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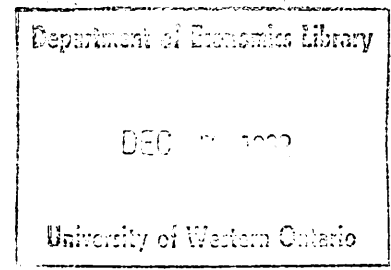
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HADLEY V. BAXENDALE REVISITED: AN
AUSTRIAN PROPERTY RIGHTS-PUBLIC
CHOICE APPROACH

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Hadley v. Baxendale Revisited: An Austrian Property Rights-
Public Choice Approach

By

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> The "loss" of an expectation, which is only a loss in
> an extended sense of the term, came to be seen as a real
> loss, a present loss. A plaintiff with an egg, was, in
> short, entitled to be treated as though he had a chicken."
> (Patrick Atiyah, 1979, p. 428)

Introduction

The 1854 English case of Hadley v. Baxendale[1] is a landmark in contract

law. The case involved a mill owner, the plaintiff, who entered into a

contract with a common carrier, the defendant, to transport a broken crank-

shaft to engineers in Greenwich as a pattern for a new shaft. The defendant

breached the contract by delaying the transportation of the crankshaft to

its destination. As a result of the delay, the mill could not operate

for several days. The plaintiff claimed £300 damages for lost profits

due to the breach. The court, in a landmark ruling, held that the plaintiff's lost

profits were not recoverable as they were not foreseeable by the defendant. In other words, the defendant is liable only for the foreseeable consequences of a breach.

The foreseeability rule of Hadley v. Baxendale was subsequently refined and restated by Lord Asquith in the form of the two rules of Hadley v. Baxendale.[2] The first rule states that

> In cases of breach of contract the aggrieved party is
> only entitled to recover such part of the loss actually
> resulting as was at the time of the contract reasonably
> foreseeable as liable to result from the breach. What
> was at the time reasonably foreseeable depends on the
> knowledge then possessed by the parties, or, at all
> events, by the party who later commits the breach. For
> this purpose, knowledge "possessed" is of two kinds--
> one imputed, the other actual.[3]

If a person, as a "reasonable man" can foresee from imputed knowledge that he possesses of the general nature and character of the business of his contracting partner, that damages will flow naturally from his breach, then the "first rule" of Hadley v. Baxendale would make such losses recoverable by the plaintiff. If knowledge is actually communicated by the plaintiff to the defendant, at the time the contract is being negotiated, of the special circumstances in which damages would flow from a breach, then the "second rule" of Hadley v. Baxendale would make additional or consequential damages also recoverable by the plaintiff. The two Hadley v. Baxendale rules actually constitute single foreseeability rule with two tests of foreseeability" the first rule applies an objective subjective test of foreseeability while the second rule applies a subjective objective test of foreseeability.[4]

The significance of the rule of <u>Hadley</u> v. <u>Baxendale</u>, which made it a landmark case in the evolution of contract law, is that the rule places <u>limits</u> on the liability for damages of a contract breaker.[5] Prior to the rule, the plaintiff was entitled to recover lost profit, subject to the mitigation principle[6] i.e. contract law's "normal rule" for assessing damages is a rule that protects the plaintiff's "expectation interest."[7]

Is the foreseeability rule of <u>Hadley</u> v. <u>Baxendale</u> efficient? In the law and economics literature, Barton[8], Posner[9], and Perloff[10], have examined the implications of the rule from an abstract static-efficiency framework. Barton concluded that the rule is efficient "in its reliance upon notice and information" and thus transmits information with respect to the magnitude of the risk to be transferred.[11] Posner also concluded that the rule is efficient because it increases the chances of the potential contract-breaking party to undertake appropriate precautions to protect himself. Instead of using an abstract theoretical framework, Danzig analyzed the efficiency implications of the rule set in the specific institutional-historical setting of mid-19th England : "Arising squarely in the middle of the 'industrial revolution' and directly in the midst of the 'Great Boom' of 1842-1874, <u>Hadley</u> v. <u>Baxendale</u> was a product of these time."[12] In other words, the rule emerged in response to the increased complexity of the economy of mid-19th England which was undergoing rapid industrialization and capital accumulation.[13] Danzig came to the same conclusion regarding the societal gain from the rule, i.e. the rule improved

"the seller's calculation about whether to breach in this situation." In short the rule permits potential contract-breakers to engage in "efficient breach".[14]

The purpose of this paper is to carry the analysis of the efficienty implications of the rule of Hadley v. Baxendale one step further by developing an evolutionary theory of contract law[15] using Property Rights-Public choice theory.[16] As Buchanan states, in his analysis of institutions such as property and law:

> Once it is recognized that observed institutions of legal-political order exist in a historical setting the attraction of trying to analyze conceptual origins independent of historical processes is severely weakened.[17]

Using Property Rights-Public choice framework, we shall provide an analysis of the conceptual evolution of contract law from a rule that protects the plaintiff's "expectation interest" to the rule of Hadley v. Baxendale. In developing our theory, we shall first begin with a theory of the emergence of a law of contract damages that protects the plaintiff's "expectation interest" anchored in the specific institutional-historical context of the 18th Century England: the mercantile or middleman economy dominated by merchants engaged in trade and commerce. We shall then consider the alternative setting of the economy of mid 19th century England which was undergoing rapid industrialization and capital accumulation.

In considering the setting of the mercantile or middleman economy of 18th century England, it is essential to note that historically, the activities of profit-seeking merchants/middleman-entrepreneurs led to their creation of the "rules of the game" of the mercantile economy--Merchant Law--to regulate the contractual relations between merchants.[18] The Law Merchant was later

appropriated by the state to become modern contract law.[19] Thus an analysis

of the conceptual origins of a contract law that protects the plaintiff's

"expectation interest" also requires a theory of entrepreneurship which places

the formation of subjective profit expectations at the heart of its analysis.

We shall therefore also draw on insights from Austrian theory including the

theory entrepreneurship as developed by Kirzner.[20] Using a hybrid framework,

an Austrian-Property Rights-Public Choice approach, we shall show that contract

law evolves in response to entrepreneurship in the context of a dynamic,

developing economy. Thus our analysis of the efficiency implications of the

rule of Hadley v. Baxendale, which place entrepreneurship at the center of

our analysis, differs from the static-efficiency framework used by Barton, Posner,

and Perloff in its emphasis on the "dynamic efficiency"[21] of contract law as

it evolves to facilitate entrepreneurship and capital accumulation via its role

in internalizing negative externalties.

The paper is organized into three sections. Section I will provide a

theory of the conceptual emergence of contract law that protects the plaintiff's

expectation interest set in the context of a middleman economy. Section II

will explain the emergence of the rule of Hadley v. Baxendale in the context

of the discrete transactions between non-merchants. Section III will examine

a few examples of lost profits damages cases to see whether there is an

underlying consistency in the courts application of the rule to achieve Pareto-

efficiency. The section will also provide an explaination of the "middleman

exception" to the foreseeability rule *in the Uniform Commercial Code*.

I. Contract Law and the Protection of the "Expectation Interest":
   The Middleman Economy

I.1 Special Features of Markets with Middlemen

Neo-Classical paradigm of an exchange is a "discrete transaction"[22] i.e.
a one-shot transaction between isolated pairs of producers and consumers. In
the alternative Austrian theory of entrepreneurship considered here, the
entrepreneur or historically the merchant or middleman plays a key role in the
exchange process in linking producer with consumers indirectly together.[23] The
existence of price differentials provide opportunities for the middleman-
entrepreneur to engage in arbitrage. The middleman perceives opportunities
for making profits from buying goods at a lower price in one market and reselling
the same goods at a higher price to final consumers in another market. As long
as price differentials persist, the entrepreneur will stay in markets in order
to exploit opportunities for making profits. The Austrian theory of entrepreneur-
ship, however, does not include a theory of how contract law would emerge in an
exchange economy with profit-seeking entrepreneurs.[24] In order to develop such
a theory, it is necessary to examine the special features of markets with
middlemen.

Markets with middlemen are different from other markets in several essential
aspects. First, the presence of middlemen in an exchange economy radically
transforms the structure of exchange relations. Instead of a single market
composing of producers and ultimate consumers, there exist two markets: consisting
of producers and middlemen plus middlemen and final consumers. The structure
of exchange relations in a middleman economy is in the form of a chain-like
arrangement with middlemen forming the links, or as a "vertical market structure"[25]
with middlemen connecting traders at different levels of the vertical market
structure together. In either case, the middleman economy cannot be decomposed

into lone pairs of traders since all traders are connected together directly
and indirectly together in complex networks of exchanges to form a system. The
nondecomposibity of middleman exchange system is due to the functional inter-
dependence between producers, middlemen, and final consumers arising from
specialization and division of labour in society. The specialization and
division of labour in which merchants are the specialized or professional
traders provide the basis for recurrent transactions between producers, middlemen,
and consumers.[26] Thus, unlike the Neo-classical paradigm of a discrete transaction,
the contractual relations between traders in markets with middlemen are "relational
contracts"[27] because of the recurrent process of profit making by merchants. In
game-theoretic terminology, the trading game played by merchants in a middleman
economy is a reiterated game or "super-game."[28]

The second distinctive feature is that markets with middlemen are characterized
by informational asymmetry in the producer-middleman market and the middleman-
final consumer market: producer-sellers know only of the prices in their own
market and not of the prices in the resale (second) market, while final consumers
know of prices in the second market and not of prices in the first market.
Only the middleman possess information on prices in both markets because in his
role or identity as the middleman, he is both a buyer (in the first market) and
a seller (in the second market).[29] Price information flowing between the two markets
is the result of entrepreneurial activities of middlemen.

The third distinctive feature of the middleman economy is that the middleman
must engage in a sequence of two bilateral transactions in order to realize his
profits; he must first buy goods from the producer located in the first market
before he can resell the same goods to ultimate consumers located in the second

market.[30] The need to engage in a sequence of transactions necessarily introduces

a time dimension into the exchange process in a middleman economy. Depending

on the technology of transacting, breach of contract becomes a possibility in an

exchange economy in which traders engage in executory contracts rather than spot

contracts.

Consider first an economy where the technology of transacting requires all

transactions to be conducted as spot transactions. In such an economy possession

of money and inventories are essential for any transaction. For the profit-

seeking middleman, he must begin with a sum of money (M) which he can exchange

for producer's goods (C), which he can resell to consumers for a larger sum of

money (M'), the difference M'-M being his gross profit margin.[31] In this sequence

of two simultaneous exchanges between goods and money, the middleman is able to

realize his profits without facing risks of breach of contract. In an economy

where all transactions are conducted as spot transactions, there is no role for

contract law to coordinate the activities of the interdependent traders. The

institutions of money and inventories allow pairs of interconnected traders

to achieve decentralized pairwise optimality and through the whole network such

exchanges allow the system to achieve coordination of the activities of inter-

dependent traders. But holding money and inventories are not costless activities.

The requirement of spot transactions acts as a constraint preventing middlemen

from exploiting all profitable opportunities for arbitrage if some traders run

short of money or inventories at any step in the sequence of bilateral spot

transactions. When the "constraint of prior possession in money or inventories"[32]

is binding, this constraint can be a source of or coordination failure.

Consider an alternative technology of transacting involving forward contracts

in goods and money which enhances the efficiency potential of an exchange economy.

Consider the following example where producer A and middleman B have entered into a bilateral executory market contract involving promises to deliver goods in the future for payment of money in the future. The terms of the contract are as follows: A promises to transfer to B right to ownership of a specified quantity and quality of a specified commodity and promises to deliver the goods to B at a specified future date, t+1. In consideration for A's promise to deliver the goods in the future, B promises to transfer to A rights to ownership of a specified sum of money, $100 and promises to pay A at a specified future date, t+2. With this contract established between A and B, B now owns a "claims to A's goods" contract (X_A) against A. In reliance upon A to honour the contract to deliver the goods at t+1, B now sells forward his X_A contract at a higher price to a final consumers, C incurring reliance costs of $5, the expenditures involved in searching for the final consumer and entering into an executory contract. The terms of the executory contract between B and C are as follows: B promises to deliver goods to C at t+1 in consideration for C's promises to pay a specified sum of money $120 at t+2. In this sequence of two bilateral executory contracts, B becomes the profit-seeking middleman-entrepreneur who started out with no money but ended with his "expectation interest", a subjective gross profit of $20 (before deducting reliance costs) and a net subjective net profit of $15 (gross profits less reliance costs). That is to say, prior to B's completion of his set of bilateral executory contracts, B's profits are only ex ante subjective profit expectations. The profit expectations become objective actual profits only if all traders honour their contracts. An economy in which contracts are in the form of executory contracts, mutual exchange of promises, thus increases the efficiency potential of an exchange economy. But the attainment of Pareto-efficiency

also depends crucially on the mutual cooperation of traders in honouring

executory contracts. If one of the contracts fails to materialize--either

because of seller's breach or buyer's breach--the middleman's profit expectations

will be disappointed.

Suppose traders operate in a Hobbesian "state of nature" in which there

are no laws or customs to constrain traders from breach of contract. In such

a setting characterized by contract uncertainty, any trader has an incentive

to behave "opportunistically"[33] by breaking contracts whenever it is profitable

to do so. Under contract uncertainty, breach of contract is a source of

coordination failure (disequilibrium) because plans and expectations of inter-

dependent traders fail to mesh. Hence profit opportunities for some entrepreneurs

will not materialize.

Imagine that t+1, A chooses to break his contract to deliver goods to B

because he has the opportunity to sell the goods to another middleman, D, who

offers to buy from A at a higher price of $110. As a result of A's breach, B

is involuntarily forced to break his contract to deliver goods to C so that

B's net profit expectations of $15 failed to materialize. A has imposed

social costs on B so that B is the victim of an "exchange externality."[34]

It is this lost of profit expectations arising from breach of contract that

makes it so important for traders to establish "rules of the game." Hence in

a middleman economy characterized by contract uncertainty, Pareto-optimal "rules

of game" for internalizing of Pareto-relevant externalities will be predicted

to emerge by public choice.

I.2 Public Choice of the Pareto-optimal "Rule of the Game"

What Pareto-optimal rules of the game will be predicted to emerge from public choice by traders in a middleman economy? Damage rules could be designed to protect the restitution, reliance or expectation interests of the contracting parties.[35] In our example, A and B might enter into a constitutional contract to choose between rules which protect reliance or expectation interest.

(a) A rule that protects plaintiff's "reliance interests": Under this rule, B will be compensated for $5, reliance costs which will restore him to his initial no-trade position vis-a-vis trader C. However, under this rule, B has wasted his time in engaging in entrepreneurship since his lost profits are not compensated. A rule that protects plaintiff's "reliance interest" and not his "expectation interest" compensates a plaintiff for his out-of-pocket transaction costs and not for the costs of foregone profits. These are very different kinds of costs and has very different implications for entrepreneurship.

Transaction costs, as currently understood, refer to the out-of-pocket expenditures involved in search for prices, search for trading partners, and contract negotiation and contract-enforcement costs; these are out-of-pocket transaction costs, and hence are sunk costs. Reliance costs are therefore a species of the usual transaction costs. Lost profits incurred as a direct result of breach of contract, on the other hand, differ from the usual transaction costs in that they are social opportunity costs of foregone profits which a trader involuntarily incur as a result of breach; they are pecuniary "exchange externalities." But unlike the usual kind of pecuniary externalities, rising supply price phenomenon,[36] exchange externalities are Pareto-relevant externalities.[37] Failure to internalize exchange externalities may result in bankruptcy of traders or may result in erosion of profit incentives of middlemen. In an environment in which profit expectations arising from contracts are not protected, risk averse traders will have the incentive to make private provisions for the protection of executory

contracts. Private protection of executory contracts may take various forms

including 1) searching for a reputable trading partner before entering into a

executory contract; 2) holding inventories of commodities as "buffer"; 3)

holding money in the event of breach so that the plaintiff can cover by going

into the market to purchase an equivalent quantity and quality of the good; 4)

pooling and spreading of risks by buying supplies from many instead of only one

supplier; and 5) integrating backwards to the source of supply. But each of

the solutions for internalizing of externalities generate its own species of

transaction costs.[38] Thus, while exchange externalities by themselves are not

considered to be a species of transaction costs, they are a source of transaction

costs.[39] Under a rule which protects plaintiff's "reliance interests", the

high transaction costs involved in private protection of traders profits

expectations may squeeze profit margins to such an extent that it is no longer

profitable for middlemen to stay in markets, thus causing "market failure."[40]

(b) A rule that protects plaintiff's "expectation interest": Under this

rule, B will be compensated for $15 in damages for his net profit losses. It is

clear that under this rule, B recovers not only his reliance costs but also his

profit expectations.[41] This will restore B to a position as if A has honoured

his contract to B.[42] From the point of B, this rule is efficient because A is

providing insurance to B, insuring B against risks of breach since his net profit

expectations will be protected whether or not A chooses to breach his contract.

From the point of view of B, a rule that protects the plaintiff's "expectation

interest" internalizes exchange externalities and hence facilitates entrepreneurship.

But such a rule will only emerge only if there are mutuality of interest.

From the point of A, however, a rule that protects the plaintiff's "expectation

interest" is inefficient because it prevents A from engaging in "efficient breach"[43]

(that is A can compensate B for his lost profits and still can make himself off by recontracting with D). In order for A to engage in an efficient breach, A must be able to foresee at the time D comes along to offer him a higher price of $110 for his goods: a) that if he breaches the contract with B, the lost profits suffered by B are caused solely by his breach; and b) the magnitude of B's lost profits. Because of the recurrent nature of the transactions between A and B, and because A knows the identity of B as the profit-seeking middleman who buys in order to resell for profit, A can perfectly foresee that his breach will cause B to lose profits. Hence the first rule of Hadley v. Baxendale is embedded in the contractual relations between traders in a middleman economy.[44] However, B cannot foresee the exact magnitude of B's profit losses and hence he cannot engage in efficient breach. This is due to the informational asymmetry that charaterize producer-middleman markets: Unlike middleman B, A knows only of prices in one market and not the price of the good in the resale market. Hence A has no way of estimating the size of B's lost profits.

If A insists that B, in order to obtain insurance from A, must choose a rule that protects the plaintiff's "expectation interests", subject to the second rule of Hadley v. Baxendale (i.e. B must communicate to A the size of his lost profits at the time they negotiate the contract), B is not likely to agree on such a rule. This is because such a rule which requires B to disclose the size of his profit losses is likely to create both a free-rider problem and a moral hazard problem which will almost certainly discourage middleman-entrepreneurship.

An essential element of middleman-entrepreneurship is possession of information of price differentials in different markets. Such price information may be

deliberately acquired by middlemen investment in information, or may be acquired

because of superior ability of middlemen to perceive profit opportunities for

arbitrage.[45] Price measures the relative value of commodities. The middleman-

entrepreneur, by buying goods at a lower price in one market and reselling the

same goods at a higher price in another market has, according to Kirzner's theory

of entrepreneurship, has thereby created a new value (profit opportunity) which

had not hiterto been discovered. Thus, the entrepreneur is, entitled to

appropriate this new value for himself according to the "finders-keepers' ethics."[46]

Only by assigning to B--the trader with superior access to information on

price differentials--a property right in information and also a property right

in the newly created value (profit opportunity) will B have the incentive to

engage in profit-seeking activities. Imposing the second rule of Hadley v.

Baxendale, as an adjunct to the rule that protects the plaintiff's "expectation

interests" is tantamount to a requirement that the private benefit of information

on price differentials is to be shared with A at zero cost to A. If B is to

provide information as a public good to A, the free-rider problem associated

with supply of public goods arises.[47] B will have no incentive to invest in

information which is essential for entrepreneurship. In addition, if A is able

to appropriate B's information on price differentials costlessly, this may give rise to

a moral hazard problem. The nature of the moral hazard problem is that A, realizing

the profits to be made from reselling his goods, may have the incentive not to

enter into a contract with B. A may, instead, decide to integrate forward

into marketing, by-passing the middleman, and selling his goods directly to the

final consumer if he percieves that the profits from doing so outweight the costs

of searching for final consumers. Because of the free-rider problem and the

moral hazard problem there is therefore no incentive for B to communicate to A

the size of his lost profits at the time A and B are negotiating their contract.[48]

(c) A rule that protects the plaintiff's "Expectation Interest ", subject
to the mitigation rule.

Fortunately a damage rule does exist which protects plaintiffs' "expectation
interest" but does not require plaintiff to disclose information on the size of
the profit losses. Such a rule requires B to mitigate damages at the date of
breach. The impact of the mitigation principle is to allow defendant to objectively
quantify the magnitude of B's lost profits, while eliminating the free-rider
problem and the moral hazard problem. For goods which are fungible (i.e. easily
replaceable) and hence have a ready market, the plaintiff must take reasonable
steps to mitigate his losses by going into the market to buy an equivalent quantity
and quality of goods to replace the goods. By buying from another seller at the
time of A's breach, and delivering the goods to C, B is not made worse off by
A's breach if the market price remains unchanged from the contract price. If
the spot price for the goods rises to $107, on the other hand, A must compensate
B by the difference in contract price and the market price i.e. $7 in order to
make B whole.[49] The use of the contract price-market value damage rule performs
two useful functions: 1) the rule restores plaintiff to a position as if
A has honoured the contract, and 2) allows the potential contract breaker to engage
in efficient breach. At the time that D appears on the scene to offer A a
higher price of $110 for his goods, A can foresee that his breach of contract with
B will cause B to incur lost profits. A can also perfectly foresee the magnitude
of the lost profits since he has information on prices in his own market at the
time of his breach. Thus A can breach his contract with B, compensate B for
$7 in lost profits and still make himself better off by $3 in recontracting with
D. The value of the contract price-market value damage rule to the potential contract
breaker is that he has the <u>right</u> to breach contracts provided he pays compensation to the
victim for the difference between the contract price and market price
of the goods. The right to breach is a valuable right because A can choose
between honoring or breaking contracts in response to benefit-cost calcul-
ations.

To this point, we have analyzed the constitutional choice of Pareto-
optimal contract rule in terms of a two-trader economy. In such a two-
person exchange economy, the decision-making costs of getting together

to agree on the Pareto-optimal rule would be low; the rule would be predicted

to emerge by unanimous consent.[52] In markets with many middlemen, an n-person

economy, the decision-making costs would increase as the size of the group

necessary to secure unanimous agreement increases. The high decision-making

costs of securing unanimous consent among numerous middlemen however, are

counterbalanced by the homogeneity of shared interests and expectations of

members of the middleman group. In addition, if middlemen belong to the same

ethnic group (e.g. Jews in Medieval Europe, Chinese middlemen in Southeast

Asia), the codes of mutual aid embedded in the ethnically homogeneous middleman

group will further reduce decision-making costs. Thus in a close-knit

homogeneous middleman group, the Pareto-efficient contract rule would be

predicted to emerge in the sub-group of merchants by unanimous or close to

unanimous agreement. In the self-government of the sub-group of merchants,

the emergence of the "rules of the game" provides the constitutional frame-

work for regulating the contractual relations between merchants. Historically,

the set of rules merchants created to regulate the relations between merchants

within national boundaries and across national boundaries was embodied in

the Law Merchant. By late 18th century in England, Lord Mansfield declared

that the traders' law was not a special, unusual customary law, but would be

applied by all of his Majesty's judges: "The Law Merchent is the law of the

land."[53] Thus by late 18th century in England, the Law Merchant had evolved

into the modern law of contract via the state appropriating the Law Merchant

for itself and generalizing the Law Merchant to apply to all individuals-

merchants and non-merchants alike within the boundaries of the nation-state.

This process of "double institutionalization of norms"[54] may be interpreted as a low decision-making cost method of establishing legal norms of contractual behaviour. This interpretation of the evolution of contract law is consistent with the law and eocnomics literature on the efficiency of common law evolution in which common law judges are seen to behave "as if" they are guided by efficiency considerations.[55]

I. 3. Contract Law, Intangible Property Rights, and Merchant-Capital

The emergence of the Law Merchant/contract law in an exchange economy constitutes a Pareto-superior move in three ways. First, by legally protecting traders' "profit expectations", all potentially Pareto-relevant exchange externalities are internalized. The internalization of negative externalities transmites traders' reasonable expectations of future profits into intangible assets which traders can appropriate for themselves as realized profits.[56] As Fuller and Perdue states it"

> The essence of a credit economy lies in fact that it tends to
> eliminate the distinction between present and future (promised)
> goods. Expectations of future values becomes, for purposes of
> trade, present values. In a society in which credit has become
> a significant and pervasive institution, it is inevitable that
> the expectancy created by an enforceable promise should be regarded
> as a kind of property, and breach of the promise as an injury to
> that property.
>
> In such a society the breach of a promise works an "actual"
> diminuation of the promisee's assets.[57]

Or as Atiyah puts it, "a plaintiff with an egg was, in short, entitled to be treated as though he had a chicken".[58] In the context of the mercantile economy in which merchants are engaged in the recurrent process of buying and reselling for profit, the "chicken" at the end of the cycle is in fact, merchant-capital. In protecting traders' profit expectations, Contract Law therefore facilitates entrepreneurship and the process of capital accumulation. Second, legal

protection of traders' expectation interest reduce the transaction costs of

private protection of executing contracts, hence making it possible for scarce

resources to be channelled into trading. Third, Contract Law by imposing

liability for damage on the contract-breaker <u>standardizes</u> contractual behaviour

thus making it possible for new markets to appear as strangers enter into

impersonal legally-binding relations across kinship, ethnic, or tribal boundaries,

regardless of the status of contracting parties. The progress of society

Sir Henry Maine wrote is from "status" to contract.[59] We may therefore interpret the

emergence of Contract Law that protects traders' expectation interest as attempts

by traders in an economy to achieve Pareto-efficiency under contract uncertainty

via the internalization of externalities which facilitate entrepreneurship,

capital accumulation and the expansion and growth of markets.

II. The Emergence of the Hadley v. Baxendale rule: Discrete Transactions
    between Non-Merchants

The alternative setting we are considering - the economy of mid-19th

century England - is very different from the predominantly mercantile economy

of 18th century England. England in the mid 19th century was in the midst

of the Industrial Revolution with its accompanying transportation revolution.

Railways and steamships providing speedy transportation of goods within national

markets and to foreign markets, hence contribute to economic development

by connecting markets. New class of industrial entrepreneurs emerged.

Increasingly transactions were discrete transactions between non-merchants who

do not share common interests or set of common expectations. Disputes and

misunderstandings will therefore be more frequently in dealings between non-

merchants. New rules must be created to resolve conflicts. Hadley v. Baxendale

is a case involving a dispute between two non-merchants, as noted. The defendant a common carrier which is in the business of transporting all kinds of goods, cannot reasonably be expected to know that a delay in delivering of crankshaft caused the mill to stop operations and resulted in lost profits. To impose liability for unforeseen lost profits (consequentials) damages on the defendant is to protect the plaintiff's "expectation interest" at the expense of the defendant's "expectation interest." In a situation of irreconciliable conflicts of interest between two profit-maximizing individuals, whose "expectation interest" should the law protect?[60]

The Hadley court's resolution to this conflict of interest is to involve the foreseeability rule: If the plaintiff wants his "expectation interest" to be legally protected in the context of a discrete transaction between the contracting parties, he must make sure that the defendant possess information -- either imputed or actual -- of the consequences of his breach. The defendant's liability depends on information of the consequences of breach.

From the viewpoint of our theory of the evolution of contract law, there is nothing surprising about the rule of foreseeability as the key determinant of the extent of the liability of the defendant. In a discrete transaction between non-merchants, communication of information to the potential contract-breaker would provide incentives for the latter to take precautions against a breach thus internalizing a potential negative externality which may force the defendant into bankruptcy. Unlike the middleman economy, the informational requirement imposed by the second rule of Hadley v. Baxendale would not create a free-rider problem or a moral hazard problem in a situation where the contracting parties are in very different lines of business. What the Hadley

court had done was to make explicit and to generalize the foreseeability rule

embedded in the sub-group of merchants to cover discrete transactions between

non-merchants. The Hadley v. Baxendale rule allows risk-averse potential

contract breakers to better protect their ~~respect~~ive property rights in their

"profit expectations."

Although the Hadley v. Baxendale rule is a judge-made rule, such a rule may

be predicted to emerge by public choice. If Hadley and Baxendale were to go

behind the Rawlsian "veil of ignorance"[61] (i.e. they have no knowledge of their

status as plaintiff or defendant), it may be predicted (following Buchanan and

Tullock) that risk averasion will lead Hadley and Baxendale to choose the

foreseeability rule.

III. Application of the Foreseeability Rule to Other Lost
      Profits Damages Cases

Since the famous English case which established a landmark in contract

law courts have applied the foreseeability rule to numerous lost profits

damages cases. In some instances, courts have allowed plaintiffs to recover

lost profits, while denying recovery in other instances. Is there consistency

in the application of the foresseability rule to lost profits damages cases so

that efficient outcomes are to emerge? This section of the paper provides an

preliminary attempt to address this question. It will only cover a very

small sample of the numerous lost profits damages cases. Our purpose is to

see whether 1) our evolutionary theory of Contract Law provides a unifying frame-

work for analyzing the courts decisions' and 2) whether our theory can explain

the "middleman" exception to the foreseeability rule in the Uniform Commercial

Code.

(a) <u>Victoria Laundry v. Newman Industries</u> [1949] [62]

The plaintiff, a firm engaging in the laundry business, entered into a contract with defendant, an engineering firm to purchase a boiler which is to be delivered to the plaintiff as soon as possible. The defendant delayed the delivery by 20 weeks. Plaintiff claimed damages for lost profits arising from their normal business as launderers and dyers and additional profits lost from not being able to perform extremely lucrative dyeing contracts. The court allowed plaintiff to recover normal business profits lost as a result of the breach under the first rule of <u>Hadley</u> v. <u>Baxendale</u>: the defendants as <u>engineers</u> possessed imputed knowledge that a breach of contract to deliver the boiler on time to the laundry firm will lead to lost profits. It is interesting to speculate that had Hadley entered into a contract directly with the engineers in Greenwich to repair the broken crankshaft and to deliver the shaft back to plaintiff when it is repaired, then Hadley would be able to recover lost profits should the defendant breached the contract by delay in its delivery.

(b) <u>The Heron II. Koufou v. C. Czarnikow Ltd.</u> (1969) [63]

The plaintiff entered into a contract with defendant to carry sugar from Constanza to the market in Basrah. The plaintiff specified that he wished to sell the sugar as soon as the ship arrived in Basrah. Defendant breached the contract by arriving in the market nine days late. When it arrived the price of sugar had fallen. Plaintiff claimed for lost profits measured by the difference between the market price at the time of arrival and the price nine days earlier. The fact the defendant possessed imputed knowledge that loss of profits could arise from price fluctuations as a result of his breach, allowed plaintiffs to recover lost profits under the first rule.

(c) H. Parsons (Livestock) Ltd. v. Uttley Ingham & Co. Ltd. [1978] [64]

The plaintiff entered into contract with defendant to provide a hopper

for storing pig food. Defendants, sheet metal workers specializing in construction

of bulk food storage hoppers, breached the contract by failure to provide for

proper ventilation so that food became mouldy and many pigs died from eating the

food. The court awarded plaintiff damages for loss of pigs on the ground that the

defendants could have foreseen that   pigs would die from the defective

installation of a feed hopper with a ventilator.

(d) Horne v. Midland Railway [1873] [65]

The plaintiff entered into a contract with defendant for the transporta-

tion of shoes to London by a certain date. The defendant delayed the transportation

by one day. As a result of this delay, the plaintiff lost the opportunity to sell

the shoes at an exceptionally high price. The court ruled that the defendants were

not liable for this exceptionable loss because they could not foresee the loss of

a profits from an unusually lucractive contract.

In those four often cited lost profits damages cases in contract law

textbooks, there is an underlying consistency in applying the foreseeability

rule to achieve efficiency. The party who has information on the consequences

of a breach either imputed or actual -- is held liable for lost profits since

he is presumed to take account of the consequences of breach in making a

decision whether or not to breach a contract. In this way, a potential contract

breaker internalizes a Pareto-relevant externality, hence protecting his

expectation interest.

Our theory can also throw light on the "middleman" exception to the

foreseeability rule of Hadley v. Baxendale which is found in comment 6 to

the Uniform Commercial Code (U.C.C.)[66]

> "In the case of sale of wares to one in the business of
> reselling, resale is one of the requirements which the seller
> has reason to know within the meaning of subsection (2) (a).

Subsection 2(a), of section 2-713 reads:

> Consequential damages resulting from the seller's breach
> include any loss resulting from general or particular
> requirements and needs of which the seller at the time of
> contracting had reason to know and which could not reasonably
> be prevented by cover or otherwise.

That is to say, under the U.C.C. a middleman who is victim of seller's breach

is entitled to recover lost profits damages without proof of foreseeability

beyond his identity as middlemen. This is consistent with our theory of contract

law appropriate to the needs of a middleman economy. A good example of

recovery by middleman-seller of lost profits damages is the case of Jennings

v. Lamb (1956).[69] The plaintiff, a lumber middleman, entered into a contract

with defendant for the purchase of timber for resale. Before plaintiff

resold the lumber, which had not yet been delivered by defendant, defendant

breached the contract by selling the lumber to someone else. Plaintiff was

unable to cover by going into the market to replace the lumber because of

scarity of supply. The court, satisfied that plaintiff could have sold all

the lumber purchased from the seller, awarded plaintiff lost profits based

on the difference between the contract price of lumber and the price at

which plaintiff could have resold them. Plaintiff did not have to prove

foreseeability in order to recover lost profits since the seller knew

the identity of the plaintiff as a lumber-dealer.

When the middleman, in his role as seller, suffers from buyer's breach of contract of non-acceptance of the good, the middleman is also entitled to recover seller's lost profits damages without the proof of forseeability on the part of the contract-breaker. What is interesting in the case of buyer's breach conpared to seller's breach is that there is an asymmetry in the measurement of lost profits damages, Before the U.C.C., the usual measure for lost profits damages for buyer's non-acceptance is the difference between the unpaid contract price and the market price. This measure assumes that the middleman can recoup lost profits by going into the market to find another buyer. Under the U.C.C., the middleman is also entitled to receive lost profits damages even when he finds another buyer to replace the buyer who breached and sold the goods to the second buyer at the original contract price. A good example of a "lost volume seller" who recovers lost profits damages is the case of _Neri_ v. _Marine Corp._ (1972).[68] The plaintiff, Marine Corporation, suffered lost profits damages on the resale of a boat after buyer, Neri, breached the contract by non-acceptance. The middleman then resold the boat to another customer for the same contract price ($12,000) and made a profit of $2,500. By the usual logic, the middleman have internalized the externality. Yet, the middleman sued the defendant for lost profits of $2,500, arguing that he would have sold another boat to the second buyer whether the first buyer breached the contract or not. The fact that the first buyer breached the contract deprived him of one lost sale and hence lost profits. The court awarded plaintiff lost-profits damages on the

grounds that the dealer has an "inexhaustiable" supply of boats, hence the second buyer did not replace the first. In the law and economics literature, the enigma of awarding lost profits to the lost-volume seller has been called "lost-profits puzzle".[70] Although there is this asymmetry between the award of damages to the middleman when the middleman is the seller and when he is the buyer, the issue here is not one of foreseeability but of the correct measurement of the middleman's lost profits.

<u>Conclusion</u> (To be written)