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## The Myth of “Expectation Interest”

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# The Myth of “Expectation Interest”

James Gordley\*

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In one of the most influential law review articles ever written about contract law, Lon Fuller and William Perdue identified three interests that remedies for breach of contract protect: the “expectation interest,” the “reliance interest,” and the “restitution interest.”<sup>1</sup> The normal remedy protects the “expectation interest.” In the words of the Second Restatement of Contracts, it is a party’s “interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed.”<sup>2</sup>

The thesis of this Article is that the goal of contract law should not be to protect a party’s “expectation interest.” Remedies for breach of contract often happen to put the non-breaching party in as good a position as he would have been in if the contract had been performed. But sometimes they do not or should not. Moreover, even when they do, the reason for giving a remedy is not to put a party where he would have been absent a breach.

### I. WHY PROTECT THE EXPECTATION INTEREST?

The original contribution of Fuller and Perdue was not to identify the expectation, reliance, and restitution interests but to list them as the three possible interests the law might protect and to ask why they should be protected. Williston, in language they quoted, had defined what they called the expectation interest in these words: “In fixing the amount of these damages, the general purpose of the law is, and should be, to give compensation: – that is, to put the plaintiff in as good a position as he would have been in had the defendant kept his contract.”<sup>3</sup> German law, as Fuller knew, drew a similar distinction between a party’s *positive Vertragsinteresse*—a damage award that would put him where he would have been if the contract had been fulfilled—and his *negative Vertragsinteresse* which would compensate for harm he had suffered because the promise had been made and then broken.<sup>4</sup> He would also have been familiar with the role of restitutionary remedies in German law in unwinding an invalid contract.

One justification that Fuller and Perdue gave for protecting the expectation interest was new: to do so is an indirect way of protecting a party’s reliance on a contract. Another justification they described and rejected was old: it “may be found in the much-discussed ‘will theory’ of contract law.” This, indeed, had been the original justification for protecting the expectation interest.

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1. L.L. Fuller & William Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 54 (1936).

2. RESTATEMENT (SECOND) OF CONTRACTS § 344 (AM. LAW. INST. 1979).

3. 3 SAMUEL WILLISTON, *THE LAW OF CONTRACTS* 1338 (1920), (citing Fuller & Perdue, *supra* note 1, at 52).

4. Fuller & Perdue, *supra* note 1, at 55 n. 4, 86, 86 n. 54.

A. The Original Justification

As Fuller and Perdue explained:

[The will] theory views the contracting parties as exercising, so to speak, a legislative power, so that the legal enforcement of a contract becomes merely an implementing by the state of a kind of private law already established by the parties. If A has made, in proper form, a promise to pay B one thousand dollars, we compel A to pay this sum simply because the rule or *lex* set up by the parties calls for this payment.<sup>5</sup>

They cited one of the foremost will theorists, the great 19th century German jurist Bernhard Windscheid: “A legal transaction is the exercise of the creative power which the private will possesses in legal matters. The individual commands, and the law adopts his command as its own.”<sup>6</sup>

In common law and civil law jurisdictions, the 19th century was an age of will theories and of conceptualism. The German jurists were masters of both. Conceptualism was a method of legal reasoning that began with the definitions of basic legal terms and then tried to extract as many legal conclusions from these definitions as possible. Contract was defined to require a “manifestation of will (*Willenserklärung*) directed to bringing about a legal result.”<sup>7</sup> The law brings about the result that the individual willed. It followed by definition that the appropriate remedy was to compel the breaching party to perform what he promised or to award damages in the amount of the non-breaching party’s *positive Vertragsinteresse*: damages that would put him in as good a position as he would have been in if the contract had been performed.

The German jurists claimed that their theory could explain the Roman legal texts that had been in force in Germany and in much of continental Europe for centuries. In Roman law, the plaintiff could recover his *interesse*, and according to one text, his *interesse* (*quod interest*) could be harm (*damnum*) he suffered, or the gain (*lucrum*) he might have made.<sup>8</sup> Since the Middle Ages, these forms of loss had been called *damnum emergens* and *lucrum cessans*. If, in principle, the non-breaching party should recover both *damnum emergens* and *lucrum cessans*, then, it would seem he should be put in as good a position as he would have been in absent a breach. Indeed, the Latin word *interesse* seemed to combine two words, *inter*, meaning “between,” and *esse*, meaning “to be.” Thus, it would seem, the plaintiff should recover the difference between where he was after the breach and where he would have been if the contract had been performed. The 19th century jurists were vastly simplifying the difficult texts that governed when

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5. *Id.* at 58.

6. 1 BERNHARD WINDSCHEID, LEHRBUCH DES PANDEKTENRECHTS § 68 (9th ed. 1906) (quoting *id.*).

7. 1 BERNHARD WINDSCHEID, LEHRBUCH DES PANDEKTENRECHTS § 69 (9th ed. 1906); see 3 FRIEDRICH CARL VON SAVIGNY, SYSTEM DES HEUTIGEN RÖMISCHEN RECHTS § 134 (Berlin, 1840); GEORG FRIEDRICH PUCHTA, PANDEKTEN §§ 49, 54 (Leipzig, 1844).

8. CODE JUST. 7.47.2.

a non-breaching party could recover for harm he suffered or profits he would have made.<sup>9</sup> Later scholars pointed out that *interesse* to the Romans meant what “interest” does to us: the plaintiff was to get “what he was interested in, what concerned him, what was of consequence to him.”<sup>10</sup>

German critics such as Rudolf von Ihering attacked conceptualism itself because it ignored purposes the law sought to achieve. Moreover, the reasoning was hollow. The conclusions which the conceptualists ceremoniously unpacked from their definitions either did not follow from them or did so only because they had been packed into the definitions in advance. Fuller and Perdue wrote after the revolt against conceptualism had taken a firm hold in the United States. They began their article by noting: “The proposition that legal rules can be understood only with reference to the purposes they serve would today scarcely be regarded as an exciting truth. The notion that law exists as a means to an end has been commonplace for at least half a century.”<sup>11</sup>

They claimed that the protection of a party’s “expectation interest” was not a logical consequence of the will theory of contract:

[T]he will theory . . . cannot be regarded as dictating in all cases a recovery of the expectancy. If a contract represents a kind of private law, it is a law which usually says nothing at all about what shall be done when it is violated. A contract is in this respect like an imperfect statute which provides no penalties, and which leaves it to the courts to find a way to effectuate its purposes. There would, therefore, be no necessary contradiction between the will theory and a rule which limited damages to the reliance interest. Under such a rule the penalty for violating the norm established by the contract would simply consist in being compelled to compensate the other party for detrimental reliance.<sup>12</sup>

True enough. But Fuller and Perdue did not seem to realize that the idea the law should protect an “expectation interest” was based on a flawed interpretation of Roman law by jurists committed to conceptualism and to a will theory of contract. Instead of suggesting we jettison the idea, they assumed that the law does (or should) protect such an interest, and then, unsuccessfully, asked why.

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9. REINHARD ZIMMERMANN, *THE LAW OF OBLIGATIONS ROMAN FOUNDATIONS OF THE CIVILIAN TRADITION* 826–27 (1990).

10. *Id.* at 826.

11. Fuller & Perdue, *supra* note 1, at 52.

12. *Id.* at 58.

B. Modern Justifications

1. Fuller and Perdue: protecting the reliance interest.

Fuller and Perdue began their article by saying that “legal rules can be understood only with reference to the purposes they serve . . . .” Yet, they acknowledged, “[i]t is . . . no easy thing” to explain why the law protects the “expectation interest. “In this case we ‘compensate’ the plaintiff by giving him something he never had. This seems on the face of things a queer kind of ‘compensation.’”<sup>13</sup>

The law does so, they suggested, as an indirect way of protecting a party’s reliance on a contract. Some losses due to reliance are hard to prove, for example “the gains prevented’ by reliance, that is, losses, involved in foregoing the opportunity to enter other contracts.”<sup>14</sup> Putting the plaintiff where he would have been if the contract had been performed “is a cure . . . in the sense that [it] offers the measure of recovery most likely to reimburse the plaintiff for the (often very numerous and very difficult to prove) individual acts and forbearances which make up this total reliance on the contract.”<sup>15</sup>

Why, then, should reliance be protected? According to Fuller and Perdue:

[T]here is . . . a policy in favor of promoting and facilitating reliance on business agreements. . . . When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated.<sup>16</sup>

Here, they anticipated one feature of the contemporary law and economics movement. The answer to why the law does something cannot be that it is fair or just to do so. The answer is that is good economic policy.

Be that as it may, if their account is correct, then, in principle, contract law collapses into tort. Indeed, Grant Gilmore claimed that “*The Death of Contract*” was due to the recognition of liability for promissory reliance. That doctrine, adopted by § 90 of the First and Second Restatements of Contracts, allows the plaintiff to recover when he changed his position to his detriment by relying on a promise. As in tort, the defendant is liable for fault, or at least for conduct he knew or should have known could harm the plaintiff. Some scholars have suggested that the plaintiff should recover only for the amount that he was hurt—the amount that Fuller and Perdue called his “reliance damages” as opposed to

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13. *Id.* at 52–53.

14. *Id.* at 60.

15. *Id.*

16. *Id.* at 61.

this “expectation damages.”<sup>17</sup> Some have suggested that the protection of reliance is based on tort principles.<sup>18</sup> If so, and Fuller and Perdue are right that the expectation interest is protected only as a way of protecting the reliance interest, then contract law is ultimately based on tort principles.

That claim, however, is deeply circular. According to Fuller and Perdue, the losses due to reliance include “the gains prevented’ by reliance, that is, losses, involved in foregoing the opportunity to enter other contracts.”<sup>19</sup> Suppose a party insures his house against fire for \$500,000 and sues to collect that amount when his house burns down. If his recovery is based on reliance, then the reason he recovers is that he relied by giving up the opportunity to enter into a different insurance contract with a second insurance company on the same terms. But the reason he could have recovered from the second company, by the same logic, is that by contracting with it, he gave up the chance of entering into a contract on the same terms with a third. And so forth. The earth rests on a turtle, which rests on another turtle, which rests on another, and it is turtles all the way down.

Moreover, Fuller and Perdue’s account ignores the obvious reason that the party to such a contract ought to recover. The insurance company assumed the risk that the insured’s house would burn down, and it was compensated for assuming that risk. Even if there were only one company selling fire insurance in the area in which the plaintiff lived, that company should pay. So should anyone who is compensated for assuming a risk if that risk materializes. The goal of a contract, as we will see, should not be to protect the expectation interest. It should be to hold a party responsible for the risks he was paid to assume. The reason is that it is fair.

## 2. *Law and economics: achieving an efficient result.*

A more recent explanation of why the law protects the “expectation interest” is that it is efficient to do so. An efficient transaction leaves both parties better off without making anyone else worse off. Each party wants what he is to receive more than what he wants to give up. As Robert Cooter and Melvin Eisenberg explained: “The difference between the value that a party places upon what he expects to receive and give up is called surplus. The *lost-surplus formula* awards the victim of breach the surplus that he would have enjoyed if the breaching party

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17. Benjamin F. Boyer, *Promissory Estoppel: Principle from Precedents* 50 MICH. L. REV. 639, 873 (1952); see Warren A. Seavy, *Reliance Upon Gratuitous Promises or Other Conduct*, 64 HARV. L. REV. 913 (1951).

18. MELVIN A. EISENBERG, FOUNDATIONAL PRINCIPLES OF CONTRACT LAW 117 (2018) [hereinafter EISENBERG, FOUNDATIONAL PRINCIPLES]. Other scholars have taken the opposite position, that the doctrine concerns the enforcement of a promise, not compensation for harm suffered by relying on it. Randy E. Barnett, *The Death of Reliance*, 46 J. LEGAL EDUC. 518, 528 (1996); Edward Yorio & Steve Thel, *The Promissory Basis of Section 90*, 101 YALE L.J. 111, 113 (1991).

19. Fuller & Perdue, *supra* note 1, at 60.

had performed.”<sup>20</sup>

It is efficient to do so, according to Cooter and Eisenberg, because:

If the promisor does not perform, the promisee loses his share of the value of the contract. If the promisor is liable for that loss, he internalizes not only his own loss but the losses to the promisee that result from his failure to perform. In contrast, if the promisor is liable only for reliance damages, he will not internalize the full value of performance to the promisee. Thus expectation damages create efficient incentives for the promisor’s performance . . . .<sup>21</sup>

According to Cooter and Eisenberg, for these reasons, the parties themselves would choose a remedy that would require a party in breach to pay expectation damages. Would they? If the promisor breached, he would be liable for the full value of the performance to the promisee. Suppose he were contracting for the same goods and services with two promisees. To one, the performance was of vastly more value than to the other. If his potential liability to the first promisee is vastly greater than his liability to the second, he will charge the first a great deal more than the second for assuming such a risk. The amount he would charge might be so high that the first promisee would rather run the risk himself than pay so much.

If we ask, as Cooter and Eisenberg do, what remedy the parties themselves would choose, the answer is not a remedy that will protect their expectation interests. It is a remedy that will hold each of them responsible for the risks he assumed. That, as we will see, should be the goal of the law of contracts. The reason is not only that it is the remedy the parties would choose. The reason is that it is fair.

### C. An Alternative Approach

In another article, Hao Jiang and I maintained that a contract of exchange should be enforceable when it is economically fair and voluntary.<sup>22</sup> It is economically fair when a party is compensated for the risks he assumes. It is voluntary so long as a party puts a higher value on what he is to receive than on what he is to give. The remedies for breach of contract can be explained by the same two principles: that each party be held responsible for the risks that he has been compensated to assume, and a party should not be held to an agreement to

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20. Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CALIF. L. REV. 1434, 1439 (1985).

21. *Id.* at 1463. See ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 283 (6th ed. 2016); EISENBERG, *FOUNDATIONAL PRINCIPLES*, *supra* note 18, at 183–84.

22. James Gordley & Hao Jiang, *Contract as Voluntary Commutative Justice*, 2019 MICH. L. REV. 1, 5–6.



which he never consented.

Eisenberg mentions both concerns when he explains why protecting a party's expectation interest is not only efficient but "fair." According to Eisenberg, "allowing a promisor to limit damages to less than the promisee's expectation would . . . have the same unfair quality as allowing a promisor to renege on a fair bet that he made and lost."<sup>23</sup> It would be better to say that for a party to escape responsibility for a risk he was paid to assume, it is economically unfair for precisely that reason. According to Eisenberg, "[i]f A has rendered a bargained-for performance to B, we know that A was willing to render that performance to B for the agreed-upon price. We cannot know whether A would have rendered that performance to B for any lesser price."<sup>24</sup> That is the consideration we refer to as voluntariness.

Eisenberg is correct that both considerations should matter. The reason is that, as Eisenberg said, a party should neither be allowed to renege on a fair bet that he made and lost or held to a bargain to which he would never have agreed. At stake is not economic policy but justice.

We believe that contract remedies can be explained by these two concerns: economic fairness and voluntariness. We will discuss them in turn.

## II. ECONOMIC FAIRNESS

### *A. The Principle: Liability for Risks Assumed*

#### *1. The allocation of risks.*

In our earlier article, Jiang and I argued that a contract is economically fair when each part is compensated for the risks that he assumed. A corollary is that a party should be held responsible for the risk that he assumed and was compensated to bear.

In some cases, the risks that each party assumed are assigned by the terms of the contract itself. The contract provides that one performance is to be exchanged for another. Knowing that much, one can tell how certain risks have been allocated.

When the parties contract at an agreed price, each gives up the chance of entering into a more favorable bargain. Each does so to avoid the risk that he will have to enter into one that is less favorable. If the contract is for the sale of a fungible commodity with a market price, the seller is giving up his chance to sell for more if the market price rises to avoid having to sell for less if it falls. The buyer is giving up his chance to buy for less if it falls to avoid the risk of having

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23. Shawn J. Bayern & Melvin A. Eisenberg, *The Expectation Measure and its Discontents*, 2013 MICH. ST. L. REV. 1, 3; see Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 CALIF. L. REV. 975, 980 (2005).

24. See Bayern & Eisenberg, *supra* note 23, at 5.

to buy for more if it rises.

If the parties contract for a unique item, such as a house, the seller gives up the chance that if he had waited longer, he could have received a higher price. The buyer gives up the chance that if he had looked further, he could have paid the same price for as satisfactory a house or a lower price for a more satisfactory one. Each party contracts to avoid the risk that otherwise he will have to accept a less favorable bargain.

When the parties contract at a fixed price for a performance that is yet to be made, one party takes the risk that the performance will cost more than he estimates, and the other that it will cost less. Specific performance requires the breaching party to assume these risks. So does a damage award that holds him responsible for the risks allocated by the terms of the contract.

Because these risks are allocated by the terms of the contract itself, one can tell which party has assumed them without speculating about the parties' intentions. If they contract at a certain price, for example, each one takes the risk of losing out on a better deal. Eisenberg has said the reason parties contract in advance for what he calls "off-the-shelf" goods or services, "would seldom be to allocate the risk of price changes or to speculate on prices: consumers normally do not make contracts to purchase off-the-shelf services for either purpose."<sup>25</sup> An example is a yoga studio that signs up a would-be student for a year-long class that is limited to 20 and will be cancelled if fewer than twelve students enroll. The student agrees to pay a fee of \$800. Her reason for doing so most likely is "to ensure a place in the class."<sup>26</sup> Another example is a dealer that sells a new Camry for future delivery for \$30,000. Eisenberg argued—correctly, as we will see later on—that the student should not be liable if she changes her mind after sixteen students have signed up. Neither should the car buyer. Nevertheless, it would be economically unfair if the studio refused to give her lessons unless she paid \$900, or the dealer refused to deliver the car unless the buyer paid \$35,000. In setting the price, the studio and the dealer gave up the chance of charging a higher price to attract more customers. It would also be economically unfair for the student or the car buyer to repudiate the contract because they found they could get cheaper lessons or a cheaper car elsewhere. They would be acting like someone who accepted a job on a five-year contract and then tried to escape when someone offered him more.

It may happen, of course, that the price in the contract is not meant to bind the parties. In the case of the five-year employment contract, there might be an understanding that if the employee's services were of exceptional value, the employer would raise his salary; and in doing so, the employer would take into account other offers the employee has received. But then, whatever the contract says, we are no longer speaking of a commitment to exchange at a price agreed in advance. But there ought to be clear evidence that the contract does not mean

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25. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 218.

26. *Id.*

what it says.

Other risks are not allocated by the terms of the contract. The breaching party may or may not have assumed these risks. An example is the loss the non-breaching party suffers because the breach prevented him from entering into favorable transactions with others. We have to ask how the parties would have allocated these risks. The answer depends on which party can bear them at the lowest cost.

Which party is best able to bear a risk, economists tell us, depends on three factors. One factor is who can best foresee the magnitude of the risk. A risk is lower for the party who can best foresee it for roughly the same reason that the risk of playing poker is lower for someone who can peek at the other players' cards. Another factor is who can best control the risk. If the party who can do so must bear the cost if the risk eventuates, then the further risk is eliminated that he may omit the precautions he ought to take to control it. A third factor is who can best spread the risk over similar transactions, whether by buying insurance or self-insuring. The risk of a house catching fire is less for an insurance company than for a homeowner because it can spread that risk over the many houses it insures. The risk of a streak of bad luck is less for a casino than an individual gambler.<sup>27</sup>

The party in breach is often in the best position to foresee and control the risk that he will breach. He is in the best position to spread that risk among similar transactions, provided that the risk is much the same for any of his customers or clients. If the adverse consequences differ from one customer or client to the next, the breaching party will be compensated for bearing it only if he charges a higher price to those customers for whom the adverse consequences are likely to be abnormally large. He will not have been compensated if he charges all his customers or clients the same price even though, for some of them, the adverse consequences of a breach are likely to be much higher than for others. As a general rule, he should not be liable to a party who suffers an abnormally large amount for harm unless that party paid an extra amount for him to assume the extra risk. Of course, that is only a general rule, and the parties, who know best what risks they can bear, can provide otherwise.

The reason parties would place the risk on whoever can bear it most cheaply is that, as economists tell us, the parties will normally be risk averse. Of course, business firms often enter into transactions that involve enormous risks; but when economists describe them as "risk averse," they are using that phrase in a technical sense. A risk averse person will not bet \$100 that a coin will come up heads unless he will win more than \$100 if it comes up tails. He will not run risks like those that gamblers run in a casino. The gamblers run a risk like those who bet on a coin flip, a risk that exists only because of the rules of the game they

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27. On the first and last of these factors, see Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977). On the second, see GUIDO CALABRESI, *THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS* (1970).

play. Risk averse parties will not gamble, but they will allocate between them the risks that one party or the other must bear. They will do so by placing them on the party who can bear them at the lowest cost.<sup>28</sup>

Some risks, then, are assigned by the terms of the contract itself. The party who assumed them should be held liable for damages. When they are not, they should fall on the party who can bear these risks at the lowest cost. In general, that will be the party in breach, unless the non-breaching party will suffer an abnormally large amount for harm and has not paid an extra amount to the other party for assuming the extra risk.

When a risk has been assigned by the terms of the contract itself, we will refer to the damages as “direct.” When it has not, we will refer to the damages as “consequential.” In drawing this distinction, we are reviving, refining, and explaining an old one that has almost disappeared.

## 2. Direct and consequential damages.

As we will see, some courts still distinguish between damages that are “direct,” “general,” or “natural,” and those that are “consequential” or “special.” As Victor Goldberg has noted, that distinction has fallen into disuse: “A Westlaw search for [‘consequential damages’ and synonymous and ‘special damages’] yielded 35 cases, and a similar search [for ‘general damages’ and synonymous and ‘direct’ damages] yielded 40.”<sup>29</sup>

As he noted, “[t]he Restatement (Second) is unhelpful.”<sup>30</sup> It discusses the distinction only as a misleading way of expressing the requirement that damages must be foreseeable when the contract was made, a requirement we will discuss later. According to the Restatement, courts have called a loss “natural” or that damage “general” when “it results from a breach in the ordinary course of events” and therefore is foreseeable. “The damages that are recoverable for loss that results other than in the ordinary course of events are sometimes called ‘special’ or ‘consequential’ damages.”<sup>31</sup> According to the Restatement, “these terms are often misleading,” which is to say, courts sometimes use them in a different sense, and one that the Restatement does not like. They concluded that “it is not necessary to distinguish between ‘general’ and ‘special’ or ‘consequential’ damages for the purpose of the rule . . . .”<sup>32</sup>

The common law courts that drew this distinction borrowed it from civil law which had distinguished between damages that are *circa rem* and those that are *extra rem*. A party’s damages were *circa rem* if they were simply due to the loss

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28. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 116 (7th ed. 2007).

29. GOLDBERG RETHINKING THE LAW OF CONTRACT DAMAGES 171–72 (2019) [hereinafter GOLDBERG, RETHINKING DAMAGES].

30. *Id.* at 172.

31. RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b (AM. LAW INST. 1979).

32. *Id.*

of the performance he had contracted for. If he suffered further damages because of the breach, they were *extra rem*. As Reinhard Zimmermann observed, this distinction “dominated the discussion for centuries.”<sup>33</sup> By the 18th century, he noted, it “became imprecise and was muddled up with other criteria.”<sup>34</sup> It was eclipsed in the 19th century with the rise of the will theories and the principle that contract remedies should protect the expectation interest. Defined with more precision, however, it is a better alternative for determining what damages to award.

The distinction goes back to medieval jurists’ interpretation of the Roman legal texts that were then in force in much of continental Europe. One Roman text said that a seller of wine who fails to deliver it on time is liable for the highest price the wine would command.<sup>35</sup> The reason, according to the text, is that “when the seller is liable for non-delivery of an object, every benefit to the buyer is taken into account that concerns the thing itself” (*circa rem ipsam consistit*).<sup>36</sup> Citing this text, medieval jurists taught that whether damages were recoverable depended in part on whether damages were *circa rem* or *extra rem*.

Accursius (c. 1182–1263), one of the most influential medieval jurists, said that for non-performance, damages can be recovered when they are *circa rem* but not when they are *extra rem*.<sup>37</sup> One of the greatest medieval jurists, Bartolus of Sassoferrato (1313–1357), refined this distinction. Damages are *circa rem*, or “intrinsic,” when they concern “that which pertains to the thing [the performance] itself, or its value, and that which is immediately from it, such as fruits and offspring. But that which arises circumstantially (*occasione rei*) and not *ex re ipsa* should be called extrinsic.”<sup>38</sup> As noted earlier, according to the medieval jurists, as damages, a party might recover for *damnum emergens* (i.e., the harm he suffered) or for *lucrum cessans* (i.e., the gain he might have made). According to Bartolus, when one party to a contract fails to perform, the other party can recover for harm suffered and lost gain provided that are *circa rem*. The harm he suffers *circa rem* is not receiving the other party’s performance. The gain he might have made *circa rem* is the difference between the contract price of a performance and its common value, or, as we would say, its market price. For example, “a basket of grain was worth 10 and five months later worth 20.” The *lucrum cessans* is ten. Damages *lucrum cessans* that are *extra rem* can be recovered only in special cases. One is when any party who entered into the contract would have made the same gain if the contract had not been breached.<sup>39</sup>

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33. ZIMMERMANN, *supra* note 9, at 831.

34. *Id.* at 832.

35. DIG. 19.21.3.3.

36. *Id.*

37. ACCURSIUS, GLOSSA ORDINARIA to CODE JUST. 7.47.2 to *dupli* (Venice, 1581).

38. BARTOLUS DE SAXOFERRATO, COMMENTARIA CORPUS IURIS CIVILIS to CODE JUST. 7.47.2 (Venice, 1615).

39. He took this distinction from Petrus de Bellapertica who, however, used it to define when damages were intrinsic rather than extrinsic. REPETITIO IN L. SI RES VENDITA § CUM PER VENDITOREM. ms. Vaticano

It is a gain, as Bartolus put it, that “follows the object regardless of to whom it goes” (*sequitur rem penes quaecumque vadat*).<sup>40</sup>

These rules are similar to those we propose. Similar, though not the same. But they more accurately state what a remedy should do rather than the principle that it should make the non-breaching party as well off as he would have been had the contract been performed.

### *B. Three Applications*

#### *1. Liability for the difference between the contract price and value at the time of breach.*

When the parties enter into a contract at an agreed price, each of them gives up his chance to contract at a price that is more favorable to avoid the chance of having to accept a less favorable price. Consequently, the typical remedy is, and should be, to allow the non-breaching party to obtain the price he locked in when he contracted rather than a less favorable one he sought to avoid. Specific performance allows a party to receive the performance that he was promised at the contract price. Damages should award the difference between the less advantageous price now available to the non-breaching party and the contract price. The formulas are well known. In a contract to buy or sell goods, the buyer receives the difference between the higher market price and the contract price. The seller receives the difference between the contract price and the lower market or resale price.

These remedies happen to protect what Fuller and Purdue called the plaintiff’s “expectation interest.” But doing so is not the purpose of giving a remedy. The purpose is to hold each party responsible for the risks he was compensated to assume. Sometimes, that purpose is achieved by a party in as good a position as he would have been had the contract been performed. But sometimes it is not.

We will examine four situations in which it is not.

#### *a. The lost volume seller.*

The non-breaching party may be worse off because of the breach, not because he was forced to accept a less favorable price, but because he lost an

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Borghese 277 fol. 76 vb - fol. 77 ra, quoted in RAFFAELE VOLANTE ID QUOD INTEREST IL RISARCIMENTO IN EQUIVALENTE NEL DIRITTO COMMUNE 99 (2012). As Volante noted, Petrus had replaced the distinction between damages *circa rem* and *extra rem* with this distinction between intrinsic and extrinsic damages.

40. *Id.* He cited Roman texts which dealt with the sale of slaves who would have brought money with them to whoever became their owner. DIG. 21.2.8; DIG. 9.2.23. The other case was one in which the profits were derived from the ownership of the thing rather than from “reselling it or some other human activity” for, with some things, “the nature of the thing plays a greater part” in producing a profit than human industry, as in the profit from a farm (*ex fundo*).

extra sale. Orthodox doctrine allows him to recover the extra amount he would have made on the sale had the buyer not breached the contract. That would be the proper result if protecting the "expectation interest" were the purpose of giving a remedy. By our approach, it is not. The lost volume seller should not recover since he was not deprived of his guarantee that he would not have to sell at a less favorable price.

Section 2-708(2) of the Uniform Commercial Code allows recovery of "the profit (including reasonable overhead) which the seller would have made from full performance by the buyer . . ." An example is *Neri v. Retail Marine Corp.*<sup>41</sup> The defendant contracted to buy a new boat of a specified model from the defendant, a dealer. Six days later, the defendant notified the plaintiff that he wished to rescind the contract because he was about to undergo hospitalization and surgery. Four months later, the boat ordered for the defendant and received by the plaintiff was sold to another buyer for the price that the defendant had agreed to pay. The defendant was held liable for the contract price minus the costs that the plaintiff saved because he did not have to purchase another boat. Thus, plaintiff was made no worse off than he would have been if the contract with the first customer had been performed.

The parties' contract at a certain price are protected against the risk of having to accept a less favorable price. In *Neri*, the seller did not receive a less favorable price. If the contract is enforced, he will be protected against a different risk: the risk that the buyer does not pay for merchandise he does not want. That risk is not one the seller would pay the buyer to assume if both parties are risk averse. It is like the risk that gamblers create when they bet on a coin flip. If neither party were bound by the terms of the wager, neither would be harmed. Risk averse parties will not enter into a contract that creates a risk of harm that exists only if the contract is binding.

Suppose there were two competing boat dealers located next door to each other, and a would-be buyer went first to one, then to the other, and then back again, seeking the most favorable terms. He asked each dealer how much extra he would have to pay for the privilege of backing out, and thereby costing the dealer an extra sale. The pressure of competition would lead each dealer to give him that privilege at no extra charge. Each dealer would realize that if the buyer did not back out, it would sell an extra boat. If the buyer did back out, the dealer would lose nothing.

Victor Goldberg began his discussion of the lost volume seller by quoting White and Summers: a remedy for lost profits is "the recovery which all right-minded people would agree that the lost volume seller should have."<sup>42</sup> According to Goldberg, "all those right-minded people are wrong . . . By cancelling the order, the buyer in effect invokes an implied termination clause. The remedy

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41. 285 N.E.2d 311, 313–14 (N.Y. 1972).

42. 1 JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 381 (6th ed. 2010), quoted in GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 47.

would be the price that the buyer would need to pay for termination (cancellation).<sup>43</sup> Goldberg is correct, but we would take this argument a step further. As we have shown, unless the seller may suffer some harm other than the loss of an additional sale, the price he would need to pay for such a clause, assuming competition among sellers, is zero.

Eisenberg maintained that the lost volume seller should recover his profits because it is a consequence of the “expectation principle.”<sup>44</sup> Yet he would not allow the seller to recover when the buyer backs out of a contract for “off-the-shelf” goods and services. His arguments concerning sellers of “off-the-shelf” goods apply equally well to lost-volume sellers.

Earlier, we described the two hypothetical cases he used to illustrate his point. Suppose a dealer sells a new Camry for future delivery. Or suppose a yoga studio signs up a would-be student for a class that is undersubscribed. In such cases, Eisenberg observes:

[I]t is unlikely that a consumer would knowingly enter into a . . . contract in which she would be required to pay the entire contract price if she cancelled, because damages measured that way would be highly disproportionate to both the benefit to the consumer from making the contract now rather than waiting . . . and the cost to the provider of resulting from a breach by the consumer.<sup>45</sup>

According to Eisenberg, the reason that the consumer did not benefit by contracting in advance is because “the reason [for doing so] would seldom be to allocate the risk of price changes.”<sup>46</sup> We noted earlier the contract should guarantee the consumer that the studio or dealer would not raise its price. But why should it matter whether or not the parties wanted to allocate the risk of price changes as long as the price never changed? In Eisenberg’s examples, moreover, the cost to the provider is zero in the case of the yoga studio. It is zero in the case of the car dealer, presumably because the dealer will not incur any extra cost buying the Camry for his customer. The dealer will not incur any extra cost if the customer cancels before he orders the Camry or if he sells the Camry to someone else. The same can be said of the lost-volume seller.

*b. The supplier with excess capacity.*

When the parties agree on a contract price, each party guarantees the other that he will not have to accept a less favorable one. If, at the time of breach, the goods or services contracted for command a less favorable price, the breaching

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43. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 47.

44. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 190–91, 218.

45. *Id.* at 218.

46. *Id.*



party must pay the difference. Suppose, however, that the goods or services cannot be sold to anyone else. The party in breach who agreed to pay for them was the only possible customer.

According to conventional doctrine, the non-breaching party recovers the contract price minus the scrap value of the goods and any costs he has saved because he did not have to perform. That remedy makes him as well off as if the contract had been kept and so protects his "expectation interest." By our approach, that is the correct result only sometimes. It depends on what risk the breaching party assumed. The fact that he assumed the risk that the seller might have to accept a less favorable offer from a third party does not mean he accepted the risk that the seller might have no other offers at all.

If the designer of a machine ordered specialty parts of no use to anyone else, or a producer hires a cast to rehearse and present a play to which no one comes, surely the risk falls on him. Suppose, however, an entrepreneur invests in an enterprise and finds that there is only one person to whom he can sell the goods or services that this enterprise provides. If that person does so and keeps the contract, the entrepreneur will recover his fixed costs and make a profit. If that person breaches, according to conventional doctrine, that customer is liable for the entrepreneur's lost profit and fixed costs. The premise, again, is that the entrepreneur's "expectation interest" should be protected by putting him in as good a position as if the contract had been kept. By our approach, it is a mistake to do so without proof that this single customer understood and assumed the risk that the entrepreneur took when he made such an investment.

In *Vitex Mfg. Corp. v. Caribtex Corp.*,<sup>47</sup> the plaintiff had invested a large amount in a factory to waterproof material for shower curtains. The factory would have stood idle except that the defendant contracted for enough material to be waterproofed for it to operate at full capacity. The defendant breached his contract and provided no material to waterproof. As it happened, he was the plaintiff's only possible customer. The plaintiff was awarded the amount of his fixed costs or overhead plus his lost profit, or, to put it another way, the contract price minus the variable costs, i.e., the costs that were saved because the plaintiff did not have to process any material. That would be the right result if the goal is to protect the parties' expectation interest. The result, however, was to transfer the risk of the plaintiff's bad investment to the one customer that he happened to find.

There is no reason that loss should be borne by that customer. Unless he was compensated for bearing the added risk, his liability should be no greater than if he had contracted with a more successful entrepreneur with more potential customers. If that were the case, the court would have mentioned it. Moreover, it is unlikely that, as a risk averse party, a buyer would have been willing to bear this risk for any discount in the price to which the seller would have agreed.

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47. 377 F.2d 795 (3d Cir. 1967).

*c. A contract for insurance cast as a contract of sale.*

Although a contract to exchange at an agreed price allocates the risk that prices will change, it is not a mere bet on what future prices will be. It is the allocation of a risk that must fall on one party or the other to the party that can bear it most easily. If a party owns or manufactures goods, he will gain or lose if the price of those goods rise or fall. If he purchases raw materials to manufacture a finished product, he will gain or lose if the price of the raw materials falls or rises. If a party who owns a mine sells ore to a party who plans to turn it into a finished product, by contracting in advance of delivery, they allocate a risk that must fall on one party or the other.

If neither party could better bear that risk, or if the risk need not be borne by either party, the contract would be no different than a bet that gamblers make on the outcome of a coin flip. The risk of loss, and the chance of gain, only exist because the gamblers have chosen to create it. As we noted earlier, risk averse parties do not make such bets. They enter into contracts that allocate risks that must fall on one party or the other to the party that can bear them most easily.

A contract for the future delivery of generic goods can have this unintended effect when the price unexpectedly skyrockets. A manufacturer who will gain or lose depending on the price of raw materials may insure against this risk by contracting to buy raw materials for future delivery at a fixed price. When he does so, he transfers part of the risk of doing business to the seller who insures him against this risk. As Paul Joskow noted, the purpose of such a contract is to insure against price changes.<sup>48</sup>

Nevertheless, it does not follow, as Joskow thought, that the seller assumes the risk of a rise in price, however drastic.<sup>49</sup> Such a contract has the sole purpose of insuring the buyer against a business risk although it is cast, not in the form of an insurance contract, but as contract of sale. In a conventional insurance policy, the amount the insurer can lose will be no greater than the loss that the insured could suffer. An insurance company will not insure a house for more than its value. The reason is not simply a fear that the insured might burn the house down to collect the insurance. It is that parties are normally risk averse. If a risk averse party wished to insure his house for a million dollars more than its value, there is no price for the extra insurance that he would be willing to pay that the insurance company would be willing to accept. The risk of gaining that extra million dollars is not one that would fall on either party absent the contract. It is a risk that the parties create just as gamblers would if they bet on a coin flip.

When a rise in the market price is sufficiently drastic, the difference between the market and the contract price may exceed any financial loss or gain against which the buyer would wish to insure. In that event, the buyer should not be

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48. Paul L. Joskow, *Commercial Impossibility, the Uranium Market and the Westinghouse Case*, 6 J. LEG. STUD. 119, 162 (1977).

49. *Id.*

made as well off as he would have been had the contract been kept. His recovery should be limited to what is recognized in insurance law as his "insurable interest": the amount of the loss he might have suffered or gain he would have foregone had he been forced to buy the goods for his own use on the open market. If the price rose to the point that he would make more by reselling the goods on the open market than by using them himself, he should not recover the excess.<sup>50</sup> Once again, the law should not protect his "expectation interest."

The question of what the buyer should recover arose in the Westinghouse litigation.<sup>51</sup> Westinghouse had agreed to provide a continuing supply of uranium at a fixed price to fuel nuclear generators. The price of uranium then skyrocketed due to the Arab oil crisis. The case was settled before appeal. One might say that Westinghouse was foolish for failing to draft the contract with a ceiling on damages. Its customers might have paid more not to have such a ceiling, but, if the parties are risk averse, they would not have been willing to compensate Westinghouse for the risk it assumed if there were no ceiling. But that is another way of saying that the risk is one that the contract was not intended to place on Westinghouse and which Westinghouse was not compensated to assume. It was not simply a bad bet. An event occurred on which the parties were not betting.

According to the official Comment to § 2-615 of the Uniform Commercial Code, relief should not be given when the change in market prices "is exactly the type of business risk which business contracts made at fixed prices are intended to cover."<sup>52</sup> Nevertheless, the same Comment implies that if the market price rises sufficiently, the difference between market and contract price may exceed the business risk that the contract was intended to cover. If so, the buyer should not receive the difference between contract and market price. As the Comment observes:

Increased cost alone does not excuse performance unless the rise in cost is due to some unforeseen contingency which alters the essential nature of performance. Neither is a rise or a collapse in the market in itself a justification for that is exactly the type of business risk which business contracts made at fixed prices are intended to cover. But a severe shortage of raw materials or of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like, which either causes a market increase in cost or altogether prevents the seller from securing supplies necessary to his performance, is within the contemplation of this section . . .<sup>53</sup>

According to the Comment, if "a marked increase in costs" is caused by "a severe shortage of supplies due to a contingency such as war, embargo, local crop failure, unforeseen shutdown of major sources of supply or the like," the

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50. JAMES GORDLEY, FOUNDATIONS OF PRIVATE LAW PROPERTY, TORT, CONTRACT, UNJUST ENRICHMENT 350-51 (2006).

51. See generally Joskow, *supra* note 48.

52. U.C.C. § 2-615, cmt. 4 (AM. LAW INST. & UNIF. LAW COMM'N 2011).

53. *Id.*

“expectation interest” of the buyer should not be protected.

One reason for thinking that the Comment means what it says is that it was drafted by Karl Llewellyn who was thoroughly familiar with German law. It is hard for someone familiar with German law to read this Comment without thinking of the earliest cases in which the highest German court for civil matters gave relief for severe and unexpected changes in the market price. In one case, the outbreak of World War I caused the price of steam to soar.<sup>54</sup> In another in which the German collapse in 1918 caused a huge increase in the price of iron wire.<sup>55</sup> Llewellyn’s friend Stefan Riesenfeld was fond of recounting a conversation in which he asked Llewellyn whether he had drawn on German law in drafting Article 2. He answered, “Of course. But I left no evidence that I did,”<sup>56</sup> which was an understandable precaution to take drafting an American model statute within a decade after the end of World War II.

*d. A hedged bet.*

In the cases we have just discussed, the non-breaching party was worse off than if the contract had been enforced but not because he had to accept a price less favorable than the one guaranteed to him by the contract. In rare situations, the non-breaching party may be no worse off, even though he had to accept a less favorable price.

An example is *KGM Harvesting Co. v. Fresh Network*.<sup>57</sup> The defendant contracted to sell lettuce to the plaintiff at nine cents per pound. When the price rose, the defendant breached its contract and sold the lettuce to a third party at the higher price. The plaintiff covered by buying lettuce at the higher price, which it processed and resold to third parties. The plaintiff was no worse off, however, because its contracts to resell the lettuce were not fixed-price but cost-plus. Consequently, it was able to pass along the higher price that it paid to its customers.

The court awarded the plaintiff the difference between the higher price it paid for the lettuce and the contract price. That result would be wrong if the purpose of giving a remedy is to put the plaintiff in as good a position as he would have been in had the contract been performed. Nevertheless, the court reached the right result. The parties bet on whether the price of lettuce would rise or fall, and the non-breaching party won the bet. Because he hedged his bets, he received a windfall. If he were not allowed to recover, however, the windfall would go to the breaching party who was the party that lost the bet. Moreover,

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54. Reichsgericht [RG] Sept. 21, 1920, ENSTSCHIEDENGEN DES REICHSGERICHTS IN ZIVILSACHEN [RGZ] 100, 129.

55. Reichsgericht [RG] Nov. 29, 1921, ENSTSCHIEDENGEN DES REICHSGERICHTS IN ZIVILSACHEN [RGZ] 103, 177.

56. A story which Riesenfeld told the author several times while we were colleagues at Berkeley, 1978–1999.

57. 42 Cal. Rptr. 2d 286 288 (Cal. App. 1995).

the contract guaranteed the breaching party that he would receive the contract price even if the market price of lettuce fell. The non-breaching party provided that guarantee. It should not matter that, by entering into another transaction, the non-breaching party provided the guarantee at no risk to himself.

2. *The requirement that damages be foreseeable.*

According to conventional doctrine, the party in breach is liable on for harm that he could reasonably have foreseen at the time he contracted. Section 351 of the Second Restatement provides:

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

(2) Loss may be foreseeable as a probable result of a breach because it follows from the breach

(a) in the ordinary course of events, or

(b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.

a. *Some history.*

The foreseeability limitation was established in England in 1854 in the famous case of *Hadley v. Baxendale*.<sup>58</sup> In that case, the plaintiff's mill was stopped because a shaft was broken. The plaintiff hired the defendant to transport the shaft to a manufacturer so that it could serve as a model for a new one. Transportation was delayed due to the defendant's breach of contract, and the plaintiff sued for the profits he had lost because the mill was stopped for a longer period of time. The court denied recovery on the grounds that this harm was not foreseeable at the time the contract was made.

The court in *Hadley* was adopting a rule that had been proposed by the French jurist Robert Pothier (1699–1772), whence it passed first into the French Civil Code.<sup>59</sup> Pothier had borrowed the idea that foreseeability should limit liability from an earlier century French jurist, Charles Du Moulin (1500–66). Du Moulin and Pothier arrived at their conclusion by combining two rules of Roman law, neither of which concerned foreseeability.

One has already been described. The party in breach is liable for damages *circa rem*, or as Pothier proposed, *propter rem ipsam*, but only in special situations for damages *extra rem*. According to Du Moulin and Pothier, the reason that the damages were recoverable if they were *circa rem* or *propter rem ipsam* was that the party in breach could have foreseen them at the time he contracted.

According to Du Moulin, this reason explained another Roman rule, one

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58. (1854) 156 Eng. Rep. 145.

59. ZIMMERMANN, *supra* note 9, at 830.

which limited the amount of damages that could be recovered for breach of contract. According to a poorly drafted Roman law, in contracts for a *certum*, the non-breaching party could recover no more than “twofold.”<sup>60</sup> Since the Middle Ages, jurists had spent much effort discussing what was meant by *certum* (certain) and what must be multiplied by two to determine the limit of recovery. Du Moulin suggested a rationale for the rule: “Most likely it was not foreseen or thought that greater damage would be suffered or that there was a risk beyond the principal object than the principal object itself.”<sup>61</sup> Pothier presented Du Moulin’s rationale as though it were, not an explanation, but a rule in its own right: “The person who owes a performance is only liable for the damages that one could have foreseen at the time of the contract that the party owed a performance would suffer.”<sup>62</sup>

Thus, a Roman rule against recovering damages that are disproportionately high had become a rule against recovering damages that are unforeseeable. Moreover, a rule providing for the recovery of damages that were *circa rem* had become a rule that provided for the recovery of these damages because they were foreseeable. The first step had been taken toward the end result we have seen in the Restatement where the distinction between direct and consequential damages is eclipsed by the distinction between damages that are or are not foreseeable in the ordinary course of events.

In *Hadley v. Baxendale*, Baron Parke still described these damages as those which are “directly and immediately results from the non-performance of the contract,” quoting Sedwick’s translation of the version of Pothier’s rule which had been enacted in the French Civil Code.<sup>63</sup> Baron Alderson, delivering the judgment of the court, described these damages as “arising naturally, i.e., according to the usual course of things, from such breach of [the] contract itself.”<sup>64</sup> But if the reason the party in breach is liable is because he could have foreseen them, then, as in the Second Restatement, all that should matter is whether they arise “according to the usual course of things,” since that is the reason they were foreseeable. As Lord Asquith said in *Victoria Laundry (Windsor) Ltd. v. Newman Industries, Ltd.*, “[e]veryone, as a reasonable person, is taken to know the ‘ordinary course of things’ and consequently what loss is liable to result from a breach [of contract] in that ordinary course.”<sup>65</sup>

The decision in *Hadley* did not make it clear when damages can be recovered if they do not “aris[e] naturally, i.e., according to the usual course of things, from [the] breach of the contract itself.” Was it enough that they were foreseeable?

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60. CODE JUST. 7.47.1 (Justinian 530).

61. CAROLUS MOLINAEUS, TRACTATUS DE EO QUOD INTEREST, no. 60 (1574).

62. ROBERT POTHIER, TRAITÉ DES OBLIGATIONS, no. 160, in 2 OEUVRES DE POTHIER 497 (Bugnet ed., 2d ed., 1861).

63. (1854) 156 Eng. Rep. 145, 148.

64. *Id.* at 151.

65. [1949] 2 KB 528 (Ct. App.).

It would seem so. Baron Alderson said “if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants . . . the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury [that] would ordinarily follow from a breach of contract under these special circumstances so known and communicated.”<sup>66</sup>

On the other hand, Goldberg has shown that *Hadley* need not be read that way, and that, for a long time, it was not. In *Hadley*, surprisingly enough, the special circumstances under which the contract was made actually were communicated to the defendants. A headnote to the case said: “The plaintiff’s servant told the [defendant’s] clerk that the mill was stopped, and that the shaft must be sent immediately. . . .”<sup>67</sup> Goldberg has shown that the headnote was “[a]most certainly not” a reporter’s error.<sup>68</sup> In 1856, two years after the decision, James William Smith and Sir Henry Singer Keating, who had been the attorneys for *Hadley* and for *Baxendale*, respectively, mentioned the communication to the clerk in their book, *A Selection of Leading Cases on Various Branches of the Law*.<sup>69</sup> Sir Roger Crompton, the trial court judge in *Hadley v. Baxendale*, said, in a later opinion: “The curious part of the case is that there was a most distinct notification to the carrier of the consequences that would follow the non-delivery of the shaft, and the Court held that these consequences could not be taken into consideration.”<sup>70</sup> Despite what he said, could Baron Alderson have thought that the communication did not matter?

Be that as it may, Goldberg has shown that “[f]or almost a century, the courts, relying on *Hadley v. Baxendale*, restricted recovery for consequential damages to those damages to which the promisor had tacitly agreed.”<sup>71</sup> Twelve years after *Hadley*, in *British Columbia Saw Mill Co. v. Nettleship*, the court held that “the mere fact of knowledge cannot increase liability. The knowledge must be brought home to the party sought to be charged, under such circumstances that the person he contracts with reasonably believes that he accepts the contract with the special condition attached to it.”<sup>72</sup> Goldberg quoted the 11th edition of Mayne’s *Treatise on Damages* published in 1946 in which the authors asked: “Is mere knowledge or communication sufficient to impose liability?” They thought that conclusion was unlikely, given that the carrier in *Hadley* had been told that the mill was stopped, and that the result would be that a “party, by acquainting [the other party] with further consequences which the law would not have implied, [could] enlarge his responsibility to the full extent of those

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66. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 151.

67. *Id.* at 147.

68. GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 166.

69. 431 (4th ed., 1856), *quoted in* GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 166.

70. *Simmons v. Patchett* [1857] 26 QB 195 at 197, *quoted in* GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 166.

71. GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 165.

72. [1868] 3 LRPC 499, 508–09, *quoted in* GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 167.

consequences, without a contract to that effect.”<sup>73</sup>

According to Goldberg, the rule “changed abruptly” in 1949 with Lord Justice Cyril Asquith’s opinion in *Victoria Laundry v. Newman*. Asquith denied that in *Hadley*, the plaintiff’s servant had communicated that the mill was stopped. The headnote was “misleading.” Asquith distinguished the “first rule” and the “second rule” of *Hadley v. Baxendale*. According to the first rule, “[e]veryone, as a reasonable person, is taken to know . . . what loss is liable to result from a breach of contract in [the] ordinary course.” According to the second rule, “he actually possesses [knowledge] of special circumstances outside the ‘ordinary course of things,’ of such a kind that a breach in those special circumstances would be liable to cause more loss.” In that event, the “additional loss is also recoverable.”

By this route, the common law arrived at the rule formulated in the Second Restatement. As long as the damages were foreseeable in the ordinary course of events, it does not matter whether they are *circa rem*, natural, general, or direct. It does not matter whether they were disproportionately high.

*b. An alternative to “foreseeability.”*

The rationale for the rule, according to Baron Alderson in his opinion in *Hadley v. Baxendale*, is that “had the special circumstances [leading to unforeseen injury] been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case.”<sup>74</sup> That may be. But why assume that the breaching party is willing to be liable for the damages he does foresee unless he agrees to be? Why would he have agreed unless he charged an extra amount?

Sophisticated economic defenses of the rule have been based on the same assumption. According to Richard Posner, the foreseeability rule “induces the party with knowledge of the risk either to take appropriate precautions himself, or, if he believes that the other party might be the more efficient preventer or spreader (insurer) of the loss, to reveal the risk to that party and pay him to assume it.”<sup>75</sup> According to Ian Ayres and Robert Gertner, the foreseeability rule will force the party who knows that harm may occur to accept liability for it or to convey that information to who may be best able to prevent it. If not, presumably, he will refuse to accept liability. If the party receiving the information agreed to assume liability, charging extra for doing so, he ought to be liable.<sup>76</sup> The trouble is that the foreseeability rule does not require this party to

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73. MAYNE’S TREATISE ON DAMAGES 28–29 (W.E. Earnegy ed., 11th ed., London, 1946), *quoted in* GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 165.

74. (1854) 156 Eng. Rep. 145, 151.

75. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 141 (7th ed., 2007).

76. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 104 (1989).



agree but merely that he be informed and, having been informed, foresee the loss that might occur.

By our approach, what should matter is whether the party in breach assumed the risk of the harm that ensued. Our conclusion is that the best formulated rule was that of Bartolus nearly seven hundred years ago. Damages should be recoverable if the harm is direct (*circa rem*), or if it would be typically be incurred by any non-breaching party (*sequitur rem penes quemque vadat*).

In the case of direct damages, responsibility for a risk is allocated by the terms of the contract. If the damages are direct, they will have been expected to occur in the ordinary course, and so will be recoverable under what Lord Asquith called the first rule of *Hadley v. Baxendale* and under the Second Restatement § 351(2)(a). But that is not why they should be recoverable. They should be recoverable because a contracting party should be liable for the risks he assumed.

In the case of consequential damages for lost profits, the party in breach may or may not have assumed the risk. Parties that are risk averse will place a risk on the party that can bear it at the lowest cost and then adjust the price to compensate him for bearing it. As we have seen, if the adverse consequences differ from one customer or client to the next, the breaching party will be compensated for bearing it only if he charges a higher price to those customers for whom the adverse consequences are likely to be abnormally large. He should not be liable to a party who suffers an abnormally large amount for harm unless that party paid an extra amount for him to assume the extra risk.

What should matter, then, is not whether or not these damages are foreseeable. What should matter is whether they were likely to have been much higher for the non-breaching party than for others for whom the party in breach provides the same goods or services. Despite Lord Asquith's statement of the second rule in *Hadley v. Baxendale*, and despite § 351(2)(b) of the Second Restatement, those are the circumstances in which many courts have given relief.

An example is *Hadley v. Baxendale* itself. The plaintiff's servant told the defendant's clerk the mill was stopped. By our approach, the plaintiff should not recover unless he paid the defendant an extra amount to assume the risk that a late delivery would cause a loss of profits. Very likely, he did not. He was charged the same amount as other customers who were shipping a package of the same weight or volume for the same distance.

The Second Restatement gives an illustration based on *Hadley* in which recovery is denied even though a carrier knows that a factory will lose profits if delivery is delayed:

A, a private trucker, contracts with B to deliver to B's factory a machine that has just been repaired and, without which B's factory, as A knows, cannot reopen. Delivery is delayed because A's truck breaks down. In an action by B against A for breach of contract the court may, after taking into consideration such factors as the absence of an elaborate written contract and the extreme disproportion between B's loss of profits during

the delay and the price of the trucker's services, exclude recovery for loss of profits.<sup>77</sup>

Presumably, the absence of an elaborate written contract matters because such a contract would have placed the risk on the trucker, if he has wished to assume it. In that case, presumably it would have charged a higher price. But why should the extreme disproportion and the absence of a written contract make the damages unforeseeable?

Indeed, there is a line of cases stretching back almost to *Hadley v. Baxendale* that deny recovery when damages were disproportionate but seem to be foreseeable.<sup>78</sup> Recovery was denied for a loss of profits caused by providing a ship with defects,<sup>79</sup> by providing tires with defects,<sup>80</sup> for failing to provide boilers on time,<sup>81</sup> for failing to finish building a railroad,<sup>82</sup> for failing to provide a machine for drying bricks with as much capacity as promised,<sup>83</sup> for failing to dress stones for the plaintiff's mill,<sup>84</sup> and for failing to return machinery on time.<sup>85</sup> There are, indeed, courts that held it to be enough that the plaintiff had informed the defendant of the loss it would suffer in the event of breach. For example, in *Cook Associates v. Wanick*,<sup>86</sup> the Utah Supreme Court awarded damages for lost profits when the late delivery of parts by a supplier prevented a manufacturing plant from opening on time. It is not surprising that when a rule is repeated often enough, a court sometimes will follow it even when it leads to a bad result.

In *Cook*, the court noted the defendant "asserts that there was no evidence that the parties 'mutually [understood] that lost profits [would] be included in damages should breach occur.'"<sup>87</sup> According to the court, it did not matter. It should.

### 3. *The requirement that damages be established with certainty.*

Another limitation on damages recognized by conventional doctrine is that they must be proven with a higher degree of certainty than damages in tort, or the

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77. RESTATEMENT (SECOND) OF CONTRACTS § 351, illus. 17 (AM. LAW. INST. 1979).

78. Larry T. Garvin, *Disproportionality and the Law of Consequential Damages: Default Theory and Cognitive Reality*, 59 OHIO ST. L. JOUR. 339, 345–60 (1998).

79. *Sundance Cruises Corp. v. Am. Bureau of Shipping*, 7 F.3d 1077, 1084 (2d Cir. 1993).

80. *Armstrong Rubber Co. v. Griffith*, 43 F.2d 689, 691 (2d Cir. 1930).

81. *McEwen v. McKinnon*, 11 N.W. 828, 830 (Mich. 1882).

82. *Snell v. Cottingham*, 72 Ill. 161, 170 (1874).

83. *Moulthrop v. Hyett*, 17 So. 32, 33–34 (Ala. 1895) (although the court added that damages were remote and speculative).

84. *Fleming v. Beck*, 48 Pa. 309, 312 (1864).

85. *Armstrong & Latta v. City of Philadelphia*, 94 A. 455, 458 (Pa. 1915).

86. 664 P.2d 1161 (Utah 1983).

87. *Id.* at 1167.

other elements of the plaintiff's claim in contract.

A party should be liable for the risks that he assumed. At the beginning of this Article, we identified three risks. Two are allocated by the terms of the contract. We have referred to them as direct damages. One is the risk of losing a more favorable bargain. When the parties contract for goods or services, they assume the risk that their market price may rise or fall. Problems of certainty can arise in long-term contracts in which a commodity is sold for delivery over a period of years. They can also arise when, in return for his own performance, a party is to receive the profits or a share in the profits of some enterprise. The amount of these profits may be uncertain. In these cases, there is no reason why difficulties of proof should be any more of an obstacle to recovery than with any other element of the plaintiff's case. We will see that courts do not require any greater degree of certainty.

A second risk is that performance may cost more than estimated. Here, again, the damages of a breach of contract are direct. That risk, like the first, is allocated by the terms of the contract. We will see, surprisingly enough, that courts require a lesser degree of certainty in the proof of lost profits than they would otherwise. We will see why they are correct to do so.

A third risk is that a breach of contract will cause the non-breaching party consequential damages, such as loss of the opportunity to enter into profitable transactions with third parties. Here, as we will see, whether damages should be awarded should not depend on the degree of certainty with which they can be established. It should depend on whether the party in breach assumed the risk of liability for consequential damages. Where he did depends on the same considerations which we discussed in the last section on foreseeability.

*a. The risk of a change in the value in the contracted for performance.*

As discussed earlier, if parties contracted to give or receive a commodity with a market price, one party will gain if the market price rises, and the other will lose if the market price falls. Having assumed that risk, the breaching party should be liable for the difference between the contract price and the market value at the time of breach.

This amount may be hard to estimate. Nevertheless, there is no reason that the non-breaching party should have to prove it with any greater certainty than any other element in his case. In *Tractebel Energy Mtg. Inc. v. AEP Power Mktg. Inc.*,<sup>88</sup> the Second Circuit, applying New York law, allowed the plaintiff to recover lost profits on a long-term contract. AEP had contracted to build a plant to sell steam to Dow Chemical and electricity to Tractebel. Tractebel agreed to buy at least \$50,000,000 of electricity and repudiated the contract when the price

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88. 487 F.3d 89 (2d Cir. 2007).

of electricity fell. The district court had refused to award damages because “[a]ny projection of lost profits would necessarily include assumptions regarding the price of electricity and the costs of operating over twenty years.”<sup>89</sup> The Court of Appeal reversed, noting that, “[t]he variables identified by the district court exist in every long-term contract.”<sup>90</sup> The non-breaching party should recover because the damages are *general*, or, as we would say, *direct*:

By contrast, when the non-breaching party seeks only to recover money that the breaching party agreed to pay under the contract, the damages sought are general damages. . . .The damages may still be characterized as lost profits . . . [b]ut, in this case, the lost profits are the direct and probable consequence of the breach. . . .AEP seeks only what it bargained for—the amount it would have profited on the payments TEMI promised to make for the remaining years of the contract. This is most certainly a claim for general damages.<sup>91</sup>

In *Tractebel*, the party in breach had contracted to buy electricity from the non-breaching party and repudiated the contract when the market price of electricity fell. The non-breaching party recovered the difference between the contract and market price of electricity. The difficulty in proving damages arose because the future price of electricity was uncertain.

It may happen that, in return for his own performance, a party is to receive profits or the share of the profits in some enterprise. He assumes the risk that the profits will be higher or lower. As before, if the other party breaches the contract, he should recover the profits to which he was entitled.

As before, there is no reason that the non-breaching party should have to prove these profits with any greater degree of certainty than any other element of his case. The court’s estimate, like that of the parties, may be too high or too low, but it is more likely to correspond to the amount of lost profits than if the court required greater certainty. Such a requirement always means an award of less than the amount that profits are estimated to be. A refusal to give relief on the grounds of uncertainty would mean an award of zero damages. In either case, a party who assumed the risk of how profitable an enterprise was will escape some or all of the liability for the risk he assumed.

Of course, there are difficulties of proof. As Victor Goldberg noted, even though proof may require “some sophisticated work by economic experts, . . . this is an exercise that the parties routinely go through in negotiating a settlement.”<sup>92</sup> Melvin Eisenberg pointed out that when the parties themselves estimate the future value of an investment, they make the same projections that a court would make in awarding damages.<sup>93</sup>

At present, the rules are unclear. Goldberg noted that “some case law

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89. *Id.* at 111.

90. *Id.* at 112.

91. *Id.* at 109–10.

92. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 25.

93. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 233–34.

suggests that the standard of proof is higher for consequential damages” than it is for direct damages.<sup>94</sup> The Second Restatement of Contracts does not recognize this distinction. It provides: “Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty.”<sup>95</sup> That rule is said to be a “limitation” on the recovery of damages. According to the Official Comment, this limitation “merely excludes those elements of loss that cannot be proved with reasonable certainty” and also that it is compatible with the decisions of “[c]ourts [which] have traditionally required greater certainty in the proof of damages for breach of a contract than in the proof of damages for a tort.”<sup>96</sup> Finally, as Goldberg noted, “[s]ome courts have concluded that all lost profits claims are for consequential damages.”<sup>97</sup>

According to Eisenberg, the requirement of greater certainty is a hangover from 19th century contract law: “Under classical contract law the degree of certainty required was typically set at a high level . . . This approach, which has been carried over in some modern cases, is exemplified in two decisions by the New York Court of Appeals, *Freund v. Washington Square Press* and *Kenford Co. v. Erie County*.”<sup>98</sup>

In *Freund*, Washington Square Press agreed to publish a book which Freund was to write, and the parties were to share the royalties.<sup>99</sup> In *Kenford*, Erie County agreed to construct a domed stadium and to lease it to an affiliate of *Kenford*, or, if the parties were unable to agree on the terms, to hire the affiliate to manage the stadium in return for a percentage of the stadium’s gross revenues.<sup>100</sup> In both cases, the court denied recovery on the ground that the plaintiff’s damages were too uncertain.

According to Eisenberg, “[t]his approach is dramatically out of touch with the reality of probability . . . .”<sup>101</sup> “Many modern courts have properly broken away from the binary, economically uniformed, all-or-nothing approach to uncertainty taken by classical contract law.”<sup>102</sup> To illustrate the modern approach, he cited three cases applying New York law. In *Ashland Management, Inc. v. Janien*, the plaintiff had been promised royalties of 15% on a computerized investment model he had developed for the defendant.<sup>103</sup> In *Contemporary Mission v. Famous Music Corp.*, the plaintiff had been assigned the exclusive right to the master tape of a rock opera and records made from the master to the

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94. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 171.

95. RESTATEMENT (SECOND) OF CONTRACTS § 352 (AM. LAW INST. 1979).

96. *Id.* at cmt. a.

97. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 172.

98. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 227.

99. *Freund v. Washington Square Press*, 314 N.E.2d 419 (N.Y. 1975).

100. *Kenford Co. v. Erie County*, 493 N.E.2d 234 (N.Y. 1986).

101. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 229.

102. *Id.* at 234.

103. 624 N.E.2d 1007 (N.Y. 1993).

plaintiff, who was to receive royalties on the sales.<sup>104</sup> The defendant was to promote the records. In *Lexington Products Ltd. v. B.D. Communications, Inc.*,<sup>105</sup> in return for an exclusive license, the defendant agreed to market the plaintiff's toothbrush, to purchase 200,000 toothbrushes a year, and to pay royalties on each brush sold. He also cited a Massachusetts case, *Rombola v. Consindas*,<sup>106</sup> in which the plaintiff agreed to train, maintain, and race the defendant's horse in return for 75% of the amount of all gross purses that the horse won. In all of these cases, the plaintiff recovered on the basis of evidence as to the profits he has failed to make: projections on the success of the investment model; data about the success for other records that had done as well as the one plaintiff had recorded but defendant failed to promote; estimates of the sales of toothbrushes; the past track record of the horse.

Eisenberg is right that *Freund* was wrongly decided. So was *Kenford*—or if the result was right it was not because damages were uncertain.<sup>107</sup> But these decisions are not relics of the past.

In 1817, in *Gale v. Leckie*, the defendant breached an agreement to provide a manuscript which the plaintiff would publish. The profits were to be equally divided. Lord Ellenborough allowed the jury to estimate the plaintiff's lost profits.<sup>108</sup> In *McNeil v. Reid*, the defendant breached a contract to make the plaintiff a partner in defendant's firm. The jury was allowed to estimate the profits the plaintiff would have made as a partner.<sup>109</sup> Both of these English cases were cited by the New York Court of Appeals in 1853 in *Bagley v. Smith*. The court allowed the plaintiff to recover the profit he lost when the defendant breached a contract to continue a partnership with him for a fixed period.<sup>110</sup> Similarly, in 1868, in *Taylor v. Bradley*, the Court of Appeals awarded the profit the plaintiff lost when the defendant breached a contract with him to lease a farm and share the profits. The court acknowledged that the profit "depends upon details more or less contingent and speculative." Yet "the plaintiff is entitled to the value of his contract. . . . [H]e is deprived of his adventure."<sup>111</sup> In 1908, in *Nash v. Thousand Island Steamboat Co.*, the New York Appellate Division allowed the plaintiff to recover the profits he would have made had the defendant not breached a contract giving him "the exclusive souvenir, confectionery, view book, news, and parcel checking privileges on these six steamers during the three years named . . . ."<sup>112</sup> The trial court denied the plaintiffs recovery "upon the

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104. 557 F.2d 918 (2d Cir. 1977).

105. 677 F.2d 251 (2d Cir. 1982).

106. 220 N.E.2d 919 (Mass. 1966).

107. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 236 (construing *Rombola v. Consindas*, 220 N.E.2d 919, 922 (Mass. 1966)).

108. *Gale v. Leckie* (1817) 105 Eng. Rep. 1228.

109. *McNeil v. Reid* (1832) 131 Eng. Rep. 540.

110. *Bagley v. Smith*, 10 N.Y. 489 (1853).

111. *Taylor v. Bradley*, 39 N.Y. 129, 144 (1868).

112. *Nash v. Thousand Island Steamboat Co.*, 108 N.Y.S. 336, 337 (N.Y. App. Div. 1908).

ground that they did not and could not show what profits they would have made if the contract had been performed by the defendants." The Appellate Division reversed, noting that "[t]here must always be difficulty in determining what future profits would arise from conditions that never come about."<sup>113</sup>

By our approach, these cases were correctly decided because in all of them, including those cited by Eisenberg, a party contracted in return for a share of the profits of some enterprise: the profits of a partnership (*McNeil, Bagley*); the profits from publishing a manuscript (*Gale*); or the purses won by racing a horse (*Rombola*). In some, the parties were to share royalties (*Ashland, Contemporary Mission, Lexington Products*), and one can cite others.<sup>114</sup>

Indeed, the only cases we have described in which the plaintiff was promised a share in the proceeds of a venture and in which recovery was denied are *Freund* and *Kenford*. In those two cases, as Eisenberg notes, the court should not have required a greater degree of certainty in the proof of damages.<sup>115</sup>

Goldberg also believes that in such cases the non-breaching party should recover direct damages. His reason is that the non-breaching party is entitled to what Goldberg calls the value of his contract as an asset. When a party contracts to give or receive a fungible commodity, the value of the asset at the time of breach is the difference between the market price and the contract price of the commodity. When a party contracts in return for a share of profits, the value of the asset is the estimated value of those profits at the time of breach. "Contracts assign the risks of market change. If the market price goes up and the seller breaches, the buyer's damages are the difference between the contract and market price." Some "'lost profits' are clearly direct damages. They give the claimant the benefit of the bargain."<sup>116</sup>

That analysis is different but consistent with our own. By our approach, contract remedies should hold each party responsible for the risks that he has been compensated to assume. One is the risk of losing a more favorable bargain. The seller of goods at a fixed price gives up the chance to profit if the market price rises to avoid the risk of losing if the market price falls. A party who contracts for a share of profits is entitled to that share.

Be that as it may, American courts were dealing with such cases by asking

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113. *Id.* at 342.

114. *Perma Research & Devel. Co. v. Singer Co.*, 542 F.2d 111 (2d Cir. 1976); *MindGames Inc. v. Western Publ. Co., Inc.*, 218 F.3d 652 (7th Cir. 2000).

115. Goldberg noted that *Kenford* may have been rightly decided but for a different reason. The plaintiff was trying to recover the profits that he would have made by investing in a domed stadium. The court held that the lost profits were too uncertain. The mistake, according to Goldberg, was to neglect the possibility that the plaintiff was then free to invest in some other project that might have been equally profitable. GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 228–31.

116. GOLDBERG, *RETHINKING DAMAGES*, *supra* note 29, at 175. Goldberg was speaking of the special case of "indirect compensation," in which, for example, instead of paying a distributor a set price for retailing services, a manufacturer sells to him for resale at a markup. His argument carries over to any case in which the benefit of the bargain is to obtain profits or a share in the profits. He mentions the case of licensing for a share in the royalties. *Id.* at 173.

whether damages were direct before they professed a concern for whether the damages were certain. Some courts borrowed Pothier's limitation to damages that were, in his words, *propter rem ipsam*, or, in Evan's translation, "in respect to the particular thing which is the object of [it]."<sup>117</sup> Although they were borrowing from Pothier, they treated these words as a limitation in themselves with little or no attention to whether they were foreseeable. These words from Evan's translation were quoted by the New York Supreme Court in 1839 in *Blanchard v. Ely*. The New York Supreme Court denied recovery for the profit the buyer would have made from the timely delivery of a steamboat.<sup>118</sup> In 1845, the *Blanchard* opinion was quoted in *Masterton & Smith v. Mayor of Brooklyn* to allow the seller to recover for breach of contract for the manufacture and delivery of marble.<sup>119</sup> The court added that such damages were "contemplated" by the parties. In 1848, the *Blanchard* opinion was quoted again in *Freeman v. Clute* to deny the buyer damages for the profits he lost during a three month delay in providing a suitable steam engine.<sup>120</sup> In time, this limitation was supplemented<sup>121</sup> or replaced<sup>122</sup> by the rule that the plaintiff must prove his damages with a greater degree of certainty.

*b. The risk of the cost of performance.*

Sometimes goods or services are to be provided when it is not certain what the cost of providing them will be. The goods have yet to be manufactured, and it is not certain how expensive it will be to manufacture them. The services have yet to be performed, and it is not certain how much it will cost to provide them. The parties must allocate the risk that the cost of performance will prove to be more or less than the amount they estimate in advance. If they make a cost-plus contract, that risk is placed on the party who is to receive the performance. If they make a fixed-price contract, the party who is to perform assumes the risk of a cost overrun but can keep the extra profit if costs are less than they were estimated to be.

If the party who was to receive the performance breaches, the other party should receive the amount of the profit he would have made had he been allowed

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117. ROBERT JOSEPH POTHIER, A TREATISE ON THE LAW OF OBLIGATIONS, OR CONTRACTS 75 (William David Evans trans., 1839).

118. *Blanchard v. Ely*, 21 Wend. 342, 348 (N.Y. Sup. Ct. 1839).

119. *Masterton & Smith v. Mayor of Brooklyn*, 9 Hill 61, 68–69 (N.Y. Sup. Ct. 1845) (holding that damages cannot be recovered when they have "no legal or necessary connection with the stipulations between the parties, and cannot therefore be presumed to have entered into their consideration at the time of contracting. . . . [P]rofits or advantages which are the direct and immediate fruits of the contract entered into between the parties, stand upon a different footing. These are part and parcel of the contract itself, entering into and constituting a portion of its very elements.") (citing *Evans' Poth.* 91).

120. *Freeman v. Clute*, 3 Barb. 424, 427 (N.Y. Gen. Term 1848).

121. *Masterton & Smith v. Mayor of Brooklyn*, 9 Hill 61, 67 (N.Y. Sup. Ct. 1845); *Wakeman v. Wheeler & Wilson Mfg. Co.*, 4 N.E. 264, 266 (N.Y. 1886).

122. *Griffen v. Colver*, 16 N.Y. 489, 493 (1858).



to perform. The reason is not that, in principle, he should be put in as good a position as he would have been in had the contract been performed. The reason is the allocation of risks established by the terms of the contract. As he would have lost in the event of a cost overrun, so he would win if he completed the work for less than the contract price.

Some courts have said that the standard of proof should be lower because the loss of profits in this situation is direct. In 1851, in *Philadelphia, W. & B.R. Co. v. Howard*, the plaintiff contracted "to furnish . . . building materials . . . [w]orkmanship and labor" to a railroad.<sup>123</sup> In holding the defendant liable for the plaintiff's lost profits, the United States Supreme Court said, again quoting the language of Pothier:

Actual damages clearly include the direct and actual loss which the plaintiff sustains *propter rem ipsam non habitam*. And in case of a contract like this, that loss is, among other things, the difference between the cost of doing the work and the price to be paid for it. This difference is the inducement and real consideration which causes the contractor to enter into the contract. For this he expends his time, exerts his skill, uses his capital, and assumes the risks which attend the enterprise. And to deprive him of it, when the other party has broken the contract and unlawfully put an end to the work, would be unjust. There is no rule of law which requires us to inflict this injustice. Wherever profits are spoken of as not a subject of damages, it will be found that something contingent upon future bargains, or speculations, or states of the market, are referred to, and not the difference between the agreed price of something contracted for and its ascertainable value, or cost.<sup>124</sup>

More recently, in *Franklin v. Demico, Inc.*,<sup>125</sup> the defendant breached a contract in which the plaintiff was to manufacture circuit boards to its specifications. The court said:

There is no merit in Franklin's argument that the amount is not proved because it includes profits, which must be shown with a requisite degree of certainty. . . . Franklin is confusing the legal concepts appropriate to profits which might accrue collaterally as a result of the contract's performance and profits necessarily inherent in the contract, which are always provable. . . . Although we acknowledge that, as the dissent contends, the complex and confusing mathematical methodology used in this case does not produce exact arithmetical accuracy, we must nevertheless presume that the trial judge, as trier of the facts, separated

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123. 54 U.S. 307, 309.

124. *Id.* at 344.

125. 347 S.E.2d 718 (Ga. Ct. App. 1986).

the wheat from the chaff.<sup>126</sup>

One might expect that in this situation, lost profits should be established with the same degree of certainty as other direct damages. One might even expect that lost profits should be established with a greater degree of certainty. Yet the opposite is true. The degree of certainty that courts require is less, and rightly so.

The reason one might expect the courts to require a greater degree of certainty is that this situation is not like one where a party is to receive profits or a share of profits in return for his own performance. There, the parties themselves will have had to estimate the amount of the profits. If they can do so, the courts should try to do so as well. In that situation, however, the parties are not betting against each other. If the profits are larger than expected, the party to receive them will obtain more, and if they are smaller, he will obtain less. But his gain is not the other party's loss, nor his loss the other party's gain. That is so even, though, if the profits had been more accurately estimated in advance. That estimate would have effected the share of the profits that a party could have successfully demanded as compensation. For example, if the profits on a book are much greater than expected, both the author and the publisher will win out, although, if the parties had known in advance how successful the book would be, the author could have demanded a greater share of the royalties.

In contrast, in a contract to pay a fixed price for goods that have yet to be manufactured or a service yet to be performed, the parties are betting against each other. The party who is to manufacture or to perform assumes the risk of a cost overrun but can keep the extra profit if costs are less than they were estimated to be. The reason for making a fixed price contract is that it is uncertain in advance what the costs will be. It would seem that to allow the non-breaching party to recover lost profits is to allow him to recover on a bet he made but never won.

Nevertheless, courts have correctly held that the contractor who is prevented from performing should recover his lost profits even if they remain uncertain. The party who hired the contractor should not be allowed to walk away from his own commitment. He took a risk when he hired the contractor—he gave up the opportunity of accepting a more favorable offer from another contractor. The contractor also took a risk. It is true that the contractor, like a lost volume seller, did not give up the opportunity to accept other offers. Since he subcontracts the work out to others, he can accept as many offers as he receives. Nevertheless, he committed himself to perform at a fixed price and so took the risk of a cost overrun. If he had offered to do the work at a higher price, he would have lessened this risk. He set a lower price to get a commitment from the party who

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126. *Id.* at 779. According to the dissent, “[h]aving essentially laid the foundation for the recovery of damages resulting from the breach, plaintiff needed only to attach some relevant figures regarding the costs of production and costs of material purchased, less the amounts received from salvage or other utilization of such materials, but it did not do so.” *Id.* at 722.

hired him. That party should be held responsible for the risk that the contractor assumed. He should not be able to accept a more favorable offer from someone else, and then, having prevented the contractor from performing, to refuse to pay because the cost of performance is uncertain.

Consequently, courts correctly have allowed the contractor to recover lost profits based on no more evidence than the estimates he used to compile his bid. In *American Fidelity Fire Ins. Co. v. Kennedy Bros. Const., Inc.*,<sup>127</sup> the defendant breached its contract by rejecting the plaintiff's low bid. The plaintiff was allowed to recover by presenting in evidence of "its calculated cost and profits for each item listed in the . . . bid form."<sup>128</sup> In *Alaska Children's Services, Inc. v. Smart*,<sup>129</sup> the jury found that the plaintiff had been awarded a roofing contract after making the lowest bid. The defendant breached by firing him and hiring a competing bidder who was allowed to rebid: "The evidence as to lost profits in this case was Smart's testimony that his profit on the ACS job would have been between \$15,000 and \$18,000 and that his normal profit percentage was 'usually anywhere from 18 to 25%.'"<sup>130</sup> Similarly, in *Foster v. United Home Imp. Co., Inc.*,<sup>131</sup> the defendant contracted with one developer and then, before he could begin work, contracted for the same project with another. The court allowed the first developer to recover on the basis of his own testimony as to "his expected profit on the total job—based on his experience in construction work since 1954. . . [He] explained such figure was calculated as the difference between the contract price and his anticipated expenses."<sup>132</sup> The court dismissed the defendant's objection that "(t)he only evidence in the record is the bald assertion by [the plaintiff] that he would have made such profit."<sup>133</sup>

The problem is similar when a manufacturer contracts to produce custom-made goods of use only to the buyer. If the buyer breaches the contract before the manufacturer has a chance to produce them, there may be little evidence of what it would have cost to perform beyond the estimates used to set the price offered. Yet again, the reason the manufacturer could not prove the costs of performance was that the defendant prevented it from doing so by breaching the contract. In *Bead Chain Mfg. Co. v. Saxton Products, Inc.*,<sup>134</sup> the Connecticut Supreme Court allowed such a manufacturer to recover lost profits based on plaintiff's testimony "about the elements he considered in pricing the job."<sup>135</sup> The court admitted that "his cost and price estimates about the actual production run were necessarily

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127. 670 S.W.2d 798 (Ark. 1984).

128. *Id.* at 799.

129. 677 P.2d 899 (Alaska 1984).

130. *Id.* at 902. The court said this evidence was "bolstered" by testimony from the competing bidders that they included a similar profit margin in their bids. *Id.*

131. 428 N.E.2d 1351 (Ind. Ct. App. 1981).

132. *Id.* at 1357.

133. *Id.*

134. 439 A.2d 314 (Conn. 1981).

135. *Id.* at 320–21.

theoretical, since [the defendant's] breach made it impossible to go forward with the production that would have made historically accurate figures available."<sup>136</sup> But he should recover precisely because "the plaintiff's difficulty in quantifying his damages often flows directly from the defendant's breach," and therefore the court would "require that degree of proof of damages which the facts permit, but no more."<sup>137</sup>

*c. The risk of losing profits on other transactions.*

Another risk is that because of the breach of contract, a party will lose the opportunity to enter into profitable transactions with third parties. The plaintiff who seeks to recover lost profits is seeking damages that are not direct but consequential.

In such cases, courts have sometimes denied recovery on the grounds that the damages were not established with certainty. By our approach, recovery should sometimes be denied. But the reason is not a lack of certainty. As in the case of the rule that damages must have been foreseeable, what matters is neither certainty nor foreseeability but whether the party in breach assumed the risk that the non-breaching party would lose the profit he would otherwise make by entering into transactions with others.

Whether the party in breach assumed the risk depends on the same considerations that we discussed earlier in dealing with foreseeability. The party in breach is often in the best position to bear a risk because he can spread the risk among similar transactions, charging each customer a bit more. But if he charges his customers the same price, he is then in the best position to spread that risk only if the risk is much the same for any of his customers or clients. If the adverse consequences differ from one customer or client to the next, the breaching party will be compensated for bearing it only if he charges a higher price to those customers for whom the adverse consequences are likely to be abnormally large.

From what has been said, we can understand how the so-called "new business rule" ought to be applied. The rule excludes damages for the profits lost when a breach of contract prevented the opening of a new business on the grounds that the profits could not be proved with sufficient certainty. Some scholars have said the rule is foolish,<sup>138</sup> and others that it has been nearly abandoned.<sup>139</sup>

Once again, we are indebted to Victor Goldberg who pointed out that the rule often serves the same purpose as the rule in *Hadley v. Baxendale*. For example,

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136. *Id.*

137. *Id.* at 320.

138. EISENBERG, FOUNDATIONAL PRINCIPLES, *supra* note 18, at 234–35; ROBERT L. DUNN, THE RECOVERY OF DAMAGE FOR LOST PROFITS 392 (6th ed. 2005).

139. E. ALLAN FARNSWORTH, CONTRACTS 833 (3rd ed. 1999).

in *Cramer v. Grand Rapids Show Case Co.*,<sup>140</sup> the court denied damages for the profit that was lost when the late delivery of furniture, priced at \$1376.75, delayed the opening of a retail store. In *Marvell Light & Ice Co. v. General Electric Co.*,<sup>141</sup> the court denied damages for the profit lost when the delivery of ice-making machinery was delayed. As Goldberg noted, the problem was not that proving the amount of lost profits was difficult. It was whether the foreseeability rule of *Hadley v. Baxendale* had been satisfied. In *Cramer* it was not. In *Marvell* it may have been. The buyer of the ice-making machinery had notified the seller when the contract was made of the consequences of delay. Nevertheless, if our approach to *Hadley* is correct, what should matter is not foreseeability but whether the buyer was apt to suffer an abnormally large amount of harm and, if so, whether he paid the seller to assume that risk.<sup>142</sup>

Indeed, Alan Farnsworth has said, citing Fuller and Perdue: “If the test of foreseeability is met, but the court concludes that liability would impose on the party in breach a risk disproportionate to the rewards that the party stood to gain by the contract, ‘the test of certainty is the most usual surrogate.’”<sup>143</sup> If that is so, one might ask Farnsworth, or Fuller and Perdue, what is the significance of the “expectation interest” if what matters is the risks the parties assumed, which depends on whether the risk was disproportionately high?

### III. ECONOMIC FAIRNESS AND VOLUNTARY EXCHANGE

Contracts of exchange should be not only economically fair but also voluntary. They are voluntary so long as a party puts a higher value on what he is to receive than on what he is to give. An adequate remedy neither deprives the non-breaching party of a compensation for a risk he paid the other party to assume, nor foists on him a transaction to which he never consented. In this part, we will see how the law of remedies reflects both these concerns.

#### A. *Unique Performances*

When performance is unique, it may have a value to the recipient that cannot

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140. 119 N.E. 227 (N.Y. 1918).

141. 259 S.W. 741 (Ark. 1924).

142. Goldberg also pointed to cases in which damages for lost profits should be recovered, not because a business is new, but because the plaintiff who was unable to open his business in one location could have made a similar profit by investing the same resources in opening his business elsewhere. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 231–39. Examples are *Fera v. Village Plaza*, 242 N.W.2d 372 (Mich. 1976), *Super Valu Stores, Inc. v. Peterson*, 506 So.2d 317 (Ala. 1987), and cases in which a would be franchisee never proved he would do better in one location than another. GOLDBERG, RETHINKING DAMAGES, *supra* note 29, at 237–38. Goldberg also discusses how the new business rule should apply to non-payment of royalties. By our approach, in these cases, damages in these cases concern the value of the performance contracted for, and so need not be proven with any greater degree of certainty than any other element of the plaintiff’s case. *See id.* at 239–45.

143. FARNSWORTH, *supra* note 139, at 831–32.

be measured by money damages. The plaintiff is entitled to specific performance.<sup>144</sup>

That remedy is usually explained as a means of protecting the “expectation interest” of the non-breaching party. A damage award may enable him to purchase a similar performance, but because the one promised him had unique features that no substitute performance will have, its value to him may be greater than its market value. Only a decree of specific performance will ensure that he is put in as good a position as he would have been in had the contract been performed.

Again, to say so is to presume that the non-breaching party has an “expectation interest” and that protecting it is the purpose of giving a remedy. By our approach, the purpose should be to respect voluntariness and economic fairness.

When performance is unique, a damages remedy that awards the difference between the market value of a substitute performance and the contract price would foist on the non-breaching party a transaction to which he never consented. He never agreed to pay the contract price for a performance that lacks some of the features that make the original performance valuable to him.

When a performance is unique, a damage remedy is economically unfair as well. As noted earlier, if the parties contract for a unique item, such as a house, the seller gives up the chance that if he had waited longer he could have received a higher price. The buyer gives up the chance that if he had looked further he could have paid the same price for as satisfactory a house, or a lower price for a more satisfactory one. Each of them contracts to avoid the risk that otherwise he will have to accept a less favorable bargain. Consequently, it is economically unfair for the seller to back out if he has found a third party who will pay more for the house. For the same reason, it is unfair if the seller should change his mind and decide the house is worth more to him than the contract price. From the standpoint of fairness, it does not matter whether the house is now worth more to a third party or to a repentant seller. It is economically unfair to deprive the buyer of his guarantee that he would not have to accept a bargain he regards as less favorable.

The reason for giving specific performance, then, is not to protect a party’s “expectation interest,” although that remedy will put the party in as good a position as he would have been if the contract had been performed. The reason is because a contract should be both voluntary and economically fair, and a remedy should therefore be concerned with voluntariness and fairness.

The idea that the purpose of a remedy is to protect the “expectation interest” may have inspired the theory of efficient breach. Those who explain contract law in terms of efficiency have described the protection of a party’s “expectation interest” as a consequence of the “indifference principle.” Under that principle,

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144. See RESTATEMENT (SECOND) OF CONTRACTS §359(1) (AM. LAW INST. 1979).

the remedies for breach of contract should "leave the [promisee] absolutely indifferent, in subjective terms, between having the defendant breach and pay damages or having the defendant perform."<sup>145</sup> That principle is said to be efficient for reasons that we described earlier.

Suppose A agrees to sell something to B for a certain price and then discovers that C will pay much more for it than B ever would, and indeed, more than the amount B will suffer if the contract is breached. According to Richard Posner, it is "efficient" for A to breach his contract with B. B is no worse off because he will receive damages sufficient to put him in as good a position as if the contract had been performed. A and C are better off. Therefore, the breach is efficient. If "[a] party's profit from breach would exceed . . . the expected profit to the other party from completion of the contract, and if damages are limited to the loss of that profit, there will be an incentive to commit a breach. But there should be."<sup>146</sup>

Admittedly, if C knew of the contract between A and B, he could have contacted B himself and asked B to resell to him. If C did not know of the contract, A could have contacted B and offered to tell him about C's interest in return for a finder's fee. Either way, C will end up owning the object in question, which is the efficient result. But a resale by B, according to Posner, "would have introduced an additional step, with additional transactions costs."<sup>147</sup> One can raise questions about the significance of these "transactions costs." Posner acknowledged that if the original buyer (B) resells "litigation costs would be reduced." But he expects transaction costs to be "high . . . because it would be a bilateral monopoly negotiation."<sup>148</sup> One difficulty with this argument is that there would also be a "bilateral monopoly negotiation" if A sells directly to C. There is no reason to suppose, as Posner does, that A will tamely accept C's first offer.<sup>149</sup> Nor is it clear that transactions costs will be particularly high given that the parties have an incentive to minimize them. Admittedly, from the standpoint of efficiency, all that matters is that C ends up with the object in a question, that A and B are no worse off, and that transactions costs are minimized. From this standpoint, if C were willing to pay a vastly greater amount for the object than B (i.e., a million dollars), and the transactions were \$1000 greater if B were to negotiate directly with C, for that reason alone, A would be entitled to so much of the million dollars as he could persuade C to pay. This kind of argument, in which who has the right to an enormously valuable asset turns on how to avoid a trivial saving in transactions costs, would appeal only to someone who is so committed to economic explanations of law that he believes nothing, but

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145. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629, 636 (1988).

146. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 89–90 (2nd ed. 1977).

147. RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 151 (8th ed. 2011).

148. *Id.*

149. *Id.*

efficiency could matter.

Suppose, instead, we ask how the parties allocated the risk that the object can be resold to a third party for more than the contract price. If the object in question is not unique and is readily available on the market, the issue of efficient breach does not arise since the third party would buy such an object on the market at the market price. Suppose that the object is unique, such as a house, a racehorse, or a Fragonard, and that it would be of interest to a number of buyers. If our previous analysis is correct, we can see why in these cases the original seller is entitled to the performance even if a third party is willing to pay a higher price. Typically, in the sale of a unique performance, the buyer gives up the chance that if he had looked further he could have paid the same price for as satisfactory a house or a lower price for a more satisfactory one. Each party contracts to avoid the risk that otherwise he will have to accept a less favorable bargain. Consequently, it is economically unfair for the seller to back out if he has found a third party who will pay more for the house. It does not matter whether the third party appears on the scene earlier than expected.

To make his claim plausible, Posner described a different type of contract: one in which the object is unique but in which, at the time of contracting, the parties believed it would be of interest to only one buyer. The object is custom-made by the seller for the buyer. In Posner's hypothetical case, a seller agreed to deliver 100,000 "custom-ground widgets" for ten cents apiece for use in the buyer's boiler factory. After he has delivered 10,000 to the buyer, a third party comes to him and "explains that he desperately needs 25,000 custom-ground widgets at once, since otherwise he will be forced to close his pinola factory at great cost," and offers to pay fifteen cents apiece. Seller sells him the widgets, causing the original buyer to lose \$1,000 in profits, but making for himself an additional profit of \$1,250.

Earlier, we discussed contracts for the manufacture of custom-made goods that are expected to be of use only to the buyer. The risk that the parties normally assume is whether the cost of performance will be greater or less than the contract price. In contrast, when the performance is unique but is expected to be of value to a number of buyers, as in the sale of the oriental rug, the racehorse, or the Fragonard, the risk the parties normally assume is whether either, if he waits, will receive an offer that is greater or lesser than the contract price. Posner picked an example that concerns a risk—the unexpected appearance of a third party who will pay more than the contract price—that parties to a contract for custom-made goods normally do not consider if they expect the good to be of use only to a particular buyer.

Because the parties did not consider that risk, it is hard to see any sound principled solution. The reason is the same as in a situation in which a contract for custom-made goods is invalid for impossibility or frustration. The party who undertook the performance may have incurred costs that he cannot recoup. Some



scholars have argued that he should be able to recover at least some of these costs from the other party,<sup>150</sup> and others that he should not.<sup>151</sup> The Second Restatement provides that "if the rules [stated elsewhere] will not avoid injustice, the court may grant relief on such terms as justice requires including protection of the parties' reliance interests."<sup>152</sup> Nevertheless, even the Reporter for the Second Restatement, Allan Farnsworth, admitted that there is little or no judicial support for allowing recovery.<sup>153</sup>

In that situation, the performance unpredictably became of use to no one. The parties did not allocate the risk that the costs incurred would be a dead loss. In Posner's hypothetical, the performance unpredictably became of use to more than one potential buyer. The parties did not allocate the risk of an unexpected windfall due to that buyer's chance appearance. In both situations, the risk the parties did allocate was a different one: the risk that the cost of the performance would be greater or lesser than the contract price. It is no wonder that it is hard in either case to reach a principled result. For that very reason, it is unwise to establish a general theory on a type of case in which a principled result is so elusive.

#### *B. Partial or Defective Performances*

As we have said, a contract of exchange should be both voluntary and economically fair. A good remedy should respect both concerns. It will not foist an unwanted exchange on either party. Neither will it allow either to party to escape the consequences of a risk that he has been compensated to assume.

When a performance is partial or defective, the non-breaching party should not be forced to accept it if he would not have agreed to do so had the opportunity been offered him at the time he contracted. Otherwise he will be obliged to exchange on terms to which he never would have consented. If, however, the non-breaching party would have agreed to accept the partial or defective performance at a reduced price, he should be required to do so. There is no reason he should be able to refuse and purchase them at a cheaper price from someone else. To do so would be economically unfair to the other party. When the parties contracted, each gave up the opportunity to seek a more favorable bargain with someone else to avoid the risk of finding a worse one.

Such a solution reconciles the principles of voluntariness and fairness only if we speak of "voluntariness" in a more extended sense. When the parties contract, the exchange is voluntary in the sense that each party gives up something he values less to receive something he values more. Here, one must ask whether a

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150. Richard Speidel, *The New Spirit of Contract*, 2 J.L. & COM. 193, 209 (1982).

151. John Dawson, *Judicial Revision of Frustrated Contracts: The United States*, 64 B.U.L. REV. 1, 17 (1984).

152. RESTATEMENT (SECOND) OF CONTRACTS § 272 (AM. LAW INST. 1979).

153. FARNSWORTH, *supra* note 139, at 666–67.

party would have valued receiving the partial or defective performance more than the reduced price which he will pay for it. That is a choice he never made. Admittedly, it strains the normal meaning of the word “voluntariness,” and to decide what he would have done requires guesswork. Nevertheless, such a solution comes closest to reconciling voluntariness and economic fairness.

Sometimes, once again, a remedy that reflects these concerns will put the non-breaching party in as good a position as he would have been in had the performance not been partial or defective. Sometimes it will not. But in any event, what should matter is voluntariness and fairness, not the protection of a party’s “expectation interest” as though it were the purpose of giving a remedy.

*1. Repudiating the contract.*

Sometimes, when a performance is partial or defective, the non-breaching party claims not to be bound by the terms of the original agreement. The concerns that matter—voluntariness and economic fairness—are far better reflected in the doctrine of substantial performance, which governs the provision of services, than in the doctrine of perfect tender which governs the sale of goods.

*2. Substantial performance.*

As we have seen, when the parties contract for the performance of a service at a fixed price, the parties have, so to speak, made a bet on whether the cost of performance will be higher or lower than the contract price. The contractor takes the risk of incurring a loss if it is higher, but he will gain if it is lower. The doctrine of substantial performance determines when a non-breaching party can be held to the terms of the bet despite the other party’s breach.

If our approach is correct, when a performance is partial or incomplete, the party owed performance should have to pay for it at a reduced price if, and only if, he would have agreed to do so at the time he contracted. If he would, he should not be allowed to use other party’s failure to perform fully as an excuse to escape the risk he assumed when he entered into a fixed price contract.

That approach is consistent with standard doctrine as summarized by the Second Restatement. It lists a series of factors to be taken into account in determining whether a party has substantially performed. Two of the factors concern the amount by which the value of the performance to the party who is to receive has been diminished: “(a) the extent to which the injured party will be deprived of the value which he reasonably expected to receive; (b) the extent to which the injured party can be compensated for the part of that benefit of which he will be deprived.”<sup>154</sup> A third is “(c) the extent to which the party failing or

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154. RESTATEMENT (SECOND) OF CONTRACTS § 241 (AM. LAW INST. 1979).

perform . . . will suffer forfeiture." By our approach, these factors should be taken into account by asking, would the injured party have agreed to receive a performance which deprives him of the value which he reasonably expected to receive if he had been offered sufficient compensation? If so, he should be liable for the contract price minus the amount of that compensation. He should not be allowed to repudiate the contract and have the work done more cheaply since then the other party would forfeit his right to profit if the work could be done more cheaply.

It may be difficult to tell when the party would have been willing to accept such a performance at a reduced price. Judge Cardozo, in his classic decision in *Jacob & Youngs v. Kent*, noted that the defects in performance were "of trivial or inappreciable importance" and "insignificant in . . . relation to the project."<sup>155</sup> The contractor, making an innocent mistake, had installed Coulter Pipes when the specifications called for Reading Pipes. The quality and cost of the two brands of pipe were much the same. In other cases, the defects were so substantial that the court questioned whether the party owed performance would have accepted them at any reduction in price: for example, when a contractor installed a russet-colored shingle roof with yellow streaks that could not be removed without rebuilding the roof.<sup>156</sup> In intermediate cases, there will be guesswork as to what the party owed performance would be willing to accept. There is no way to avoid the guesswork, however, and still have a rule that reflects both of the concerns we have described. The party owed performance should not be obliged to accept an exchange to which he would not have agreed. Neither should he be allowed to escape the consequences of the risk that, in a fixed-price contract, he was compensated to assume.

In two situations, however, this rule needs to be qualified. In one, the contractor has completed very little of the work. Courts have recognized that his failure to do so should prevent him from claiming that he has substantially performed.<sup>157</sup> It may be that the other party can receive exactly the performance for which he contracted by hiring someone else to complete the work. But, by entering into a fixed price contract, the party who was to perform assumed the risk of how high the cost of completing the work would be. If he was fired before he had done much or any work, as we have seen, courts have allowed him to recover the profits he might have made on little more evidence than the estimates he used to compile his bid. The reason is that a breach by the party who was to receive the performance made it impossible to tell what his actual costs would have been. If the contractor breaches the contract having completed little or no work, his own breach has made that determination impossible. If he were allowed to recover the contract price minus the cost of completion incurred by the owner, he could enter into a contract, breach it immediately, and then recover a lost

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155. *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889, 890, 892 (N.Y. 1921).

156. *O.W. Grun Roofing & Constr. Co. v. Cope*, 529 S.W.2d 258, 261 (Tex. Civ. App. 1975).

157. *Keyer v. Driscoll*, 159 N.W.2d 680, 683 (Wisc. 1968).

profit by claiming that the other party overbid.

In another situation, the contractor acted in bad faith. As the Second Restatement notes, in determining whether a party has substantially performed, another factor to consider is “the extent to which the behavior of the party failing to perform comports with standards of good faith and fair dealing.”<sup>158</sup> For example, the contractor should not be able to claim he has substantially performed if he deliberately substituted different and cheaper materials than those called for by the contract to lower his cost of performance. That is so even if the non-breaching party would have been willing to accept a performance using these cheaper materials and if he had been offered a suitably reduced price. Under the contract, the contractor assumed the risk of how much it would cost to complete the project using the materials the contract specified. He should not be able to cheat and also hold the other party to the terms of their bet. Consider a game of bridge in which one party cheats by peeking at the other party’s cards. It should not matter whether the information he obtains is actually of use to him: for example, whether or not he learns that he can finesse the other party’s king, or that he can pull the other party’s trump. By peeking he changed the odds that he would win. The fact that he happens to win anyway does not make the game a fair one.

### 3. *The perfect tender rule.*

As a general rule, as in the case of services, whether the buyer can reject goods that are defective should depend on whether, at the time of the contract, the buyer would have been willing to accept the goods despite the defect with a discount in price. If so, his later refusal to accept them on delivery has nothing to do with the defect. He may have changed his mind. He may now be able to buy similar goods more cheaply. But he should not be able to deprive the seller of a remedy based on the contract price.

Consequently, the “perfect tender rule” of the Uniform Commercial Code is not the correct solution. It provides that, “[i]f the goods or the tender of delivery fail in any respect to conform to the contract, the buyer may . . . reject the whole . . . .”<sup>159</sup> If the seller was acting in good faith, and the buyer would have been willing to accept the defective goods with a price discount, there is no reason why the buyer should be able to refuse the goods and allow them to buy goods at a cheaper price when the market price has fallen. Yet the Code allows him to do so.<sup>160</sup>

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158. RESTATEMENT (SECOND) OF CONTRACTS § 241(e) (AM. LAW INST. 1979). The remaining factor is “(d) the likelihood that the party failing to perform . . . will cure the failure . . . .” As the Official Comment to that provision notes, that factor concerns, not the right of the non-breaching party to repudiate the contract, but his “right to withhold further performance as a means of securing his expectation of an exchange of performances.” *Id.*

159. U.C.C. § 2-601 (AM. LAW INST. & UNIF. LAW COMM’N 1977).

160. One limitation on the buyer’s right to refuse the goods is the general requirement that rights under

One limitation on the perfect tender rule is that the buyer who accepts goods may reject them afterward only if their "nonconformity substantially impairs its value to him . . . ." <sup>161</sup> A similarly worded limitation applies to installment contracts. The buyer may reject a single installment only if its nonconformity substantially impairs its value even the seller cannot cure. He may cancel the entire contract if the nonconformity of one or more shipments substantially impairs the value of the whole. <sup>162</sup>

By our approach, the rule should be that the buyer must accept non-conforming goods at a discount if he would have done so had the offer been made to him originally. The rule that he can reject the goods only if they substantially impair their value to him is a step in that direction. The test, however, should not be "substantial impairment"; he might have been willing to accept such goods only if he were offered with a discount, and indeed, with a greater discount, he might have been willing to accept them even if their value to him is substantially impaired.

Another limitation on the perfect tender rule is that the seller may have the right to cure by making a conforming delivery. His right to do so, however, is restricted in two ways. First, he has the right to cure so long as "the time for performance has not yet expired." <sup>163</sup> Second, if the time for performance has expired, the seller has a "reasonable time to substitute a conforming tender" provided that he "had reasonable grounds to believe it would be acceptable with or without money allowance." <sup>164</sup>

In either case, the buyer is entitled to a conforming tender even if he would originally have agreed to accept goods that do not conform albeit at a lower price. The first restriction allows the seller's right to cure to depend on how speedily he can buy conforming goods. If he cannot do so within the time of performance, the buyer is free to reject the goods, even if he does so because the market price has fallen since the contract was made, and even if the lack of conformity does not impair their value to him at all.

The second limitation is strange. It allows the seller's right to cure to depend on his expectations of what goods the buyer would have been willing to accept with a discount. Why should the seller's reasonable expectations matter? His good faith should matter. But good faith is not the same as a belief that the goods would be acceptable to the buyer. The seller may not know of the defect. He may know of the defect and suspect that they are not acceptable. Bad faith should cost

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the Code must be exercised in good faith. U.C.C. § 1-304 (AM. LAW INST. & UNIF. LAW COMM'N 2001). But it does not prevent a buyer from rejecting goods on account of a defect that does not "substantially impair" their value to him. U.C.C. § 2-608(1) (AM. LAW INST. & UNIF. LAW COMM'N 1977). The Code deems him to be acting in good faith even if he does so to obtain a price that is more favorable to him, and less favorable to the seller, than the contract price.

161. U.C.C. § 2-608(1) (AM. LAW INST. & UNIF. LAW COMM'N 1977).

162. U.C.C. §§ 2-612(2)-(3) (AM. LAW INST. & UNIF. LAW COMM'N 1977).

163. U.C.C. § 2-508(1) (AM. LAW INST. & UNIF. LAW COMM'N 1977).

164. U.C.C. § 2-508(2) (AM. LAW INST. & UNIF. LAW COMM'N 1977).

him his bargain only if he is trying to cheat the buyer. He is not trying to do so as long as he is honest with the buyer about the condition of the goods.

Consider some variations on the facts of *T.W. Oil, Inc. v. Consolidated Edison Co.*<sup>165</sup> There, the seller was under contract to deliver fuel oil with a sulfur content of less than 0.5%. He did not realize that the oil he was delivering had a sulfur content of 0.9 %, but, had he known, he would have reasonably believed that the buyer would find oil of that sulfur content acceptable. The court ruled that the seller did not have to believe that his oil was non-conforming to be allowed to cure. That result is sensible. There is no reason that the seller should be in a better position if it thinks it is delivering non-conforming goods than if it thinks it is not. Suppose, however, that the facts were the same but that the seller did not know that the buyer could use oil with a sulfur content of 0.9%. It would seem that the result should be the same as long as the buyer should reasonably have found oil of that sulfur content acceptable. What the seller believed, reasonably or not, did not affect what the seller did. It delivered oil that it reasonably believed had a sulfur content of 0.5 %.

Suppose, then, that the seller had no information as to the maximum sulfur content of the oil that the buyer could use, and that it had learned that the oil it had already purchased had a sulfur content of 0.9 %. It delivered the oil anyway, informing the buyer of the discrepancy, in the hope that that the buyer would accept the shipment. Can the buyer reject the oil anyway? If so, then the seller is worse off because he made the wrong guess about the buyer's needs than, as in the previous hypothetical, in which he made no guess at all. If not, then despite subsection 2, the seller's expectations do not matter. What matters is whether he delivers goods that meet the buyer's needs.

### *C. Breach of warranty.*

We have already discussed when the buyer should recover consequential damages for a defective performance. It depends on how the parties have allocated the risk that they will occur. Leaving that question aside, according to our approach, the buyer should be allowed to repudiate the contract only if he would have been unwilling to accept the goods with a price discount had that alternative been offered him at the time of the contract. If he would have been willing to do so, he should be required to accept the goods and receive the amount of the price reduction that would have induced him to accept them.

This was the approach of the *ius commune*, the version of Roman law that became accepted throughout most of continental Europe before codification. In Roman law, if goods were defective, the buyer might have the right to return them and recover the purchase price. Or he might have the right to recover for the diminution the value of the goods due to the defects. The remedies had first been

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165. 443 N.E.2d 932, 934 (N.Y. 1982).

provided for the sale of slaves and animals, and later granted to buyers in general. There was a continuing discussion over when a buyer was entitled to rescission and when to the diminution of value. The prevailing opinion among early modern jurists was that the buyer should only be able to seek rescission if he would not have bought the object had he known of the defect.<sup>166</sup>

The same option was given to the buyer by the French Civil Code of 1804<sup>167</sup> and the German Civil Code of 1900,<sup>168</sup> and recognized intermittently in common law. In the United States, the Uniform Sales Act of 1906, in provisions copied almost verbatim from the English Sale of Goods Act of 1893, provided that the buyer might "rescind the contract . . . and recover the price"<sup>169</sup> or he might "accept or keep the goods, and set up against the seller, the breach of warranty by way of recoupment or diminution or extinction of the price."<sup>170</sup>

In both Acts, side by side with this earlier solution, a modern one appeared which later became the exclusive solution. The buyer was given an alternative remedy. He might "maintain an action against the seller for damages for breach of warranty"<sup>171</sup> in which "the measure of damages" is "the difference between the value of the goods at the time of delivery to the buyer and the value they would have had if they had answered to the warranty."<sup>172</sup> Under the Uniform Commercial Code, the earlier solution disappeared and the alternative remedy became the exclusive remedy. Section 2-714(2) provides: "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, unless special circumstances show proximate damages of a different amount."<sup>173</sup>

If it were true that the goal of remedies for breach of contract is to protect a party's "expectation interest," then this rule would be the correct one. It may be, however, that if the defects had been known at the time of contracting, the seller would not have been willing to part with them at a reduced price. He would have agreed to the exchange only at a higher price than the buyer would be willing to pay. There would have been no contract. In that event, to require the buyer to pay the increased price would be to bind him to a bargain to which he never consented. But to require the seller to pay the higher price, or to provide conforming goods that he would not have sold except for that higher price, would be to bind him to a bargain that he never accepted. If the seller would have been unwilling to provide conforming goods at such a price, it is economically unfair to require him to do so without any evidence that he assumed such a risk. In such

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166. ZIMMERMANN, *supra* note 9, at 325.

167. CODE CIVIL [C. CIV.] [CIVIL CODE] art. 1644 (1804) (Fr.).

168. BÜRGERLICHES GESETZBUCH [BGB] [CIVIL CODE], § 480 (1900) (Ger.).

169. UNIFORM SALES ACT § 69(a)(4) (AM. LAW INST. & UNIF. LAW COMM'N 1906).

170. *Id.* § 69(a)(1).

171. *Id.* § 69(a)(2).

172. *Id.* § 69(f).

173. U.C.C. § 2-714(2) (AM. LAW INST. & UNIF. LAW COMM'N 1977).

situations, the non-breaching party should not be put in as good a position as he would have been in if the breach had not occurred.

In one such situation, the goods are worthless unless they are repaired, and the cost of repairing them exceeds the contract price. In *Continental Sand and Gravel v. K & K Sand and Gravel*,<sup>174</sup> the defendant sold front-loaders, cranes, and other equipment for \$50,000.<sup>175</sup> An express warranty was breached, and the plaintiff recovered \$104,206.75, which was the cost of the repairs necessary to put the equipment in the condition warranted. The court allowed recovery of that amount under § 2-714(2) of the Code, rejecting the defendant's argument that recovery should be "diminution in value from the purchase price as the result of the breach of warranty."<sup>176</sup> The "result is logical," the court said, "since to limit recoverable damages by the purchase price . . . would clearly deprive the purchaser of the benefit of its bargain . . . ."<sup>177</sup> At the time the parties contracted, the seller gave up his chance that if he sold later, he would receive more than \$50,000 for the equipment to avoid the risk that he would have to sell it for less. Had he known of the defect, presumably, he would have been willing to sell the equipment at a discounted price to avoid the similar risk that later he would have to sell the defective goods for less. But there is no reason to think that he was willing to assume the risk of paying twice the contract price to the buyer if the equipment was defective. There is no reason to think that the buyer would have been willing to pay that much to acquire it.

In another such situation, the goods will not do the job that they were warranted to do, and the cost of goods that will do the job exceeds the contract price. In *Chatlos Systems, Inc. v. National Cash Register Corp.*,<sup>178</sup> the plaintiff purchased a computer for \$45,000 that was warranted to run an accounting program that the plaintiff wished to use. The computer was unable to do so. The value of a computer that would do so was \$207,826.50.<sup>179</sup> The court awarded that amount, which was correct if the true goal of remedies for breach of contract is protect the non-breaching party's expectation interest.

To avoid the evident unfairness of the result, as Christopher Wonnell observed, some have suggested that the expectation is protected if we read in an implied or gap-filling term that limits their damages to those that they would have wanted.<sup>180</sup> As he noted:

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174. 755 F.2d 87, 89 (7th Cir. 1985).

175. I thank Mark Gergen for noting how unlikely it is that \$50,000 was a genuine sales price. It was the price set for the equipment in a larger deal which included the transfer of other assets and may have been artificially low. The court, however, treated it as a genuine price.

176. *Continental Sand*, 755 F.2d at 91.

177. *Id.* at 91-92.

178. 670 F.2d 1304, 1305 (3rd Cir.1982).

179. At least, the court accepted that figure although the dissent pointed out there was little evidence to support it. *Id.* at 1307.

180. E. ALLAN FARNSWORTH & JOHN HONNOLD, CASES AND MATERIALS ON COMMERCIAL LAW 690 (4th ed. 1985), cited by Christopher Wonnell, *Expectation, Reliance and the Two Contractual Wrongs*, 8 SAN DIEGO L. REV. 53, 75 n.63 (2001).



The problem with this argument is that any remedial scheme can be made consistent with expectation theory in this way, by saying that parties would have wanted it. The interesting question is what kind of substantive and remedial scheme the parties to a contract would want . . . .<sup>181</sup>

So, we come back to the question which, by our approach, should be asked: what risks did the parties assume when they contracted? In *Chatlos*, there is no reason to believe that the seller would have been willing to assume the risk that he would have to pay that amount to the buyer had the parties known about the defect at the time the contract was made. There is no reason to believe that the buyer would have been willing to pay that much to have a computer that would run his accounting program.

#### IV. CONCLUSION

We have realized that we cannot live with what Eisenberg has called "classical law" of contract. Its formalism and conceptualism have been under attack since the early 20th century. We have not fully realized how many of our assumptions about contract law are holdovers from the contract law we are trying to escape.

One example is the 19th century principle that contract is the expressed will of the parties. We have recognized that this principle does not explain why sometimes, the parties are bound to terms that they never contemplated, and sometimes, they are not bound to terms which they agreed. Hao Jiang and I argued that the problems remain because we look for answers by manipulating the idea of what constitutes the will of the parties: it must be autonomous, informed, given without unfair pressure, and so forth. We should ask a question that the 19th century jurists did not: when are the terms of a contract fair? We suggested that for the terms of a contract to be fair, they must be voluntary in the sense that each party prefers what he is to receive to what he is to give in return. It must also be economically fair in the sense that each party is compensated for the risks he assumes.

Another example we have seen is the principle that a party's expectation interest should be protected. I have argued that the problems it leads to arise because the principle itself is a legacy of the 19th century which we should do without. We should not try to find a modern justification for it. We should consider instead when a remedy is fair. That should depend on two principles: that each party be held responsible for the risks that he has been compensated to assume, and that a party should not be held to an agreement to which he never consented.

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181. Wonnell, *supra* note 180.