rates applied.” *Id.*

²⁷¹ Moss cites a study, conducted by Bob Benenson, which indicated that “as few as one in five mortgageholders in flood-zone areas participated in the NFIP.” *Id.* at 320.

²⁷² *Id.* at 339.

²⁷³ *Id.* Similar measures had to be taken in California following the Northridge earthquake. *Id.* at 339–40.

fundamental shift in public expectations about the role of government. Americans increasingly expected protection against an ever-widening array of hazards.”²⁷⁴ This expectation of protection has created a moral hazard of sorts: more and more people are moving to floodplains and hurricane zones, ostensibly because they believe that the government will protect them in the case of a catastrophic storm.²⁷⁵ Against this background, this Part will analyze insurance regulation in Florida in the wake of Hurricane Andrew and suggest appropriate courses of action for Katrina-affected states.

B. Florida’s Reinsurance Program: Hurricane Andrew’s Impact

An observer of the destruction wrought by Hurricane Andrew noted: ““This one storm alone blew apart Florida’s private insurance market and even much of its fail-safe regulatory apparatus.””²⁷⁶ Private insurers had taken a big hit after Hurricane Hugo in 1989, with two small firms buckling under the pressure of large claims;²⁷⁷ Hurricane Andrew was responsible for the closing of twelve small insurance companies.²⁷⁸ Florida legislators responded with several initiatives.

The Florida Hurricane Catastrophe Fund exists to bolster the insurance market by providing mandatory reinsurance.²⁷⁹ Every property insurer writing policies in Florida is required to contribute to this fund in exchange for coverage in the case of a catastrophe, such as a hurricane.²⁸⁰ The fund takes in approximately \$500 million of premiums annually.²⁸¹ However, critics fear that the fund has insufficient funds to cope with a severe hurricane like Hurricane Andrew.²⁸²

²⁷⁴ *Id.* at 326.

²⁷⁵ Froot, *supra* note 266, at 4.

²⁷⁶ See Moss, *supra* note 270, at 338 (quoting Phillip Longman, *The Politics of Wind*, FLA. TREND, Sept. 1994, at 30).

²⁷⁷ See Beatrice E. Garcia & David Satterfield, *Hurricane Andrew to Test Insurance Companies*, J. COM., Sept. 15, 1992, at 11A.

²⁷⁸ Christopher M. Lewis & Kevin C. Murdock, *Alternative Means of Redistributing Catastrophic Risk in a National Risk-Management System*, in THE FINANCING OF CATASTROPHE RISK, *supra* note 4, at 51, 64. The policies payable by the bankrupt insurers were eventually paid by the state guarantee fund. *Id.*

²⁷⁹ *Id.* at 69.

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² *Id.*

The Florida Insurance Guarantee Fund was formed to handle policies in the event that the policy writer is put out of business after a severe hurricane.²⁸³ The Insurance Guarantee Fund mainly redistributes loss; it assigns any unpaid claims to the remaining insurance companies according to their relative market share.²⁸⁴ Unlike the Residential Property and Casualty Joint Underwriting Association (RPCJUA), discussed below, the Insurance Guarantee Fund is geared towards business claims.²⁸⁵

The third cornerstone of Florida's insurance market is the Florida Wind Underwriting Association (FWUA).²⁸⁶ Since its creation in 1970, the FWUA has been "sell[ing] hurricane insurance in areas where private insurance companies refuse to cover the risk."²⁸⁷ To qualify for FWUA insurance, the area seeking it—typically a county—must show that good faith efforts have been made to purchase insurance in the private market and that buildings in the area meet heightened building code provisions.²⁸⁸ FWUA's rates require the approval of Florida's Department of Insurance.²⁸⁹ Clement Dwyer characterizes this semi-public, semi-private entity, and the Florida insurance market as a whole, as "an example of the political process standing in the way of market-clearing pricing."²⁹⁰ The FWUA has also been criticized for its "lack of consumer representation."²⁹¹ Insurers, who sit on the board of the FWUA, counter that the FWUA is the only mechanism by which to provide coverage to the most vulnerable parts of the Florida coast: "'We don't think the hurricane risk is fully insurable in the voluntary market,' said Barry Thomas, an FWUA board member who oversees State Farm's homeowners business in Florida."²⁹²

²⁸³ Barbara De Lollis, *Hurricane Insurance Passes Risk to Insured*, MIAMI HERALD, Aug. 21, 2000, at 1A.

²⁸⁴ The Guarantee Fund, however, does *not* cover claims with surplus line insurers. *E.g.*, Susan Stone, *Technical Report: Run-Off; Battle of the Best Guess*, REINSURANCE MAG., May 7, 1998, at 21.

²⁸⁵ See De Lollis, *supra* note 283.

²⁸⁶ Clement S. Dwyer Jr., Comment, *following* David A. Moss, *Courting Disaster: The Transformation of Federal Disaster Policy Since 1803*, in *THE FINANCING OF CATASTROPHIC RISK*, *supra* note 4, at 355, 355. Sometimes the FWUA is referred to as the Florida Wind Pool. *Id.*

²⁸⁷ De Lollis, *supra* note 283.

²⁸⁸ Jan Gorrie, *Property Insurance in Florida: The 1997 Legislative Reform Package*, 25 FLA. ST. U. L. REV. 351, 353–54 (1998).

²⁸⁹ *Id.* at 354.

²⁹⁰ Dwyer, *supra* note 286, at 356.

²⁹¹ De Lollis, *supra* note 283.

²⁹² *Id.*

Finally, legislators created the RPCJUA in the mold of the FWUA.²⁹³ The RPCJUA was intended to be an insurer of last resort; it was designed to fill the gaps in the insurance market left by fleeing insurers.²⁹⁴ By all accounts, the RPCJUA was meant to be a temporary program.²⁹⁵ As of the mid-1990s, however, it was the second-largest property insurer in Florida.²⁹⁶ By 1996, “Florida homeowners had experienced a seventy-two percent increase in insurance premiums, and most property insurers were still trying to limit coverage in the state wherever possible.”²⁹⁷ Critics believe that the RPCJUA is too ambitious, attempting to take on a risk that is too large for the Florida market to sustain by itself.²⁹⁸

C. Insurance and Reinsurance for Gulf Coast Businesses

“Florida is a microcosm of the problem that the insurance industry faces nationally.”²⁹⁹ Therefore, its strengths and weaknesses are good guides for future legislation and regulation of the insurance industry, particularly in other Gulf Coast states. The programs established in Florida highlight two distinct concerns: (1) the availability of insurance to individual homeowners and businesses located in vulnerable areas and (2) the depth of existing reinsurance markets to support direct insurers in the case of an extremely severe hurricane.

1. Making Insurance Available

The first problem was solved in Florida by the FWUA and the RPCJUA.³⁰⁰ These associations were established to provide insurance where private insurers were unable or unwilling.³⁰¹ Data regarding the number of insured homeowners and businesses in the Katrina-affected swath of the Gulf Coast are sketchy at best; the best estimates so far are based on the number of loan applications issued by the Small Business Administration (SBA).³⁰² The

²⁹³ Moss, *supra* note 270, at 339.

²⁹⁴ Florida attempted to prevent insurer flight in the wake of Hurricane Andrew by legislatively banning nonrenewals and cancellations of policies in the months immediately following Hurricane Andrew. *Id.*

²⁹⁵ *E.g.*, Gorrie, *supra* note 288, at 353.

²⁹⁶ *Id.*

²⁹⁷ Moss, *supra* note 270, at 339.

²⁹⁸ Dwyer, *supra* note 286, at 355. Another cause of criticism is rising premiums; in this regard, the RPCJUA is similar to the FWUA. *See supra* notes 293–97.

²⁹⁹ Dwyer, *supra* note 286, at 305.

³⁰⁰ *See supra* Part IV.B.

³⁰¹ *See supra* Part IV.B.

³⁰² Jaquetta White, *SBA Loans Can Help Many Get Back on Their Feet*, TIMES-PICAYUNE (N.O., La.), Sept. 20, 2005, at A15. The SBA is authorized to issue loans of up to \$1.5 million to businesses to cover

uninsured businesses that will be receiving SBA loans should have been insured. It is the task of the Louisiana, Mississippi, and Alabama state governments to make insurance not just reasonably available but practically mandatory.

It should be noted that the concept of required insurance is one that most people—especially most economists—cringe at, and rightfully so. Ideally, risk allocation should be an individual decision that is informed by market forces.³⁰³ However, this generally sound logic does not apply to natural disasters for a simple reason. Failure to insure against natural disaster, when living or doing business in a vulnerable region, results in externalities, or costs that are not internalized by the markets producing them.³⁰⁴ The first externality is that federal and state governments are forced to expend millions, if not billions, of dollars to cover uninsured loss.³⁰⁵ These expenditures shift funding from other programs and may increase the tax burden on citizens living outside of the vulnerable regions. The second externality is more indirect. As a result of massive uninsured loss, government typically seeks to lower premiums to entice more individuals to take advantage of insurance options. This decrease—or more often, limited increase—of premiums results in premium hikes in other insurance sectors across the country and across the world.³⁰⁶ These externalities illustrate the point that when individuals and businesses located in vulnerable regions fail to purchase insurance, they are not the only ones that pay, and this is why under-regulating insurance does not make sense.³⁰⁷

On a more practical note, many political observers insist that it is a political impossibility to pass legislation requiring insurance for certain areas.³⁰⁸ Certainly, a national requirement that all individuals and businesses purchase catastrophe insurance can not, will not, and should not pass Congressional

uninsured losses resulting from Hurricane Katrina. *Id.* The SBA had issued 740,000 loan applications by the end of September; “more than two thirds of those were issued to Louisiana business owners and individuals.” *Id.*

³⁰³ See generally MALLOY, *supra* note 77, at 169–74.

³⁰⁴ Malloy defines an externality as “an adverse (or beneficial) side effect of consumption or production, for which no payment is required (or no payment is received).” *Id.* at 177.

³⁰⁵ See, e.g., Moss, *supra* note 270, at 308–12.

³⁰⁶ See Sharon Wrobel, *Katrina to Increase Insurance Costs in Israel*, JERUSALEM POST, Sept. 6, 2005, at 17.

³⁰⁷ See Dwyer, *supra* note 286, at 356.

³⁰⁸ E.g., Matt Weiser, *Levee Monitoring Sinks in Legislature*, SACRAMENTO BEE, Sept. 10, 2005, at A16 (a proposed bill requiring mandatory insurance for homes and businesses on California floodplains failed).

scrutiny.³⁰⁹ However, forays into strong regulation of insurance have been made before.³¹⁰ For example, California requires that all homeowners' policies provide coverage for earthquake damage.³¹¹ Granted, California does not require homeowners to purchase insurance policies, but surely this is a step in the right direction.

2. *Strengthening Reinsurance Markets*

In the weeks following Katrina, most insurers issued tentatively optimistic statements regarding their respective abilities to service outstanding policies.³¹² The reinsurance industry was seemingly able to accommodate Katrina's wrath.

Although it is too early to determine whether the insurers' confidence was justified,³¹³ it is not too early to begin enriching the reinsurance market. Even if the reinsurance market was strong enough to withstand Katrina, making direct insurance more available means burdening insurers with more risk.³¹⁴ This transfer cannot be realistically accomplished without facilitating the distribution of excess risk across a larger number of parties; this is exactly what the reinsurance market is designed to do.³¹⁵

Mandatory contributions to state insurance funds, like those in Florida, could be used to spread the cost of reinsurance among all the insurers writing policies in the Gulf Coast states. If states' incentives are aligned—i.e., they are equally exposed to risk and equally likely to benefit from strong insurance—multi-state reinsurance pools could be extremely efficient in allocating risk.³¹⁶ It seems that the Gulf Coast states affected by Katrina have sufficiently similar incentives for this type of program to operate smoothly.

³⁰⁹ Alan Wickman, the Nebraska representative in a national insurance regulation group, agrees. Steve Jordon, *Forced Coverage Idea Gets Criticism*, WORLD HERALD (Omaha, Neb.), Oct. 6, 2005, at 1D.

³¹⁰ See *supra* Part IV.A.3; see also *supra* part IV.B.

³¹¹ Moss, *supra* note 270, at 339.

³¹² Henry Tricks, *Lloyd's Insurers Hope to Weather Katrina's Fury*, FIN. TIMES, Sept. 6, 2005, at 22; *Insurer Has Katrina Exposure Covered: QBE Storm Wash-up*, HOBART MERCURY (Tasmania, Austl.), Sept. 7, 2005, at 25.

³¹³ At the time this Comment was completed, insurance companies were still in the midst of sorting and paying claims.

³¹⁴ See *supra* Part IV.A.3.

³¹⁵ See *supra* Part IV.A.3.

³¹⁶ See Lewis & Murdock, *supra* note 278, at 70.

CONCLUSION

The law is a living thing, changing in response to its environment. Nowhere is this clearer than in the realm of contract law. As the needs of contracting parties change, so does the body of law that governs the interpretation of contracts.³¹⁷ This Comment has traced the development of the contract doctrine of impossibility from a very narrow rule designed to excuse performance in very rare circumstances to a much broader rule designed to embrace situations in which performance has become economically inefficient.³¹⁸ This evolution reflects a change in the needs of contracting parties.³¹⁹ Enforcement of contracts at all costs is no longer a desirable goal because contracting parties are already confident that appropriate contracts will be enforced, either by courts or informally.³²⁰ In a world with myriad overlapping industries, where business relationships span decades and long-term relationships are often more important than short-term gains and losses, contracting parties now turn to contract law to guide them in making the most efficient decisions, as viewed from a long-term perspective.³²¹

Contract law has responded. The U.C.C. and superior risk bearer tests indicate that contract law has evolved to address the much more commonplace problem of commercial impracticability.³²² However, it is important to understand that this evolution, while positive, has costs. Specifically, this Comment has shown that the evolution of the doctrine of impossibility has rendered it unwieldy when applied to the very situation it initially sought to remedy: the case of true impossibility presented by disaster-affected contracts.³²³

Hurricane Katrina and other recent catastrophic events have brought this problem into the limelight. Fortunately, we are not confined to the realm of contract law in searching for solutions. This Comment suggests that the insurance industry—as bolstered by an appropriate reinsurance industry—can help resolve the thorny question of risk allocation and contract interpretation in

³¹⁷ See *supra* Parts I.B–C.

³¹⁸ See *supra* Part I.

³¹⁹ See *supra* Part I.

³²⁰ See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 737–39 (1992).

³²¹ *Id.*

³²² See *supra* Parts I–II.

³²³ See *supra* Parts III.A.5, B.4.

disaster-affected areas.³²⁴ Instead of relying on lengthy litigation to determine how to allocate the cost of damage caused by catastrophic events *ex post*, it is more efficient to make insurance more attractive—if not mandatory—for businesses.³²⁵ However, this cannot be done without strengthening the reinsurance market.³²⁶ As previous catastrophes have taught us, insurance without sufficient reinsurance is a recipe for disaster.³²⁷ The Katrina-affected states must develop effective insurance and reinsurance programs that guarantee that all claims will be paid out if and when another catastrophic event occurs.

Effective insurance bypasses the calculations of risk that both the U.C.C. and the superior risk bearer tests entail. Because those risk calculations are so difficult to make in the context of post-disaster contracts, skipping the calculations altogether represents a significant advantage.³²⁸ Requiring insurance and providing for reinsurance essentially predetermines the risk of a future event. As long as the risk is calculated in a reasonable manner, the cost of overprotecting against the risk outweighs the costs associated with underprotecting.³²⁹

This approach seeks to correct an apparent market failure. Prior to Hurricane Katrina, information relating to the risk of a future severe hurricane was not properly incorporated into the market for a number of reasons.³³⁰ Strengthening the insurance markets in the areas vulnerable to natural disasters ensures that information is properly incorporated, thus allowing businesses to make the best possible decisions for both the short and long term.

SHIRLEY R. BRENER*

³²⁴ See *supra* Part IV.

³²⁵ See *supra* Part IV.

³²⁶ See *supra* Part IV.

³²⁷ See *supra* Part IV.B.

³²⁸ See *supra* Part IV.

³²⁹ See *supra* Part IV.

³³⁰ See *supra* Part IIC (noting that information was incomplete and ignored due to biases).

* J.D., Emory University School of Law, Atlanta, Georgia (2007); B.A., Columbia University, New York, New York (2004). I received insightful and constructive advice from Sorin and Gratiella Brener, Peter Kuhlmann, and Jawad Muaddi. Special thanks to all of my grandparents, who struggled through multiple versions of this Comment despite the fact that English is a third, fourth, or even fifth language, and to all of my family and friends for their support and interest.

