ARTICLES

THE MEANING OF VALUE IN CONTRACT DAMAGES AND CONTRACT THEORY

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INTRODUCTION

The concept of "value" is fundamental to contract damage rules and related economic theory. The law attaches inconsistent meanings to the word value in different contexts, resulting in contract damage rules that are unnecessarily complex.[1] The meaning of value in economics has no apparent connection to the meaning of value in law, which obscures the intuition underlying economic theory. When

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  1. *See infra* Part II.

economic theory is applied to contract law, the confusion over what value means results in an unnecessarily confusing analysis of the incentives created by overly complex contract remedies.

The conflicting uses of the word value in law would be of no great significance if economics were irrelevant to contract law, but contracts are understood as a means for reallocating resources from less valuable to more valuable uses, thereby increasing the wealth of society.[2]   Contract damage rules are understood as promoting "efficient breach," which means that the rules create incentives for parties to breach only when the resource that is the subject matter of the contract subsequently will be devoted to a more *valuable* use.[3] Economic theory has a well-accepted definition of value that conflicts with the law's definition. The leading text in law and economics defines the economic value of something as "how much someone is willing to pay for it or, if he has it already, how much money he demands for parting with it."[4] When evaluating whether a contract breach is efficient, it becomes clear that economists interpret "the most valuable use" as "the most profitable use," or the one that generates the greatest profit or surplus.[5] Despite the conflict and the fact that the theory of efficient breach is addressed in every major contracts casebook,[6] the relationship between the value of a contract

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2. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 31 (4th ed. 1992) ("Common law . . . can be conceived in economic terms as having three parts [including] . . . the law of contracts, [which is] concerned with facilitating the voluntary movement of property rights into the hands of those who value them the most . . . ."); *see also* DAVID W. BARNES & LYNN A. STOUT, CASES AND MATERIALS ON LAW AND ECONOMICS 189 (1992) (citing voluntary exchange as playing important role in allocating goods and services efficiently).

3. *See* BARNES & STOUT, *supra* note 2, at 232 (finding breach efficient when it creates sufficient benefit such that promisor can compensate promisee fully and still be better off by breaching than by performing and leaving one party better off and no one worse off); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 291 (1988) (finding breach efficient when resources needed for performance are more valuable in alternative use).

4. POSNER, *supra* note 2, at 12.

5. *See infra* text accompanying notes 51-53.

6. *See* RANDY E. BARNETT, CONTRACTS: CASES AND DOCTRINE 171-73 (1995); STEVEN J. BURTON, PRINCIPLES OF CONTRACT LAW 289-91 (1995); JOHN D. CALAMARI ET AL., CASES AND PROBLEMS ON CONTRACTS 639-45 (2d ed. 1989); THOMAS D. CRANDALL & DOUGLAS J. WHALEY, CASES, PROBLEMS, AND MATERIALS ON CONTRACTS 381-88, 405-06, 453-56 (2d ed. 1993); JOHN P. DAWSON ET AL., CASES AND COMMENT ON CONTRACTS 31-32, 151 (6th ed. 1993); E. ALLAN FARNSWORTH & WILLIAM F. YOUNG, CASES AND MATERIALS ON CONTRACTS 20-22 (5th ed. 1995); LON L. FULLER & MELVIN A. EISENBERG, BASIC CONTRACT LAW 205-08 (5th ed. 1990); CHARLES L. KNAPP & NATHAN M. CRYSTAL, PROBLEMS IN CONTRACT LAW, CASES AND MATERIALS 1009-16 (3d ed. 1993); EDWARD J. MURPHY & RICHARD E. SPEIDEL, STUDIES IN CONTRACT LAW 1037 (4th ed. 1991); JOHN E. MURRAY, JR., CONTRACTS, CASES AND MATERIALS 657-58 (4th ed. 1991); ROBERT E. SCOTT & DOUGLAS L. LESLIE, CONTRACT LAW AND THEORY 82-83, 792-94 (2d ed. 1993); ROBERT S. SUMMERS & ROBERT A. HILLMAN, CONTRACT AND RELATED OBLIGATION: THEORY, DOCTRINE, AND PRACTICE 225-26, 330-36 (2d ed. 1992).

and the most valuable use of a resource is not explored and the implications of conflicting definitions are not discussed.

The confusion over the meaning of value makes it difficult to understand and to apply both damage rules and efficient breach theory. This Article clarifies the meaning of value in its various uses and shows how that meaning relates to one motive for encouraging contracting—promoting the allocation of resources to their most valuable uses. In addition, this Article argues for an alternative description of the damage measure based on lost surplus.[7] The surplus-based damage rule is free from ambiguity and applicable to a wide variety of cases, which simplifies the understanding of damage theory.

Part I of this Article discusses the meaning of value as set forth in the *Restatement (Second) of Contracts* and how it relates to an alternative measure of damages based on the net benefit that the injured party expected to realize. Although all of the *Restatement* interpretations of value give consistent results in simple, straightforward cases, none can be applied to all cases. This conflict encourages a search for a consistent, intuitively appealing method for measuring damages for breach of contract that is easy to apply. The surplus-based damage rule is such a method.

People enter into contracts to improve their lot in life, whether measured in terms of wealth or otherwise. It is appropriate to think about damages in terms of the extent to which the breaching party denies the injured party the improvement or enhancement of condition the injured party would have realized had the breach not occurred. Part II of this Article describes how the economist's focus on *surplus* value compares to the law's focus on *total* value, and Part III reconceptualizes the theory of efficient breach as a means of

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7. To capture both lost profits (the excess above the costs that a business anticipates from another's performance of his promise) and lost consumer surplus (the amount above cost that a consumer anticipates from another's performance), this Article refers to both as *lost surplus.* The sophisticated reader should be alerted to the fact that at least one commentator uses the word "surplus" in a specialized, and not entirely consistent, manner to describe the amount in excess of anticipated profit a seller realizes from a particularly favorable resale that follows a buyer's breach. *See* 3 WILLIAM D. HAWKLAND, UNIFORM COMMERCIAL CODE SERIES § 2-706:01 (1995) (discussing obligation of seller to account to buyer for surplus realized over contract price because of resale). The economic concepts of producer and consumer surplus are discussed in all major law and economics texts. *See, e.g.,* BARNES & STOUT, *supra* note 2, at 362-68 (using banning of lawn darts by Consumer Product Safety Commission and regulation of gold mining by Occupational Safety and Health Administration as illustrations of cost of regulation as measured by loss in consumer and product surplus); COOTER & ULEN, *supra* note 3, at 301 (explaining lost-surplus formula that awards victim of breach surplus that injured party would have received had breaching party performed); POSNER, *supra* note 2, at 278 (discussing transfer of wealth accompanying conversion of consumer surplus into producer surplus).

allocating resources to uses that generate the greatest surplus. Theoretical support for the current regime of damage rules is derived from efficient breach theory, which focuses on whether damage remedies encourage people to allocate resources to their most *valuable* uses.[8] Appreciation of the significance of the incentives created by damage rules is enhanced by focusing on the profit or "surplus" created by the deal rather than on the value of the contract. Focusing on surplus highlights the resources saved and the wealth generated by creating appropriate damage remedies.

Part IV of this Article describes how contract damage rules based on conflicting definitions of value can be reconciled by focusing on the surplus generated by a contractual exchange. The key to devising clearer damage rules is to separate "profit" from "value" and to recognize that, in addition to lost profit, the victim of a contract breach is entitled to recover all costs incurred to earn such profit and costs wasted as a result of the breach. These costs include all expenses, whether in anticipation of the other's performance or caused by the breach, to the extent that recovery is not denied because of problems of proof or foreseeability. This approach facilitates an intuitive understanding of damage rules for cases involving total or partial breach as well as for cases involving substitute transactions (including cover and resale), breaches of warranties, and partial performance.

I. DAMAGE RULES BASED ON VALUE

The quantum of damages to which a complainant is entitled in a breach of contract action is based on the value she attached to the other party's performance.[9] Three alternative rules are based on this value. The first rule reflects the general approach of the *Restatement (Second) of Contracts*: a party injured by another's breach of contract "has a right to damages based on his expectation interest as measured by ... the *loss in the value* to him of the other party's performance."[10] The second rule applies to cases in which the breaching party's performance is defective or incomplete,[11] or in which there

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8. *See* FARNSWORTH & YOUNG, *supra* note 6, at 20-22 (advocating that contracts be broken and resources reallocated if party in breach will be better off after paying damages).
9. *See id.* at 483.
10. RESTATEMENT (SECOND) OF CONTRACTS § 347(a) (1979) (emphasis added).
11. *See id.* § 347 cmt. b (finding that defective or partial performance will result in loss in value equal to difference between value that performance would have had absent breach and value of such performance as actually rendered).

is a breach of warranty.[12] Under the second rule, the injured party is entitled to recover the *difference in value* between the performance received and the performance promised.[13] The third rule awards the victim of a contract breach the contract price, which, according to commentators, measures the full *value* of the performance promised.[14]

Subject to rules limiting recovery to unavoidable,[15] foreseeable,[16] and provable damages[17] and to various adjustments reflecting the facts of particular cases, each of these measures can be employed to arrive at a correct calculation of the appropriate damage amount if the meaning of value in the context of the particular case is understood. The first rule provides the basis for calculating damages in all straightforward cases of contract breach, without regard to the nature of the injured party's expectations or to the types of costs the injured party incurred in anticipation of the breaching party's performance.[18] The second rule describes the measure of damages in more complicated cases involving breaches of warranty and defective, partial, and substantial performance, as well as in cases involving cover by a buyer or resale by a seller.[19] The meaning of value, however, is not the same in these two rules and may be the same as the third measure of damages based on the contract price only coincidentally. This Article demonstrates that value in the *Restatement* sense usually means the total benefit that the recipient of another's performance would have derived from the performance. In the more complicated cases, value is interpreted most accurately as including only the profit (or surplus return above that necessary to cover costs) associated with each party's performance. The contract price is only sometimes an accurate measure of the total benefits to the recipient and seldom equivalent to the anticipated profit. The lack of clarity in the meaning of value makes contract damage rules difficult to understand and apply.

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12. *See* U.C.C. § 2-714(2) (1978) ("The measure of damages for breach of warranty is the difference at the time and place of acceptance between the value of the goods accepted and the value they would have had if they had been as warranted . . . .").

13. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. b.

14. *See* 5A ARTHUR L. CORBIN, CORBIN ON CONTRACTS §§ 1188-1191 (1964 & Supp. 1996).

15. *See* RESTATEMENT (SECOND) OF CONTRACTS § 350 (reducing damages awarded to parties injured by breach who fail to take reasonable steps to avoid losses).

16. *See id.* § 351 (denying recovery of damages that breaching party did not have reason to foresee).

17. *See id.* § 352 (denying recovery of damages that cannot be established with reasonable certainty).

18. *See infra* Part IV.A (analyzing expectation-based damage calculation under *Restatement*).

19. *See infra* Part IV.B (analyzing damage calculation based on difference between performance promised and performance received).

It is complicated to examine the various sorts of losses resulting from a contract breach and the social consequences of a breach without a common framework for understanding the expectation theory of damages. This theory is widely accepted and applied in breach of contract cases by all courts in the United States.[20] In principle, the expectation damage measure is designed to put the victim of a contract breach in the same position, with respect to wealth, as if the breaching party had performed.[21] Because we are concerned with wealth, it would be useful to be able to relate both this damage measure and the "position with respect to wealth" to well-defined rules of contract damages and to the concept of value, which is central to the analysis of efficient breach.

The *Restatement* provides a convenient starting point for the description of a value-based theory of damages.[22] Section 347(a) states the rule that "the injured party has a right to damages . . . as measured by the loss in the *value* to him of the other party's performance."[23] Value, as used in the *Restatement*, refers to all of the benefits that the injured party would have received as a result of the breaching party's performance.[24] Value is not simply the profit she expected, nor is it necessarily just the benefit the breaching party would have conveyed to her. The value includes the profit from the deal itself and any larger project of which this contract was an integral part.[25] The value also includes enough money to pay for all of the costs associated with the deal (and, again, any larger project of which

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20. *See* RESTATEMENT (SECOND) OF CONTRACTS § 344 cmt. b (defining expectation interest); FARNSWORTH & YOUNG, *supra* note 6, at 13 (discussing expectation interest and comparing to reliance and restitution).

21. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. a (noting that contract damages based on injured party's expectation interests are intended to position injured party as if performance had taken place).

22. *See id.* § 347 (measuring damages in terms of injured party's expectation interest and loss of value).

23. *Id.* § 347(a) (emphasis added).

24. *See id.* § 347 cmt. b (measuring value by benefit received from performance).

25. *See id.* § 347(b) (stating that injured party has right to recover losses consequential to contract breach). Illustration 2 describes a case in which the profit is earned from resale to a third party rather than from the sale to the breaching party. The resale is the larger project of which this contract is a part. An application of this rule from case law appears in *Laredo Hides Co. v. H & H Meat Products Co.*, 513 S.W.2d 210 (Tex. Civ. App. 1974), in which H & H breached a contractual promise to sell hides to Laredo. *Id.* at 213-14. The contract to purchase hides was part of a larger project, as Laredo had promised to sell the hides to tanneries in Mexico. *Id.* at 216. After the breach, Laredo was able to acquire sufficient hides, albeit at a higher price, to complete the project with the tanneries. *Id.* H & H was held liable for enough damages to ensure that Laredo realized the expected profit from this deal with subsequent buyers. *Id.* at 223. For further discussion of *Laredo Hides Co.*, see *infra* text accompanying notes 70-76.

the contract was a part), whether paid to the breaching party or to someone else.[26]

Separating "value" from "profit" is not intuitive. It is tempting to think of the value of the contract as the profit to be earned as a result of the other's performance. In the *Restatement* sense, however, the value of a property that one buys from another is the revenue stream that property generates for the purchaser, much like the value of a piece of rental real estate is the rental income the property generates. The costs of acquiring, managing, and maintaining the property (generating the revenue) are deducted from that revenue stream, leaving profit. Thus, the value of the property (all of the future revenue) includes enough to cover the costs and to leave some amount of profit or surplus remaining.

Contracts casebooks often begin the discussion of damages with cases involving the definition of "value" in a consumer context.[27] *Hawkins v. McGee*[28] and *Sullivan v. O'Connor*[29] both involved plastic surgery. After the respective operations, the patients expected a perfect hand[30] or a beautiful nose.[31] That is the value of the operation. Because these are cases involving consumers,[32] the profit or consumer surplus[33] is the difference between the value of the perfect hand or beautiful nose and the psychogenic and financial cost of the procedure. Value clearly is more than just financial profit. It also includes the costs, whether paid to the doctor (a direct cost such as a doctor's fee), a third party (the hospital, for instance), or expended and benefitting no other person (the pain suffered by the

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26. *See Laredo Hides Co.*, 513 S.W.2d at 223 (awarding damages with interest).

27. *See, e.g.*, CRANDALL & WHALEY, *supra* note 6, at 3 (discussing case granting specific performance of agreement to sell real estate); FARNSWORTH & YOUNG, *supra* note 6, at 483 (discussing plaintiff's loss in value as primary measure for damages resulting from contract breach); FULLER & EISENBERG, *supra* note 6, at 192 (discussing case that provided damages to patient following faulty skin graft).

28. 146 A. 641 (N.H. 1929).

29. 296 N.E.2d 183 (Mass. 1973).

30. *See* Hawkins v. McGee, 146 A. 641, 643 (N.H. 1929).

31. *See* Sullivan v. O'Connor, 296 N.E.2d 183, 184 (Mass. 1973).

32. Because *Sullivan v. O'Connor* involved an entertainer, *see id.* at 184, the surplus the plaintiff might have derived from the plastic surgery would have enhanced her business profits (producer surpluses) as well as her private pleasure (consumer surplus). In *Hawkins v. McGee*, the plaintiff's injury was work related, *see id.* at 642, so perhaps there was a profit component in that value as well, though it is less clear. If the plaintiff's surgery in any way was intended to increase the vocational utility of his hand, then there was a profit component; if it was purely cosmetic, then probably not. At any rate, because both are surplus, they are analytically indistinguishable. *See* COOTER & ULEN, *supra* note 3, at 300-01 (relating substitute price and lost-surplus formulas as measures for damages to concept of consumer surplus).

33. Surplus, whether profit or consumer surplus, is the difference between the value that a party attaches to what she receives as a result of the other's performance and what she gives up in order to obtain that benefit. For a discussion of the economic meaning of these terms, see *supra* note 7 (defining lost profit and lost consumer surplus collectively as lost surplus).

patient). In the consumer context, there may be *no* stream of revenue flowing from the contract, but rather a stream of pleasure or utility. The value reflects all of the pleasure or utility derived from the contract. The surplus or profit is that amount of pleasure or utility left after all of the costs associated with contracting have been paid.

Section 347 of the *Restatement (Second) of Contracts* intends that "value" include more than simply the net gain (whether consumer surplus or profit); value must include all of the anticipated benefits that a party expects to receive, some of which will be offset by costs she has incurred and the balance going to profit.[34] After determining the value of the contract as instructed by section 347(a), section 347(b) requires addition of "any other loss, including incidental and consequential loss, caused by the breach."[35] After this addition, section 347(c) requires subtraction of "any cost or other loss that he has avoided by not having to perform."[36] Subtracting costs avoided, as instructed in section 347(c), presents no particular conceptual difficulty. The victim of a breach is likely to have saved some anticipated expenses when one party breaches before the victim has performed. When a buyer repudiates a contract to purchase real estate, for instance, the seller may save brokerage fees and taxes that are due only if the sale is completed.[37] The injured party, having avoided those expenses, would be overcompensated if her damages included an allowance for them.

Confusion does arise when "other losses" are added to the value described in section 347(b). If value includes surplus *plus* enough to cover anticipated costs, why does the rule instruct us to add costs incurred to value? These are unanticipated, *breach-related costs*,[38]

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34. The *Restatement* provides:
  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 the *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.
RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979) (emphasis added).
  35. *Id.* § 347(b).
  36. *Id.* § 347(c).
  37. *See* Sabin-Goldberg v. Horn, 578 N.Y.S. 2d 187, 189 (N.Y. App. Div. 1992) (awarding seller of property lost profit less brokerage fee and tax upon breach by buyer).
  38. This Article uses the term "breach-related costs" to refer to these incidental and consequential costs collectively, because the analysis of breach requires no distinction and because linguistic confusion arises over the terms "incidental" and "consequential."
  The *Restatement* uses "incidental" to include "costs incurred in a reasonable effort, whether successful or not, to avoid loss" from the breach—clearly expenses that would not have been

which must be distinguished from costs the injured party had expected to incur. The *Restatement* intends these "other losses, including incidental and consequential loss" to include only those costs that resulted from the breach but that would not have been among the anticipated direct and collateral costs[39] of earning the

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incurred had the breaching party performed. RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. c. The Uniform Commercial Code ("U.C.C.") employs a similar usage. *See* U.C.C. § 2-710 (1977) (providing that incidental damages to seller include commercially reasonable charges incurred in stopping delivery after buyer's breach); *see id.* § 2-715(1) (providing that incidental damages resulting from seller's breach include expenses reasonably incurred in inspection and custody of goods rightfully rejected, any commercially reasonable charges in connection with effecting cover, and other reasonable expense incident to breach).

One of the most influential articles in contract damage law, however, uses the term "incidental" to refer to the collateral expenses a contracting party incurs in order to enhance the profit he will make from the contract in question. Lon Fuller and William Perdue refer to these collateral expenses as "incidental reliance." *See* Lon L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 YALE L.J. 52, 78 (1936) (contrasting natural expenses, or incidental reliance, with necessary expenses, or essential reliance). To avoid such confusion, this Article refers to these collateral reliance expenses or incidental reliance expenses as "collateral costs."

Although the *Restatement*'s use of "consequential" clearly contemplates losses arising due only to breach, the U.C.C. uses "consequential" to include lost profits. *Compare* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. c, illus. 2 (defining consequential losses as injury to person or property resulting from defective performance), *with* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 268 (3d ed. 1988) (explaining that most common claim for consequential damages involves lost profits). In its section entitled *Buyer's Incidental and Consequential Damage*, the U.C.C. provides:

Consequential damages resulting from the seller's breach include

(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise; and

(b) injury to person or property proximately resulting from any breach of warranty.

U.C.C. § 2-715.

Subsection (2)(a) of U.C.C. section 2-715 contemplates "any" loss, including lost profits, but consequential damages are not limited to lost profits. *See* HAWKLAND, *supra* note 7, § 2-710:01 (stating that as general rule, consequential damages are losses involving relationships between seller and third parties). This logically includes, but is not limited to, losses associated with the frustration of larger projects of which the contract in question was an integral part. *See infra* text accompanying note 50 (providing and explaining formula for calculating damages). Given these linguistic confusions surrounding the terms "incidental" and "consequential," the term "breach-related" seems more descriptive and avoids ambiguity.

39. Corbin differentiates between expenditures that are part of performance and those that are collateral:

There are many expenditures made in reliance upon an existing contract that can not properly be regarded as having been made in part performance of it, or even as in necessary preparation for such performance. Such expenditures as these are not expected to be compensated directly by the payments or other performance promised by the defendant, for they do not constitute a party of the agreed exchange. Nevertheless, the net loss involved in such expenditures may be included in the damages awarded, if at the time the contract was made the defendant had reason to foresee that such expenditures would be made and that his own breach would prevent their reimbursement. These expenditures now referred to are collateral to performance of the contract for breach of which the action for damages is brought; and the net losses resulting may readily be regarded as too remote from contemplation and too likely to be the result of other factors to justify their inclusion in the damages for breach. Whenever their inclusion is just, their amount is an addition to the full contract price unpaid that is, to the full value of the performance promised and not

profit had the breach not occurred.

The common-law meaning of value is understood more easily when the *Restatement* is viewed as recognizing three kinds of costs: the two types that would have been incurred even if there had been no breach (direct and collateral costs described above) and those breach-related costs that would not otherwise have been incurred but for the breach. In addition to these three types of costs, only the concept of surplus (whether profit or consumer surplus) must be added to apply the *Restatement* rule. If the value of the contract to the injured party includes the costs that she anticipated incurring plus the surplus, then the value can be depicted as in the pie chart in Figure 1. The value is the entire pie—anticipated direct and collateral costs plus surplus. The breach-related costs, represented by the size of the adjacent rectangle, are not part of the value; the injured party did not anticipate incurring those costs.
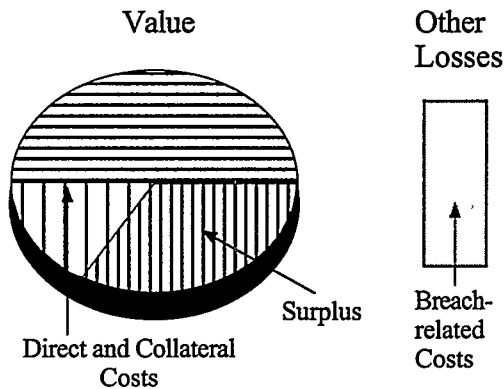

FIGURE 1

The *Restatement* rule does not recognize these divisions as surplus and direct, collateral, and breach-related costs. Rather, it recognizes them as value,[40] other losses (breach-related),[41] and costs avoided.[42] Some of the anticipated direct and collateral costs associated with obtaining the profit from the contract may not have been incurred at the time of breach; they are costs *avoided* by the breach. Thus, the *direct and collateral* category is subdivided into costs actually incurred and costs avoided. All breach-related costs that a victim would seek to recover necessarily are incurred.

Damages are calculated, under the *Restatement* formula, by following three steps: (1) determining the value of the contract (section 347(a)); (2) adding other losses (section 347(b)); and (3) subtracting costs avoided (section 347(c)).[43] Arithmetically, combining steps (1) and (3) yields an amount equal to the anticipated surplus plus direct and collateral costs actually incurred. Step (2) adds breach-related costs actually incurred. Thus, a formula equivalent to the *Restatement* approach, but much more straightforward, is as follows: damages equal lost surplus plus direct and collateral costs actually incurred plus breach-related costs. Alternatively, and more simply, damages equal lost surplus plus all costs incurred. The pie chart in Figure 2 shows the equivalence of the *Restatement* and surplus-based approaches. The entire pie represents the value of performance (section 347(a)). The *Restatement* formula for damages directs us (in section 347(c)) to subtract (remove from the pie) costs of all types avoided by the breach from the value of performance, which leaves only the striped areas made up of surplus and costs of all types that were incurred. To this amount, add breach-related costs (as instructed by section 347(b)), represented by the shaded rectangle. Under the alternative formula, simply add the lost surplus to the actual direct, collateral, and breach-related costs incurred.

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40. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. b.
41. *See id.* § 347(a) cmt. c.
42. *See id.* § 347(b) cmt. d.
43. *See id.* § 347(a), (b), (c).

Equivalent
Damage
Formulas

Damages = Value + Breach-related Costs
- Costs Avoided
= Surplus + Actual Costs (Direct,
Collateral and Breach-related)

Direct and Collateral Costs (Direct,
(not included in Damages)

+

Actual Breach-
related Costs

Surplus

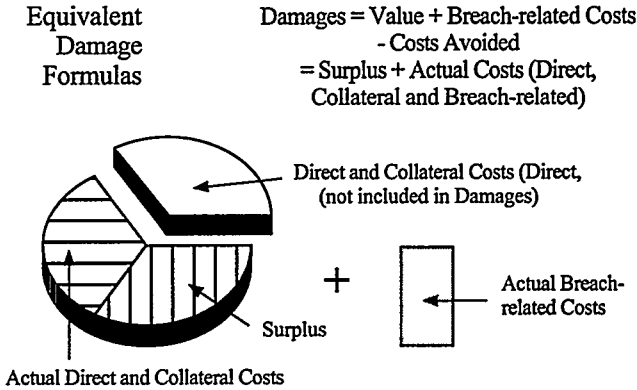Actual Direct and Collateral Costs

FIGURE 2

In every case, both the value-based and surplus-based approaches yield the same result if the data is available. *Native Alaskan Reclamation & Pest Control, Inc. v. United Bank of Alaska*[44] is a typical case involving lost surplus, direct and collateral costs, and breach-related costs. Figure 3 illustrates the losses suffered by a party who had been promised a loan from a bank that later withdrew the promise. The borrower, a corporation planning to buy and restore airplanes for forest fire fighting, incurred costs amounting to $97,394.22 while preparing to buy the planes before the bank's default.[45] After denial of the promised loan, the borrower incurred an additional $86,705.97 in costs trying reasonably to rescue the deal.[46] As a result of the bank's breach, the corporation also lost its anticipated profit of $2,385,605.00.[47]

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44. 685 P.2d 1211 (Alaska 1984).
45. *See* Native Alaska Reclamation & Pest Control, Inc. v. United Bank of Alaska, 685 P.2d 1211, 1215 (Alaska 1984).
46. *See id.*
47. *See id.*

Damage Calculation
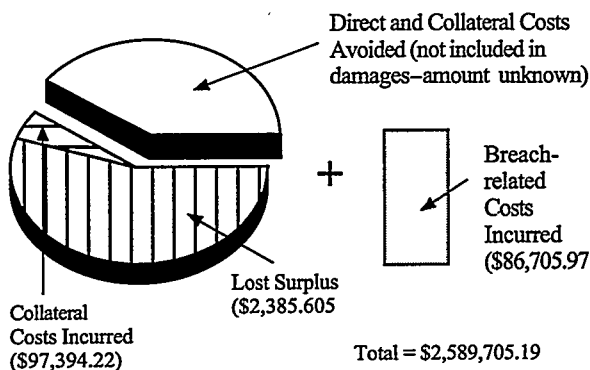Native Alaskan v. United Bank

FIGURE 3

The *Restatement* formula is more difficult to apply because the value of the contract is unknown. Although the amount of direct cost avoided (the interest payments on the loan) can be calculated ($536,000.00),[48] there was no indication of the amount of collateral cost avoided. These collateral costs would have included other expenses associated with buying and restoring the airplanes. The alternative formula gives a ready answer to the damages question: add the anticipated surplus (profit) ($2,385,605.00) to the costs actually incurred (direct ($0), collateral ($97,394.22), and breach-related ($86,705.97)) for a total of $2,569,705.19.[49]

The damage formula appearing in section 347 of the *Restatement* and the surplus-based damage formula are equivalent. Each approach awards the victim of contract breach her lost profits and compensates her for losses incurred. The remainder of this Article demonstrates

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48. *See id.*
49. There are cases that do not allow recovery of both profits and costs incurred (whether direct or collateral), but they do not reflect the intent of the *Restatement* rule and do not reflect either the underlying logic of expectation damages or the principle of full compensation. In *Smith v. Onyx Oil & Chemical Co.*, 218 F.2d 104 (3d Cir. 1955), for instance, Smith contracted to sell a chemical product that Onyx promised to develop. *See id.* at 107. When Onyx repudiated the contract, Smith sued for lost profits and for more than $3000 in expenses incurred in getting ready to perform. *See id.* at 110-12. With respect to those expenses, the court held, "This, we think, is not recoverable. If he has the profit he was to make, had the contract been performed, he cannot also have the expenses to which he was put to make that profit." *Id.* at 112. Without award of those expenses, however, the injured party will not fully realize his profits. Without recovery of the $3000 in costs incurred, the injured party will have $3000 less than his expectation, and thus he will be undercompensated. Awarding costs in addition to profits does not result in double counting; without costs there is undercounting. The *Restatement* approach includes recovery of costs incurred as well as profit. *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 cmt. a-d (1979) (allowing for recovery of expectation damages).

that the relative ease of application of the two approaches depends on the availability of data and the simplicity of the facts of the case. It also demonstrates, however, that only the surplus-based approach generally is applicable. Without tortured interpretation of the provisions of section 347, that approach gives an incorrect result in many cases.

II. ECONOMIC THEORY BASED ON *SURPLUS* VALUE

Like the *Restatement* approach to damages, the economic theory of efficient breach supposedly is based on the value of the contract.[50] Economists, although identifying their concern as the allocation of resources to their most *valuable* uses,[51] really are concerned with the surplus a use generates. Instead of focusing on the total benefit that one party anticipates from the other's performance (a return sufficient to cover both costs and a surplus), economists are most interested in the excess society earns above the costs invested.[52] This surplus measures the extent to which a party and the society of which that party is a member are better off as a result of the exchange. The surplus is profit—producer surplus if the party is engaged in a business activity and consumer surplus if the party is not.[53]

Both parties to a contract generally anticipate a surplus at the time of contract. Why else would one engage in the contracting process? The extent to which society's welfare improves as a result of contracting is measured by the sum of the surpluses earned by the parties.[54] When economists speak of the value of using a resource in a particular way, they are referring to the total surplus earned as a result of that allocative choice.[55] Thus, allocating a resource to its most valuable use means devoting it to the use that produces the greatest surplus. The economic meaning of "value," which refers only to the surplus earned as a result of contracting,[56] therefore, is at odds with the *Restatement* meaning of value, which includes all of the

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50. *See* FARNSWORTH & YOUNG, *supra* note 6, at 20-21 (reasoning that measure for damages in efficient breach should be diminution in value to injured party).

51. *See* POSNER, *supra* note 2, at 16.

52. *See generally* COOTER & ULEN, *supra* note 3, at 49-51 (demonstrating tendency of economists to look for excess societal earnings above individual satisfaction, even in example of two-person society).

53. *See* POSNER, *supra* note 2, at 278 (describing increases in producer surplus as price consumers pay increases).

54. *See id.* at 13-14 (describing efficiency in terms of sum of benefit to contracting parties).

55. *See, e.g.,* COOTER AND ULEN, *supra* note 3, at 291 (finding efficient breach when resources needed for performance are more "valuable" in alternative use); PAUL SAMUELSON, ECONOMICS: AN INTRODUCTORY ANALYSIS 424-25 (7th ed. 1967) (relating concept of "market value" to that of "surplus").

56. *See* POSNER, *supra* note 2, at 12-16 (explaining economic meaning of value).

return from a contract, part of which is devoted to repaying costs.[57]
A party's surplus depends on the costs she must incur in order to
earn the surplus, including both direct[58] and collateral[59] costs,

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57. *See supra* text accompanying notes 22-26.

58. The direct costs of contracting have been described more precisely in the legal
literature as essential reliance costs. Essential reliance costs are a party's costs of performing her
obligations under the contract, the promises expressly or implicitly included in the contract.
See Fuller & Perdue, *supra* note 38, at 78 (defining essential reliance as costs necessary to
complete contract). These costs are "essential" in the sense that it is essential that a party bear
the costs of performing her obligations in order to be entitled to either the other's performance
or compensatory damages. *See id.* A party's essential reliance costs are those associated with
"those acts necessary to the perfection of the plaintiff's rights on the contract." *Id.* They may
be described more simply as "performance costs," a party's costs associated with performing and
preparing to perform. *See id.* Fuller and Perdue include under the definition of essential
reliance "the losses involved in entering the contract itself, as, for instance, in foregoing the
opportunity to enter other profitable contracts." *Id.* By defining essential reliance this way,
Fuller and Perdue promote the recovery of opportunity costs as a conceptual substitute for lost
profits, a position that never has been accepted by the courts. *See* United Sav. Ass'n v. Timbers
of Inwood Forest Assoc., 484 U.S. 365, 375-76 (1988) (denying compensation to creditor for lost
opportunity costs).

Thus, the definition of essential reliance is overinclusive for the purposes of this Article. In
the simplest case, a buyer's obligation is to pay the contract price, but a buyer may be obliged
to incur such additional costs as the cost of supplying specifications. In the simplest case, a
seller's only obligation may be to relinquish possession of a resource to the buyer, but it hardly
would be surprising for the seller to be obligated to incur other costs, such as transportation.
A party's performance costs include all costs that party must incur in order for the party to avoid
being in breach of contract. The value of a contract in the *Restatement* sense includes all
anticipated performance costs, although performance costs avoided because of the other's
breach are subtracted from the value when damages are calculated. *See* RESTATEMENT (SECOND)
OF CONTRACTS § 347(c) (1979).

59. A party incurs collateral costs, not because he is obliged to do so, but because doing
so will enhance or increase the benefits he derives from the other party's performance. The law
and economics literature describes these costs more precisely as "surplus enhancing reliance
costs," recognizing that a party is not obligated to incur them but will earn a greater surplus by
doing so. *See* Robert Cooter & Melvin A. Eisenberg, *Damages for Breach of Contract,* 73 CAL. L.
REV. 1432, 1465 (1985). The term "surplus enhancing reliance" appears to have been used first
by Professors Cooter and Eisenberg. *See id.* In their illustration, a boat buyer might buy special
navigational equipment in advance of delivery of the boat so that he can depart on a lengthy
voyage as soon as the boat is delivered rather than delaying his pleasure. *See id.* They use the
term "to refer to discretionary reliance by a contracting party that is undertaken to increase the
surplus over and above what he would enjoy had he simply done what was explicitly or implicitly
required under the contract." *Id.* In some cases, there is good reason for incurring surplus
enhancing reliance costs in anticipation of the other party's performance, or more simply
enhancing costs, before the time that performance is due. In *Anglia Television, Ltd. v. Reed,* 3 All
E.R. 690 (C.A. 1971), a film producer hired a director, designer, stage manager, assistant
manager, and others in anticipation of a film performance by an actor, Robert Reed. All of
these costs were incurred to exploit the talents of Reed and to increase the surplus earned from
the contract with Reed. Even though Anglia Television had promised to pay a salary to Reed
and to pay for his travel and lodging, none of these performance expenses were incurred.
When Reed refused to perform, the court awarded Anglia Television the total of their
enhancing costs incurred. *See* 3 All E.R. at 695. *Anglia Television* illustrates that referring to
enhancing costs as a type of *reliance* cost is somewhat a misnomer. Some of these (recoverable)
costs were incurred prior to formation of the contract with Reed such that the film company
could not have *relied* on a contract that did not exist at the time the expenditures were made.
Rather, they were enhancing costs in the sense that the film company was not obliged by the
contract with Reed to incur them but did so to increase its profits from the contract it hoped
to sign with Reed. The value of a contract includes all anticipated enhancing costs, though the

either in economic terms or under the *Restatement* approach to damages.

This part of the Article examines the correspondence between the economic focus on *surplus* value and the *Restatement* focus on *total* value. Part III considers efficient breach theory from the perspective of damages measures based on the loss of surplus. Hereafter, the word value is used in the *Restatement* sense to refer to the total value of the contract, and the words "surplus" or "profit" are used to refer only to that part of the value that remains after costs are removed.

Economic theory focuses on the surplus realized as a result of contracting.[60] How the surplus is divided depends on the bargain struck between the parties. The size of the column in Figure 4 reflects the value to one party of the other's performance in a simple case in which there are no collateral costs. Figure 4 illustrates a case in which the recipient of the other's performance—who, for convenience, is called the buyer—would be willing to pay up to $1500 for that performance, which is the buyer's reservation price. The reservation price might be determined by the commercial potential created by the other's performance or by a subjective valuation by the buyer of the pleasure she anticipates deriving from it. The surplus earned by the buyer, whether profit or consumer surplus, is the difference between that maximum amount and the price actually paid. The price actually paid measures the direct costs. The price actually paid, hence the surplus derived, is the result of the bargaining between the parties. Figure 4 illustrates a reservation price of $1500 and direct costs of $1000, yielding a surplus of $500.

Restatement damage formula includes in recovery only the amount actually incurred by subtracting enhancing costs avoided from the value of the contract. The law governing recovery of pre-contractual expenses in the United States is unsettled. *See* Gregory S. Crespi, *Recovering Pre-contractual Expenditures as an Element of Reliance Damages*, 49 SMU L. REV. 43 (1995) (discussing contradictory case law in this area).

60. *See* POSNER, *supra* note 2, at 12-16 (defining value, utility, and efficiency through illustrative models focusing on surplus).

$1500

Surplus

$1000
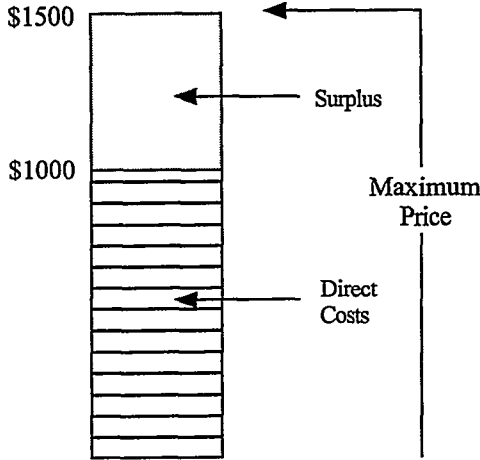
Maximum
Price

Direct
Costs

FIGURE 4

If a party to a contract must incur collateral costs to realize the value of the contract, the maximum price she will be willing to pay will be lower, other things being equal. The column in Figure 5 depicts the surplus in a case in which the promisee anticipates incurring collateral costs to increase her surplus. The maximum price the buyer will consider is now constrained by the fact that she must incur $700 in collateral costs to realize the full contract value of $1500. Unwilling to pay up to $1500, her reservation price is only $800. To pay more would result in a loss. Having agreed on a price of $300 in this illustration, the surplus anticipated by the buyer is $500.

$1500

Collateral
Costs

$800

Surplus

Maximum
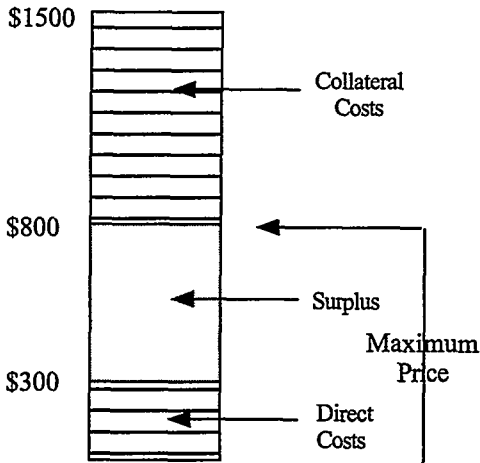Price

$300

Direct
Costs

FIGURE 5

A seller's surplus is determined in an analogous fashion. The seller's direct costs dictate a reservation price below which he will be unwilling to make a deal with the buyer. Clever bargaining by a seller will yield a higher price and higher surplus for him; clever bargaining by the buyer will yield a lower price and higher surplus for her. Viewed in this way, bargaining simply involves a negotiation over division of the total surplus available from the deal; if the promisee earns more, the promisor earns less. The economic theory underlying efficient breach is not directly concerned with which party gets how much of the total surplus.[61] Society's well-being is maximized when the total surplus is maximized, without regard to who gets it.[62] But the value each party places on performance by the other limits the total amount of surplus to be shared.

The correspondence between the economic focus on *surplus* value and the *Restatement* focus on *total* value is straightforward. Figure 6 shows that each of the variables relevant to determining the bargaining range in economic theory translates into an element of damages under the *Restatement* approach. A contract has a given value to a party, represented by either the pie or the column in Figure 6. The amount of collateral costs necessary to earn the surplus or profit from the contract (shown in vertical stripes in both the pie and the column) decreases the maximum amount that a party will be willing to pay for the other's performance. Once the parties have agreed on a price for performance, the remainder of the pie or column is divided into two parts, one reflecting the cost of performance (the direct cost depicted in horizontal stripes) and the other reflecting surplus (the shaded slice of pie or portion of column).

Increases in the wealth of society accompany increases in surplus generated by the parties. Reducing costs increases surplus and wealth. This correspondence between the economic goal of increasing wealth and the expectation measure of damages reflected in the *Restatement* enables one to evaluate how damage rules affect a party's willingness to breach and the effect of a breach on society's wealth, as measured by the surplus gained as a result of a transaction.

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61. *See generally supra* note 6 and texts cited therein (discussing efficient breach in terms of greater societal good but not specifying distribution of surplus).

62. *See* FARNSWORTH & YOUNG, *supra* note 6, at 21 (noting that in efficient breach, "it is in society's interest that the contract be broken and the resources allocated").
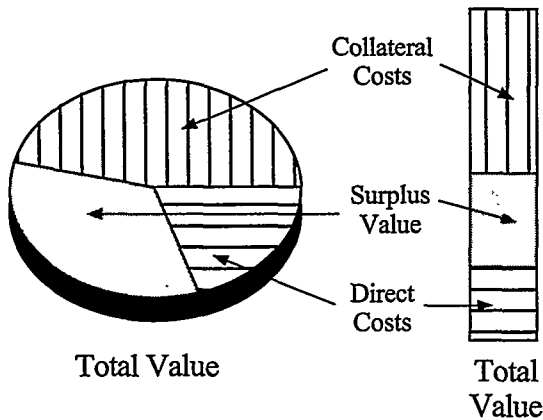
FIGURE 6

III. VALUE AND SURPLUS IN EFFICIENT BREACH THEORY

The distinction between value and surplus has obscured the analysis of incentives created by contract damage rules. Although scholarly literature has addressed other implications of contract damage rules,[63] efficient breach is the topic of greatest scholarly interest. Economic analysis suggests that there are times when a party to a contract should not be compelled to perform,[64] and the *Restatement* recognizes that this conclusion is consistent with the traditional

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63. Prominent among the other incentives created by contract damage rules are incentives for parties to take precautions to avoid or minimize losses associated with breach. *See generally* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1 (1985) (analyzing relationship between precaution against injuries and allocation of cost of injuries); Cooter & Eisenberg, *supra* note 59, at 1432 (exploring differences between expectation and reliance damages); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967 (1983) (noting divergence between cost-minimizing principles of mitigation and common law contractual obligations). For a discussion of the effect of contract damage rules on precaution taken by both the promisee and promisor and on the choice of a contracting party, see Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988) (finding that efficiency of incentives to take precautions against breaches depends on whether remedy is over- or undercompensatory and on availability of substitute mechanisms).

64. *See* POSNER, *supra* note 2, at 130-31 (noting that to compel specific performance in particular cases can result in systematic undervaluation of costs of breach).

response of common-law judges.[65] Judges often refer to the theory of efficient breach, particularly when approving full compensation to the victim of a breach (as in the case of recovery for emotional distress)[66] or when denying more-than-full recovery (as when denying recovery of punitive damages),[67] and are comfortable with its implications.[68] It is hard to find a first-year contracts casebook that does not teach the basic principles of efficient breach.[69] Yet, only the simplest examples are considered, and it is difficult to extrapolate from these examples to the variety of special circumstances in which contract damage rules are applied. To a large extent, difficulty with the concept of value has impeded application of the theory to more complicated cases. Rather than thinking of contracts as a way of allocating resources to more valuable uses, it is useful to think of justifying a breach of contract as a way of generating a greater total

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65. The *Restatement* provides:

In classic economic theory the mechanism of exchange resulting from bargain is essential to the voluntary reallocation of goods, labor and other resources in a socially desirable manner. However, a party may err in calculating the net benefit to be expected from the performance of a bargain, or circumstances may so change as to disappoint his expectations. A contract that he once thought would be profitable may therefore become unprofitable for him. If the contract is still profitable for the other party, however, a question arises as to whether the reluctant party should be compelled to perform. The answer provided by at least some economic analysis tends to confirm the traditional response of common-law judges in dealing with this question.

RESTATEMENT (SECOND) OF CONTRACTS ch. 16, introductory note (1979).

66. *See* Gaglidari v. Denny's Restaurants, Inc., 815 P.2d 1362, 1377 (Wash. 1991) (Utter, J., concurring and dissenting) (advocating allowing recovery for emotional distress to discourage economically inefficient breaches).

67. *See, e.g.,* Thyssen, Inc. v. SS Fortune Star, 777 F.2d 57, 63 (2d Cir. 1985) (encouraging breaches of contract that are efficient and wealth-enhancing by denying award of punitive damages in addition to traditional contract remedies); Reiver v. Murdoch & Walsh, P.A., 625 F. Supp. 998, 1015 (D. Del. 1985) (ruling that plaintiff is not entitled to punitive damages following intentional efficient breach unless breach is similar in character to intentional tort); Harris v. Atlantic Richfield Co., 17 Cal. Rptr. 2d 649, 653 (App. Dep't Super. Ct. 1993) (finding that limitations on liability in contract law encourage efficient breaches, resulting in increased production of goods at lower cost to society); Kutzin v. Pirnie, 591 A.2d 932, 941 (N.J. 1991) (declining to impose penalties that deter efficient breaches of contract).

68. Opinions reveal that judges are comfortable with the idea that an efficient breach is a breach in which one party decides that it is not in her interest to perform as promised. *See* Magallanes Inv., Inc. v. Circuit Sys., Inc., 994 F.2d 1214, 1219-20 (7th Cir. 1993). In *Magallanes,* a buyer, who had promised to pay $257 per ton for a ship, defaulted after finding that it could only earn $220 per ton for the ship on resale. *See id.* at 1220. The buyer's telegram informing the seller that he fully understood the implications of the default was read by the court as "a notice of an efficient breach by the buyer." *Id.* at 1220. The cases cited in note 67, *supra,* demonstrate that courts approve of the policy of wealth maximization underlying efficient breach. *See* Centric Corp. v. Morrison-Knudson Co., 731 P.2d 411, 413-14 (Okla. 1986) ("Hard bargaining, efficient breaches, and reasonable settlements of good faith disputes are acceptable, even desirable, in our economic system."); 3 E. ALLEN FARNSWORTH, CONTRACTS § 12.8, at 195-96 (1990) ("Most courts have not infringed on the freedom to keep or to break a contract traditionally afforded a party by the common law and endorsed by the notion of efficient breach.") (footnotes omitted).

69. *See supra* note 6 (listing examples of casebooks that discuss efficient breach).

surplus.

Consider the simple example depicted in Figure 4, above, in which a buyer has contracted to pay $1000 for a performance she values at $1500. Another buyer may entice the seller to breach by offering $1100 for the same performance, which the second buyer values at $2000. The second buyer's use may be more valuable, in the *Restatement* sense of the word, but allocating the performance to the second buyer may not produce the greatest surplus, or the greatest increase in wealth for society. Breach may be inefficient.

Figure 7 depicts the value of the performances to Buyers 1 and 2. For the sake of expository convenience, the performances require the same direct and collateral costs by the seller. At the prices given in the preceding paragraph, the surplus generated for Buyer 2 is only $150, less than the $500 Buyer 1 would have earned. Despite the higher value, the surplus available to Buyer 2 is lower because of his collateral costs. Although it is true that the seller makes $100 more from the deal with Buyer 2, that is insufficient to make the breach profitable because the seller must pay damages to Buyer 1. Assuming that there has been no prepayment by Buyer 1, damages will be equal to Buyer 1's lost surplus, $500, which outweighs the additional $100 the seller earns from selling to Buyer 2. Given his collateral costs, Buyer 2 is unable to offer the seller enough to make breach profitable. Nor is breach efficient. The potential surplus available to be shared in the deal between the seller and Buyer 1 is $250 greater ($1500 - $1250) than for the deal with Buyer 2. Even though the resource is more valuable in the hands of Buyer 2 (in the *Restatement* sense of total revenues it will generate), it generates less surplus. Focusing on surplus rather than value demonstrates the inefficiency of this breach.
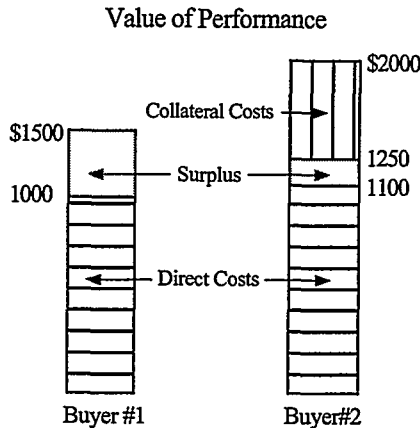
Value of Performance

FIGURE 7

If Buyer 2 could reduce his collateral costs enough to raise his bid more than $500 above Buyer 1's bid, breach not only would be efficient (because it would increase the total surplus produced by the second use to an amount greater than that available from the first use), but it also would be profitable. When Buyer 2 reduces his collateral costs from $750 (the amount in Figure 7) to $150, Buyer 2's reservation price increases to $1850, more than enough to induce the seller to breach. Buyer 2 would be willing, for instance, to offer $1700, which, even after paying damages of $500, leaves the seller with $1200, more than she would have earned from performing as promised. Having reduced the collateral costs necessary to obtain the value of $2000, the surplus available to be shared by the parties has increased by an amount equal to the collateral cost savings and to an amount that is greater than the surplus to be shared with Buyer 1. This decrease in costs makes breach profitable and desirable from an economic perspective. The *values* of the buyers' uses have not changed in the two examples. It is because the *surplus* has changed that breach suddenly becomes efficient.

Focusing on surplus rather than on value also illustrates why contract theory is concerned with the efficiency of breach. Aside from the apparent increase in surplus, which constitutes an addition to the wealth of society, the example illustrates the source of the increase in wealth. Collateral costs are real resources—whether raw materials, labor, or time—expended in making the item purchased useful. The example above illustrates the conservation of those resources without a diminution of the value obtained. It is this saving of real resources that generates the increased wealth.

Focusing on surplus also facilitates analysis of efficient breach in substitute transactions cases. In *Laredo Hides Co. v. H & H Meat Products Co.*,[70] H & H Meat repudiated its contract to sell to Laredo Hides, which covered by buying hides from another seller and was able to complete its resale of the hides to Mexican tanneries.[71] The value of the promised and substituted performance was the same, but

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70. 513 S.W.2d 210 (Tex. Ct. App. 1974).
71. *See* Laredo Hides Co. v. H & H Meat Prods. Co., 513 S.W.2d 210, 216 (Tex. Ct. App. 1974).

the direct and collateral costs associated with each were different.[72]

Imagine that the figures in the *Laredo Hides Co.* transaction are as shown in Figure 8, in which the value of performance remains constant at $600 but costs increase by $150, and profits are reduced by that same amount. Direct costs (costs of buying hides) increase by $100 (from $250 to $350), and collateral costs (costs of shipping hides to Mexico) increase by $50 (from $100 to $150). The Difference-in-Value rule[73] will not yield the correct answer without adjustments, because the value (in the *Restatement* sense) does not change. A Difference-in-Surplus[74] rule readily reveals the correct damage amount as the difference in profits, $150 (the difference between $250 and $100). Breach is efficient only if the total surplus generated by the breach exceeds the total surplus that would have resulted from performance.
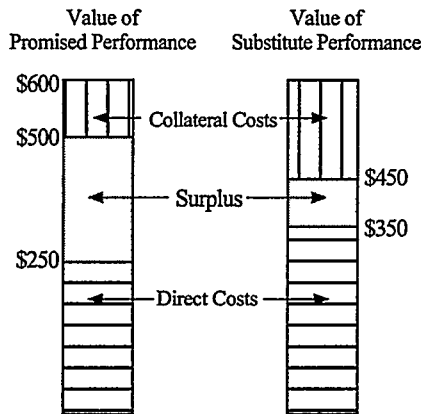

FIGURE 8

Evaluating the profitability and efficiency of breach in substitute transactions cases mimics the evaluation of these issues in other cases. To determine the profitability of breach, the seller must compare the price the second buyer offers with the damage payments due the first party.[75] Whenever the second price offer exceeds the first price offer by an amount sufficient to pay damages yet leaves more than the

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72. *See id.*
73. *See infra* notes 109-22 and accompanying text (describing Difference-in-Value rule).
74. *See infra* notes 136-43 and accompanying text (describing Difference-in-Surplus rule).
75. In *Laredo Hides Co.*, for example, H & H would have to consider the price offered by its second buyer and the damages it would owe Laredo in the event of breach.

first price, the seller has an incentive to breach. Breach will be efficient in all such cases, because only a second buyer with a potential surplus greater than the first buyer's will be willing to offer such a high price. For substitute transactions cases, damages are equal to lost profits, which equal the sum of increased direct and collateral costs if the value of performance stays the same.[76]

For breach to be profitable in substitute transaction cases, the second buyer's offer must exceed the first buyer's price by the amount of the increased costs that the injured party will sustain. Because damages are equal to those increased costs, it is that amount that the party contemplating breach must consider. This consideration is appropriate from a social point of view, because the seller's breach increased the first buyer's costs of producing exactly the same result. Only if the surplus earned by the second party is so great that it makes up for this loss will breach be desirable from a cost-minimizing/wealth-maximizing viewpoint.

IV. RECONCILING CONFLICTING MEANING OF "VALUE" IN DAMAGE RULES

Recognizing the equivalency between the *Restatement* approach to damages and the surplus-based approach facilitates appreciation of the relationships among the three damages formulae that are based on value. Conflicting meanings of value are embodied in: (1) the *Restatement* formula (the "value plus breach-related costs less costs avoided" approach to damages); (2) the Difference-in-Value formula (the "difference between value promised and value received" approach); and (3) the Contract Price formula (the "value equals contract price" approach). The *Restatement* and Contract Price formulae are equivalent under certain restricted conditions, but the *Restatement* and Difference-in-Value definitions of value are irreconcilable. This section describes the circumstances under which value, in the *Restatement* sense, equals contract price, then discusses the fundamentally different concept of value embodied in the Difference-in-Value formula for contract damages.

A. *The* Restatement *Formula and the Contract Price*

Awarding the contract price yields the same result as applying the *Restatement* formula whenever: (1) the contract is not an integral part of a larger project being undertaken by the injured party; (2) there

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76. *See Laredo Hides Co.*, 513 S.W.2d at 216.

is no need to adjust the amount of damages to reflect direct or collateral costs avoided by the injured party as a result of breach; (3) no breach-related costs were incurred; and (4) no mitigation of losses was attempted by the injured party. Discussion of the adjustments necessary to account for the possible complications to damage recovery—enumerated above as (2) to (4)—would be relevant to a dissertation on damages calculations, but those adjustments are not relevant to the conflicting definitions of value appearing in contract rules. This section discusses the implications for damage rules of the "larger project" problem for buyers and sellers (item (1) above) and the treatment of that problem by the Uniform Commercial Code ("U.C.C."). This section also identifies the surplus-based approach as a more straightforward conceptual tool while recognizing that the availability of data occasionally may make damages easier to calculate under an explicitly value-based formula.

The *Restatement* formula and the Contract Price formula have coincident meanings for value when the contract breached was not an integral part of a larger project in which the victim of the breach was engaged.[77] The "larger project" condition recognizes that the injured party's anticipated surplus would have been earned by using the other's performance in furtherance of another endeavor. Some of these cases involve injured parties who have been promised loans of money to be used to finance a larger project. *Native Alaskan Reclamation & Pest Control, Inc. v. United Bank of Alaska*[78] is such a case. The bank loan at issue in that case would have been used to

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77. In the broadest sense, every contract is part of a "larger project," which simply may be "the project of increasing the wealth of the contracting party." Contract law does not recognize the right to receive compensation for all costs associated with such a larger project. *See* Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (1854) (denying recovery of damages for losses in profit not reasonably foreseen by breaching party). Recovery of collateral costs is limited to cases in which the larger project is reasonably foreseeable to or within the contemplation of both parties. *See id.* Cases applying the *Hadley* rule focus on the foreseeability that the victim of the breach would incur particular costs rather than on the foreseeability of a larger project of which they might be a part, but if a particular "larger project" is unforeseeable, then, *a fortiori*, costs associated with that project are unforeseeable and therefore unrecoverable. *See* Rochester Lantern Co. v. Stiles & Parker Press Co., 31 N.E. 1018, 1021 (N.Y. 1892) (denying recovery for incurred costs not reasonably foreseen by breaching party); *see also* Florida E. Coast Ry. Co. v. Beaver St. Fisheries, Inc., 537 So. 2d 1065, 1068 (Fla. 1989) (denying special damages against railway for unforeseeable replacement costs associated with jet charter). Recovery similarly is denied when the lost profits are too speculative, because, for instance, the breaching party could not anticipate the nature of the larger project of which the contract in question allegedly was a part. For example, in *Kenford Co. v. County of Erie*, 493 N.E.2d 234, 235 (N.Y. 1989), the complainant, who donated land to a county for development of a sports stadium in exchange for the right to manage the facility, was denied recovery of lost profits on anticipated development of peripheral lands after the county failed to build the stadium (loss of profits not in the contemplation of the parties at the time of execution of the contract was too speculative).

78. 685 P.2d 1211 (Alaska 1984).

restore and resell airplanes.[79] Awarding the borrower corporation
the amount it would have paid for the loan (principle plus inter-
est)—the contract price—would have undercompensated the injured
party, because the breach had deprived him of the opportunity to
participate in the restoration and reselling project and to earn the
associated profits.[80]

Because money is often a business' ultimate purpose for contract-
ing, victims with larger projects typically are promised a resource
other than money. In *Wartzman v. Hightower Productions, Ltd.*,[81] a
client contracted for a lawyer's assistance in incorporating his
business, intending to use the incorporated status to further his
planned commercial exploitation of an entertainment event.[82] The
failure of the lawyer to deliver his promised performance prevented
the business from being able to raise sufficient funds to proceed with
its plans.[83] As illustrated in *Wartzman*, the likelihood that buyers will
use the resource promised in exchange for the purchase price to
further a larger project, even if only the resale of the resource,
justifies application of U.C.C. sections 2-711,[84] 2-713,[85] and 2-715,[86]
which allow buyers who have paid the purchase price in full to
recover lost profits in addition to the contract price. Award of the
contract price alone, whether it is measured in the dollars of principal
and interest to be repaid, the dollar amount of a purchase price, or
bushels of grain, understates the loss suffered by the injured party
when the promised performance was to have been part of a larger
project. When cover is not reasonably available to buyers, the award
of a substantially equivalent performance, which would be something
resembling the contract price is, by definition, not reasonably
possible, often because it would be too late.[87]

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79. *See* Native Alaskan Reclamation & Pest Control, Inc. v. United Bank of Alaska, 685 P.2d
1211, 1213 (Alaska 1984).

80. *See id.* at 1223 (affirming expectation damages awarded by trial court).

81. 456 A.2d 82 (Md. Ct. Spec. App. 1983).

82. *See* Wartzman v. Hightower Prods., Ltd., 456 A.2d 82, 84 (Md. Ct. Spec. App. 1983).

83. *See id.* at 86.

84. The U.C.C. allows a buyer to recover "so much of the price as has been paid" in
addition to "damages for non-delivery as provided in [§ 2-713]." U.C.C. §§ 2-711(1), (b) (1987).

85. The U.C.C. allows recovery of "any incidental and consequential damages provided in
[§ 2-715]." *Id.* § 2-713(1).

86. The U.C.C. allows recovery of consequential damages including "any loss resulting from
general or particular requirements and needs of which the seller at the time of contracting had
reason to know and which could not reasonably be prevented by cover or otherwise." *Id.* § 2-
715(2)(a). The U.C.C. explicitly recognizes that the reselling of goods "is one of the
requirements of which the seller has reason to know within the meaning of subsection (2)(a)."
Id. § 2-715 cmt. 6.

87. *See* Native Alaskan Reclamation & Pest Control, Inc. v. United Bank of Alaska, 685 P.2d
1211, 1221 (Alaska 1984) (finding that court award equal to amount of business loan would be

When addressing remedies based on the contract price, the U.C.C. implicitly views sellers as having no larger project in mind when engaging in a sale. The U.C.C. recognizes the opportunity for both buyers and sellers to re-enter the market for the goods in question to minimize the losses associated with breach.[88] Buyers may procure substitute goods and recover "the difference between the cost of cover and the contract price together with any *incidental and consequential* damages" with adjustments for expenses saved.[89] Sellers may resell the goods and recover the difference between the market price and the unpaid contract price "together with any *incidental* damages" with adjustments for expenses saved.[90] Resale is the seller's primary remedy under the U.C.C., but the U.C.C. also recognizes that in special cases in which resale is not feasible, "the action for the price . . . would then be necessary to give the seller the value of his contract."[91] The U.C.C. allows for recovery of incidental damages (breach-related costs)[92] but makes no explicit allowance for recovery of consequential damages (lost profits in the U.C.C. context) as it does for buyers[93] in sections 2-712[94] and 2-715.[95] The contract price is presumed to include all of the seller's anticipated surplus.

When mitigation by resale or cover is impossible, a buyer or seller would be unable to recoup profits associated with a larger project by taking advantage of a substitute performance. Because the underlying goal of U.C.C. damage remedies is to put the injured party in as good a position as performance would have done,[96] one might anticipate judicial opinions allowing sellers an alternative to the market

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too late because business opportunity had passed); *Wartzman,* 456 A.2d at 86 (finding that court award of equivalent lawyer services would be too late because opportunity to exploit entertainment event had passed).

88. *See* U.C.C. § 2-706 (1) (allowing seller to resell goods); *id.* § 2-712(1) (allowing buyer to purchase substitute).

89. *Id.* § 2-712(2) (emphasis added).

90. *Id.* § 2-706(1) (emphasis added).

91. *Id.* § 2-704 cmt. 1.

92. *See id.* § 2-710.

93. *See* HAWKLAND, *supra* note 7, at §§ 2-710:01, 2-711:02 (stating that buyer is permitted to recover consequential damages in appropriate cases, but that seller does not have such right).

94. *See* U.C.C. § 2-712(2) (allowing buyer to recover difference between cost of cover and contract price plus any incidental or consequential damages less expenses saved).

95. U.C.C. section 2-715 defines incidental damages resulting from the seller's breach as "expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or breach." *Id.* § 2-715(1). Consequential damages resulting from the seller's breach include any loss of which the seller had reason to know at the time of contract but which could not have been prevented reasonably and any injury "proximately resulting from any breach of warranty." *Id.* § 2-715(2)(a)-(b).

96. *See id.* § 1-106(1) (stating that remedies shall be administered liberally so that aggrieved party is in position as if performance occurred).

price/contract price differential of U.C.C. section 2-708(1)[97] to account for "larger project" situations. An alternative remedy for sellers appears in U.C.C. section 2-708(2). This provision offers the surplus-based approach,[98] which is equivalent to the *Restatement* approach in that it allows for a divergence between contract price and value, in which a remedy based on the contract price fails to compensate the injured party fully.[99] The cases in which courts apply section 2-708(2), however, are not the "larger project" cases. They are typically cases involving specialty goods with no established market price,[100] lost volume sellers,[101] or jobbers[102]—all factual contexts that disable the court from applying the customary damage measure in section 2-708(1). For sellers, at least, the U.C.C. treats the contract price as reflecting the entire return (the value in the *Restatement* sense) the seller would have received as a result of the buyer's performance. There are, of course, cases in which the award of the contract price is fully compensatory and results in the same award as the *Restatement* approach.[103] In such cases, the seller's only anticipated return from the contract was the price, so the contract price accurately reflects the value.

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97. U.C.C. section 2-708(1) measures the seller's damages as the difference between the market price and the unpaid contract price, plus incidentals, less expenses saved.

98. U.C.C. section 2-708(2) establishes as the measure of damages "the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages provided in [section 2-710], due allowance for costs reasonably incurred and due credit for payments or proceeds of resale."

99. *See supra* notes 34-37 and accompanying text.

100. *See* Tigg Corp. v. Dow Corning Corp., 962 F.2d 1119, 1129 (3d Cir. 1992) (stating that contract/market damages must be determined inadequate before § 2-708(2) can be applied for seller); Taft-Pierce Mfg. Co. v. Seagate Tech., Inc., 789 F. Supp. 1220, 1228 (D.R.I. 1992) (distinguishing specialty item with limited market from unfinished item with no market price subject to § 2-708(2) remedy).

101. *See* R.E. Davis Chem. Corp. v. Diasonics, Inc., 924 F.2d 709, 710 (7th Cir. 1991) (stating that contract/market damages may be inadequate when seller has finite number of customers and limited capacity for resale); Ragen Corp. v. Kearney & Trecker Corp., 912 F.2d 619, 627 (3d Cir. 1990) (defining lost volume seller as one who resells product at same price but loses profit from first sale because second buyer would have purchased product anyway).

102. *See* Blair Int'l Ltd. v. LaBarge, Inc., 675 F.2d 954, 960 (8th Cir. 1982) (stating that § 2-708(2) is applicable when jobber seller never acquires contract goods and when decision not to acquire goods after learning of breach is commercially reasonable); JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 313-21 (3d ed. 1988) (discussing application of § 2-708(2) to lost volume sellers, components, jobber sellers, and selected other cases in which contract price measure is inappropriate without discussing larger project issue).

103. *See* Connecticut Inv. Casting Corp. v. Made-Rite Tool Co., 416 N.E.2d 966, 969-70 (Mass. 1981) (awarding full contract price to seller of barrel latches because buyer did not revoke acceptance properly); Aymond v. Lambert, 262 So. 2d 795, 796 (La. Ct. App. 1972) (awarding contract price to seller who completed furnishing and installation of central air conditioner without defect that was accepted by buyer who then refused to pay).

B.   Value in Substitute Transactions Cases

Substitute transactions cases are those involving: (1) breach of warranty; (2) defective, partial, or substantial performance; (3) cover; and (4) resale.[104] All of these cases are characterized by a performance rendered that differs from a performance promised. They can be resolved by reference to a rule that awards the difference in value between the performance promised and the substitute performance received. In the warranty cases and defective, partial, or substantial performance cases, the promisor substitutes a less desirable performance for the one promised. In cover and resale cases, the injured party obtains the performance from another (substitute) person.[105] To cover the widest variety of substitute transaction cases, however, value must be understood to mean "surplus or profit," rather than anticipated total return including enough to cover costs and provide a surplus (the *Restatement* section 347 sense). This section explores the application of the Difference-in-Value rule to substitute transaction cases, considers the limited circumstances in which the difference in the value of two performances is a sensible measure of damages, and compares the relative simplicity and conceptual accuracy of a Difference-in-Surplus rule.

The Difference-in-Value rule appears to students of contracts in *Hawkins v. McGee*,[106] the "hairy hand" case in which the court held that the plaintiff was entitled to the difference in value between a good hand and the quality of the hand that the doctor produced.[107] In such cases, when the injured party realizes some of the value anticipated from the other's performance, damages are reduced accordingly.[108]

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104. *See* sources cited at *infra* notes 112-15 (ascertaining damages in substitute transaction cases).

105. *See* Laredo Hides Co. v. H & H Meat Prods. Co., Inc., 513 S.W.2d 210, 221 (Tex. Ct. App. 1974) (holding that plaintiff was within purview of cover by purchasing hides from substitute seller).

106. 146 A. 641 (N.H. 1929).

107. *See* Hawkins v. McGee, 146 A. 641, 644 (N.H. 1929).

108. An injured party is entitled to the difference between the value anticipated from performance and the value received. *See id.* But *see* RESTATEMENT (SECOND) OF CONTRACTS § 347 (1979) (entitling injured party to only "loss in value"). With respect to partial performance, the *Restatement* provides:

> If no performance is rendered, the loss in value caused by the breach is equal to the value that the performance would have had to the injured party. . . . If defective or partial performance is rendered, the loss in value caused by the breach is equal to the difference between the value that the performance would have had if there had been no breach and the value of such performance as was actually rendered.

Id. § 347 cmt. b.

With respect to reduction in damages that reasonably can be avoided by mitigation, see *id.* § 350 (stating that injured party's attempts to avoid injury will limit damage awards).

Construction cases[109] are as prominent among partial and defective performance cases in casebooks as "reconstruction" cases like *Hawkins*,[110] although partial performance also may occur in sales of goods or services contexts.[111] The comparison of differences in the values of two transactions is most obviously apparent in cover and resale cases.[112] Whatever the type of case, the damages calculation becomes more complicated because the outcomes associated with two transactions, the promised performance and the realized performance, must be compared.[113]

In the most straightforward substitute performance cases, the Difference-in-Value approach yields the correct measure of damages, even when the *Restatement* definition of value is applied. The simplest illustration of a substitute performance case in which the Difference-in-Value formula gives the correct answer under the *Restatement* definition is one in which there has been partial payment for goods accepted. Partial payment cases are substitute performance cases, because the breaching buyer has substituted partial for full payment. In these cases, the award may be based on the contract price, with adjustments for the performance rendered, so that the contract price also reflects the value of the contract to the seller in the *Restatement* sense.

Industrial Molded Plastic Products, Inc. v. J. Gross & Son, Inc.[114] is a simple application of the Difference-in-Value rule in a breaching buyer context. The manufacturer in this case manufactured five million plastic clips for a clothing wholesaler who paid only $203.55

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109. *See, e.g.*, Castricone v. Michaud, 583 N.E.2d 1184 (Ill. App. Ct. 1991) (allowing homeowners to recover amount in excess of contract needed to complete construction after complaints about quality halted construction of home before completion); J.E. Pierce v. Drees, 607 N.E.2d 726 (Ind. Ct. App. 1993) (holding that defective construction of garage was breach of contract); K & G Constr. Co. v. Harris, 164 A.2d 451, 456 (Md. 1960) (determining that partial performance by subcontractor was breach of contract).

110. *See* Sullivan v. O'Connor, 296 N.E.2d 183, 185 (Mass. 1973) (allowing entertainer to recover damages as remedy for defective reconstruction of nose).

111. *See* Rowan Heating-Air Conditioning-Sheet Metal, Inc. v. Williams, 580 A.2d 583, 584 (D.C. 1990) (awarding purchaser amount needed to complete and repair defective heating and air conditioning system); Miller v. Bealer, 608 N.E.2d 1133, 1135 (Ohio Ct. App. 1992) (holding that partially-performed auto repair was breach of contract).

112. *See* City Univ. of N.Y. v. Finalco, Inc., 514 N.Y.S.2d 244, 246 (App. Div. 1987) (affirming resale case in which seller found substitute buyer after contractor refused to perform); Laredo Hides Co. v. H & H Meat Prods. Co., 513 S.W.2d 210, 216 (Tex. Ct. App. 1974) (considering cover case in which middleman brought from second supplier to complete obligations to buyers).

113. One also might view the straightforward cases of total breach with no cover or resale as "substitute transaction" cases, with no performance substituted for the promised performance. The comparison of the two transactions is simplified because there is no value to the lack of performance and there is no possibility for an increase in either performance or enhancing costs.

114. 398 A.2d 695 (Pa. Super. Ct. 1979).

of its $31,710.00 obligation.[115]   The value of the contract to the manufacturer was the purchase price, $31,710.00,[116] as the sale was not part of any particular larger project for the seller. If this contract had been part of a larger project of which the sale was only a part, the contract price might have been less than the value of the contract in the *Restatement* sense, but that was not the case.   The unpaid balance in *Industrial Molded Plastic Products,* $31,506.45,[117] represents not the unpaid profit but the loss in value due to the buyer's breach. Lost profit would be the purchase price less the cost of supplying the clips. All direct and collateral expenses already had been incurred by the manufacturer, so there were no "costs avoided" by the manufacturer.[118]   At the same time, the breaching party's behavior imposed no additional costs, as would be present when the manufacturer incurs breach-related costs.[119]   In this instance, therefore, awarding the unpaid contract price accurately reflects the loss in value caused by the breach.

It is easy to see that a Difference-in-Surplus rule would yield the same result in cases such as *Industrial Molded Plastic Products.* Instead of earning whatever profit the plastics manufacturer expected, for example, $5000.00 of the $31,710.00 contract price, the partial payment created a loss. If $5000.00 would have been profit, then $26,710.00 was cost to be covered by the full payment. The partial payment of only $203.55 would result in a loss of $26,506.45 ($26,710.00 - $203.55). To restore the manufacturer to its full profit potential, the difference between the loss produced and the profit expected requires a payment of $26,506.45 (to cover the costs) and an additional $5000.00 (to cover the lost profit). The difference in surplus is the difference between $5000.00 and *negative* $26,506.45, which is $31,506.45, the unpaid balance of the contract price.

In every case in which the injured party incurs additional costs as a result of the breach or covers or sells at a price different from the contract price, however, the Difference-in-Value formula yields the wrong answer if the *Restatement* definition of value is applied literally. The Difference-in-Surplus approach results in a correct award of damages. Some cases in which costs are incurred as a result of breach are cases in which the value of the substitute performance to the

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115. *See* Industrial Molded Plastic Prods., Inc. v. J. Gross & Son, 398 A.2d 695, 697 (Pa. Super. Ct. 1979).

116. *See id.*

117. *See id.*

118. *See id.*

119. *See id.*

injured party is unchanged, but the costs associated with obtaining that value change because of the breaching party's default. In *Spang Industries Inc. v. Aetna Casualty & Surety Co.*,[120] the buyer of steel incurred increased collateral costs in pouring cement for a bridge because the steel was delivered late.[121] Here, the seller of steel may be viewed as substituting a late performance for a timely performance. The value of the steel is determined by reference to the payment the contractor was to receive for the completed bridge, not the price paid for the steel. Because the payment for the bridge did not change, the value of the steel (in the *Restatement* sense) did not change.[122] No damages would be awarded under the value-based approach if the *Restatement* meaning of value were applied literally. Nevertheless, the contractor/buyer was awarded the amount of increased costs because failing to do so would have reduced the surplus associated with the steel contract, which is the profit from building the bridge on time.[123] The same difference in result would occur if the buyer of steel were forced to cover by substituting a purchase from a higher priced steel supplier for the contract steel.[124] It would be more accurate to apply a Difference-in-Surplus approach, which, as will be illustrated, makes adjustments for changes in direct, collateral, and breach-related costs.

Once the Difference-in-Value formula is adjusted to reflect the difference in costs incurred, the result is essentially the same as applying a more straightforward Difference-in-Surplus rule. The breach in *Spang* imposed breach-related costs on the bridge manufacturer, costs not included in the anticipated direct or collateral costs that would have been incurred even if breach had not occurred.[125] The increased costs of pouring cement would be recoverable as a breach-related cost incurred (a cost not anticipated but caused by the breach), without reference to changes in value.

A similar error occurs if the difference in value is not adjusted to reflect costs avoided. When an injured party receives and pays for only half of the goods promised by the breaching party, the Difference-in-Value approach would award the buyer half of the value of the contract, which would be an incorrect result. Costs avoided must be

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120. 512 F.2d 365 (2d Cir. 1975).
121. *See* Spang Indus. Inc. v. Aetna Cas. & Sur. Co., 512 F.2d 365, 367 (2d Cir. 1975).
122. *See id.* at 371 (concluding that prompt response to breach provided reasonable mitigation thereby avoiding serious damage to larger project).
123. *See id.*
124. *See* Laredo Hides Co. v. H & H Meat Prods. Co., 513 S.W.2d 210, 221 (Tex. Ct. App. 1974) (substituting higher-priced hides for those promised under contract).
125. *See supra* note 38 and accompanying text (discussing breach-related costs).

deducted to avoid overcompensating the injured party. By deducting costs avoided, the court essentially is awarding the difference in surplus (the difference between the value of two transactions *and* costs associated with the two transactions), rather than simply the difference in value. Deducting costs avoided from lost value yields the amount of profit that would have been earned had performance occurred.

The same conclusion applies to cover and resale cases. When collateral costs associated with the substitute performance are different, but the value of the transaction is unchanged, a comparison of values (in the *Restatement* sense) again will undercompensate. In *Laredo Hides Co.*,[126] Laredo Hides incurred a $3,448.95 increase in transportation and handling costs associated with buying hides in a cover transaction.[127] Even if it could have sold the substitute hides to its buyers for the same price as the promised hides (that is, if it could have realized the same total value), Laredo Hides would have suffered a loss if the *difference in value* was the basis for the damage calculation. The increased costs affect the amount of surplus earned, not the value of the hides purchased, and it is the *difference in surplus* that must be awarded.

Only when the cover and resale transactions involve no change in either the direct or collateral costs involved will the Difference-in-Value rule give a correct damage calculation. If Laredo Hides had incurred no increase in transportation and handling (collateral costs) and had paid the same price for the substitute hides, the damage award properly would be based on the difference in the price the tanneries would be willing to pay for the substitute hides. That price reflects the total revenues Laredo Hides anticipated earning from the breaching party's performance, the *value of that performance*.[128] Similarly, in *City University of New York v. Finalco, Inc.*,[129] a resale case, the only change in the transaction was the price obtained from the substitute buyer of used computers, which was lower than the price promised by the breaching party.[130] The seller's direct cost (giving up the used computers) and collateral costs (none) were un-

126. 513 S.W.2d 210 (Tex. Ct. App. 1974).

127. *See Laredo Hides Co.*, 513 S.W.2d at 216. For a resale case presenting similar issues, see McMillan v. Meuser Material & Equip., 541 S.W.2d 911 (Ark. 1976) (awarding increased costs of maintaining bulldozer until resale was possible).

128. *See* Red River Commodities, Inc. v. Eidsness, 459 N.W.2d 811, 818 (N.D. 1990) (awarding damages equal to difference between contract price for 229,000 pounds of sunflowers ($25,762.50) and cover price ($59,540.00)).

129. 514 N.Y.S.2d 244 (App. Div. 1987).

130. *See* City Univ. of N.Y. v. Finalco, Inc., 514 N.Y.S.2d 244, 245 (App. Div. 1987).

changed.[131]   The proper damage award is the difference in value received by the seller, which properly is captured in the difference in contract price.

The Difference-in-Surplus rule yields the correct measure of damages in cover and resale cases, as it does in all substitute performance cases. Figure 8, above, depicts the value of a promised and a substitute performance in a cover case. To realize the value of the promised performance, the injured party anticipated incurring $100 in collateral costs and $250 in direct costs to obtain the total value of $600 from the breaching party's performance and to earn a $250 surplus.   The substitute performance has a similar value although collateral costs and direct costs have increased (to $150 and $350, respectively), squeezing surplus from top and bottom down to $100. To receive the benefit of his bargain—that is, to be placed in the same wealth position she would have occupied had there been no breach—the injured party must receive $150 in damages, the difference in surpluses, even if there is no change in value.

Many cover and resale cases are more complicated but can be addressed using the same surplus-based framework. When a buyer covers with better or worse quality goods, the difference in surpluses captures the essence of the injured party's losses. In *Martella v. Woods*,[132] a case in which the buyer bought heifers of a better quality than those promised by the breaching party,[133] the increased price the injured party obtained from resale of the better heifers translated into increased profit (surplus) and was taken into account as the court reduced damages to an amount less than the simple difference in price.[134]

The bottom line for damages reflects the surplus resulting from all of the related transactions. Buyers may arrange a series of transactions to protect themselves from damages associated with nondelivery or late delivery. Accordingly, in *Fertico Belgium S.A. v. Phosphate Chemicals Export Ass'n, Inc.*,[135] the buyer/trader, Fertico, covered (at

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131. *See id.*
132. 715 F.2d 410 (8th Cir. 1983).
133. *See* Martella v. Woods, 715 F.2d 410, 412 (8th Cir. 1983).
134. The buyer covered by buying a herd of heifers that was heavier and composed of more pregnant cows than the contract heifers. *See id.* There is no mention of a general market increase or decrease, so it may be assumed that the difference in market prices between the higher quality cover heifers and the contract heifers reflects an increase in the value of the herd acquired. With an increased price and increased value, the difference in surplus, which reflects both the difference in value and the difference in prices, is $S_1 - S_2 = (DC_2 - DC_1) - (V_1 - V_2)$, where S = surplus, DC = direct costs, V = value, and the subscript = either the original (1) or cover (2) transaction.
135. 510 N.E.2d 334 (N.Y. 1987).

an increased cost of $700,000) in order to avoid breaching its own contract with a subsequent buyer.[136] It sold the cover fertilizer at a renegotiated higher price that included more expensive transportation.[137] When the original fertilizer finally arrived, Fertico sold it to another buyer for a $454,000 profit.[138] Damages, in this situation, equal the changes in values received *and* the changes in costs incurred in all of the transactions—the difference in surplus rather than simply the differences in value. For the resale of the cover fertilizer, there is an increase in cover price ($700,000), an increase in collateral costs (the more expensive transport), and an increase in the value of the renegotiated contract. For the sale of the contract fertilizer, there is a $454,000 surplus.[139] Like *Martella,* the award in *Fertico* reflects differences in costs *and* values, not simply the difference in values.[140]

CONCLUSION

For reasons of clarity and analytical convenience, it is preferable to conceptualize damage rules in terms of surplus lost and costs incurred. When a seller has no larger project of which the promised performance is an integral part, the contract price accurately measures the seller's loss only when all of the seller's costs have been

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136. *See* Fertico Belgium S.A. v. Phosphate Chems. Export Ass'n, 510 N.E.2d 334, 335 (N.Y. 1987).

137. *See id.*

138. *See id.*

139. There are three transactions in *Fertico Belgium:* (1) the resale Fertico had planned to make when contracting with a surplus $S_1 = V_1 - DC_1 - CC_1$ (where S = surplus, V = value, DC = direct costs, and CC = collateral costs associated with the first contract); (2) the renegotiated resale with an increased value (higher resale price), direct cost (due to $700,000 increased price of cover fertilizer) and collateral costs (due to more expensive transportation) with a surplus $S_2 = V_2 - DC_2 - CC_2$, (subscript 2 = second deal); and (3) assuming as the trial court did, that this third transaction was made possible only by the breach, the resale to a new buyer (with a surplus $S_3 = \$454,000$). *See id.* Damages equal the difference between the first surplus, S_1, and the sum of the other surpluses, $S_2 + S_3$, that is:

$$\text{Damages} = S_1 - (S_2 + S_3) = (V_1 - DC_1 - CC_1) - [(V_2 - DC_2 - CC_2) + (S_3)].$$

The award would reflect the difference in cost between the first two deals $((DC_2 - DC_1) + (CC_2 - CC_1))$, plus the difference in values between the contracts $(V_1 - V_2)$, less the surplus earned on the resale to a new buyer, S_3.

Serendipitous circumstances simplified the calculation of damages in *Fertico* when the Court of Appeals found that the increased contract price reflected in V_2 exactly offset the increased transportation costs reflected in CC_2 and that the third transaction would have occurred even without the breach (making Fertico a lost volume seller). *See id.* at 468 (describing lower court decision from which Fertico appealed). Ultimately, damages were simply the difference between the contract price and the cover price, that is:

$$\text{Damages} = (V_1 - DC_1 - CC_1) - (V_2 - DC_2 - CC_2) \text{ and,}$$
$$\text{because } V_1 - V_2 = CC_2 - CC_1,$$
$$\text{Damages} = DC_2 - DC_1 = \$700,000.$$

See id. at 470 (awarding $700,000 in damages).

140. *See id.* at 468.

incurred and there is no substitute transaction. In those cases, the contract price reflects the sum of surplus lost plus costs incurred. In all other cases with no larger project, the contract price overstates the seller's losses. A measure that adds to lost surplus only those costs actually incurred precisely captures the losses. For buyers whose intended purchase was part of a larger project, the contract price measure does not suffice, because it fails to include lost profits to be derived from the larger project. When an injured party intended to use the other's performance as part of a larger project, the surplus-based approach includes the benefits that would have flowed from the larger project.

Focusing on surplus aids calculation of damages in more complicated cases as well. When the breaching party performs in part or defectively or when the injured party arranges a substitute performance, a surplus-based formula directs attention to the bottom line—lost surplus—rather than focusing on changes in value received, which, without adjustments, ignores the effect of the breach on changes in costs. A buyer intending to resell to a third party may cover by purchasing more expensive goods. The effect of the cover is not to create a more valuable resale but to reduce profits, which can be restored through damages. Similarly, a seller who resells after the buyer's breach for less than the buyer promised suffers a comparable loss in surplus for which she can be compensated through damages without regard to the value of either the thwarted original transaction or the substitute. A more intuitive and conceptually clearer set of rules based on lost surplus easily could be drafted without the conflicting definitions appearing in the current approach. Consider, for example, the following language:

> *Proposed Surplus-Based Restatement of the Law of Contract Damages*
> § 1. Subject to limitations described in § 2, the nonbreaching party is entitled to recover in damages an amount equal to all losses suffered as a result of the breach, including
>   (a) the surplus lost as a result of the other's failure to perform as promised and
>   (b) costs incurred, whether they were
>   (i) incurred in anticipation of the other's performance and wasted because of the breach or
>   (ii) caused by the other's breach.
>
> § 2. Losses, whether from lost surplus or from costs incurred, are compensable only to the extent that
>   (a) the injured party could not have avoided them using

reasonable methods,
(b) the parties contemplated or could reasonably have foreseen
that the losses would result from a failure to perform, and
(c) the fact of the loss and the amount of the loss are provable
with reasonable certainty.

§ 3. When the breaching party has performed in part and/or the
injured party has obtained substitute performance from another,
the injured party is entitled to recover in damages an amount equal
to the difference between the surplus she would have obtained if
the breaching party had performed as promised and the surplus
she obtained from the part performance or substitute performance
or both, taking into account the changes in all types of costs
incurred as a result of the breach, subject to the limitations
described in § 2.

Similarly, focusing on surplus rather than value aids in the analysis
of incentives created by contract damage rules. Despite economists'
focus on allocating resources to their most *valuable* uses, the well-
being of contracting parties and of society is enhanced by allocating
resources to the uses that generate the greatest surplus. Even when
the reallocation of a resource generates no increase in value, the
reallocation may be preferred because it increases surplus, adding to
society's wealth.