

# Notes

## The New Business Rule and the Denial of Lost Profits

[M]en keep their promises when neither side can get anything by the breaking of them.<sup>1</sup>

### I. INTRODUCTION

American contract law is based on the private<sup>2</sup> exchange of promises between individuals. Because it is essential that individuals be able to rely on these promises in determining their future business plans and in assessing the risks of contracts or ventures entered, the law of contract damages generally requires that a breaching party pay to the injured party damages based on the injured party's expectation interest, *i.e.*, an amount sufficient to put the injured party in as good a position as he would have been in had the contract been performed.<sup>3</sup> In line with Solon's view that "men keep their promises when neither side can get anything by the breaking of them,"<sup>4</sup> the expectation interest ensures that before a breaching party can get anything through breach, he must give the injured party all the benefits he would have enjoyed had the contract been honored.

The new business rule, however, is a rule that artificially reduces the injured party's expectation interest. This rule provides that, as a matter of law, a new or unestablished business cannot recover lost profits because absent a history of past profits, future profits are too "uncertain, contingent, and speculative."<sup>5</sup> By denying anticipated future profits, the new business rule automatically precludes one important aspect of the expectation interest and, thus, artificially increases the gain to the breaching party from breaking his promise. Ohio is among a minority of states which continues to adhere to the new business rule<sup>6</sup> to deny recovery of lost profits as a matter of law when there is no track record of business profits.

This Note focuses on the new business rule and its declining significance as a restraint on contract damages. The Note first examines the historical development of court-created limitations on the expectation interest and the consequent emergence of the new business rule as a limitation demanding that damages be proved with

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1. PLUTARCH, *THE LIVES OF THE NOBLE GRECIANS AND ROMANS* 100 (J. Dryden trans., rev. by Arthur Hugh Clough 1981).

2. While twentieth century commentators consistently characterize contracts as "private," doctrines such as the implied-in-law contract or quasi-contract create public obligations. See Dalton, *An Essay in the Deconstruction of Contract Doctrine*, 94 *YALE L.J.* 999, 1000-02 (1985). The author concludes that the public aspect of contracts is "consistently 'reprivatized,' with the undoing of a defective deal presented as depending upon the absence of will or intent rather than a mere inequivalence of exchange. . . . [Yet,] this privatization ineluctably partakes of the public." *Id.* at 1001.

3. See *infra* notes 7-18 and accompanying text.

4. PLUTARCH, *supra* note 1, at 100.

5. See, e.g., *Grupe v. Glick*, 26 Cal. 2d 680, 692-93, 160 P.2d 832, 840 (1945). See also *Hickman v. Coshocton Real Estate Co.*, 58 Ohio App. 38, 43-44, 15 N.E.2d 648, 650 (1936) (future profits of a new business are "too uncertain and speculative").

6. *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file); *Hickman v. Coshocton Real Estate Co.*, 58 Ohio App. 38, 15 N.E.2d 648 (1936).

certainty. It next analyzes Ohio's treatment of lost profits as typical of those states still adhering to a strict application of the new business rule: evidence of lost profits is inadmissible because lost profits are *per se* uncertain. This Note then discusses the trend in other American jurisdictions toward allowing the owner of a new business to recover lost profits if the owner can prove such profits with reasonable certainty. Finally, this Note shows that an economic analysis of contract damages presents not only an interesting parallel to traditional contract analysis but also a further justification for abandoning the new business rule. This Note concludes that Ohio and other jurisdictions still applying the new business rule should abandon the rule in favor of the majority approach.

## II. ORIGIN OF THE NEW BUSINESS RULE

The new business rule developed as a restriction on the general principle of contract damages which provides that an injured party should receive an award based on his expectation interest.<sup>7</sup> As traditionally formulated, recovery of the expectation interest provides that the injured party receive an amount sufficient to put him in as good a position as he would have been in had the contract been performed.<sup>8</sup> The rules defining damage awards, however, were created largely during the nineteenth century when America was still a young, industrializing nation. In an effort to spur economic growth, early common law courts developed several limitations<sup>9</sup> on a party's

7. RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) [hereinafter RESTATEMENT (SECOND)]. Section 347 defines the expectation interest as follows:

Subject to the limitations stated in §§ 350-53, the injured party has a right to damages based on his expectation interest as measured by

- (a) the loss in value to him of the other party's performance caused by its failure or deficiency, plus
- (b) any other loss, including incidental or consequential loss, caused by the breach, less
- (c) any cost or other loss that he has avoided by not having to perform.

Less formally, the expectation interest gives the promisee the "benefit of his bargain"—the amount required to put the promisee in as good a position as he would have been in had the contract been performed. D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 12.1, at 786 (1973); see also *infra* note 8.

8. 5 A. CORBIN, *CORBIN ON CONTRACTS* § 992, at 5 (1964); RESTATEMENT (SECOND), *supra* note 7, § 347 comment a (to the extent possible, contract damages return to the injured party an amount sufficient to put him in the position he would have been in had the contract been performed); 11 S. WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 1338 (3d ed. 1968) ("the general purpose of the law is, and should be, to give compensation, that is, to put the plaintiff in as good a position as he would have been in had the defendant kept his contract.").

9. The common law courts developed three principal limitations on a promisee's recovery of his expectation interest, which still restrict recovery of damages in contract today. First, a party cannot recover damages for any loss he could have avoided after the breach. Second, a party cannot recover damages beyond the amount that was foreseeable as a probable result of the breach when the contract was made. Third, a party cannot recover damages unless they are proved with reasonable certainty. E.A. FARNSWORTH, *CONTRACTS* § 12.8, at 841 (1982).

The *Second Restatement of Contracts* defines these three limitations as follows:

§ 350. Avoidability as a Limitation on Damages

(1) Except as stated in Subsection (2), damages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation.

(2) The injured party is not precluded from recovery by the rule stated in Subsection (1) to the extent that he has made reasonable but unsuccessful attempts to avoid loss.

§ 351. Unforeseeability and Related Limitations on Damages

(1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.

§ 352. Uncertainty as a Limitation on Damages

Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.

recovery of his expectation interest in order to preclude large or excessive damages<sup>10</sup> and to limit jury discretion.<sup>11</sup> One such limitation was the requirement that an injured party prove his damages with "certainty."<sup>12</sup> American common law courts used this certainty requirement as a primary means of reducing damage awards and, thus, the risks taken by entrepreneurs.<sup>13</sup> The new business rule, which evolved as a specific application of the rule of certainty, served as an additional tool for minimizing potentially disproportionate damage awards.

Paralleling the development of restraints on the amount of contract damages was the emergence of the precept that a promisor had no moral obligation to keep his promises. Indeed, Justice Holmes, in accord with his objective view of contract law in general,<sup>14</sup> promulgated the idea that every person had a *right* to break his contract if he chose to do so.<sup>15</sup> According to Holmes, there was to be no moral opprobrium attached to a breach of contract—a promisor could either choose to perform his contract as he had promised or he could breach and pay damages.<sup>16</sup> This philosophy encouraged entrepreneurs to move easily from an unprofitable enterprise to a more profitable one and, at least in theory, led to economic growth. Thus, Professor E. Allen Farnsworth has aptly observed that the American law of contract damages, "heavily influenced by the economic philosophy of free enterprise, has shown a

RESTATEMENT (SECOND), *supra* note 7, §§ 350–52, at 126–49.

10. Note, *Lost Profits as Contract Damages: Problems of Proof and Limitations on Recovery*, 65 YALE L.J. 992, 998 (1956) ("Although the foreseeability rule is directed primarily toward the problem of excessive damages and the certainty rule toward the problem of proof, the distinction is often blurred and either rule can be related to both problems."). In accord is the *Second Restatement of Contracts* which notes that while the problem of extremely disproportionate damages is usually limited by denial of "unforeseeable" damages, "[s]ometimes these limits are covertly imposed by means of an especially demanding requirement . . . of certainty."). RESTATEMENT (SECOND), *supra* note 7, § 351 comment f, at 142.

11. According to Professor McCormick, limitations on modern contract damages originated from the desire of judges for greater control over the jury. In the eighteenth century, judges began to make large inroads in the jury's discretion to award appropriate contract or tort damages. Eventually, judges garnered substantial control over the damage award through the authority to rule on the admissibility of evidence, to grant new trials for excessive awards, and to instruct the jury on the manner of calculating damages. The modern rules of unforeseeability and uncertainty also evolved from the struggle to strengthen judicial control. C. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 138, at 562 (1935); E.A. FARNSWORTH, *supra* note 9, § 12.8, at 840 (the expectation interest is "severely limited by rules that grew out of the attempts by judges . . . to control the award of damages by juries."); Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1210 (1970).

12. See D. DOBBS, *supra* note 7, § 12.3, at 798–99; E.A. FARNSWORTH, *supra* note 9, § 12.15, at 881–88; RESTATEMENT (SECOND), *supra* note 7, § 352 ("Damages are not recoverable beyond the amount that the evidence permits to be established with reasonable certainty."). See generally A. CORBIN, *supra* note 8, §§ 1020–23, at 124–57.

13. Farnsworth, *supra* note 11, at 1216; Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 RUTGERS L. REV. 273, 273–74 (1970).

14. See generally O.W. HOLMES, THE COMMON LAW 227–40 ([1881] Howe ed. 1963); B. KAPLAN, *Encounters with O.W. Holmes, Jr. 6–7*, in HOLMES AND THE COMMON LAW: A CENTURY LATER (1983); G. GILMORE, THE DEATH OF CONTRACT 35–52 (1974).

15. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

16. *Id.* ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it,—and nothing else. . . . If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can."); O.W. HOLMES, *supra* note 14, at 236 ("The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass. In every case it leaves him free from interference until the time for fulfilment has gone by, and therefore free to break his contract if he chooses."); *But cf.* R. POSNER, ECONOMIC ANALYSIS OF LAW § 4.8, at 106 (3d ed. 1986) (Holmes' formulation is useful but "overbroad.").

marked solicitude for men who do not keep their promises."<sup>17</sup> This solicitude for the contract breaker, moreover, necessitated limitations on the size of damage awards because entrepreneurs could not be encouraged to shift their capital to more profitable ventures if breach of contract were punished severely.

The certainty limitation requiring that contract damages be "certain" was originally a rule requiring absolute certainty.<sup>18</sup> A promisee could recover no damages save those that were shown with complete certainty.<sup>19</sup> This formulation of the certainty requirement was, of necessity, soon modified to a rule of *reasonable* certainty because "if absolute certainty were required as to the precise amount of loss that the plaintiff had suffered, no damages would be recovered at all in the great number of cases."<sup>20</sup> Today, all American jurisdictions enforce the certainty limitation but require only "reasonable" certainty.<sup>21</sup> The *Restatement (Second) of Contracts* also expresses the certainty requirement in terms of reasonableness: "[d]amages are not recoverable for loss beyond an amount that the evidence permits to be established with *reasonable* certainty."<sup>22</sup> Even under this modified certainty requirement, however, lost profits have frequently been denied for breach of contract with a new or unestablished business.<sup>23</sup>

In purpose and in practice, then, the certainty requirement operated to control the discretion of jurors and, thus, preclude excessive damage awards. In fact, Professor McCormick concluded that "[t]he standard of 'certainty' was developed, and has been used, chiefly, as a convenient means for keeping within the bounds of reasonable expectation the risk which litigation imposes upon commercial enterprise."<sup>24</sup>

The certainty requirement placed two negative restrictions on the size of contract damage awards. First, it increased the injured party's burden of persuasion beyond

17. Farnsworth, *supra* note 11, at 1216.

18. In *Griffin v. Colver*, 16 N.Y. 489 (1858), which Professor McCormick recognizes as a "classic statement" of the early certainty rule, the court required that "damages to be recovered from a breach of contract be shown with certainty, and not left to speculation or conjecture . . ." *Griffin v. Colver*, 16 N.Y. 489, 491 (1858).

19. *Id.*

20. J. MAYNE & H. MCGREGOR, *MAYNE & MCGREGOR ON DAMAGES* § 174, at 163 (12th ed. 1961).

21. See generally C. McCORMICK, *supra* note 11, § 26, at 99-100 ("[T]he certainty rule in its most important aspect, is a standard requiring a reasonable degree of persuasiveness in the proof of the fact and of the amount of damage. . . . [I]t appears that the epithet *certainty* is overstrong, and that the standard is a qualified one, of 'reasonable certainty' merely, or, in other words, of 'probability.'") (emphasis in original); S. WILLSTON, *supra* note 8, § 1345, at 234-37.

Further, the following principles listed in *McCormick* are used by courts to avoid the harsh results inherent in a strict application of the certainty doctrine:

- a) If the fact of damage is proved with certainty, the extent or amount may be left to reasonable inference.
- b) Where the defendant's wrong has caused the difficulty of proof of damage, he cannot complain of the resulting uncertainty.
- c) Mere difficulty in ascertaining the amount of damage is not fatal.
- d) Mathematical precision in fixing the exact amount is not required.
- e) If the best evidence of the damage of which the situation admits is furnished, this is sufficient.

C. McCORMICK, *supra* note 11, § 27, at 101.

22. RESTATEMENT (SECOND), *supra* note 7, § 352, at 144.

23. See *infra* note 32.

24. C. McCORMICK, *supra* note 11, § 28, at 105; see also Farnsworth, *supra* note 11, at 1213 (quoting this passage from McCORMICK, *supra* note 11, in explaining the evolution of the certainty requirement).

the normal preponderance test.<sup>25</sup> In most civil cases, the plaintiff need only prove his case by a preponderance. The requirement of certainty, however, raises the quantum of proof for damages above the more-likely-than-not standard. Second, in some instances, the certainty rule did more than increase the injured party's burden of proof; it became a rule of admissibility that justified exclusion of evidence if the judge deemed the evidence uncertain as a matter of law.<sup>26</sup> The new business rule is an example of the latter type of certainty restriction: the rule makes all lost profits of a new business uncertain *per se, i.e.*, evidence of lost future profits is, as a matter of law, inadmissible.<sup>27</sup>

### III. SIGNIFICANCE OF THE NEW BUSINESS RULE TODAY

American jurisdictions today apply the new business rule in two greatly divergent ways. One group applies the rule as an absolute bar to the recovery of prospective profits by a new or unestablished business.<sup>28</sup> These jurisdictions contend that lost profits of a new business are, as a matter of law, too uncertain, contingent, or speculative to be recovered. Thus, an injured promisee in these jurisdictions must come within one of an increasing number of exceptions<sup>29</sup> created by the courts in order to recover lost profits. Ohio falls within this category.<sup>30</sup>

The clear and growing majority of courts, however, now apply the new business rule as a rule which delimits the sufficiency of evidence.<sup>31</sup> In these jurisdictions, the new business rule merely restates and emphasizes the evidentiary requirement that a new business, like an existing business, must prove lost profits with reasonable certainty.

#### A. *The New Business Rule as a Per Se Bar to Recovery of Lost Profits*

##### 1. *General Background*

A dwindling number of jurisdictions still use the new business rule mechanically to deny recovery of anticipated future profits to a new business, as a matter of law, because there is no history of past profits from which to project future profits.<sup>32</sup> These

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25. Farnsworth, *supra* note 11, at 1210-11.

26. *Id.* at 1210. See also Note, *supra* note 10, at 998-99 (the certainty, unforeseeability, and causation restrictions have all been used to find inadmissible evidence offered to establish lost profits).

27. Professor Dobbs suggests that part of the reason for the development of the new business rule is that common law courts were traditionally more concerned with protecting capital than income. Lost profits, of course, were part of the plaintiff's expected income. To the common law court, however, the value of capital was more important than the value of the income or lost profits that might have been made through collateral transactions. Thus, Dobbs concludes that rules denying lost profits are frequently unconcerned with the certainty of proof. D. Dobbs, *supra* note 7, § 3.3, at 154.

28. See *infra* notes 32-35 and accompanying text.

29. See *infra* notes 48-78 and accompanying text.

30. *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file); *Hickman v. Coshocton Real Estate Co.*, 58 Ohio App. 38, 15 N.E.2d 648 (1936).

31. See *infra* notes 107-26 and accompanying text.

32. *G.M. Brod & Co. v. U.S. Home Corp.*, 759 F.2d 1526 (11th Cir. 1985) (construing Florida law); *Coastland Corp. v. Third Nat'l Bank Mortgage Co.*, 611 F.2d 969 (4th Cir. 1979) (construing Virginia law); *Poultry Health Serv. of Ga., Inc. v. Moxley*, 538 F. Supp. 276 (S.D. Ga. 1982) (construing Georgia law); *Sambo's of Ohio v. City Council of Toledo*, 466 F. Supp. 177 (N.D. Ohio 1979); *Polyglycoat Corp. v. Hirsh Distrib., Inc.*, 442 So. 2d 958 (Fla. Dist.

jurisdictions provide a definite, bright line test which promotes efficiency and judicial economy,<sup>33</sup> but the rule leads often to harsh results since the plaintiff may be denied part of his expectation interest solely because it is, by chance, a new business rather than an established business. Thus, there is an increasing trend in states espousing a *per se* application of the new business rule to create “exceptions and mitigating subdoctrines”<sup>34</sup> which threaten to subsume the new business rule without outright court abandonment.<sup>35</sup>

Ohio courts fall squarely within the minority group of states which still adhere to a rigid application of the new business rule.<sup>36</sup> Ohio has never seriously considered discarding the new business rule but, in line with other states still retaining the rule, has broadened existing exceptions and created new limitations in an effort to soften the rule’s harsh effects.

## 2. Application of the New Business Rule in Ohio

Ohio first adopted the new business rule in 1936,<sup>37</sup> noting that there existed “almost universal support”<sup>38</sup> for denying prospective profits absent provable documentation of past profits.<sup>39</sup> In 1979, the U.S. District Court for the Northern District of Ohio in *Sambo’s of Ohio v. City Council of Toledo*,<sup>40</sup> signaled continued adherence to the principle.<sup>41</sup> In *Sambo’s*, the plaintiff, Sambo’s, sued the City Council of Toledo for anticipated future profits claiming that the City Council had violated the first amendment guaranty of free speech when it revoked restaurant permits because the trade name “Sambo’s” had racial connotations.<sup>42</sup> Although the district court meticulously established that “the record not only shows evidence of damages, but establishes beyond question that the real damages suffered by the plaintiff are irreparable,” the court flatly rejected the plaintiff’s proof of lost profits.<sup>43</sup> Without comment or consideration of the policies underlying the new business rule, the court held:

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Ct. App. 1983); *In re Phoenix Restoration Specialists, Inc.*, 14 Bankr. 115 (Bankr. Mass. 1981); *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985)(LEXIS, States library, Ohio file); *Hickman v. Coshocton Real Estate Co.*, 58 Ohio App. 38, 15 N.E.2d 648 (1936); *Anbeck Co. v. Zapata Corp.*, 641 S.W.2d 608 (Tex. Ct. App. 1982); *My Sister’s Place v. City of Burlington*, 139 Vt. 602, 433 A.2d 275 (1981); *Kay Advertising Co. v. Olde London Transp. Co.*, 216 Va. 273, 217 S.E.2d 876 (1975).

33. Note, *Lost Profits for Unestablished Business: Should Virginia Retain the New Business Rule?*, 67 VA. L. REV. 433-39 (1981). In this Note, the author answers in the affirmative the question he poses in the title of his article, concluding that the efficiency and judicial economy inherent in the bright line new business rule outweigh the advantages of fairness to be gained by abandoning the *per se* rule.

34. *Olivetti Corp. v. Ames Business Sys., Inc.*, 81 N.C. App. 1, 344 S.E.2d 82, 91 (1986), *aff’d in part, rev’d in part on other grounds*, 319 N.C. 534, 356 S.E.2d 578 (1987); see also Comment, *Remedies—Lost Profit as Contract Damages for an Unestablished Business: The New Business Rule Becomes Outdated*, 56 N.C.L. REV. 695 (1978).

35. See generally R. DUNN, RECOVERY OF DAMAGES FOR LOST PROFITS 2d §§ 4.4-4.7, at 200-12 (2d ed. 1981).

36. See *supra* note 32.

37. *Hickman v. Coshocton Real Estate Co.*, 58 Ohio App. 38, 15 N.E.2d 648 (1936).

38. *Id.* at 32, 15 N.E.2d at 650.

39. *Id.*

40. 466 F. Supp. 177 (N.D. Ohio 1979).

41. *Id.*

42. *Id.* at 179.

43. *Id.* at 181.

The law is well established that loss of profits from a new business enterprise is too speculative to be allowed as an element of damages. *Only where the evidence establishes a history of profitable operations, followed by the actionable wrong and a diminution of profits, can there be any recovery.*<sup>44</sup>

The court gave no consideration to the fact that the plaintiff might be able to show evidence of lost profits by means other than a past history of profits, such as by comparison to other similar restaurants in the locale<sup>45</sup> or through business projections and expert testimony.<sup>46</sup>

Although Ohio courts retain the bright line distinction between new and existing businesses,<sup>47</sup> the courts have acted in accord with courts in other jurisdictions to narrow the scope of the rule.<sup>48</sup> Thus, Ohio has allowed an established business which had never shown a profit to prove lost future profits by means other than a past history of success.<sup>49</sup> In *Brookridge Party Center v. Fisher Foods, Inc.*,<sup>50</sup> for example, the plaintiff was an established business which had experienced "consistent business losses."<sup>51</sup> The Ohio Appellate Court for the Eighth District held that when a going business has never shown a profit but has "favorable prospects," lost profits are not automatically too speculative or uncertain as a matter of law.<sup>52</sup> The court allowed the plaintiff to try to prove lost profits with reasonable certainty, through expert testimony and profit projections.<sup>53</sup>

The court suggested in *Brookridge Party Center*<sup>54</sup> that allowance of lost profits to an established business which had never produced a profit was at variance with cases applying the new business rule,<sup>55</sup> but it made no attempt to distinguish the two situations or to reject the new business rule. Most other jurisdictions addressing the issue concur in the conclusion that the established but initially unsuccessful business

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44. *Id.* (emphasis added). In *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file), the court cites this portion of *Sambo's of Ohio v. City Council of Toledo* as controlling law in Ohio, and, indeed, this is an accurate summation of the new business rule as applied in Ohio. The case, however, actually construes federal law.

45. See *infra* notes 147-49 and accompanying text.

46. See *infra* notes 150-51 and accompanying text.

47. An existing business, by virtue of its history of past profits, may recover anticipated future profits. A new business, however, is automatically denied even the opportunity to attempt to prove lost profits. Under this approach, past profits are not merely the *best* data from which to project future profits, they are the only sufficient evidence. See *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file).

48. See, e.g., *G.M. Brod & Co. v. U.S. Home Corp.*, 759 F.2d 1526 (11th Cir. 1985) (construing Florida law: a business in existence for three months is not a new business); *Pauline's Chicken Villa v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985) (a franchise is sufficiently similar to other franchise outlets to negate nearly all uncertainty in proof of lost profits); *General Dynafab, Inc. v. Chelsea Indus. Inc.*, 301 Pa. Super. 261, 447 A.2d 958 (1982) (if a new business can show a "significant interest" in the product and sufficient commitments for orders, it may recover lost profits).

49. *Brookridge Party Center v. Fisher Foods, Inc.*, 12 Ohio App. 3d 130, 468 N.E.2d 63 (1983).

50. *Id.*

51. *Id.* at 136, 468 N.E.2d at 71.

52. *Id.*

53. *Id.* at 135-36, 468 N.E.2d at 71.

54. *Id.* at 130, 468 N.E.2d at 63.

55. *Id.* at 136, 468 N.E.2d at 71. The court explicitly compared *Hickman v. Coshoccon Real Estate Co.*, 58 Ohio App. 38, 15 N.E.2d 648 (1936), which first stated Ohio's adherence to the new business rule, to its holding that lost revenues could be received by a business with no prior profit history. *Id.*

need not show previous success or profits to recover lost profits.<sup>56</sup> The usual rationale is that many new businesses sustain a period of initial losses before becoming profitable, and it is, therefore, unfair to deny prospective profits to the established though initially unprofitable enterprise.<sup>57</sup>

A second method of circumventing the strict all-or-nothing effects of the new business rule is to narrow the scope of the term "new business." Another Ohio case, *Schechter v. Flavor Kitchens, Inc.*,<sup>58</sup> evidences this method of mitigating the unfairness of the *per se* ban on recovery of lost profits. In *Schechter*, Herbert Schechter, the owner of a small packaging plant, entered into written agreements with defendant Flavor Kitchens under which Flavor Kitchens contracted to package and sell products for Schechter under Schechter's label.<sup>59</sup> Under Flavor Kitchens' management, the high quality of plaintiff's packaging declined almost immediately.<sup>60</sup> Schechter sued for breach of contract, and the trial court awarded lost profits as part of the damage award.<sup>61</sup> On appeal, the Ohio Appellate Court for the Eighth District confirmed that Ohio adheres to the new business rule and prohibits recovery of lost profits as a matter of law but stated that, under the facts of the instant case, the enterprise was not a "new business."<sup>62</sup> Instead, contracting out the packaging process to another company was a continuation of Schechter's previous business under a new guise.<sup>63</sup> Thus, the court held that the new business rule is still controlling law in Ohio, but because the plaintiff came within an exception to the rule, it could try to prove lost profits through any evidence sufficient to establish profits with reasonable certainty.<sup>64</sup>

While this solution is fair in that it did not automatically deny the plaintiff a chance to prove lost profits, it is not logically consistent with the premise of the new business rule which holds that, without a history of past profits, lost future profits are simply too speculative to be recovered.<sup>65</sup> In the *Schechter* case, the defendant packaging company had no history of past success packaging these particular items for Schechter or for Schechter's customers. Thus, according to the strict logic of the

56. See, e.g., *Western Geophysical Co. v. Bolt Assocs.*, 584 F.2d 1164 (2d Cir. 1978); *Westric Battery Co. v. Standard Elec. Co.*, 482 F.2d 1307 (10th Cir. 1973); *National Soda Prods. Co. v. City of Los Angeles*, 23 Cal. 2d 193, 143 P.2d 12 (1943), *cert. denied*, 321 U.S. 793, *reh'g denied*, 322 U.S. 768 (1944); *Dean W. Knight & Sons v. First W. Bank & Trust Co.*, 84 Cal. App. 3d 560, 148 Cal. Rptr. 767 (1978); *Dallman Co. v. Southern Heater Co.*, 262 Cal. App. 2d 582, 68 Cal. Rptr. 873 (1968); *Vickers v. Wichita State Univ.*, 213 Kan. 614, 518 P.2d 512 (1974); *Bader v. Cerri*, 96 Nev. 352, 609 P.2d 314 (1980); *Larsen v. Walton Plywood Co.*, 65 Wash. 2d 1, 390 P.2d 677 (1964). *But cf.* *Keener v. Sizzler Family Steak Houses*, 597 F.2d 453 (5th Cir. 1979); *McBrayer v. Teckla, Inc.*, 496 F.2d 122, *reh'g denied*, 502 F.2d 1167 (5th Cir. 1974); *Murcurio v. Urroz*, 455 So. 2d 463 (Fla. App. 1984) (All found a history of past profits necessary). Cases cited in this footnote were cited in R. DUNN, *supra* note 35, § 4.6, at 206.

57. R. DUNN, *supra* note 35, § 4.6, at 209-10: "The plaintiff who opens a new business may often pass through a promotional stage while incurring losses. . . . It may be more difficult for a plaintiff to project profits from a history of losses, but having made a convincing showing, he should not be denied recovery."

58. No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file).

59. *Id.* at 3.

60. *Id.* at 4.

61. *Id.* at 4-5.

62. *Id.* at 7.

63. *Id.*

64. *Id.* at 8-9.

65. See R. DUNN, *supra* note 35, § 4.7, at 212 (If a court adheres to the new business rule, it should probably apply the rule to new ventures of existing businesses).



new business rule, future profits were uncertain and should have been denied. The court reached the correct conclusion that the plaintiff should be allowed to try to prove lost profits as long as the profits can be proved with reasonable certainty, since this is the rule applied to established businesses.<sup>66</sup> The court should not, however, have created a new and inconsistent exception to the new business rule in order to reach this conclusion. Instead, it should have rejected the new business rule outright and held that, like its precursor “certainty,” the new business rule is better employed as a rule of reasonable certainty that merely characterizes the quantum of evidence needed to obtain lost profits.<sup>67</sup>

Other jurisdictions have developed additional methods of avoiding the strict application of the new business rule. One technique is to recharacterize the recently established business as an “existing” or “established” business. An example of this recharacterization can be found in *G.M. Brod & Co. v. U.S. Home Corp.*<sup>68</sup> In *Brod*,<sup>69</sup> the U.S. Court of Appeals for the Eleventh Circuit noted that it is “the settled law of Florida that [for a new business] ‘proof of profits for a reasonable time anterior to the breach is required to establish lost profits.’”<sup>70</sup> The court then held that a business which had only existed for three months was not “in its inception at the time of defendants’ breach” and thus could prove lost profits by a means other than a history of past profits.<sup>71</sup> The plaintiff successfully proved lost profits through expert testimony based largely on profit projections and comparisons with industry averages for comparable businesses.<sup>72</sup> Other courts have likewise allowed proof of lost profits based on a new business’ short period of operation.<sup>73</sup>

This type of exception may also be inconsistent with the premise of the new business rule that only a history of past profits can ensure that there will be future profits. Unless the three month profit history in *Brod* produced sufficient data from which to extrapolate future profits, this exception for the recently established business is little more than a fiction contrived to circumvent the rule in appropriate cases—cases in which profits can be proved with reasonable certainty. A court willing to create this type of exception to the new business rule effectively abrogates the rule in favor of a rule of evidence.<sup>74</sup> The court should, instead, admit its disenchantment

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66. See, e.g., *Charles R. Combs Trucking, Inc. v. International Harvester Co.*, 12 Ohio St. 3d 241, 466 N.E.2d 883 (1984) (lost profits are recoverable when proved with reasonable certainty).

67. 5 A. CORBIN, *supra* note 8, § 1022, at 139 (“The term ‘speculative and uncertain’ is not really a classification of profits, but is instead a characterization of the evidence that is introduced to prove that they [profits] would have been made if the defendant had not committed a breach of contract. The law requires that this evidence shall not be so meager or uncertain as to afford no reasonable basis for inference, leaving the damages to be determined by sympathy and feelings alone.”).

68. 759 F.2d 1526 (11th Cir. 1985).

69. *Id.*

70. *Id.* at 1537.

71. *Id.* at 1537–38.

72. *Id.* at 1538–39.

73. See, e.g., *Heattransfer Corp. v. Volkswagenwerk, A.G.*, 553 F.2d 964, 983 (5th Cir. 1977), *cert. denied*, 434 U.S. 1087 (1978) (five months). *But cf.* *Pollack v. Morelli*, 245 Pa. Super. 388, 397–98, 369 A.2d 458, 463 (1976) (nine months operation by plaintiff plus twelve months operation by plaintiff’s predecessor not sufficient to create an established business).

74. See R. DUNN, *supra* note 35, § 4.4, at 201–02.

with the all-or-nothing quality of the new business rule and repudiate the rule without qualification.

Another arena in which courts are displaying increasing reluctance to apply the new business rule is that of the recently established franchise or chain store.<sup>75</sup> As noted in *Pauline's Chicken Villa v. Kentucky Fried Chicken Corp.*,<sup>76</sup> certain characteristics of franchise outlets eliminate nearly all uncertainty. When the franchisor is a national or regional franchisor with uniform advertising and quality control, and when there is available data on earnings and expenses and on failure and success ratios from similar locations, the franchisee can usually show lost profits with "reasonable certainty."<sup>77</sup> It should be allowed to do so. If, in addition, the franchisee is experienced in the particular business or has a past record of success in that industry, the case for awarding lost profits becomes even stronger.<sup>78</sup>

### 3. Abrogation of the New Business Rule in Ohio

Although the eighth Ohio appellate court in *Schechter v. Flavor Kitchens, Inc.*<sup>79</sup> affirmed the new business rule, it argued persuasively in dicta for Ohio's abandonment of the rule.<sup>80</sup> First, the court noted that the trend in other jurisdictions is to allow a new business to recover anticipated profits when it can prove lost profits with reasonable certainty.<sup>81</sup> The court further intimated that Ohio could abandon rigid adherence to the new business rule by noting that there are various methods other than a past profit history by which a plaintiff can show lost profits with reasonable certainty: by comparison with a business similar in size, location, and nature; by examination of the profit performance of plaintiff's successor; by comparison to a similar business operated by the plaintiff; or, by expert testimony and business forecasting techniques.<sup>82</sup>

Finally, the court found support for abandoning the new business rule by analogizing to a similar measure taken by the Ohio General Assembly in enacting Ohio's commercial code.<sup>83</sup> Comment 2 to Ohio Revised Code, section 1302.82<sup>84</sup> [UCC section 2-708] explicitly rejects the requirement that a new business demonstrate past earnings in order to recover anticipated profits: "[i]t is not necessary to recovery of 'profit' to show a history of earnings, especially if a new venture is involved."<sup>85</sup> Although section 1302.82 deals with the sale of goods and thus is not

75. *Pauline's Chicken Villa v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985); *Smith Dev. Corp. v. Bilow Enters., Inc.*, 112 R.I. 203, 308 A.2d 477 (1973).

76. 701 S.W.2d 399 (Ky. 1985).

77. *Id.* at 401.

78. *Id.* at 401-02.

79. No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file).

80. *Id.* at 6 n.2.

81. *Id.* at 5-6 n.1. For a list of jurisdictions which have abandoned the rule, see *infra* note 103.

82. *Id.* at 6 n.2. See generally S. WILLISTON, *supra* note 8, § 1346A, at 245-51 (3d ed. 1968) (explaining that when proof of profits made by others, by the plaintiff in a similar business, or through expert testimony is the best evidence available, it should be sufficient if it presents a reasonable inference that profits would have been made).

83. *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. at 6 n.2 (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file).

84. OHIO REV. CODE ANN. § 1302.82 comment 2 (Anderson 1979).

85. *Id.* (emphasis added). See also Caselton, *Lost Profit Damage Awards Under Uniform Commercial Code*

directly applicable to most breach of contract cases leading to lost profits by a new business, the statute does illustrate the judgment of the Ohio legislature that, at least in some cases, a new business in Ohio should not automatically be denied lost profits as a matter of law.

While arguing cogently for abandonment of the rigid new business rule in Ohio, the *Schechter* court refused to abrogate the rule. It opted, instead, to widen the exceptions to the rule.<sup>86</sup> Ohio and other jurisdictions could probably continue to award fair damages in many, although not all, cases by following the present procedure of increasing the number and scope of exceptions to the new business rule. The courts should, however, repudiate the new business rule and acknowledge that the rule, as an absolute bar to recovery of lost profits by a new business, is no longer helpful or desirable.<sup>87</sup>

#### 4. Deterioration of the Rule's Foundation

Just as the new business rule is facing increasing resistance in the courts, so the underlying rationale of the rule is being recognized as outdated<sup>88</sup> or simply inadequate.<sup>89</sup> Initially, the rule was premised on the assumption that the issue of lost profits in contract damages should be removed from jury consideration.<sup>90</sup> This argument rests in large part on a distrust of jurors as the ultimate arbiters of contract damage awards and a desire to take crucial issues away from that body. This notion is increasingly at variance with the modern view that jurors are competent to determine issues of fact. Further, in contract cases concerning lost profits of an *established* business, the jury is considered fully competent to receive extensive evidence and to decide the amount of damages.<sup>91</sup>

Moreover, modern rules of evidence help ensure that extensive and complicated statistical evidence needed to prove lost profits is presented in a manner understandable to the trier of fact.<sup>92</sup> For example, the judge rules on the admissibility of

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Section 2-708(2), 37 STAN. L. REV. 1109 (1985) (provides an economic analysis and justification for awarding lost profits under section 2-708(2) of the UCC in cases involving the sale of goods).

86. See *supra* notes 58-67 and accompanying text. The court said that contracting out part of a business to a new packager is not similar to creating a new business even though the new packager has never performed successfully for the particular customers.

87. The rule is both unhelpful and undesirable because it can operate to preclude legitimate claims based on an anachronistic determination, which has been refuted by most jurisdictions and commentators, that prospective profits of a new business are inherently speculative.

88. *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); *Olivetti Corp. v. Ames Business Sys., Inc.*, 81 N.C. App. 1, 344 S.E.2d 82 (1986), *aff'd in part, rev'd in part on other grounds*, 319 N.C. 534, 356 S.E.2d 578 (1987). See generally Comment, *supra* note 34. *But cf.* Note, *supra* note 33 for a justification of the continuing vitality of the new business rule.

89. See *infra* notes 127-41 and accompanying text.

90. See *supra* notes 11-24 and accompanying text.

91. See, e.g., *Smith v. Shasta Elec. Co.*, 190 Cal. App. 2d 728, 729-31, 12 Cal. Rptr. 167, 169 (1961); *Bishop v. East Ohio Gas Co.*, 41 Ohio L. Abs. 353, 366-67 (1943); *rev'd on other grounds*, 143 Ohio St. 541, 56 N.E.2d 164 (1944); *Commonwealth Trust Co. of Pittsburgh v. Hachmeister Lind Co.*, 320 Pa. 233, 240-45, 181 A. 787, 790-91 (1935). E.A. FARNSWORTH, *supra* note 9, § 12.8 at 840 (Of course, the judge retains control over damages to the extent that he gives specific instructions to the jury. These instructions include the major limiting rules that damages be certain and foreseeable and that the plaintiff avoid such losses as can be avoided without undue risk, burden, or humiliation. See *supra* note 9 for the RESTATEMENT (SECOND) definitions of these terms.).

92. See Note, *supra* note 33, at 436-38 for a critical evaluation of the effect of most of the evidentiary advances

evidence and may exclude evidence he deems too speculative or remote.<sup>93</sup> Both parties may also present expert testimony<sup>94</sup> and may cross-examine the experts at length<sup>95</sup> to ensure the reliability of the evidence so presented. In addition, the business records and other data from which experts calculate lost profits are no longer barred by the hearsay rules.<sup>96</sup> Finally, if the actual award is excessive, the trial judge can use the device of remittitur as an overriding check on the decision of the jurors. Remittitur is a procedural device by which a trial judge can require that a plaintiff either accept a lesser award or agree to a new trial limited to the issue of damages, if the judge determines that the original jury award is grossly excessive. Thus, because of the efficacy of these evidentiary and procedural measures, it is no longer necessary to take the issue of damages away from the jury entirely in order to avoid jury confusion or speculative damage awards.

Closely allied to the aim of circumscribing jury discretion was the goal of prohibiting excessive damage awards.<sup>97</sup> This policy, of course, implicitly provides

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considered herein. The author concludes that "the number of new businesses that could prove lost profits does not justify the expense and potential [jury] speculation of the evidentiary approach." *Id.* at 438.

93. See FED. R. EVID. 104(a): "Preliminary questions concerning . . . the admissibility of evidence shall be determined by the court . . ." See also McCORMICK ON EVIDENCE § 53, at 135 (E. Cleary 2d ed. 1984) ("[U]nder the traditional view and the generally accepted principle the trial judge decides with finality these preliminary questions of fact upon which depends the admissibility of an item of evidence that is objected to under an exclusionary rule of evidence [such as the new business rule].").

94. See FED. R. EVID. 702: "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert . . . may testify thereto in the form of an opinion or otherwise." OHIO EVID. R. 702 is identical. In addition, Williston states that proof of lost profits can be made by expert witnesses as long as the expert's opinion is more than mere conjecture. Williston concludes that although the witness' testimony cannot be wholly speculative and conjectural, "still the best evidence of which the subject will admit is receivable, and this is often nothing better than the opinion of well-informed persons upon the subject under investigation." S. WILLISTON, *supra* note 8, § 1364A, at 250 (quoting *Daughetee v. Ohio Oil Co.*, 263 Ill. 518, 105 N.E. 308 (1914)). The opportunity for cross-examination ensures that the expert testimony will not be wholly speculative and conjectural. See *supra* note 92.

95. According to the *Federal Rules of Evidence*, an expert may testify as to his opinion or inferences and may give his reasons for so believing without disclosing the underlying facts or data unless otherwise required by the court. Only on cross-examination *must* the expert reveal the data supporting his conclusions. FED. R. EVID. 705. The Ohio Rule 705, however, differs markedly from the federal rule in that it requires disclosure of the underlying facts and data *before* the expert can give his opinion or conclusions on the subject. See OHIO R. EVID. 705: "The expert may testify in terms of opinion or inference and give his reasons therefore *after* disclosure of the underlying facts and data." (emphasis added). The Ohio Rule 705 facilitates understanding of the frequently complex lost profits evidence in two ways. First, it ensures that the jury is, from the outset, aware of the basis of the expert testimony. If the basis is weak or faulty, the factfinder will know this before he is swayed by the expert opinion. Second, Ohio Rule 705 shifts the burden of disclosure from the opposing counsel who will be less conversant with the expert's testimony to the proponent. The Staff Note accompanying Ohio Rule 705 explains this advantage as follows: "The federal rule can result in disclosure being the burden of the cross-examiner. Under [Ohio] Rule 705, the disclosure is always on direct exam." The opposing counsel, of course, can supplement any evidence thus produced through cross-examination.

96. FED. R. EVID. 803(6) provides a hearsay exception allowing introduction of business records including memoranda, reports, records and data compilations of acts, events, conditions, opinions or diagnosis if the data meets certain requirements set out in the rule. OHIO R. EVID. 803(6) provides a similar though somewhat narrower hearsay exception for business records. Of equal importance is hearsay exception 803(17) which allows introduction of market quotations, tabulations, lists, directions and other published compilations generally used and relied on by persons in particular occupations. FED. R. EVID. 803(17). Ohio Rule 803(17) is identical to the federal rule. OHIO R. EVID. 803(17).

97. See Comment, *supra* note 34, at 696; see also Note, *supra* note 10, at 1020. Here, the author argues that although the certainty rule was traditionally concerned with requiring adequate proof of profits, it is sometimes combined with the causation requirement which demands that the breach be the cause of the lost profits. When certainty and cause are combined, the focus shifts from problems of proof to avoidance of excessive damage awards. Once the courts see the problem as one of excessive damages, they frequently use the certainty rule as an "all-or-nothing [bar to] recovery rather than compromise."

that, in the interest of commercial enterprise, it is better to limit the *injured* party's recovery of his expectation interest than to require the *breaching* party to pay excessive damages.<sup>98</sup> One commentator has noted that even if placing the risk of large damages on the injured promisee were a desirable goal, the certainty doctrine and the new business rule are both overbroad and underbroad and should not be used as a method of accomplishing this goal.<sup>99</sup> The new business doctrine is underbroad because whenever a promisee can show a history of past profits, the party may recover his entire expectation interest no matter how large the award.<sup>100</sup> Thus, the new business certainty requirement is inconsistent; it places the burden of excessive profits on the injured promisee only in the limited number of instances in which a promisee, by chance, is a new or unestablished business. If the real intent is to burden the promisee, then a rule should be imposed which does not single out one particular class of promisees but which applies evenly to all. The new business rule is also overbroad as a means of limiting excessive jury verdicts because the rule creates an all-or-nothing bar that mechanically precludes recovery of all profits, even those profits which can be proved and which are not excessive.<sup>101</sup> Thus, the new business rule is inherently incapable of satisfactorily addressing the problem of excessive verdicts. It should not be used for that purpose.

A final justification for the *per se* new business rule is that it reduces uncertainty, promotes judicial economy, and avoids the need for extensive evidence concerning the failed business and alternative measures of damages. In fact, one commentator argues that the ends of efficiency and judicial economy obtainable under a *per se* application of the new business rule outweigh any benefits of allowing the plaintiff to try to prove lost profits with reasonable certainty.<sup>102</sup> While it cannot be denied that the new business rule, like all bright line rules, naturally serves the goals of certainty and judicial economy, these goals are not inherently desirable in all instances; the initial inquiry must be whether the benefits of certainty and efficiency outweigh the

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98. Comment, *supra* note 34, at 704. The *Restatement (Second)* also recognizes this implicit policy of denying excessive verdicts, but attempts to face the problem squarely. It avoids facades such as "uncertainty" or "unforeseeability" and frankly states that awarding the full expectation interest does not always serve the interests of justice:

It is not always in the interests of justice to require the party in breach to pay damages for all of the foreseeable loss that he has caused. There are unusual circumstances in which it appears that the parties assumed that one of them would bear the risk of loss, or that although there was no assumption, it would be unjust to put the risk on that party. One such circumstance is an extreme disproportion between the loss and the price charged by the party whose liability for that loss is in question. . . . Typical examples of the limitations imposed on damages under this discretionary power involve the denial of recovery for loss of profits and the restriction of damages to loss incurred in reliance on the contract. *Sometimes these limits are covertly imposed, by means of an especially demanding requirement of foreseeability or certainty. The rule stated in this Section recognizes that what is done in such cases is an imposition of a limitation in the interests of justice.*

RESTATEMENT (SECOND), *supra* note 7, § 351 comment f (emphasis added).

99. Comment, *supra* note 34, at 705. Again, this notion comports with the philosophy of the *Restatement (Second)* which holds that even though excessive profits are to be avoided in some instances, the court should not deny recovery entirely but should limit the damages recoverable. RESTATEMENT (SECOND), *supra* note 7, § 351(3).

100. Comment, *supra* note 34, at 705.

101. *Id.* See also Note, *supra* note 10, at 1020 (using the certainty rule to handle the problem of large verdicts is problematic because the rule is an "all-or-nothing" rule that "precludes weighing of probabilities or awarding partial recoveries.").

102. See Note, *supra* note 33, at 433-39.

benefits and fairness of allowing an injured party to attempt to prove the extent of his damages. Courts faced with this choice are increasingly deciding in favor of allowing the additional measure of damages if the plaintiff can prove such damages.<sup>103</sup> Although courts have “traditionally treated claims for lost profits erratically,”<sup>104</sup> they now are relaxing the requirement of certainty in order to ensure that the plaintiff gets his full expectation interest, *i.e.*, out-of-pocket losses plus gains prevented by the breach. Thus, courts are abandoning the new business rule as a rule of admissibility<sup>105</sup> just as they abandoned the rule of absolute certainty in favor of the reasonable certainty doctrine.<sup>106</sup>

## B. *The New Business Rule as a Rule of Evidence*

### 1. *The Transition to a Rule of Evidence*

The requirement of reasonable certainty in contract damages need not mandate *per se* exclusion of all evidence of lost profits by a new business. Instead, the new business rule can operate as a rule of evidence ensuring that reasonable proof of lost profits is brought before the trier of fact, rather than as an absolute bar to recovery of lost profits:

Courts are now taking the position that the distinction between established businesses and new ones is a distinction that goes to the weight of the evidence and not a rule that automatically precludes recovery of profits by a new business. What is required is reasonable evidence, and that may at times be found in some fact other than the fact of past profits.<sup>107</sup>

A growing number of jurisdictions are adopting this evidentiary approach to the rule.<sup>108</sup> In fact, since January 1985, when Ohio last confirmed adherence to the new

103. See, e.g., *Rancho Pescado, Inc. v. Northwestern Mut. Life Ins. Co.*, 140 Ariz. 174, 680 P.2d 1235 (1984); *International Technical Instruments, Inc. v. Engineering Measurements Co.*, 678 P.2d 558 (Colo. App. 1983); *Harsha v. State Sav. Bank*, 346 N.W.2d 791 (Iowa 1984); *Pauline's Chicken Villa, Inc. v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985); *Olivetti Corp. v. Ames Business Sys., Inc.*, 319 N.C. 534, 356 S.E.2d 578 (1987).

104. Note, *supra* note 10, at 993 (courts often allowed less than full recovery or denied recovery altogether under the aegis of uncertainty).

105. See *infra* note 108.

106. Note, *supra* note 10, at 1020; *R. DUNN, supra* note 35, § 4.2, at 188. See also *supra* notes 18–22 and accompanying text.

107. *Olivetti Corp. v. Ames Business Sys., Inc.*, 81 N.C. App. 1, 344 S.E.2d 82 (1986) (quoting *D. Dobbs, supra* note 7, § 3.3, at 155), *aff'd in part, rev'd in part on other grounds*, 319 N.C. 534, 356 S.E.2d 578 (1987). See also *R. DUNN, supra* note 35, § 4.2, at 188.

108. *Guard v. P & R Enters., Inc.*, 631 P.2d 1068 (Alaska 1981); *Rancho Pescado, Inc. v. Northwestern Mut. Life Ins. Co.*, 140 Ariz. 174, 680 P.2d 1235 (1984); *S. Jon Kreedman & Co., v. Meyers Bros. Parking-Western Corp.*, 58 Cal. App. 3d 173, 130 Cal. Rptr. 41 (1976); *International Technical Instruments, Inc. v. Engineering Measurements Co.*, 678 P.2d 558 (Colo. App. 1983); *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); *Harsha v. State Sav. Bank*, 346 N.W.2d 791 (Iowa 1984); *Vickers v. Wichita State Univ.*, 213 Kan. 614, 518 P.2d 512 (1974); *Pauline's Chicken Villa, Inc. v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985); *John D. Copanos & Sons, Inc. v. McDade Rigging and Steel Erection Co.*, 43 Md. App. 204, 403 A.2d 402 (1979); *Fera v. Villa Plaza, Inc.*, 396 Mich. 639, 242 N.W.2d 372 (1976); *Cardinal Consulting Co. v. Circo Resorts, Inc.*, 297 N.W.2d 260 (Minn. 1980); *Alliance Tractor & Implement Co. v. Lukens Tool & Die Co.*, 204 Neb. 248, 281 N.W.2d 778 (1979); *General Elec. Supply Co. v. Mt. Wheeler Power, Inc.*, 94 Nev. 766, 587 P.2d 1312 (1978); *Price v. Von Lint*, 46 N.M. 58, 120 P.2d 611 (1942); *Kenford Co. v. Erie County*, 108 A.D.2d 132, 489 N.Y.S.2d 939 (1985) *aff'd*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986); *Olivetti Corp. v. Ames Business Sys., Inc.*, 319 N.C. 534, 356 S.E.2d 578 (1987); *Ferrell Constr. Co. v. Russell Creek Coal Co.*, 645 P.2d 1005 (Okla. 1982); *Welch v. U.S. Bancorp Realty & Mortgage Trust*, 286 Or.

business rule,<sup>109</sup> four new states have rejected the rule as an absolute rule of law and have recognized the rule, instead, as a rule regulating the sufficiency of the evidence adduced by the plaintiff trying to establish lost profits.<sup>110</sup> In these and other states,<sup>111</sup> an injured party may recover anticipated future profits if he can show lost profits with reasonable certainty, by evidence other than a prior track record of success.

In *Pauline's Chicken Villa v. Kentucky Fried Chicken Corp.*,<sup>112</sup> for example, the plaintiff had contracted with Kentucky Fried Chicken to operate a franchise in Clarksville, Kentucky.<sup>113</sup> When Kentucky Fried Chicken later rescinded the contract, the plaintiff sued seeking damages consisting solely of lost anticipated profits.<sup>114</sup> The trial court ordered a directed verdict for defendant,<sup>115</sup> but the appellate court reversed and remanded with the proviso that, as a matter of law, damages could not be awarded for lost profits of a new business.<sup>116</sup> The Kentucky Supreme Court reversed the decision and abolished the new business rule, stating that "the test should not be whether the business is a new or unestablished business without a history of past profits but whether damages in the nature of lost profits may be established with reasonable certainty."<sup>117</sup>

Likewise, in *Chung v. Kaonohi Center Co.*,<sup>118</sup> the Supreme Court of Hawaii allowed prospective lessees of a fast food Chinese restaurant to prove lost profits even though the defendant's breach of contract had prevented the plaintiffs from opening the restaurant.<sup>119</sup> In *Chung*, the court noted that only uncertainty as to the fact of damage and not the amount of damage<sup>120</sup> would prevent recovery under the rubric of

673, 596 P.2d 947 (1979); *Delahanty v. First Pa. Bank*, 318 Pa. Super. 90, 464 A.2d 1243 (1983); *Smith Dev. Corp. v. Bilow Enters., Inc.*, 112 R.I. 203, 308 A.2d 477 (1973); *Golden Gate Hop Ranch, Inc. v. Velsicol Chem. Corp.*, 66 Wash. 2d 469, 403 P.2d 351 (1965), *cert. denied*, 382 U.S. 1025 (1966); *Wyoming Bancorporation v. Bonham*, 563 P.2d 1382, *reh'g denied*, 566 P.2d 219 (Wyo. 1977).

109. *Schechter v. Flavor Kitchens, Inc.*, No. 48552, slip op. (8th Ohio Dist. Ct. App., Jan. 31, 1985) (LEXIS, States library, Ohio file).

110. *Pauline's Chicken Villa, Inc. v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985), *aff'd*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986); *Kenford Co. v. Erie County*, 108 A.D.2d 132, 489 N.Y.S.2d 939 (1985); *Olivetti Corp. v. Ames Business Sys., Inc.*, 319 N.C. 534, 356 S.E.2d 578 (1987) (abrogated the new business rule in the context of a tort action); *Petty v. Weyerhaeuser Co.*, 288 S.C. 349, 342 S.E.2d 611 (1986) (tort action).

111. *See supra* note 108.

112. 701 S.W.2d 399 (Ky. 1985).

113. *Id.* at 400.

114. *Id.* at 401.

115. *Id.*

116. *Id.*

117. *Id.* *See also* § 352, illustration 6 of the *Restatement (Second)*. Illustration 6 of § 352 provides a good example of the new business rule as a rule requiring only reasonable certainty:

6. A contracts with B to construct a new outdoor drive-in theatre, to be completed on June 1. A does not complete the theatre until September 1. Even though the business is a new rather than an established one, B may be able to prove his lost profits with reasonable certainty. B can use records of the theatre's subsequent operation and of the operation of similar theatres in the same locality, along with other evidence including market surveys and expert testimony, in attempting to do this.

RESTATEMENT (SECOND), *supra* note 7, § 352 comment b, illustration 6.

118. 62 Haw. 594, 618 P.2d 283 (1980).

119. *Id.* at 606, 618 P.2d at 291. *See also Fera v. Village Plaza, Inc.*, 369 Mich. 639, 242 N.W.2d 372 (1976) (lessee may recover lost profits for breach of lease preventing lessee from going into possession of the leasehold where lessee proves lost profits to a reasonable certainty).

120. *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 605, 618 P.2d 283, 290-91 (1980) (quoting *Ferreira v. Honolulu Star-Bulletin*, 44 Haw. 567, 575-76, 356 P.2d 651, 656 (1960)).

uncertainty.<sup>121</sup> Courts have long used this distinction between fact of loss and amount of loss to soften the unqualified requirement that damages be proved with reasonable certainty.<sup>122</sup> Under this principle, as long as the fact of damages is certain, the exact amount need not be shown with certainty.<sup>123</sup> “If the fact of damages is proved with certainty the extent or amount may be left to reasonable inference.”<sup>124</sup> Relying on this logic, the Hawaii Supreme Court concluded that if, under the circumstances, the new business proved future profits with reasonable certainty, it could recover although it had no history of past profits.<sup>125</sup> During the past ten years, this sufficiency of the evidence approach has become the prevailing view in the majority of American jurisdictions.<sup>126</sup>

## 2. Rationale for Adoption of an Evidentiary Use of the New Business Rule

The evidentiary use of the new business rule should be adopted by Ohio and other states currently using a *per se* application because the evidentiary approach stands on firm doctrinal foundations. Among those factors arguing persuasively for adoption of a rule that requires only sufficient evidence of lost profits are the following: the expectancy interest is designed to fully compensate the injured party by returning both the loss in value of the breaching party’s performance and the loss of expected gains prevented by the breach;<sup>127</sup> the accuracy of methods of proving lost future profits has increased significantly;<sup>128</sup> and the new business rule is unfair because it encourages breach against a new business by allowing the breaching party to escape damages in the form of lost profits that might be proved to a reasonable certainty.<sup>129</sup>

The fundamental premise of contract damages is that damages should compensate the injured promisee.<sup>130</sup> Courts generally do not apply legal sanctions to prevent a promisor from breaching his contract but seek, instead, to ensure that the injured

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121. *Id.* See also Farnsworth, *supra* note 11, at 1214.

122. *Story Parchment Co. v. Paterson Parachment Paper Co.*, 282 U.S. 555, 562 (1931); *Cope v. Vermeer Sales & Serv. of Colo.*, 650 P.2d 1307, 1309 (Colo. App. 1982); *El Fredo Pizza, Inc. v. Roto-Flex Oven Co.*, 199 Neb. 697, 705–06, 261 N.W.2d 358, 363–64 (1978); *Smith Dev. Corp. v. Bilow Enters., Inc.*, 112 R.I. 203, 214, 308 A.2d 477, 483 (1973). See also C. McCORMICK, *supra* note 11, § 27 at 101–02 (if the fact of damage is proved with certainty, the extent or amount of damage may be left to reasonable inference); Farnsworth, *supra* note 11, at 1214; Note, *supra* note 10, at 1027 (if fact of loss is proved, most courts will give damages to prevent wrongdoer from profiting from the uncertainty he created by breaching).

123. See S. WILLSTON, *supra* note 8, § 1345, at 232.

124. C. McCORMICK, *supra* note 11, § 27, at 101. Professor McCormick lists this fact of loss-extent of loss dichotomy among the “modifying doctrines” which allow courts to require a high standard of certainty and yet avoid harsh applications of the rule. For a complete list of McCormick’s “modifying doctrines,” see *supra* note 21.

125. *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 606, 618 P.2d 283, 291 (1980) (the plaintiff’s proof of lost profits included a reproduction cost analysis, a comparative market analysis, and an income stream analysis. These were found to be satisfactory substitutes for a past profit history).

126. See *supra* notes 108–11 and accompanying text.

127. See *infra* notes 130–45 and accompanying text. See also *supra* note 7 containing the *Restatement (Second)* definition of expectation interest which encompasses “other loss, including incidental or consequential loss, caused by the breach:” as well as the loss in value of the other party’s performance.

128. See *infra* notes 146–51 and accompanying text.

129. See *infra* notes 152–56 and accompanying text.

130. A. CORBIN, *supra* note 8, § 1002, at 31; D. DOBBS, *supra* note 7, § 12.1, at 786–87; RESTATEMENT (SECOND), *supra* note 7, § 347 comment a.



promisee is compensated for his loss.<sup>131</sup> Full compensation for breaches involving an on-going business or a new business includes not only out-of-pocket costs but also collateral profits or prevented gains that may be expected to flow from the transaction.<sup>132</sup> To use the new business rule as a rule specifying only that lost profits be proved with reasonable certainty will put damages for lost profits of a new business in line with other damage awards which purport to fully compensate the plaintiff.<sup>133</sup>

Moreover, adoption of a test of reasonable certainty will not automatically make the contracting promisor a guarantor of lost profits.<sup>134</sup> The plaintiff still must establish lost profits with the traditionally required "reasonable certainty."<sup>135</sup> In *Kenford Co. v. Erie County*,<sup>136</sup> for example, plaintiff Kenford Company contracted to donate 178 acres of land to Erie County in exchange for the County's promise to build a domed stadium on the premises and to allow the shareholder of Kenford Company and his advisor to lease or manage the domed facility for a period of time not to exceed forty years.<sup>137</sup> When Erie County did not receive bids on the stadium that were within their budget, they voted not to proceed.<sup>138</sup> A jury eventually awarded Kenford Company \$25.6 million in profits lost because of breach of the management contract.<sup>139</sup> The Fourth Department of the New York Appellate Division held that

131. See E.A. FARNSWORTH, *supra* note 9, § 12.1, at 812-13 (the injured promisee receives the "benefit of his bargain," *i.e.*, his expectation interest; generally there is no attempt to compel the promisor to perform); RESTATEMENT (SECOND) Chap. 16, Introductory Note ("The traditional goal of contract damages has not been compulsion of the promisor to perform his promise, but compensation of the promisee for the loss resulting from breach."); Farnsworth, *supra* note 11, at 1145 (The American "system . . . is not directed at compulsion of promisors to prevent breach; rather it is aimed at relief to promisees to redress breach." (emphasis in original). If courts do not require the promisor to perform, however, they do require him to compensate the promisee for resulting losses.); O.W. Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

132. See generally A. CORBIN, *supra* note 8, §§ 1022-23, at 139, 147-57 (Lost profits are, in essence, the prevention of a plaintiff's "hoped-for gains." Full compensation of an established or a new business includes lost profits. The limitation of certainty should not preclude lost profits for a new business if such profits are proved with reasonable accuracy.). See also RESTATEMENT (SECOND), *supra* note 7, § 347 (the definition of expectation interest includes consequential losses).

133. See Farnsworth, *supra* note 11, at 1147; Note, *The Requirement of Certainty in the Proof of Lost Profits*, 64 HARV. L. REV. 317, 319-321 (1950); See generally A. CORBIN, *supra* note 8, §§ 1022-23, at 135-57.

134. See, *e.g.*, *Guard v. P & R Enters., Inc.*, 631 P.2d 1068 (Alaska 1981) (in remanding for reconsideration of plaintiff's claim for lost profits, the Alaska Supreme Court said that although plaintiffs had the opportunity to prove lost profits, the profits must meet the "reasonable certainty" threshold); *Rancho Pescado, Inc. v. Northwestern Mut. Life Ins. Co.*, 140 Ariz. 174, 680 P.2d 1235 (1984) (inadequate basis for expert projections combined with fact that plaintiff had no assured market and that there is a ninety-five percent failure rate for new catfish enterprises made proof insufficient); *Kenford Co. v. Erie County*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986) ("the multitude of assumptions required to establish projections of profitability over the life of . . . [the] contract require speculation and conjecture, making it beyond the capability of even the most sophisticated procedures to satisfy the legal requirements of proof with reasonable certainty.").

135. See, *e.g.*, *Cope v. Vermeer Sales & Serv. of Colo., Inc.*, 650 P.2d 1307 (Colo. App. 1982); *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); *Harsha v. State Sav. Bank*, 346 N.W.2d 791 (Iowa 1984); *John D. Companos & Sons, Inc. v. McDade Rigging and Steel Erection Co.*, 43 Md. App. 204, 403 A.2d 402 (1979); *Butcher v. Garrett-Enumclaw Co.*, 20 Wash. App. 361, 581 P.2d 1352 (1978). See also RESTATEMENT (SECOND), *supra* note 7, § 352, at 144 ("Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.").

136. 108 A.D.2d 132, 489 N.Y.S.2d 939 (1985), *aff'd*, 67 N.Y.2d 257, 493 N.E.2d 234, 502 N.Y.S.2d 131 (1986).

137. *Id.* at 134, 489 N.Y.S.2d at 941-42.

138. *Id.* at 134, 489 N.Y.S.2d at 942.

139. *Id.* at 135, 489 N.Y.S.2d at 942.

although there is no rule in New York which automatically precludes a new business from recovering lost profits, plaintiff's evidence contained too many variables and was too uncertain to support an award of lost profits.<sup>140</sup> The New York Court of Appeals affirmed, but substituted a slightly different rationale. The court held that liability for extensive lost profits was not within the contemplation of the parties at the time of the contract's execution or breach.<sup>141</sup> It further held that the numerous assumptions relied upon to establish profitability projections precluded calculation of lost profits within a reasonable degree of certainty.<sup>142</sup>

Thus, a new enterprise's success in proving prospective profits will necessarily depend on the particular facts and circumstances of each case.<sup>143</sup> The *Restatement (Second) of Contracts* embraces the idea that a new business may recover lost profits that it proves with reasonable certainty<sup>144</sup> but also recognizes the natural limitations of that standard on new businesses. Comment b of the *Restatement (Second) of Contracts* succinctly states the rule as follows:

[I]f the business is a new one . . . proof will be more difficult. Nevertheless, damages may be established with reasonable certainty with the aid of expert testimony, economic and financial data, market surveys and analyses, business records of similar enterprises, and the like.<sup>145</sup>

The promisor, then, is not automatically an insurer of the promisee's losses. Weaknesses in the promisee's proffered evidence, however, should affect only the weight and credibility of the testimony, not its admissibility.

A further reason for accepting a sufficiency of the evidence approach is that the alternative means of proving prospective profits have increased greatly in accuracy.<sup>146</sup> These alternative methods include: (1) the yardstick method under which a comparison is made with the profit performance of a business similar in size, nature,

140. *Id.* at 141-44, 489 N.Y.S.2d at 948-49. The expert had projected that plaintiffs would be able to negotiate contracts securing ten professional football games, and forty-two "open time events" including "three consumer shows, six high school football games, five circuses and seven musical or entertainment events." He then estimated ticket prices and parking and concession revenues as well as all salaries, advertising fees, legal fees, and miscellaneous expenses over a twenty year period. The court concluded that although the breaching party bears the risk of uncertainty, plaintiff had established neither the *fact* of loss nor the amount of loss. *Id.* at 144, 489 N.Y.S.2d at 947-49. On appeal, the New York Court of Appeals affirmed on slightly different grounds as noted in the text.

141. *Kenford Co. v. Erie County*, 67 N.Y.2d 257, 262, 493 N.E.2d 234, 236, 502 N.Y.S.2d 131, 133 (1986).

142. *Id.*

143. *See, e.g.*, *Guard v. P & R Enters., Inc.*, 631 P.2d 1068, 1072-73 (Alaska 1981) (intimating that, on these facts, the lower court might find no loss profits on remand); *Rancho Pescado, Inc. v. Northwestern Mut. Life Ins. Co.*, 140 Ariz. 174, 184, 680 P.2d 1235, 1245 (1984) (new business could not prove lost profits given particular facts of the case); *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 606, 618 P.2d 283, 291 (1980) (evidence needed to prove future profits with the requisite legal certainty depends on the individual facts of each case); *Pauline's Chicken Villa v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399, 401 (Ky. 1985) (there is no "single definition of 'reasonable certainty.'") The court must look to the "factors and elements" of the case.; *Smith Dev. Corp. v. Bilow Enters. Inc.*, 112 R.I. 203, 212, 308 A.2d 477, 482 (1973) (reasonable certainty will "depend in large measure upon the circumstances of the particular case and thus will escape the hard and fast rules of general applicability.") (quoting Note, *The Requirement of Certainty in Lost Profits*, 64 HARV. L. REV. 317, 319 (1950)).

144. RESTATEMENT (SECOND), *supra* note 7, § 352 comment b.

145. *Id.* (emphasis added).

146. *See generally* Comment, *supra* note 34, at 713-21 (analyzing various methods of proving lost profits with reasonable certainty, absent a past profit history). *See also* A. CORBIN, *supra* note 8, § 1023, at 150-57; E.A. FARNSWORTH, *supra* note 9, § 12.15, at 841-42; S. WILLISTON, *supra* note 8, § 1346A, at 245-51 (methods of proving lost profits); Note, *supra* note 133, at 319; Note, *supra* note 10, at 1018-20.

and location;<sup>147</sup> (2) comparison with the profit history of plaintiff's successor, as in a case in which a lessor breaches his promise to lease land to the plaintiff and subsequently leases to another person who establishes a successful business;<sup>148</sup> (3) comparison of profits made by the plaintiff himself in a previously or subsequently owned business which is similar in nature and location;<sup>149</sup> and (4) use of economic and financial data and expert testimony.<sup>150</sup> In addition to these more accurate measures of proving lost profits, the rules of evidence have been relaxed to permit business reports, records, and other documents as admissible evidence and to ensure that the complex statistics needed to prove profits is presented in a way comprehensible to the jury or court.<sup>151</sup>

Finally, fairness also weighs in favor of adoption of the sufficiency of the evidence approach. The new business rule is an all-or-nothing rule which gives nothing to a new business seeking lost profits. When two parties freely enter a contractual relationship and the promisor later breaches the contract and, thus, precludes ascertainment of the amount of damages with certainty, it is patently unfair to reward the promisor by automatically denying lost profits which is often the principal element of the damage award. Such a denial has been characterized as follows:

[I]t would be a perversion of fundamental principles of justice to deny all relief to the injured person, and thereby relieve the wrongdoer from making any amends for his acts. . . . The wrongdoer is not entitled to complain that they [profits] cannot be measured with the exactness and precision that would be possible if the case, which he alone is responsible for making, were otherwise.<sup>152</sup>

Indeed, fairness requires that the strict application of the new business rule be rejected because American rules of contract damages, which purport to put the plaintiff in the position he would have been in had the other party performed, encourage all parties, including new businesses to rely on the contracts they make.

147. See, e.g., *G.M. Brod & Co. v. U.S. Home Corp.*, 759 F.2d 1526 (11th Cir. 1985); *Miller Indus. v. Caterpillar Tractor Co.*, 733 F.2d 813, 822 (11th Cir. 1984); *Lehrman v. Gulf Oil Corp.*, 500 F.2d 659, 677 (5th Cir. 1974), cert. denied, 420 U.S. 929 (1975); *Pauline's Chicken Villa, Inc. v. Kentucky Fried Chicken Corp.*, 701 S.W.2d 399 (Ky. 1985); *Cardinal Consulting Co. v. Circo Resorts, Inc.*, 297 N.W.2d 260 (Minn. 1980); *Smith Dev. Corp. v. Bilow Enters., Inc.*, 112 R.I. 203, 308 A.2d 477 (1973).

148. See, e.g., *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); see also S. WILLISTON, *supra* note 8, § 1346A, at 249 and cases cited therein (profits made by others, including those of plaintiff's successor may be a sufficient substitute for a past profit history); Comment, *supra* note 34, at 715-16 (same).

149. See, e.g., *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); *Fera v. Village Plaza, Inc.*, 396 Mich. 639, 242 N.W.2d 372 (1976); S. WILLISTON, *supra* note 8, § 1346A, at 249; Comment, *supra* note 34, at 716.

150. See, e.g., *G.M. Brod & Co. v. U.S. Home Corp.*, 759 F.2d 1526 (11th Cir. 1985); *Lehrman v. Gulf Oil Corp.*, 500 F.2d 659 (5th Cir. 1974), cert. denied, 420 U.S. 929 (1975); *S. Jon Kreedman & Sons v. Meyers Bros. Parking-Western Corp.*, 58 Cal. App. 3d 173, 130 Cal. Rptr. 41 (1976); *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980); *Fera v. Village Plaza, Inc.*, 396 Mich. 639, 242 N.W.2d 372 (1976); *Smith Dev. Corp. v. Bilow Enters., Inc.*, 112 R.I. 203, 308 A.2d 477 (1973); *Larsen v. Walton Plywood Co.*, 65 Wash. 2d 1, 390 P.2d 677 (1964); *Butcher v. Garrett-Enumclaw Co.*, 20 Wash. App. 361, 581 P.2d 1352 (1978); see also S. WILLISTON, *supra* note 8, § 1346A, at 250 (evidence of experts may be sufficient); Comment, *supra* note 34 at 719-21.

151. See *supra* notes 92-96 and accompanying text.

152. *Story Parchment Co. v. Paterson Parchment Paper Co.*, 282 U.S. 555, 563 (1931); see also *Lee v. Joseph E. Seagram & Sons, Inc.*, 552 F.2d 447 (2d Cir. 1977); *Chung v. Kaonohi Center Co.*, 62 Haw. 594, 618 P.2d 283 (1980) (new business rule is "grossly unfair.").

Both new and established businesses incur preparatory costs and forego other business opportunities in part in reliance on the belief that if the contract is breached, the promisee will be put in the same position he would have occupied had the contract been performed.<sup>153</sup> This reliance on promised performance allows for efficient production and lower operating costs.<sup>154</sup> Failure to reimburse a new business for its lost profits, therefore, is unfair because it fails to return to the disappointed promisee his full expectation after encouraging the promisee to rely on the promise. Furthermore, the new business rule can lead to inefficiency because, as will be discussed more fully in the next section,<sup>155</sup> it actually encourages breaches<sup>156</sup> against a new business by making the lost profits element of traditional damage awards irrelevant to a promisor's decision of whether or not to breach his contract.

#### IV. ECONOMIC THEORY AND THE NEW BUSINESS RULE

Economic analysis of contract damages<sup>157</sup> provides an important analogue to the traditional view of contract damages examined above. An economic analysis supports the conclusion that courts should award damages for future profits to a new business when profits are provable with reasonable certainty. Traditional economic theory posits that the goal of the economy is efficiency, *i.e.*, that goods and resources be used in their most productive manner. Under this analysis, a promise of future dealings with a new business allows both parties to plan their behavior, such as entering into collateral contracts to equip a plant, sell merchandise, or increase output.<sup>158</sup> Assuming that individuals act rationally to maximize their own welfare, contracts can be accurately defined as voluntary exchanges of assets by individuals seeking to obtain goods or services they value more highly in exchange for goods they own.<sup>159</sup> If the contract results in a benefit or gain to both parties, society moves closer to the goal of economic efficiency. Within the economic framework, then, the purpose of contract damages is to facilitate maximum societal benefit or efficiency from these voluntary exchanges.

According to Judge Posner, the objective of maximum societal efficiency can be achieved by encouraging, through appropriate damage awards, the fulfillment of promises unless the result would be an inefficient reallocation of resources.<sup>160</sup> In

153. Fuller & Purdue, *The Reliance Interest in Contract Damages*, 46 *YALE L.J.* 52, 62-63 (1936); Note, *supra* note 10, at 995.

154. Fuller & Purdue, *supra* note 153, at 61-65; Note, *supra* note 10, at 995.

155. See *infra* notes 157-65 and accompanying text.

156. See, *e.g.*, *Guard v. P & R Enters., Inc.*, 631 P.2d 1068, 1072 (Alaska 1981) (to deny lost profits as a matter of law would be to encourage promisor's contracting with a new business to breach their contracts); *Vickers v. Wichita State Univ.*, 213 Kan. 614, 620, 518 P.2d 512, 517 (1974) (same).

157. See generally *THE ECONOMICS OF CONTRACT LAW* (A. Kronman & R. Posner eds. 1979); E.A. FARNSWORTH, *supra* note 9, § 12.3, at 816-18; R. POSNER, *ECONOMIC ANALYSIS OF LAW* Chap. 4 (3d ed. 1986); *RESTATEMENT (SECOND)*, *supra* note 7, Chap. 16 Introductory Note, at 101-02; Birmingham, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 *RUTGERS L. REV.* 273 (1970).

158. R. POSNER, *supra* note 157, § 4.8, at 109-10 (reliance costs during the executory period include planning and adjustments in the business necessary to perform the contract); Fuller & Purdue, *supra* note 153, at 62-63.

159. E.A. FARNSWORTH, *supra* note 9, § 12.3, at 816; *RESTATEMENT (SECOND)*, *supra* note 7, Chap. 16 Introductory Note, at 101.

160. R. POSNER, *supra* note 157, § 4.8, at 107.

other words, given a promise which society wants to encourage, such as a promise to a new business, contract damages must exact from the party in breach an amount sufficient to cover the other party's entire loss because only then can we be assured that the breaching party will use the goods in a more productive, more efficient manner than under the original voluntary agreement. Assuming that the breaching party acts rationally to maximize his own welfare, he will breach the contract only if his gain from the breach is greater than the amount necessary to fully compensate the injured party for his loss from the breach.<sup>161</sup> Judge Posner illustrated the importance of not awarding damages which are less than the injured party's expectation or subjective measure of losses with the following example.<sup>162</sup>

A contracts to sell B for \$100,000 a machine that is worth \$110,000 to B, i.e., that would yield him a profit of \$10,000. Before delivery C comes to A and offers him \$109,000 for the machine promised B. A would be tempted to breach were he not liable to B for B's loss of expected profit. Given that measure of damages, C will not be able to induce a breach of A's contract with B unless he offers B more than \$110,000, thereby indicating that the machine really is worth more to him than to B.<sup>163</sup>

Posner concluded that a rule which returns the injured party's expectation interest, including his expected gains or "lost profits," ensures that the goods or services are used at their highest value.<sup>164</sup>

Only if the gain to the breaching party is greater than the injured party's loss, including lost profits, will the breaching party break his contract, compensate the injured party, and use the resources in the more productive manner. This measure of damages, derived from economic analysis, is remarkably parallel to the traditional "expectation interest" which demands damages sufficient to put the injured party in the position he would have been had the contract been performed. Economic analysis, however, goes further than traditional contract analysis because it not only prescribes the appropriate measure of damages upon breach, but also teaches that "efficient breaches" are to be encouraged by society.<sup>165</sup>

The new business rule, however, artificially removes from the breaching party's calculation of costs of the breach the element of lost profits, which is often the greatest element of damages. Thus, in a jurisdiction adhering to the *per se* application of the new business rule, it will not always be the case that what is beneficial for the individual breaching party will be efficient for society as a whole. A promisor may find it profitable to breach only if he need not pay lost profits. If this is the case and

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161. *Id.*; see also E.A. FARNSWORTH, *supra* note 9, § 12.3, at 817 (A principle called the Kaldor-Hicks principle is often used to evaluate the breacher's gain and the injured party's loss. Under this principle, breach is to be encouraged if the party who benefits from the breach calculates his gain as large enough to receive a net benefit after fully compensating the injured party, according to the injured party's subjective measurement of his own loss. Tersely stated, the breach is efficient if "the party who benefits [the breacher] values his gains more than the loser values his losses.").

*Id.*

162. R. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.9 (2d ed. 1977) (this example did not appear in the third edition of Judge Posner's book which is otherwise cited herein).

163. *Id.* at 90.

164. *Id.*

165. R. POSNER, *supra* note 157, § 4.8, at 107 (efficient breaches are really "involuntary" because they are committed "only to avert a larger loss").

the promisor does breach, the result is that the promisor is transferring his resources to a less efficient use, and society will be less well off. The *per se* application of the new business rule, then, is skewed toward allowing inefficient breaches. To prevent such inefficient breaches, and thus maximize societal productivity, the damage award to a new business should include lost profits when proved with the requisite degree of certainty.

## V. CONCLUSION

The new business rule is a *per se* rule that automatically denies recovery of lost profits by a new business or enterprise because the business has no history of past profits. The rule is a manifestation of the requirement of certainty adopted by common law courts to restrict the award of large damages by jurors. The majority of American jurisdictions have abandoned this absolute denial of all lost profits in favor of a rule of evidence which permits the owner of a failed new business to try to establish lost profits with reasonable certainty through expert testimony, business forecasting techniques, or other reliable data.

Under this evidentiary approach, the fact that there is no history of past profits goes to the weight and sufficiency of plaintiff's proof but not to its admissibility. A minority of states, including Ohio, however, still embrace the rigid application of the new business rule and deny lost profits as a matter of law. Many of these states have created and enlarged exceptions to the new business rule in order to award a fair measure of contract damages.

The new business rule, however, no longer retains its original vitality. Policy considerations in favor of an evidentiary use of the new business rule outweigh those considerations originally advanced for the *per se* denial of lost profits to a new business. First, the rule does not adequately address the problem of excessive verdicts. Second, courts have almost unanimously recognized other methods of accurately showing lost profits. Finally, the policies of efficiency and judicial economy inherent in the new business rule are outweighed by the fairness to the plaintiff of the evidentiary approach and by the procedural safeguards provided under the rules of evidence.

Thus, Ohio and other courts still adhering to the strict new business rule should welcome the opportunity to address the issue of lost profits by a new business. These courts should reject the new business rule in favor of the majority approach requiring only that the plaintiff prove his losses with reasonable certainty.

*Bernadette J. Bollas*