A Unifying Theory of Contract Damage Rules

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David W. Barnes & Deborah Zalesne†

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INTRODUCTION

Unifying principles for calculating damages lie in the shadow of contract law. These principles reflect the goals underlying the rules formalized in Article 2 of the Uniform Commercial Code (UCC), the Restatement (Second) of Contracts and their computational methods. The Shadow Code presented in this Article combines these principles and formulas into a new image of legal remedies for contract breach. This reconceptualization is based on the foundational principle that parties injured by contract breach are entitled to any surplus of benefits over costs those parties would have realized had the breaching parties performed. The Shadow Code reflects the modern understanding that damages are intended to ensure that the injured party is as well off as if the other party had performed as promised.

3. This Article is not concerned with either equitable remedies for contract breach, such as restitution and specific performance, remedies for breaches of non-contractual promises, such as those involved in cases of promissory estoppel, or remedies when the existence of the contract is denied, as in cases involving rescission.
4. The Shadow Code’s underlying principle is “foundational” in the same sense that the formal statements of the goals of contract damages in the U.C.C. and Restatement are—each articulates an equivalent compensatory premise upon which computational formulas are based and to which exceptions apply. The most significant exceptions are described in Section 4 of the Shadow Code, infra, Part III.C, which codifies the traditional limitations on recovery to those losses that are foreseeable, demonstrable, and unavoidable. George M. Cohen’s article, The Fault Lines in Contract Damages, 80 VA. L. REV. 1225 (1994), may be the most complete exploration of the contract doctrines that lead away from the foundational principle. His thesis is that courts’ departures from the foundational principle can be systematically explained by their tendency to create desirable incentives for parties to, for instance, perform contracts that should be performed, refrain from opportunistically breaching other contracts, avoid making contracts that should not be made, and take precautions to avoiding breaching. Id. at 1231-32. We do not question that limitations on the foundational principle have desirable incentive effects. See, e.g., David W. Barnes, The Anatomy of Contract Damages and Efficient Breach Theory, 6 S. CAL. INTERDISC. L.J. 397, 470-80 (1998) [hereinafter, Barnes, Anatomy of Contract Damages] (considering the incentive effects of the traditional limitations on recovery identified above, liquidated damage rules, and rules governing awards of specific performance). Nor do we propose in the Shadow Code any rules that modify the incentive structures created by the exceptions to the principle. As a result, Professor Cohen’s classification of cases as deservedly getting special treatment by limitations and exceptions is not affected by the surplus-based approach.
5. See U.C.C. § 1-106(1) (“The remedies provided by this Act shall be liberally administered to the end that the aggrieved party may be put in as good a position as if the other party has fully performed.”); RESTATEMENT § 347 cmt. a (“Contract damages are
This Article justifies restating the law of damages in a single black letter rule applicable to all breaches of contract. The surplus-based approach to damages recognizes an injured party’s entitlement to the difference between the surplus he or she would have realized had the other performed as promised and the actual surplus obtained. Section 1 of the Shadow Code articulates this central principle. It applies to all types of parties injured in all types of partial and total contract breaches, whether consumers or merchants, buyers or sellers.

The central principle of the Shadow Code is as dramatic a restatement of contract damage rules as the Learned Hand formula was for the theory of negligence. Judge Hand recast the “community expectations” approach in a way that gave substantive content to what a reasonable person would have done in similar circumstances. The BPL formula focused scholars’ attention not only on how to prove negligence, but on what objectives a negligence rule furthers. The surplus-based approach to contract damages described in the Shadow Code analogously balances costs and benefits—those associated with performance and those associated with breach. By relating surplus to the improvement in wellbeing, whether associated with performance or breach, the Shadow Code focuses attention on the motivation for awarding damages. The Learned Hand formula is an

ordinarily based on the injured party’s expectation interest and are intended to give him the benefit of his bargain by awarding him a sum of money that will, to the extent possible, put him in as good a position as he would have been in had the contract been performed.

6. While Judge Learned Hand had articulated the cost-benefit approach to analyzing negligence since at least 1931, see Stephen G. Gilles, United States v. Carroll Towing Co.: The Hand Formula’s Home Port, in TORT STORIES 18 n.37 (Robert L. Rabin & Stephen D. Sugarman eds., 2003) (quoting opinions dating from 1931 to 1940), the first algebraic description of the formula came in United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947), where, evaluating the costs and benefits of having a bargee present on the barge at a particular time, Judge Hand stated:

Since there are occasions when every vessel will break from her moorings, and since, if she does, she becomes a menace to those about her; the owner’s duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) the probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B < PL.

Carroll Towing Co., 159 F.2d at 173.

7. Gilles, supra note 6, at 33-34 (describing the “community expectations” approach as looking to social understanding and norms and what we can fairly expect from one another as a guide to society’s best interests).

articulation of what the law of negligence implicitly requires and how reasonable people behave, whether they know it or not. The surplus-based approach similarly describes what the law has already embraced, but has not implicitly recognized.

At the same time, the surplus-based rule is unlikely to be as controversial as the Learned Hand negligence formula and is much easier to apply in practice. Judge Hand recognized in Carroll Towing that his cost-benefit analysis dealt with incommensurables, variables for which information is unavailable and between which comparisons cannot be made. Most contract cases, by contrast, involve monetizable costs and benefits. For contracts cases, non-quantifiability is routinely handled by rules of evidence (losses must be proved with “reasonable certainty”) and blanket prohibitions (no subjective or psychic losses allowed “even if the limitations of unforeseeability and uncertainty can be overcome”). The Learned Hand test was also a change from a cultural “community expectations” perspective to an economic perspective. The surplus-based approach requires no novel types of unusual information. While reflecting a consideration of costs and benefits, the surplus-based approach alters neither the philosophic orientation of damage rules nor, generally, the

9. Conway v. O'Brien, 111 F.2d 611, 612 (2d Cir. 1940) (“All these are practically not susceptible of any quantitative estimate, and the second two [factors, P and L] are generally not so, even theoretically. For this reason a solution always involves some preference, or choice between incommensurables, and it is consigned to a jury because their decision is thought most likely to accord with commonly accepted standards, real or fancied.”).

10. See Gilles, supra note 6, at 28-33 (discussing these two criticisms of the Learned Hand formula).

11. See E. Allan Farnsworth, Contracts § 12.15, at 800 (4th ed. 2004); Restatement § 352. This rule is reflected in section 4 of the Shadow Code, infra Part III.C.

12. Farnsworth, supra note 11, § 12.17, at 810. See, e.g., Silva v. Albuquerque Assembly & Distrib. Freeport Warehouse Corp., 738 P.2d 513, 514 (N.M. 1987) (holding that “damages for emotional distress are not recoverable in an action for breach of an employment contract . . . in the absence of a showing that the parties contemplated such damages at the time the contract was made”). Sometimes, however, the result is justified on the ground of unforeseeability or uncertainty. See, e.g., Hatfield v. Max Rouse & Sons Northwest, 606 P.2d 944, 951 (Idaho 1980) (denying recovery to owner of logging equipment for “emotional distress” resulting from auctioneer’s sale of equipment below minimum specified price because it was “simply impossible to imagine that the parties . . . contemplated that [the owner] might suffer emotional distress upon its breach.”). There are several exceptions to the rule denying recovery for emotional distress. “Some courts have looked to the nature of the contract and made exceptions . . . where serious emotional disturbance was a particularly likely result of breach.” Farnsworth, supra note 11, § 12.17, at 810. Other courts have allowed recovery where the nature of the breach was “reprehensible, perhaps amounting to a tort, or that it caused bodily harm.” Id.

13. Categorical prohibitions of recovery of certain types of losses are discussed infra text accompanying notes 138-147.
bottom line amount of damages awarded. This Article demonstrates the equivalence of the Shadow Code to both Article 2 of the U.C.C. and the Restatement (Second) of Contracts.

The Shadow Code reveals goals of legal remedies for breach of contract that have long been buried in the details, much as the principles of the equitable remedy of restitution were revealed in the Restatement of Restitution. Principles of restitution had been embedded in the common law for centuries before the Restatement of Restitution was published in 1937. Using the element of unjust enrichment as the “common factor” to unite the disparate rules governing this remedial approach, the Restatement of Restitution brought to light principles lying in the shadows. The key to understanding restitution lay in defining “unjust” and “enrichment.” The key to the surplus-based approach is distinguishing between “anticipated surplus,” the improvement in wellbeing the injured party would have realized had the other performed as promised, and “actual surplus,” the improvement in wellbeing (often negative) resulting from the breach.

Just as the Restatement of Restitution followed its basic principle with definitions of what “enriched” and “unjust” mean, the Shadow Code follows its basic principle in section 1 with only two explanatory sections, defining in sections 2 and 3, respectively, the difference between anticipated and actual surplus. The principle of lost surplus relies on a comparison of the benefits and costs of contracting and recognizes a definition of benefits as broad as the Restatement of Restitution, which states that a person “confers a benefit upon another if he . . . in any way adds to the other’s security or advantage.” Costs may similarly be defined as subtracting from the other’s security or advantage. Sections 2 and 3 of the Shadow Code illustrate the broad range of costs and benefits relevant to calculating lost surplus. With a general principle in section 1 and explanatory sections 2 and 3, the Shadow Code draws together hugely

16. The basic principle of restitution is that “[a] person who has been unjustly enriched at the expense of another is required to make restitution to the other.” See Restatement of Restitution § 1.
17. See id. § 1 cmts. a-c.
18. Restatement of Restitution § 1 cmt. b states that:
A person confers a benefit upon another if he gives to the other possession of or some other interest in money, land, chattels, or choses in action, performs services beneficial to or at the request of the other, satisfies a debt or a duty of the other, or in any way adds to the other’s security or advantage. He confers a benefit not only where he adds to the property of another, but also where he saves the other from expense or loss.
disparate rules. It accomplishes a unification of legal remedies comparable in scope to the objective of the Restatement of Restitution. The Shadow Code spares future generations of law students, lawyers, and judges the difficulty of applying different rules for cases involving sales of goods and for other exchanges and, within the realm of sales of goods, different rules for buyers and sellers in a multiplicity of factual contexts.

Part I of this Article discusses the failings of present approaches to contract damages. It focuses on the unnecessary multiplicity of rules that obscure the law’s purposes and on conflicts in terminology that hamper the law’s straightforward application. Current translations of underlying remedial principles into formulas for computing damages are unclear, ambiguous, conflicting and fail to address all potential cases. While the interest-based approach of the Restatement is without principled justification and is redundant, the specific formulas in the U.C.C. are so specialized in their application that the underlying rationale is lost, and the court’s time is wasted attempting to interpret the statute. The legal literature on contract damages has produced a unifying theory for legal remedies but has not translated that theory into a practical set of damage rules. The computational approach of the Shadow Code explicitly reflects both the theory and its practical application.

In May 2003, the membership of the American Law Institute approved proposed revisions to Article 2 of the U.C.C.\(^\text{19}\) These revisions resolve a few internal ambiguities and inconsistencies in the damages sections,\(^\text{20}\) but continue to treat buyers and sellers differently, and fail to resolve the broader problems. The Shadow Code’s simplicity and focus on the underlying principle of ensuring the injured party obtains its lost surplus eliminates the conflict.

In addition to inherent ambiguities and unnecessary complexity, there is also inconsistent language employed in different sources of law. Courts, the Restatement, the U.C.C., and the legal literature have adopted

\(^{19}\) See Amendments to U.C.C. Art. 2 - Sales, Proposed Final Draft, approved on May 13, 2003 [hereinafter Rev. U.C.C.].

\(^{20}\) For example, to parallel the provision in the cover section (§ 2-712), and to reflect judicial interpretations, the revisions clarify that the failure of an aggrieved seller under section 2-706 does not bar that seller from any other remedy. See Rev. U.C.C. § 2-706(7). The new section (§ 2-708(1)(b)) clarifies when contract-market is calculated on a repudiation, and the word “unpaid” has been deleted from section 2-708(1) as “superfluous and misleading.” See Rev. U.C.C. § 2-708(1) and cmt. 1(b). In addition, in the equation for determining market damages, the revisions reverse the terms “market price” and “contract price” to read “the difference between the contract price and the market price,” to avoid confusion, because “the contract price must be the larger number for there to be direct damages.” Rev. U.C.C. § 2-708(1) and cmt. 1(c).
conflicting definitions of common terms, such as “incidental” and “consequential” damages and “lost profit.” “Consequential damages,” for instance, may include lost profits under the U.C.C., but never under the Restatement. 21 “Incidental” may refer either to expenditures a party anticipates incurring in order to earn a profit when the other party performs as promised or to expenditures the injured party would never had incurred but for the other party’s breach. 22 Courts regularly use conflicting definitions of “profit,” confusing “profit,” “gross profit,” “net profit,” and “clear profit.” 23 The Shadow Code substitutes unambiguous labels for this confusing and conflicting terminology.

Part II summarizes and critiques the attempts to reconcile and simplify the modern understanding of contract damages. Most of them have been theoretical (focusing on the underlying principles), 24 although there have been attempts to develop new computational formulas. 25 These have either been too simple to apply to the vast variety of contract cases or, if all embracing, too unwieldy to be useful. The Shadow Code offers a straightforward rule that applies to all cases.

Part III of this Article introduces the Shadow Code, which unifies the strains of legal literature, reconciles approaches to different types of contract breaches, and simplifies damage rules. It avoids the confusing interest-based language of the Restatement and resolves the ambiguities found in the U.C.C. The Shadow Code enables calculations incorporating both the reliance and expectation measures of the Restatement and recharacterizes the dominant remedial theory as one that restores “lost surplus,” rather than the one that awards expectations or net expectations. 26 There is only one basic rule in the Shadow Code and the principle underlying the calculation of damages is explicit in that rule. The result avoids the conflicting definitions employed in the two sources of law and the impression that these two sources are engaged in different tasks, rely on different premises, and have different underlying goals. Part III and the

22. Id.
24. See infra Part II.
25. See infra text accompanying notes 112-130.
Summary also demonstrate, textually and mathematically, that applying the Shadow Code generally yields results equivalent to application of the U.C.C. and Restatement formulas. It discusses the few circumstances where divergence from this equivalence (and from the well-recognized goals of compensation) may occur. These include a minority position of courts allowing an election of remedies under the U.C.C. which might result in overcompensation, blanket denial of recovery of subjective and emotional losses, undercompensation, and U.C.C. limitations on recovery of consequential damages, which is unlikely to be of any practical import.

The Shadow Code appears as four sections. Section 1 of the Shadow Code (hereinafter SC § 1) offers a single, basic, black letter rule for all contracting parties based on the improvement in wellbeing the injured party would have realized from the other’s promised performance. Sections 2 and 3 (hereinafter SC § 2 and SC § 3, respectively) describe and explain the components of the basic rule. Section 4 of the Shadow Code (hereinafter SC § 4) codifies generally recognized limitations on contract damages. Section 4 recognizes that claimed losses must not be too speculative in either their existence or amount, that an injured party must take reasonable steps to mitigate his or her losses, and that damages are limited to those reasonably foreseeable. These limitations are well established in contract law. The purpose of Section 4 is to clarify ambiguities in the rules governing limitations on recovery and to describe how damages calculated using the surplus-based approach account for these limitations.

I. PROBLEMS WITH CURRENT CONTRACT DAMAGE FORMULAS

The motivation for drafting the Shadow Code is a lack of clarity and focus in both the Restatement and U.C.C. contract damage provisions. The


28. Damages generally must be established with reasonable certainty. See Farnsworth, supra note 11, § 12.15, at 800; Restatement § 352. Damages must also be reasonably foreseeable. See Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (1854) (holding that a party is entitled only to those damages that: (1) may “reasonably be considered ... as arising naturally, i.e., according to the usual course of things,” from the contract breach or (2) “may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it”); Restatement § 351 (stating that loss may be foreseeable if it follows “in the ordinary course of events, or as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know”); U.C.C. § 2-715(2)(a) (limiting a buyer’s consequential damages to those the seller “had reason to know”). Finally, damages are not recoverable to the extent they could have been reasonably mitigated. See Restatement § 350.
problems in these sources of law lie in the Restatement's confusing and unnecessary distinction between the expectation and reliance interests and the U.C.C.'s separation of rules from the underlying compensation policy. In addition, the Restatement, the U.C.C., and the legal literature on contract damages adopt conflicting definitions of key concepts related to computation of damages. The Shadow Code resolves these problems.

A. Restatement (Second) of Contracts

The fundamental problem with the Restatement is conceptual. Its approach is based on a jurisprudential distinction between the expectation and the reliance interests that is irrelevant to calculating damages for contract breaches. The interest-based approach contrasts an injured party's expectation interest in being restored to the wealth position she would have occupied had the contract been performed, with her reliance interest in being restored to the wealth position she would have occupied had she never contracted at all. The former allows recovery of lost profits, while the latter allows recovery only for out-of-pocket expenditures. In practice, the law resorts to the latter only when proof of lost profits is impossible. In theory, the interest never changes just because the injured party has evidentiary problems. The straightforward approach of the Shadow Code ensures that the injured party obtains its anticipated improvement in wellbeing subject to its ability to prove those losses with

29. See Restatement § 344 (describing purposes underlying remedies for breach of contract).

30. Compare id. § 347 ("[T]he injured party has a right to damages based on his expectation interest") with id. § 349: As an alternative to the measure of damages stated in § 347, the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed.

Id. Taking into account the limitation in section 349, requiring deduction of any loss the injured party would have suffered, the rules in practice collapse into a single principle that the injured party is entitled to obtain so much of its expectation as can be proved with reasonable certainty. See infra Part I.A.

adequate certainty. The Restatement organizes its primary measure of damages around the concept of lost value, which is properly interpreted as lost revenue. The conceptual focus of the common law, however, is the improvement in wellbeing the injured party failed to realize. The Shadow Code abandons the reliance interest (and any reference to “interests”) and substitutes the concept of “surplus” for “value.”

Damage provisions of the Restatement (Second) of Contracts are based on a distinction between the expectation and reliance interests. This dichotomy was undoubtedly influenced by Lon Fuller and William Perdue’s classic article on contract damages. The article purported to articulate a jurisprudential preference for damages based on restoring the injured party to its pre-contractual position by awarding out-of-pocket costs incurred in reliance on the other’s promise, i.e., protecting the reliance interest. Practical concerns, however, led Fuller and Perdue to adopt an “opportunity cost” measure of reliance damages almost indistinguishable from the expectation interest, which focuses on the injured party’s anticipated position if the parties perform as promised. Nevertheless, the Restatement and court opinions still refer to the “out-of-pocket” reliance interest in cases where the injured party is unable to prove lost profits with

32. The “anticipated” improvement in wellbeing refers to the likely improvement in wellbeing measured at the time the contract was to have been performed rather than the time of formation, subject to conventional limitations on damages requiring foreseeability, mitigation, and proof of the existence and amount of those losses with reasonable certainty. See Barnes & Zalesne, supra note 27 § 2 cmts. a-f; infra Part III.C, SC § 4.

33. See Fuller & Perdue, supra note 26, at 52.

34. Id. at 53-54.

35. Fuller and Perdue came perilously close to eliminating any practical distinction between the reliance and expectation interests. At one point, they argued that the reliance interest includes both losses of an affirmative nature (expenditures of labor and money that are wasted if the other does not perform) and opportunities forgone. Id. at 55. Referring to those opportunities forgone as “gains prevented” by reliance on the other’s promise, Fuller and Perdue concluded that “there is nothing in the definition of the reliance interest itself which would exclude items of this sort from consideration.” Id. “Gains prevented” sound suspiciously like the “lost profits” that are included in the expectation interest. Id. By referring to opportunities forgone, Fuller and Perdue were including in the reliance measure the injured party’s lost profits on some potentially unknown, hypothetical, next-best alternative. Lost profits on the breached contract are likely to be the best available estimate of opportunities forgone and vice versa; one rarely can know because the latter often is unidentifiable. Including opportunity costs in the reliance interest threatens to destroy the distinction between it and the expectation interest. See Barnes, Net Expectation Interest, supra note 26, at 1154 (discussing Fuller and Perdue’s reliance measure). Professor Michael Kelly identifies at least three distinct reliance interests in Fuller and Perdue’s article. Kelly, supra note 31, at 1768, 1759 (describing the various conflicting interests in Fuller and Perdue’s article and the lack of clarity in their definitions).
reasonable certainty and is able to prove only the out-of-pocket expenses incurred in the thwarted attempt to earn those profits.  

There is no need to treat these cases of uncertain profit as recovery based on the "reliance" as opposed to the "expectation" theory. As Professor Barnes has elsewhere observed:

The court's limitation of damages to expenses incurred does not reflect a lack of concern for the plaintiff's lost surplus. The law's interest in placing the injured party in the position she would have occupied had the other not breached does not suddenly change. Rather, the injured party simply has failed to prove the full amount of her loss. The law's goal is to get as close as possible to the award of net expectancy consistent with its standards of proof. The latitude given to claimants in proving lost profits evidences this concern. When it has been established that a significant loss has occurred, the proof of damages need not be mathematically precise; an approximation will suffice. The award of costs incurred (expressed as reliance damages) in cases like Security Stove is simply the closest provable approximation of the net expectation amount.

The out-of-pocket measure of reliance is simply an attempt to award expectation subject to proof requirements.

36. The classic case on the reliance interest is Security Stove & Manufacturing Co. v. American Railways Express Co., 51 S.W.2d 572 (Mo. Ct. App. 1932), in which a manufacturer could not prove the quantum of profits lost due to an express company's failure to deliver its stove on time for display at a sales exposition. The court limited the plaintiff's recovery to expenditures the plaintiff had made in reliance on the express company's promised delivery. Id. at 576. There are also examples of modern cases recognizing a distinct reliance interest. See, e.g., Anderson Excavating & Wrecking Co. v. Sanitary Improvement Dist. No. 177, 654 N.W.2d 376, 383 (Neb. 2002) (focusing on the "out-of-pocket" reliance measure and rejecting injured party's claim for out-of-pocket expenditures based on the reliance interest because the injured party had repudiated the contract); Scott v. Grimmell Mut. Reinsurance Co., 653 N.W.2d 556, 562-63 (Iowa 2002) (focusing on the "opportunity cost" reliance measure and rejecting claim for reliance damage, including opportunity costs, where injured party did not offer proof of lost opportunities); Thousand Dollar Club v. Krispinsky, 47 Pa. D. & C.4th 393, 408 (following the approach of Security Stove and determining that the reliance interest was the appropriate basis for computing damages because lost profits could not be proved).

37. Barnes, Net Expectation Interest, supra note 26, at 1153 (footnote omitted).

38. If the "out-of-pocket" reliance measure permitting an injured party engaged in an unprofitable transaction to recover all of her costs, the reliance measure might allow such a plaintiff to recover more under the reliance measure than the expectation measure, thus destroying the equivalence of the measures. Contract damage rules, however, do not allow this extra recovery. See Wartzman v. Hightower Prods., Ltd., 456 A.2d 82, 86 (Md. Ct. Spec. App. 1983), holding that

[recovery based upon reliance interest is not without limitation. If it can be shown that full performance would have resulted in a net loss, the plaintiff cannot escape the consequences of a bad bargain by falling back on his reliance interest.}
of reliance, occasionally recognized by some modern courts, is similarly an approximation of the expectation interest because of its recognition of the injured party's right to the surplus it could have realized. There is no need to recognize a distinct reliance interest where the resulting measures are simply approximations for the expectation measure. The Restatement recognizes that the reliance and expectation measures yield equivalent damages in the case of a losing contract.

Where the breach has prevented an anticipated gain and made proof of loss difficult to ascertain, the injured party has a right to damages based upon his reliance interest, including expenditures made in preparation for performance, or in performance, less any loss that the party in breach can prove with reasonable certainty the injured party would have suffered had the contract been performed. Id. (citing RESTATEMENT § 349). This rule restores the equivalence between the reliance and expectation measures.

39. See, e.g., Scott, 653 N.W.2d at 562-63 ("Reliance damages are not designed to rescue the plaintiff from the consequences of a bad bargain, but to compensate him for gains unrealized as a result of the breaching party's conduct.").

40. See RESTATEMENT § 349; see also Bausch & Lomb, Inc. v. Bressler, 977 F.2d 720, 729 (2d Cir. 1992) (involving a manufacturing contract); Manganaro Bros. v. Gevyn Constr. Corp. 610 F.2d 23, 23 (1st Cir. 1979) (involving a construction contract); United States v. Mountain States Constr. Co., 588 F.2d 259, 261 (9th Cir. 1978) (involving a construction contract); L. Albert & Son v. Armstrong Rubber Co., 178 F.2d 182, 190-91 (2d Cir. 1949) (stating that recovery of reliance damages should be reduced by losses the aggrieved party would have suffered had the contract been performed, but that the breaching party should have the burden of proving the existence and amount of such losses); Kizas v. Webster, 532 F. Supp. 1331, 1332 (D.D.C. 1982) (involving an employment contract), rev'd on other grounds, 707 F.2d 24 (D.C. Cir. 1983); Gruber v. S-M News Co., 126 F. Supp. 442, 446 (S.D.N.Y. 1954) (holding that damages of manufacturer of Christmas cards against breaching distributor consists of costs of reliance, reduced by losses manufacturer would have suffered from full performance); Mistletoe Express Serv. v. Locke, 762 S.W.2d 637, 638-39 (Tex. App. 1988) (holding that reliance damages of a freight company whose contract was wrongfully cancelled should be reduced by losses the breaching party can prove the freight company would have suffered); Dialist Co. v. Pulford, 399 A.2d 1374, 1376 (Md. Ct. Spec. App. 1979) (involving a franchise agreement). According to Professor Farnsworth, the reliance measure of damages "rests on the premise that the injured party's reliance interest is no greater than that party's expectation interest." See FARNSWORTH, supra note 11, § 12.16, at 807. In the words of Fuller and Perdue, the rationale for this rule is based on the mandate of section 1-106: "We will not, in a suit for reimbursement for losses incurred in reliance on a contract knowingly put the plaintiff in a better position than he would have occupied had the contract been fully performed." Fuller & Perdue, supra note 26, at 79. See generally John E. Murray, Jr. & Harry M. Flechtnier, The Summer, 1999 Draft of Revised Article 2 of the Uniform Commercial Code: What Hath NCCUSL Rejected?, 19 J. L. & Com 1, 94 (1999) (explaining that in losing contracts where reliance damages would exceed expectation damages, recovery of reliance damages is limited and noteing that restitutionary recovery has generally not been so limited); Harry M. Flechtnier, Enforcing Manufacturers' Warranties, "Pass Through" Warranties, and the Like: Can the Buyer Get a Refund?, 50 Rutgers L. Rev. 397, 443 n.152 (1998) (noting that in losing contracts, "courts will generally deduct from reliance damages the amount that the breaching party can prove the aggrieved party would have lost on the contract," so that the aggrieved party "will not be permitted to recover more on a reliance theory than under an
Under the rule stated in section 349, the injured party may, if he chooses, ignore the element of profit and recover as damages his expenditures in reliance. He may choose to do this if he cannot prove his profit with reasonable certainty. He may also choose to do this in the case of a losing contract, one under which he would have had a loss rather than a profit. In that case, however, it is open to the party in breach to prove the amount of the loss, to the extent that he can do so with reasonable certainty under the standard stated in section 352, and have it subtracted from the injured party’s damages. The resulting damages will then be the same as those under the rule stated in section 347.41

The Restatement fails to apply this logic to profitable contracts. Applying the “proof with reasonable certainty” requirement of section 352 in cases where profits were certain to exist but uncertain in amount, the Restatement could simply have allowed recovery of out-of-pocket expenditures under the expectation interest. The Restatement rules in sections 347 and 349 do not recognize that the reliance interest is unnecessary to the calculation of damages in either losing or profitable contract cases. They unnecessarily complicate damage rules and obscure the underlying goal. A unifying rule would have been that the injured party is entitled to recover all amounts necessary to ensure his expectations subject to the section 352 proof requirements for different elements of loss. The Shadow Code embodies such a unifying approach.

B. Uniform Commercial Code Article 2

The U.C.C.’s remedial provisions reflect a supposedly “practical” approach contrasting sharply with the Restatement’s interest-based approach. U.C.C. Article 2 sections 2-706 to 2-714 describe a different rule for every circumstance in which contract breach might occur. There are different rules for buyers and sellers,42 different rules for buyers who

41. See RESTATEMENT § 349.
42. Damage rules applying to buyers are contained in U.C.C. sections 2-702 through 2-
reject goods, buyers who accept defective goods, or buyers who arrange substitute transactions when the seller breaches;\textsuperscript{43} and different rules for sellers who resell and those who do not, and those who cannot collect the purchase price.\textsuperscript{44} Because these provisions are so specifically tailored to various situations, it is impossible to keep in sight the underlying goal articulated in section 1-106(1), which is to place the injured party in as good a position as if the other party had fully performed.\textsuperscript{45} The U.C.C. rules suggest that buyers and sellers have different rights and remedies. In addition, the theoretical connection between remedies for different kinds of breaches is obscured by the welter of rules. Some buyers, for instance, are entitled to damages based on market prices,\textsuperscript{46} while others obtain damages based on the value of nonconforming goods received.\textsuperscript{47} While all of these rules are supposedly governed by the principle articulated in section 1-106(1), there is no hint in the way the rules are formulated that they are in any way connected to the compensatory goal articulated in section 1-106.

The central failing of the U.C.C., then, is the lack of connection among its damage rules and between each rule and its underlying purpose.\textsuperscript{48} The lack of obvious relationship between the rules and the goal

\textsuperscript{43} Damages for buyers who rightfully reject goods are calculated according to a formula in U.C.C. section 2-713, while recovery by buyers who accept defective goods is governed by section 2-714.

\textsuperscript{44} Damages for sellers who resell are treated under U.C.C. section 2-706, for those who do not resell under section 2-708, and for sellers who cannot collect the purchase price under section 2-709.

\textsuperscript{45} U.C.C. § 1-106(1) cmt. a. (2001).

\textsuperscript{46} Id. § 2-713.

\textsuperscript{47} Id. § 2-714.

\textsuperscript{48} Numerous articles have been written about the ambiguities in Article 2’s remedial provisions and attempting to reconcile them with U.C.C. section 1-106(1). See, e.g., Roy Ryden Anderson, Damage Remedies Under the Emerging Article 2 — An Essay Against Freedom, 34 Hous. L. Rev. 1065, 1066 (1997) [hereinafter Anderson, Damage Remedies] (arguing that the Code’s “egalitarian philosophy” of free election of remedies is “substantially undercut by the strong compensation principle embodied in section 1-106 of the U.C.C.”); Roy Ryden Anderson, An Overview of Buyers’ Damage Remedies, 21 UCC L.J. 28 (1988) (discussing opposing interpretations of section 2-713); Robert Childres, Buyer’s Remedies: The Danger of Section 2-713, 72 NW. U. L. Rev. 837 (1978) (arguing that, contrary to the mandate of section 1-103, section 2-713 fails to measure actual damages); John D. Clark, The Proposed Revisions to Contract-Market Damages of Article Two of the Uniform Commercial Code: A Disaster Not a Remedy, 46 EMORY L.J. 807, 809 (1997) (discussing the “occasional manipulation of U.C.C. section 1-106 by courts to limit contract-market damages to lost profits”); Vincent A. Coppola, U.C.C. Section 2-708(2): A Sheep in Wolf’s Clothing?, 96 DICK. L. Rev. 429 (1992) (addressing controversies arising from ambiguities in provisions of the U.C.C. governing seller’s remedies for repudiation or non-acceptance and attempting to reconcile them with the underlying remedial purpose of the code); Henry Gabriel, The Seller’s Election of Remedies Under the Uniform Commercial
of U.C.C. section 1-106(1) leads to conflicting terminology and confusion among the courts when interpreting the rules. The drafters of the U.C.C. helpfully created particularized damage rules to apply to different circumstances in which buyers and sellers breach,49 but each seems to exist in a vacuum, divorced from other damage rules and the reasons for them.50 Two examples of controversies focusing on the dissonance between interpretation of U.C.C. provisions and the remedial goal of section 1-106 illustrate these points.

1. **Damages Based on Seller's Resale or Market Price?**

A classic problem arising from the codification of alternative remedial provisions is the opportunity to elect among them. For the Article 2 damage provisions, the explicit option to elect one over the other51 may conflict with the underlying goal of section 1-106. For instance, where a buyer breaches and the seller resells the goods, there is some debate as to whether the seller is limited to recovering damages under section 2-706 (based on the contract/resale price differential) or whether the seller can still elect recovery under section 2-708(1) (based on the contract/market price differential). An underlying assumption of section 2-706 is that goods will generally be resold for their market value, in which case the

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49. See infra notes 173-79. In addition to a variety of rules for different circumstances, U.C.C. section 2-714 allows damages to be “determined in any manner which is reasonable.”

50. This observation is hardly new to the literature on contract damages. See, e.g., Peters, supra note 48, at 204 (“[T]he inter-relationship between the various remedies is often left unnecessarily obscure in Article 2; a remedy which is permitted by one section appears to be interdicted by another; conduct apparently harmless when viewed from the vantage of one provision is fraught with danger when another section is considered.”).

damage award would be roughly the same under both sections. Markets regularly fluctuate, however, and this assumption is only valid "if the market for the goods is sufficiently stable to allow the seller to access it before it changes."52

The disparity between the two damage measures may arise where the market price has fallen since contracting but starts to rise again shortly after the breach. This creates a disparity between the market price at which the seller could reasonably have resold and the (higher) price at which the seller did resell. In such a case, the resale price is greater than the available market price causing the damage award to be greater under section 2-708(1) than section 2-706. For example, imagine that the contract price is $700 and that, due to a falling market, the market price at which the seller could have resold after the buyer's breach was $650. If a rising market shortly thereafter allows the seller to resell at $675, should the seller be entitled to resell at $675 and pursue the section 2-708 remedy? The section 2-708 damage measure, based on the contract/market price differential ($700-650) provides greater damages than the section 2-706 measure, based on the smaller contract/resale price differential ($700-675).

Scholarly treatment of this question illustrates the consequences of divorcing rules from their underlying purpose. Commentators in favor of free election of remedies have argued that the drafters intended the contract to be treated as a "separate and isolated legal event which should not be influenced by other contractual arrangements made by the seller."53 This permits recovery of greater damages based on the market price. The more popular resolution of the issue, however, seems to be that the U.C.C. favors damage awards based upon the actual substitute transaction (§ 2-706), not upon a hypothetical estimate of relief (§ 2-708(1)), and section 2-708(1)'s market formula should be used as an estimation of damages only in cases in which a more exact measure of the seller's expectation is not possible.54

52. See generally Anderson, Damage Remedies, supra note 47, at 1070.
53. Gabriel, supra note 47, at 429 (arguing for free election of remedies based on the language of section 2-703, comment 1 to that section, and the U.C.C.'s legislative history); see also Robert E. Scott, The Case for Market Damages: Revisiting the Lost Profits Puzzle, 57 U. CHI. L. REV. 1155, 1161 (1990) (summarizing and lending support for common law court decisions "holding that any third party contract was irrelevant in computing the injured party's loss"). Others favor the free election of remedies in order to prevent an injured seller with good sales and negotiating skills from being penalized for making another "good deal" with the new buyer. See, e.g., David H. Vernon, Expectancy Damages for Breach of Contract: A Primer and Critique, 1976 WASH. U. L.Q. 179, 193.
54. See, e.g., Anderson, Damage Remedies, supra note 47, at 1070-71; JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 7.7, at 260-61 (4th ed. 1995). Professors White and Summers have noted that the current U.C.C. and comments "bend in the direction of permitting the seller to choose at will," but "stop well short of clearly
Indeed, most cases decided under the current rules hold that a seller who resells may not recover greater damages based upon market price.55

Despite some consistency in judicial decisions favoring this approach, the issue persists, as some courts continue to adhere strictly to the U.C.C.'s allowance of election of remedies. These cases often arise where the seller has resold the goods but has failed to comply with the requirements of section 2-706.56 In such cases, the U.C.C. "relegates him to [damages] provided in section 2-708."57 But where the seller has resold for an amount higher than the market price, damages under section 2-708(1) would be more than the seller's actual losses, resulting in a windfall. In such cases, courts will often limit the seller's section 2-708 damages to the amount that could have been recovered under section 2-706.58 This logical, but strained result is compelled by the U.C.C.'s competing principles, which force courts to decide between preventing a windfall and strictly adhering to the procedural requirements of section 2-706.59 Ultimately, neither reading is explicit in the U.C.C., and each interpretation causes difficulties with fundamental principles of the U.C.C.
The Shadow Code compares an injured party’s anticipated to actual improvement in wellbeing based on reasonable substitute transactions, thereby preventing windfalls. When an injured party arranges a reasonable substitute transaction, losses are based on the facts of that transaction. When the injured party does not arrange an available reasonable substitute transaction, losses are based on the best evidence of what losses would have been sustained had that transaction been arranged. A seller who benefits from or a buyer who is harmed by a rising market gets no windfall because the surplus-based rules compare anticipated and actual gains. In a parallel fashion, a seller who is harmed by or a buyer who benefits from a falling market gets no windfall because of the focus on the anticipated and actual position of the injured party.

2. **Damages in Fixed Profit Cases**

Another contested issue under the Article 2 damage provisions occurs where there has been no substitute transaction but the contract/market differential does not accurately reflect the aggrieved party’s expectation of gain. This issue typically involves fixed price supply contracts in a fluctuating market. Where a contract calls for delivery of goods in a well-developed market, typically the market will set the value of the seller’s performance. Where the injured party’s improvement in wellbeing from the transaction is fixed in advance, however, and therefore not dependent on changes in market prices, the market price arguably is not an accurate reflection of the injured party’s loss. In such cases, some courts have limited a buyer’s recovery under section 2-713 or a seller’s recovery under section 2-708, despite those sections’ unqualified language to the contrary, on the basis of proof of limited expectations.

Suppose, for example, a buyer/reseller contracts to buy 2,000 steers for $67 per steer from a seller and to sell 2,000 steers of the same description on the retail market to a third party for $67.35 per steer, guaranteeing him a profit of $700 (($.35 x 2,000 steers). The seller breaches when the market price for steers increases to $70 per steer. The buyer cannot reasonably cover and seeks damages. To focus attention of the fixed profit problem assume that the aggrieved buyer is released from

60. *See* Barnes & Zalesne, *supra* note 27, § 3 cmt. d, illus. 8, 9 and cmt. g, illus. 21, 23.
61. *Id.* § 3 cmt. d, illus. 8, 9 and cmt. g, illus. 22, 24. If an injured party takes a deliberate risk by delaying the arrangement of a substitute transaction until beyond the time after breach when it was reasonable to do so, damages are based on a reasonable substitute transaction. *See id.* § 4 cmt. d. Gains and losses associated with risk-taking behavior are allocated to the party taking the risks, rather than the breaching party, which seems appropriate.
its resale contract and has no liability for failing to perform that contract.\textsuperscript{62} The question is whether such a buyer may recover damages of $6,000 based on the contract/market differential [($70-67) \times 2,000], or whether her damages should be limited to her lost commission of $700, an amount not tied to the market.

This was roughly the scenario in \textit{H-W-H Cattle Co. v. Schroeder}, in which the court held that an award of market damages would have resulted in a substantial windfall and damages should be limited to lost profits.\textsuperscript{63} \textit{H-W-H} reflects the modern development in damage calculations, standing in contrast to a longstanding “common law preference for market damages.”\textsuperscript{64} Widely approved by many commentators,\textsuperscript{65} the reasoning in \textit{H-W-H} and other similar cases is based on the compensation principle and the notion that recovery should be limited to the buyer’s actual loss, rather than upon the hypothetical substitute.\textsuperscript{66}

Despite the strong justification for preventing a windfall in accordance with section 1-106’s compensation principle, limiting contract/market damages to an aggrieved party’s expectancy interest is contrary to the explicit language of the U.C.C. and has caused concern among some commentators.\textsuperscript{67} Indeed, several courts have declined to

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\item \textsuperscript{62} This assumption is not unrealistic. Liability to a third party from breach of a transaction dependent on the breaching party’s performance of the contract in question is added to damages otherwise recoverable, both under the U.C.C., see \textit{White and Summers, supra}, note 54, § 6-4, at 207, and Barnes & Zalesne, \textit{supra} note 27, § 3 cmt. f, illus. 20, subject to traditional limitation on recovery to those losses that are foreseeable, unavoidable, and ascertainable. See infra Part III.C, SC § 4. In \textit{H-W-H Cattle Co. v. Schroeder}, 767 F.2d 437, 440 (8th Cir. 1985), the court said that the third party would at best only have broken even on the cattle due to be delivered under the resale contract. In \textit{Allied Canners & Packers, Inc. v. Victor Packing Co.}, 209 Cal. Rptr. 60, 62 (Cal. Ct. App. 1984), one third party buyer released the injured party from its contract and the other never sued, presumably because of a force majeure clause.
\item \textsuperscript{63} 767 F.2d at 439.
\item \textsuperscript{64} Scott, \textit{supra} note 53, at 1159.
\item \textsuperscript{65} \textit{See, e.g.}, \textit{White & Summers, supra} note 54, § 6-4 at 319-20; Peters, \textit{supra} note 48, at 257-59.
\item \textsuperscript{66} \textit{See, e.g.}, \textit{H-W-H Cattle}, 767 F.2d at 439-40; Texas Co. v. Pensacola Mar. Corp., 279 F. 19, 30 (5th Cir. 1922); \textit{Allied Canners}, 209 Cal. Rptr. at 62; Pastor v. B. Lindner & Bros., 253 N.Y.S. 184, 187 (1st Dep’t 1931); Delmont Gas Coal Co. v. Diamond Alkali Co., 119 A. 710, 711 (Pa. 1923); Foss v. Heineman, 128 N.W. 881, 883-85 (Wis. 1910).
\item \textsuperscript{67} Commentators have argued that a lost profits rule allocates market risks in an inefficient and unstable way. \textit{See Clark, supra} note 47, at 827. They also argue a policy of limiting market damages may serve to “undermin[e] the incentives for parties to adequately allocate market risks and perform their contractual obligations under unusual circumstances that dramatically affect the market price.” \textit{Id. See generally} David Simon & Gerald A. Novack, \textit{Limiting the Buyer’s Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts}, 92 HARV. L. REV. 1395, 1403 (1979), summarizing the arguments of various commentators in favor of market damages as including:
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follow the reasoning in *H-W-H Cattle* and *Allied Canners* and awarded contract-market damages rather than lost commission.\(^68\) These cases, noting the conflict between section 2-713, which allows recovery based on market price, and section 1-106's compensation principle, have used rules of statutory construction to resolve this conflict in favor of section 2-713, the more specific provision.\(^69\) Although there is some level of consensus that these cases were not decided properly,\(^70\) they illustrate the danger of a system of damage rules that specify different formulas for different circumstances and that are not explicitly related to the underlying compensation principle. On this issue, the Shadow Code again adheres to the resolution reflecting the goals of section 1-106.

Notably, the recent U.C.C. revisions fail to resolve the difficulties identified above or to simplify the rules.\(^71\) The Shadow Code does not propose eliminating the helpful formulas currently appearing in sections 2-706 through 2-714. It explicitly permits utilization of those approaches in certain cases, with their interpretation to be consistent with the purposes of section 1-106.\(^72\)

**C. Inconsistencies in Nomenclature**

While calculation of damages for businesses by common law or U.C.C. formulas often requires identification of what "profit" would have been earned had there been no breach and what "costs" were incurred or

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\(^69\) See, e.g., *Trans World Metals*, 769 F.2d at 908 (noting that "nothing in the language or history of section 2-708(2) suggests that it was intended to apply to cases in which section 2-708(1) might overcompensate the seller").

\(^70\) *See generally* Anderson, *Damage Remedies*, *supra* note 47, at 1108-09.

\(^71\) The Article 2 Revision Study Group and the ABA Task Force recommended that the comments clarify that the seller who has actually resold should be limited to section 2-706 damages, and the buyer who has covered should be limited to section 2-712 damages. The original revisions reflected the recommendation of the Study Group. The final revisions, however, do not incorporate that change. *See generally* Rev. U.C.C.

\(^72\) *See* Barnes & Zalesne, *supra* note 27, § 1 cmt. b.
avoided by the injured party, neither term has an unambiguous meaning. The Restatement is most clearly understood to award businesses the difference between anticipated and actual profits.\textsuperscript{73} The U.C.C. explicitly focuses on "profit" in one of its most often applied formulas: § 2-708(2) (Seller’s Damages for Non-Acceptance or Repudiation).\textsuperscript{74} Yet courts offer conflicting definitions of "profit." Similarly, though costs are often described as "consequential" or "incidental," there is no agreement between the Restatement and the U.C.C. on what these classifications embrace. Consequential losses are defined differently in these two sources of law, one definition including lost profit and the other referring only to personal injury and property damages. "Incidental" is used by courts and the legal literature to refer confusingly either to anticipated costs or unanticipated costs incurred by the injured party. Neither the meaning of profit nor the definitions of types of cost are clear. The Shadow Code corrects these inconsistencies.

1. Inconsistencies in Terms Describing Lost Profit

For the purposes of damage calculations, "profit" properly refers to the difference between the total benefits obtained from a particular contract and the costs incurred in order to produce those benefits. Only those variable costs, the costs that would not have been incurred but for the contract, are deducted from total benefits derived from the contract to determine profit. Accordingly, profit is correctly understood in the U.C.C. as including overhead or fixed costs.\textsuperscript{75} Overhead or fixed costs are those that would have been incurred even had the party not engaged in the particular contract in question; they are costs of running the enterprise as a whole. Despite this general understanding, courts regularly refer to this difference between revenues and variable costs as either "net profit" or "gross profit."

Conflicting uses of the term "profit" abound and cannot easily be dismissed. Parties frequently disagree about whether they are entitled to

\textsuperscript{73} See supra Part I.A.
\textsuperscript{74} U.C.C. § 2-708(2) (2001) provides:
If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages provided in this Article (§ 2-710), due allowance for costs reasonably incurred and due credit for payments or proceeds of resale.
\textsuperscript{75} See, e.g., U.C.C. § 2-708(2) (2001) (stating that the calculation of damages for contract breach begins with calculation of "the profit (including reasonable overhead)"); see also FARNSWORTH, supra note 11, § 12.10, at 774.
“gross” or “net” profits. This was the essence of the dispute in Automated Medical Labs., Inc. v. Armour Pharmaceutical Co., where the court concluded that the plaintiff was “entitled to gross profits, which includes the net profit element and an overhead expense element.” 76 Apparently, “gross profits” are the same as “profits.” But, in Starr Printing Co. v. Air Jamaica, the court held that lost net profits were compensable but lost gross profits were not, equating “net profits” to “profits” and apparently using “gross profits” to refer to total revenues.77 Is “profit” greater, less than, or equal to “net profit?” How does “profit” compare to “gross profit?”

By the dictionary definition of “net,”78 net profit should be less than “profit.” For the court in Roth v. Speck, however, “net profit” was something greater than revenues less variable costs.79 The court described the difference between revenues brought in by a hairdresser and the salary paid to a hairdresser under contract with the salon as the “net profit” to the salon owner from the contract with the hairdresser.80 But this “net profit” included some variable costs (the additional costs of shampooing or cleaning up after the hairdresser’s clients, for instance) that must be deducted from revenues to yield what the U.C.C. means by “profit.” Contrast the court’s definition in Bead Chain Mfg. Co. v. Saxton Products, Inc., which found that “profit (including reasonable overhead)’ is the equivalent of net profit plus overhead.”81 For the Bead Chain court, profit is something greater than net profit—greater by the amount of overhead.

There is equal confusion in the relationship between gross profit and profit. The First Circuit, in Teradyne, Inc. v. Teledyne Industries, Inc., used the term “gross profit” to describe the difference between revenues and variable costs, those identified with the contract to buy and sell a transistor test system.82 Following customary usage,83 “gross” suggests some number greater than the “profits” to which the U.C.C. refers. But not in Teradyne, where the court seems to mean “profit” in the U.C.C. sense,

76. 629 F.2d 1118, 1126 (5th Cir 1980).
77. 45 F. Supp. 2d 625, 634 (W.D. Tenn. 1999).
78. See WEBSTER’S SEVENTH NEW COLLEGIATE DICTIONARY 568 (1967) [hereinafter WEBSTER’S DICTIONARY] (defining “net” as “remaining after the deduction of all charges, outlay, or loss”).
80. Id. at 155.
82. 676 F.2d 865, 867 (1st Cir. 1982).
83. See WEBSTER’S DICTIONARY, supra note 78, at 368 (defining “gross” as “consisting of an overall total without deductions”).
rather than including all revenue. The court in Teradyne also used the term “net profit,” apparently to mean the difference between total revenues associated with a contract and all costs, whether variable or fixed. For the Teradyne court, “net profit” is less than “profit,” while for the Roth court, “net profit” is something greater than “profit.” Profit terminology is further complicated by the Teradyne court’s reference to the Third Circuit’s use of the term “clear profit,” which has some connection, apparently, to net profit in the sense of total revenues less variable costs less some portion of fixed costs.

The U.C.C. refers to lost profit in the black letter of sections 2-706(6) and 2-708(2) but usually relies on surrogates that may be easier to prove from an evidentiary perspective, such as the difference between contract price and market price, as in sections 2-708(1) (Seller’s Damages for Non-acceptance or Repudiation) and 2-713(1) (Buyer’s Damages for Non-Delivery or Repudiation). Appropriately interpreted, the surrogates work fine. By contrast, the Restatement drafters compute damages by a formula based on the “loss in value” due to breach. When “loss in value” is understood to be the difference in total revenues due to breach rather than profit, the Restatement approach works fine. When integrating various approaches to damage computations, it would be useful to have a common reference point, but the term “profit” is not suitable. This is especially true since both sources of legal rules cover damages to consumers, who do not have a “profit” to calculate in the usual sense of that word. Consumers and businesses do, however, both hope for a “surplus,” an excess of benefits

84. Teradyne, 676 F.2d at 868 (applying U.C.C. § 2-708).
86. Teradyne, 676 F.2d at 868 (citing Vitex Mfg. Corp. v. Caribtext Corp., 377 F.2d 795, 798-99 (3d Cir. 1967) (stating that “the price the businessman should charge on each transaction could be thought of as that price necessary to yield a pro rata portion of the company’s fixed overhead, the direct costs associated with production, and a ‘clear’ profit”). State court opinions confirm this interpretation. See, e.g., Texas Power & Light Co. v. Barnhill, 639 S.W.2d 331, 335 (Tex. App. 1982) (referring to testimony by a contractor who said that he normally bid into his contracts “10% ‘clear’ profit, that is, profit after taxes, insurance, and hidden costs”); Messina v. Koch Indus., Inc., 267 So. 2d 221, 225 (La. Ct. App. 1972) (identifying the key issue as whether the 10% fixed fee in the contract was “intended to be ‘clear’ profit or to include profit and some or all overhead expenses”).
over costs. The Shadow Code substitutes a concept of "surplus" that applies equally to consumers and business entities.

2. Inconsistencies in the Meaning of "Consequential" and "Incidental" as Applied to Costs and Losses

Consequential Losses. Because damage rules award both lost profits and costs incurred, clear categories of the types of costs are essential for a contract damages code. Unfortunately, confusion worse than that attached to "profit" accompanies the use of terms describing costs incurred by the injured party. The terms "consequential" and "incidental" damages are central to both the Restatement and U.C.C. approaches to contract damages. The Restatement allows recovery of "any other loss, including incidental or consequential loss, caused by the breach."\(^87\) U.C.C. section 2-715 allowed only buyers to recover consequential losses until the recent revisions, which allow sellers to recover consequential damages, but only from merchants.\(^88\) Setting aside the different treatment of buyers and sellers, which has no parallel in the Restatement, it would be convenient if the two sources of law defined consequential loss in the same way.

Unfortunately, consequential losses under the Restatement are only a subset of those as defined by the U.C.C., and perhaps an insignificant subset. According to Restatement section 347, consequential losses include "such items as injury to person or property resulting from defective performance."\(^89\) The illustration accompanying that section provides an example of these tort-like injuries:

\(A\) leases a machine to \(B\) for a year, warranting its suitability for \(B\)'s purpose. The machine is not suitable for \(B\)'s purpose and causes $10,000 in damage to \(B\)'s property and $15,000 in personal injuries. \(B\)

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87. **Restatement** § 347. Measure of Damages in General: Subject to the limitations stated in sections 350-53, the injured party has a right to damages based on his expectation interest as measured by (a) the loss in the value to him of the other party's performance caused by its failure or deficiency, plus (b) any other loss, including incidental or consequential loss, caused by the breach, less (c) any cost or other loss that he has avoided by not having to perform.

88. Buyers were permitted consequential damages by U.C.C. section 2-715. There was no comparable section for sellers and U.C.C. section 1-106(1) provided that "neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law." The revision allows a seller to recover consequential damages, but states that "[i]n a consumer contract, a seller may not recover consequential damages from a consumer." Rev. U.C.C. § 2-710(3).

89. **Restatement** § 347 cmt. c.
can recover the $25,000 consequential loss in addition to any other loss suffered. See Uniform Commercial Code § 2-715(2)(b).

The Restatement’s reference to U.C.C. section 2-715(2)(b) suggests an overlap with the U.C.C., but the overlap is far from complete. For the U.C.C., consequential damages include both “(a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise;” and “(b) injury to person or property proximately resulting from any breach of warranty.” While subparagraph (b) refers to those tort-like injuries related to the breach, subparagraph (a) includes a broad category of other types of losses not included in the Restatement definition.

What is included in the U.C.C. definition of consequential damages, but not included in the Restatement? Professors White and Summers’ leading commercial law treatise explains that the most common claim for consequential damages under the U.C.C. involves lost profits. Professor Hawkland’s multi-volume treatise is largely in accord, concluding that “consequential damages do not arise within the scope of the immediate buyer-seller transaction, but rather stem from losses incurred by the non-breaching party in its dealings, often with third parties.” For buyers, the difference between contract price and the price at which a good is resold to a third party is an example of consequential damages, i.e., profit. Both treatises emphasize the meaning of “consequential” contained in the first subparagraph of that section, U.C.C. section 2-715(2)(a), including losses other than the tort-like damages to person and property.

90. Id. § 347 cmt. c, illus. 4.
92. WHITE & SUMMERS, supra note 54, § 6.5, at 211.
94. The special treatment of lost profits in the U.C.C. is strange in its suggestion that lost profits are unusual and outside the normal anticipation of breaching parties. In a case where the defendant’s insecticide damaged the plaintiff’s blueberry crop, the court stated that consequential damages were different from direct damages because they “do not arise directly according to the usual course of things from the breach itself.” Duyck v. Northwest Chemical Corp., 764 P.2d 943, 946 (Or. Ct. App. 1988). According to the court, consequential damages apparently occur as the result of special circumstances in particular cases. Id. It cannot be that courts and the drafters of the U.C.C. think it unusual for buyers to anticipate a profit from their dealings with sellers. Profit-making must be the fundamental motivation for the exchange of goods. What these rule-makers want to emphasize must be the requirement that lost profits resulting from breach must be foreseeable. It is misleading to single out lost profits for special treatment under the unforeseeability rule. The principle that recoverable losses include only those within the contemplation of the parties, outlined in Shadow Code section 4, applies not only to lost
Incidental Costs and Losses. The Restatement and the U.C.C. are in accord on the definition of incidentals, but the legal literature’s use of the term “incidental” conflicts with both the Restatement and the U.C.C. The Restatement uses “incidental” to include “costs incurred in a reasonable effort, whether successful or not, to avoid loss” from breach. These are expenses the injured party would not have incurred, but for the breach. The U.C.C. is in accord, permitting sellers and buyers to recover incidental damages. The examples in their definitions, comments, and illustrations are all expenses incurred only because the other party breached, costs that would not have been incurred had the other performed as promised. By contrast, legal scholarly literature refers to “incidentals” as anticipated costs that would have been incurred even if the other had performed but were wasted as a result of breach.

Legal scholarship has been widely influenced by Fuller and Perdue’s article, The Reliance Interest in Contract Damages, which is the most frequently cited and most influential article on contract damages. That

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95. Restatement § 347 cmt. c.
96. For sellers, these are “any commercially reasonable charges, expenses or commissions incurred in stopping delivery, in the transportation, care, and custody of goods after the buyer’s breach, in connection with return or resale of the goods or otherwise resulting from the breach.” See U.C.C. §2-710. For buyers, incidental costs “include expenses reasonably incurred in inspection, receipt, transportation and care and custody of goods rightfully rejected, any commercially reasonable charges, expenses or commissions in connection with effecting cover and any other reasonable expense incident to the delay or other breach.” See U.C.C. § 2-715.
99. See Krier & Schwab, supra note 97, at 2146 app. II. In his critical reflections on Fuller and Perdue’s article, Michael Kelly quotes scholars praising Fuller and Perdue’s work as the most significant or most famous article on contract law, discusses the influence of that article on the Restatement (Second) of Contracts, and cites court opinions relying on Fuller and Perdue’s logic and scholarship extending and expanding Fuller and Perdue’s theories. Kelly, supra note 31, at 1757-58 & nn.9-14. In his article on teaching contract law, Professor Frost states:

Among contract teachers and scholars, Fuller and Perdue’s The Reliance Interest in Contract Damages . . . is certainly an influential piece of legal scholarship. Perhaps no single article in any legal discipline has had the pervasive impact on the way the law is taught. Nearly every contracts casebook makes reference to the
article uses the term "incidental" to refer to the collateral expenses a contracting party incurs in order to enhance the profit he will make from the contract in question. Fuller and Perdue used this term to distinguish the enhancing costs ("incidental reliance") from necessary expenses ("essential reliance"), the performance costs a contracting party incurs to fulfill her contractual obligations. While distinguishing enhancing and performance costs is analytically useful, these "incidental" costs are not expenses related to breach included in either the U.C.C. or the Restatement definitions. They are costs the injured party would have incurred even if the other had not breached; they were, in fact, incurred in anticipation of the other's performance. Nevertheless, legal scholars have adopted Fuller and Perdue's terminology and curtailing its use would reduce confusion.

The Shadow Code eliminates the conflicting language presently complicating the discussion of contract damages by recognizing that the loss for which compensation can be awarded is the loss of improvement in one's wellbeing the injured party would have realized, less surplus. These losses arise from reduced revenues or unreimbursed costs. To the extent that losses come from revenues never obtained, the Shadow Code recognizes a difference between anticipated and actual revenue. To the extent that losses come from unreimbursed costs, the Shadow Code only distinguishes between anticipated and actual costs, whether the costs are incidental or consequential losses, however defined. Anticipated costs are only those that would have been incurred had the other performed. Actual costs are those actually incurred, whether anticipated or incurred only because of the other's breach. In the Shadow Code, all categories of costs are treated the same way in measuring damages.

work. Most casebook authors provide it as a central organizing feature of the remedies section.


100. Fuller & Perdue, supra note 26, at 78.

101. For recent examples, see Frost, supra note 98, at 1365 n.27 (describing how discussing losing contracts leads to a discussion of the important distinction between incidental and essential reliance); Paul L. Regan, Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups, 21 Cardozo L. Rev. 1, 35 (1999) (detailing the types of damages awarded under contract law); and Michael T. Gibson, Reliance Damages in the Law of Sales under Article 2 of the Uniform Commercial Code, 29 Ariz. St. L.J. 909, 991-95 (1997) (reviewing the frequency with which courts award damages based on incidental reliance).

102. The concept of "lost surplus" is explained in more detail in Part III.A.1.

103. The concept of "breach-related cost" is explained in more detail in Part III.A.2.
II. ATTEMPTS TO RECONCILE AND SIMPLIFY

For more than twenty years, scholars have explored the desirable properties of fully compensatory contract damages. Much of the modern work contributing to an appreciation of the underlying structure of contract damage rules came from economists. In 1980, building on the work of Professors Charles Goetz and Robert Scott,104 Professor Steven Shavell offered a general economic model of incentives created by various contract damage rules.105 He defined the expectation measure of damages as the difference between the gross value of the other’s performance to the injured party less the value enjoyed by the injured party if the other party defaults.106 His mathematical model laid a foundation for the analysis of incentives to make and break promises, to rely on promises, and to mitigate losses. The formula was not particularly subtle, however, and failed to capture the nuances of the variety of circumstances in which contracts are breached. It was even less nuanced than the general formula in Restatement section 347, which is also based on “gross value,” total revenue. To be fair, Professor Shavell’s model was not designed, as the Shadow Code formula in Shadow Code section 1 is, to be a universally applicable tool for calculating damages.

In the 1980’s, extensions of Professor Shavell’s analysis brought the abstract economic model closer to reality. Prominent among these articles are those attempting a summary description of the expectation measure of damages for the purpose of analyzing, as Professors Goetz, Scott, and Shavell had done, the incentives created by contract damage rules. In 1985, Professor Robert Cooter modeled the damage remedy as a means for restoring the injured party’s lost revenues,107 taking the same general

104. Charles J. Goetz and Robert E. Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on An Enforcement Model and a Theory of Efficient Breach, 77 COLUM. L. REV. 554 (1977). Professors Goetz and Scott defined just compensation as an amount equal to the value of performance (reflecting the language of RESTATEMENT § 347), but allowed in the analysis for partial performance and compensation sufficient to place the injured party on a graphical “quasi-performance curve,” which indicated, in theory, amounts of compensation for various degrees of performance by the breaching party that would leave the injured party as well off as full performance. Id. at 558, 565. Their model implicitly recognized, in a graphic rather than formulaic manner, the need to develop a general model applicable to a variety of circumstances, including partial performance, in which contract breaches may occur.


106. Id. at 473.

approach as Professor Shavell and the Restatement. Professor Cooter seemed to recognize, however, that restoring lost profits was the ultimate goal: “Full compensation restores [the injured party’s] profits to the level that would be achieved in the event of performance, so setting \[ D \text{[Damages]} = b(yr) \] [the total benefit from the injured party’s reliance on the other’s promise], may be interpreted as awarding expectation damages.”

Rather than obliquely approaching lost profits through lost revenues, the Shadow Code takes a more straightforward approach, focusing directly on the lost surplus. The Shadow Code is explicitly organized around that goal.

The purpose of a 1985 article by Professors Robert Cooter and Melvin Eisenberg was “to develop certain theoretical and actual measures of contract damages.” They started with the statement that “protection of the expectation interest requires an award such that the injured party will achieve the level of satisfaction (if a consumer) or profits (if a firm) that would have been achieved if the contract had been performed.” This statement advanced the development of a universally applicable rule in two ways. First, it explicitly recognized that, for firms, it is the anticipated level of profits that is the focus of damage rules. Second, it recognized that consumers have analogous expectations of improving their wellbeing, “achieving a level of satisfaction.” The Shadow Code treats consumers and firms as both contracting in order to increase their “surplus.”

Translating this principle into methods for computing damages, Professors Cooter and Eisenberg developed five formulas, which they said described damage calculations in almost all cases. Three of these reflected the expectation interest: the “substitute price” formula, which is analogous to the spirit of U.C.C. formulas based on the difference between contract price and market price (§§ 2-708(1) and 2-713(1)) and perhaps the actions for resale and cover (§§ 2-706 and 2-712); the “lost surplus” formula, which is analogous to the spirit of a seller’s action for the price (§ 2-709); and the “diminished value” formula, which is analogous to a buyer’s damages for breach with regard to accepted goods (§ 2-714). In their analysis, each of their formulas could be applied to both buyers and

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108. Id. at 50.
110. Id. at 1438.
111. See infra note 132 (defining and explaining consumer and producer surplus).
112. Cooter & Eisenberg, supra note 108, at 1443 (acknowledging that additions to and subtractions from the basic formulas are necessary to fit individual cases).
113. Id. at 1439.
114. Id. at 1439-40.
115. Id. at 1442.
sellers. This feature constructively recognized the underlying similarities between buyers' and sellers' remedies. The other two formulas reflected different interpretations of the reliance interest, but also recognized the fundamentally similar treatment of buyers and sellers. While the literature had not yet developed a single, universally applicable formula, Professors Cooter and Eisenberg's work contributed recognition of the focus on lost profit, of similar interests of consumers and producers, and of the symmetry of treatment of buyers and sellers.

Mainstream contract law scholars have also considered the simplification of contract damage rules. In various editions of his treatise on contract law, Professor E. Allan Farnsworth has presented a profit-based formula for suppliers' damages. This formula recognizes the right of a supplier to recover lost profits plus its incurred cost of performing less losses avoided plus other losses. An abbreviated discussion of this approach also appears in the 2001 edition of his casebook with Professors William Young and Carol Sanger. This formula is reminiscent of the Restatement section 347 general formula in its structure, though it appropriately makes the transition from "loss in value" to lost profit. As the Shadow Code illustrates, focusing on lost profit (or lost surplus) facilitates an understanding of the relationship of the universal damage rule to the underlying goal. The surplus-based approach championed by the Shadow Code makes the connection more explicit than either Professor Farnsworth's approach or that of the Restatement. While playing around

116. Id. at 1440-42. The "opportunity cost" measure reflects the interpretation of Fuller and Perdue's reliance measure, which recognized that the injured party implicitly declined other wellbeing-enhancing opportunities when it contracted with the breaching party. Fuller & Perdue, supra note 26, at 71-75. This opportunity cost measure may also be interpreted as an approximation of recovery under the expectation measure of damages. See supra, text accompanying notes 35-39. The "out-of-pocket" measure reflects the modern understanding of the reliance interest reflected in the RESTATEMENT § 349. Id.

117. Sellers are often (though not necessarily) expecting the buyers' performance to consist of money and other financial instruments and buyers expect the sellers' performance to consist of an exchange of goods and services. The exchanges are symmetric, however, and the providers of goods and services may be considered buyers of financial instruments while the providers of financial instruments may be viewed as sellers. Both have a similar interest in having the other perform as promised, may have opportunities to arrange substitute transactions in the market, and are concerned with both partial and defective performance.

118. See, e.g., FARNSWORTH, supra note 11, § 12.10, at 768-74 (discussing alternative formulas for suppliers' damages).


120. Id. at 469-71.

121. See supra Part I.A (describing the Restatement's approach to measuring expectation damages).
with these general formulas may provide accurate measurements of expectation damages, it is never clear in their exposition how these approaches apply to vast numbers of damages cases involving, for instance, part performance of contracts, breaches of warranty, or cases where the injured party arranged a substitute transaction through cover or resale to minimize losses.

Recognition of the right to recover both lost profits and costs, as Professor Farnsworth's formula does, is fundamental. A most basic error in calculating contract damages lies in concluding that an injured party may recover lost profit or may recover costs incurred but not both. This conclusion is seductive. One might think that recovering lost profits, in the sense of total revenues less variable costs, is sufficient to make injured parties whole. The anticipated profit was what the party expected to take home, after all, and that is what she takes home. The problem is that when she gets home, there are collection agents at home, waiting for her to pay the costs she incurred. After paying those costs, there may be nothing left. The misperception lies in the idea that the injured party gets to "take home" the entire damage award.

Perhaps thinking of lost profit (or lost surplus) as analogous to "take-home pay" will prevent the misconception about recovering both lost surplus and costs incurred. Take-home pay is that portion of one's wages or salary that is left over after deductions for costs one is obliged to pay, such as income and social security taxes. If an employer fails to pay a worker one week, the employer cannot make up for it by simply giving the worker cash equal to the take-home pay. Unless the employer also makes the appropriate tax payments, the worker will be required to pay for those obligations out of the take-home pay, leaving her with less disposable income than she would otherwise have had. What the injured party hoped for when contracting was to realize enough benefits (salary before deductions in our analogy, revenues for a person in commerce) to pay off those costs (deductions in our analogy) and have the profits (take-home pay) left over.

Courts have occasionally made this mistake, concluding that a party injured by contract breach would be overcompensated if awarded both lost profits and costs incurred. These opinions reflect neither the intent of the Restatement or U.C.C. rules, nor the underlying logic of expectation damages. Smith v. Onyx Oil & Chemical Co. illustrates the potential for confusion. In that case, Smith contracted to sell a chemical product that

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122. 218 F.2d 104 (3d Cir. 1955).
Onyx promised to develop.\textsuperscript{123} When Onyx repudiated the contract, Smith sued for lost profits and for more than $3,000 in expenses incurred in getting ready to perform.\textsuperscript{124} With respect to those expenses, the court held, "This, we think, is not recoverable. If he has the profit he was to make, had the contract been performed, he cannot also have the expenses to which he was put to make that profit."\textsuperscript{125} Without award of incurred expenses, however, the injured party will not fully realize his anticipated surplus.

In 1998, Professor Barnes explored the connection between specific rules of damages described in the Restatement and Article 2 of the U.C.C. and claimed to have developed a universally applicable formula that was an extension of the lost profits plus costs incurred approach suggested by Professor Farnsworth.\textsuperscript{126} Professor Barnes claimed that the formula could be used to calculate expectation damages under any circumstances in which a contract might be breached.\textsuperscript{127} While a generous commentator described the underlying theory as "detailed and nuanced,"\textsuperscript{128} applying the model was admittedly cumbersome and unwieldy. It required arranging nine pieces of data into five modules, which captured the variety of potential contracts cases.\textsuperscript{129} While Professor Barnes's work identified the connections between damage rules for different kinds of breaches, its complexity rivaled the U.C.C.\textsuperscript{130} The universality of the resulting rule, however, laid the foundation for the Shadow Code.

\section*{III. THE SHADOW CODE}

The Shadow Code completes the evolution towards a single unified rule governing recovery of expectation damages for breach of contract. It does so by restating that measure in surplus-based terms and by adopting

\begin{itemize}
\item \textsuperscript{123} \textit{Id.} at 107.
\item \textsuperscript{124} \textit{Id.} at 110-12.
\item \textsuperscript{125} \textit{Id.} at 112.
\item \textsuperscript{126} Barnes, \textit{Anatomy of Contract Damages}, supra note 4, at 464.
\item \textsuperscript{127} \textit{Id.} at 468.
\item \textsuperscript{129} Barnes, \textit{Anatomy of Contract Damages}, supra note 4, at 464 (demonstrating how contract damage rules create incentives to breach contracts only when doing so maximizes societal wealth).
\item \textsuperscript{130} To be fair, Professor Barnes's purpose was not to derive a useful means for measuring damages. The nature of his formula was dictated by his goal of evaluating previous scholars' claims that the expectation measure of damages provides an incentive for party's to breach only when it is efficient to do so. By reflecting all possible cases of contract breach where the expectation measure might be applied, he was able to prove mathematically that the incentive was consistent for all types of factual circumstances in which parties breach. \textit{See} Barnes, \textit{Anatomy of Contract Damages}, supra note 4 at 488-89.
\end{itemize}
language that eliminates present inconsistencies. That single rule is contained in Shadow Code section 1. Shadow Code section 1 is based on an injured party’s recovery of its lost surplus. This approach covers buyers and sellers, consumers and producers, merchants and non-merchants under a single rule. Because restoring lost surplus is equivalent to placing the injured party in the position it would have occupied had the other not breached, the lost-surplus approach explicitly implements the goal of full compensation articulated in U.C.C. section 1-106.

Sections 2 and 3 of the Shadow Code are definitional. The amount of lost surplus in Shadow Code section 1 depends on a calculation of anticipated and actual benefits received and costs incurred. Accordingly, these two sections elaborate on how anticipated and actual surpluses, respectively, are calculated in the vast variety of cases that can occur.131 The language of these sections eliminates the current inconsistencies between the U.C.C., the Restatement, and the legal literature on contract damages.

Section 4 of the Shadow Code codifies the traditional limitations on damage recovery well known to contract remedies. It does not purport to change the law, but rather to clarify the meaning of those limitations.132

A. Abandoning Confusing Terminology

The first step in describing the principles lying in the shadow of current contract damage rules is to abandon inconsistent and unclear language. For years, courts have grappled with the conflicting use of common terms such as “incidental” and “consequential” damages and “lost profit” found in the different sources of law, not to mention the divergent judicial interpretations, even within a given source of law. The Shadow Code substitutes unambiguous labels for this confusing and conflicting terminology.

1. Lost Profit, Value, and Surplus

The Shadow Code proposes a modest substitution of the word “surplus” for profit. Both describe the difference between a party’s total revenues or benefits and that party’s variable costs, but “surplus” avoids the legacy of confusion created by conflicting uses of “profit.” Using “surplus” instead of “profit” has the further advantage of permitting the

131. See generally the comments and illustrations in Barnes & Zalesne, supra note 27.
132. The comments and illustrations to the Shadow Code demonstrate how traditional damage limitations affect the computation of damages under the surplus-based approach. Id.
language of the Shadow Code to be as applicable to consumers, whom we do not think of as earning a profit from their exchanges, as to business enterprises. Shadow Code section 1 bases all damage calculations on lost surplus:

§ 1 General Rule for Recovery of Damages for Breach of Contract

When a contract is not fully performed, an injured party may recover damages as measured by the lost surplus, which is the difference between anticipated surplus and actual surplus.

Economists use the term "surplus" to refer to the improvement in wellbeing a party realizes from engaging in exchange.\textsuperscript{133} It captures the essence of people's fundamental reason for engaging in exchange, making themselves better off. Any party to an exchange is willing to incur only so much cost in order to obtain the benefits the exchange will produce. To the extent that the costs fall short of that maximum, the party earns a surplus. For a buyer, the costs include the contract price as well as other expenses necessary to produce the benefit. In a commercial context, the buyer's benefits may be from reselling or producing something from the material that was the subject of the contract. The seller's benefit is often simply the contract price, though perhaps also goodwill, while her costs may just be the expense of producing the goods. The concept of surplus, then, measures the improvement in wellbeing associated with contracting; the benefits less the costs. The appeal of the idea of surplus is that it captures the essence of people's fundamental reason for engaging in exchange, to make themselves better off.\textsuperscript{134}

\textsuperscript{133} In economics, the consumer's surplus is the difference between the maximum a buyer would be willing to pay and the amount she must pay to obtain the product or service. For a seller, the producer's surplus is the difference between the minimum a seller is willing to accept and the amount she is paid. For a buyer, the maximum she is willing to pay measures the total benefits she would derive from the exchange. If she pays that maximum, the benefits equal the costs and she realizes no net improvement—the surplus is zero. For any price below that maximum, subtracting the amount she does pay leaves a measure of her improvement in wellbeing. The minimum a seller is willing to accept is a measure of the total benefits (or cost savings) he realizes by declining the exchange and either keeping and using the good himself or refraining from supplying the good. For any price above that minimum, subtracting the minimum price from the actual price measures the seller's surplus, the improvement in wellbeing he realizes from exchange. The economic concepts of producer and consumer surplus are discussed in all major law and economics texts. See, e.g., RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 278 (4th ed. 1992); ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 301 (1988); DAVID W. BARNES & LYNN A. STOUT, CASES AND MATERIALS ON LAW AND ECONOMICS 362-68 (1992). See also David W. Barnes, The Meaning of Value in Contract Damages and Contract Theory, 46 AM. U. L. REV. 1, 7, 14-16 (1996).

\textsuperscript{134} Illustrations of what the surplus means in a wide variety of contract damages
The term "surplus" relates to both consumers and producers in the way profit describes the excess of benefits ("revenues" only in the commercial context) over variable costs. Even if the term "profit" were clearly defined, it would not capture the surplus consumers anticipate from their contracting. Consumers injured by contract breach are as entitled as entrepreneurs to be placed in as good a position as the promised performance would have done. This is illustrated by the famous "hairy hand" case, applying a measure of damages equal to the difference between the value of a "perfect" hand and the value of the hand "delivered" by the surgeon.\textsuperscript{135} This holding recognizes the consumer/patient's right to realize his anticipated improvement in wellbeing, which the concept of "surplus" captures.

The holdings in other cases may similarly be phrased in terms of ensuring that the consumer recovers her lost surplus. The court in \textit{Deitsch v. Music Co.}, found that the plaintiffs were entitled to their lost surplus resulting from the diminished value of the wedding reception when the band hired for the occasion failed to perform.\textsuperscript{136} The increased pleasure derived from a wedding with a live band rather than the record player to which they resorted less the increased expenses of the live band is the residuum to which the surplus refers. In \textit{Pullman Co. v. Willett}, the court held that a honeymooning couple was entitled to lost surplus resulting from the diminished value of their honeymoon train trip when sleeping accommodations promised by the Pullman Company were unavailable.\textsuperscript{137} The total benefits of a sleeping car train trip less the greater price of the sleeping berth ticket, when compared to the total benefits of a coach car train trip less the price of a coach ticket \textit{reflects the lost surplus}. It would not be conventional to describe the anticipated gain by these consumers as lost "profits." The term surplus captures the balance of benefits over costs for both consumers and business people, whether the case involves the sale of goods or services.

Conceptually, the foundational principle of ensuring that the injured party obtains her surplus requires recognition of all elements of benefit and cost. Recall that the Restatement of Restitution states that a person "confers a benefit upon another if he . . . in any way adds to the other's security or advantage"\textsuperscript{138} and that costs may similarly be defined as

cases are provided in the comments and illustrations in Barnes & Zalesne, \textit{supra} note 27, §§ 1-3.

\textsuperscript{135} Hawkins v. McGee, \textit{146 A. 641, 644 (N.H. 1929).}
\textsuperscript{136} 453 N.E.2d 1302, 1304 (Ohio 1983).
\textsuperscript{137} 7 Ohio C.C. (n.s.) 173, 174 (1905).
\textsuperscript{138} \textit{RESTATEMENT OF RESTITUTION} § 1 cmt. b.
subtracting from the other's security or advantage. Anticipated benefits that are subjective in nature, such as the benefit of a sleeping berth or a live band in the preceding cases, are benefits that theoretically should be included in computations. Similarly, emotional harms (mental distress) are breach-related costs that subtract from the injured party's advantage. Claims for subjective benefits are often dismissed as unforeseeable or uncertain in amount, consistent with Shadow Code section 4. Claims for mental distress could similarly be denied on one of these bases or on the principle that such claims can easily be feigned. But the surplus-based approach can still be applied even if there were a blanket prohibition on consideration of subjective benefits or emotional harms.

Notorious cases in which the subjective benefits to the injured party are denied are those involving substantial performance and "economic waste." In these cases, generally involving construction contracts, courts

139. See supra text accompanying note 18.
140. The inability to recover uncertain or unforeseeable subjective losses is addressed by other remedial rules allowing for liquidated damages and specific performance. See Goetz & Scott, supra note 103 (arguing that the remedy of specific performance is preferable to a damage remedy where the injured party attaches values to the other's performance that are not reflected in a market). Application of the specific performance remedy in this context demonstrates that some exceptions to the general rule awarding expectation damages promote, rather than lead away, from the foundational principle of compensation. See, e.g., Cohen, supra note 4 (arguing that many contract damage rules are contrary to the purported goal of compensation based on expectations and identifying cases where courts give less than fully compensatory damages).
141. Fear of fraud is often cited as the reason for denying recovery of emotional distress damages in tort in the absence of an accompanying indicia of reliability, such as bodily injury or property damage, or a breach of contract where emotional harm is particularly foreseeable, such as mishandling of corpses and negligent transmission of death notices. See W. PAGE KEeton ET AL., PROSSER AND KEeton ON THE LAW OF TORTS 361-63 (5th ed. 1984). Emotional harm is treated similarly in tort and contract cases. See ARTHUR LINTON CORBIN, 11 CORBIN ON CONTRACTS: DAMAGES 369 (Interim ed. 2002) (referring to cases involving carriers, telegraph companies, and innkeepers).
142. The approach of the Shadow Code is applicable regardless of whether recovery of certain categories of loss are categorically denied or severely limited. Recovery of prejudgment interest and attorneys' fees, for example, is limited, reflecting valid principles that conflict with full compensation. See DAN B. DOBBS, LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION 246-47, 285-86 (2d ed. 1993) (describing awards of prejudgment interest only when amounts are liquidated or ascertainable and awards of attorneys fees as designed to sanction parties who have a duty to protect the injured party from litigation costs). We are not devoted to full compensation as an inviolable principle and we have no intention of arguing here against any departure from it. The purpose of drafting the Shadow Code is to create a rule that is founded on the same goal as in the Restatement and the U.C.C., that is easier to apply than the welter of rules in those sources, and that avoids conflicting definitions and interpretations.
143. Where performance under the contract is defective, rather than just unfinished, and the cost to complete requires undoing some of the work already done, the total cost to remedy the defect may be greater than the loss in value. It is said that this excess expense
apply the rule that "if the builder can meet the test of substantial performance, the builder can recover on the contract the full price, less any damages to which the owner is entitled because of breach. These damages are based sometimes on the loss in value to the owner and sometimes on the cost to the owner to remedy the defect." Loss in value is generally approximated by diminution in market price, which may be nominal, even where the loss in value to the injured party "is not fully reflected in the diminution in market price." Award of the less generous diminution in market price is "sometimes defended on the ground that allowing the more generous measure, based on cost to remedy the defect, would result in "economic waste." It is a stunted view of economics that rejects as valuable a party’s bona fide subjective loss. If the substantial performance rule is truly based on an excess of cost to remedy over benefits to be realized, damages could still be based on the subjective benefits to be realized, rather than market value, subject to the well-recognized requirement that the subjective benefits be verifiable.

To the extent that the substantial performance rule relies on market value even where the subjective value is ascertainable, it is a conscious departure from the foundational compensatory principle. Perhaps the rule is really based on the difficulty of discerning whether the injured parties’ claims of injury disproportionate to market value are bona fide. Without leads to "economic waste." In those cases, generally, if "the cost of completion is grossly and unfairly out of proportion to the good to be attained," then the court will award damages based on the difference in value (which may be nominal) rather than the cost to complete (which may be great). Jacob & Youngs, Inc. v. Kent, 129 N.E. 889, 891 (N.Y. 1921); Farnsworth, supra note 11, § 12.13, at 789; see also Restatement § 348(2)(b) (stating that cost of completion is only recoverable where such cost "is not clearly disproportionate to the probable loss in value to [the injured party].").

144. Farnsworth, supra note 11, § 12.13, at 788-90. Courts consider several factors to determine which measure of damages to apply, including: (1) the extent of harm the injured party has suffered from the breach; (2) the extent of forfeiture the breaching party will suffer from having to cure the deficiency; and (3) whether the breach was willful or the breaching party failed to observe standards of good faith. See Jacob & Youngs, Inc., 129 N.E. at 890-91 (describing factors used to determine which measure of damages to apply).

145. Farnsworth, supra note 11, § 12.13, at 790.

146. Id.

147. For example, commentators have suggested that the reason the plaintiff in Jacob & Youngs requested pipe specifically manufactured by the Reading Company was to guarantee that the pipe would be wrought iron quality as opposed to steel. See Richard Danzig, THE CAPABILITY PROBLEM IN CONTRACT LAW 122 (1978). Evidently, there were four companies at the time manufacturing wrought iron pipe, all of which brands "were of the same quality and price." Id. at 121. Witnesses testified that "[t]he manufacturer's name would make absolutely no difference in pipe or in price." Id. Since the plaintiff did get wrought iron pipe quality, the harm from the deviation from contract specifications is questionable. A more likely explanation for the litigation, Danzig reasons, may have been
regard to the basis of the exception, however, the surplus-based rule can recognize the limitation. It is no different in principle from any policy-based reason for limiting liability, such as rules limiting recovery of attorneys' fees and costs.

Focusing directly on lost surplus is sensible from economic, philosophic, and moral perspectives.\textsuperscript{148} It is sensible to imagine that people contract in order to improve their wellbeing, their level of satisfaction or profits. The anticipated surplus measures the improvement they would have realized had the other not breached. Compensating for lost surplus protects people from disappointment and demoralization that might discourage contracting behavior.\textsuperscript{149} Restoring lost surplus is social wealth maximizing, in the sense that it encourages performance whenever the exchange allocates resources to their most valuable uses.\textsuperscript{150} The surplus-based rule also acknowledges free will, by presuming that people would want to protect their anticipated improvement in wellbeing and establishing a default rule ensuring that improvement.\textsuperscript{151} Aside from being a more straightforward approach to damages and being more focused on the purpose for awarding damages, the underlying objective is sensible and appealing.

2. Consequential and Incidental Costs

To overcome the inconsistencies between the Restatement and the U.C.C. with respect to consequential damages, these losses may be lumped together under the label of "breach-related costs."\textsuperscript{152} Breach-related costs

\begin{flushleft}
to express "other dissatisfactions in his relationship with Jacob and Youngs." \textit{Id.} at 123.
\textsuperscript{148} See generally Barnes, \textit{Net Expectation Interest}, supra note 26, at 1157-70.
\textsuperscript{149} \textit{Id.} at 1159-60 (citing Frank I. Michelman, \textit{Property, Utility, and Fairness: Comments on the Ethical Foundations of "Just Compensation"} Law, 80 \textit{Harv. L. Rev.} 1165, 1214 (1967) (describing demoralization costs as including both the immediate disappointment and the future disruption to cooperation in society by people disturbed by the thought that they have been or might in the future be subject to unfair treatment)).
\textsuperscript{150} See generally Barnes, \textit{Anatomy of Contract Damages}, supra note 4 (evaluating incentives created by contract damage rules for parties to breach only when it is efficient to do so).
\textsuperscript{151} See Barnes, \textit{Net Expectation Interest}, supra note 26, at 1160 (describing the "will theory" of contract as suggesting that the court's role in enforcing contracts is to reflect the subjective will of the parties at the time of contract formation) (citing CHARLES FRIED, \textit{CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION} (1981) (describing and updating the will theory of contract) and MORTON J. HORWITZ, \textit{THE TRANSFORMATION OF AMERICAN LAW 1780-1860} (1977) (describing the development of contract doctrine and the period when the will theory was dominant)).
\textsuperscript{152} See generally Barnes, \textit{Anatomy of Contract Damages}, supra note 4 (discussing the relationship between breach-related costs and damages); Barnes & Zalesne, supra note 27, § 3 cmt. f (describing and illustrating breach-related costs).
\end{flushleft}
are costs the injured party would not have incurred had the other party not breached. The term includes the tort-like personal and property damage of the Restatement’s definition and of the U.C.C. section 2-715(b). The definition of breach-related costs cannot include lost profits or expenses the injured party expended in anticipation of the other’s performance. Lost profits are losses, but are not “costs,” which are out-of-pocket expenses incurred by the injured party. Anticipated expenses are costs, but are not breach-related costs, because the injured party would have incurred them even if the other had not breached.

Adoption of the term “breach-related costs” also resolves an inconsistency around use of the term “incidental costs” in the legal literature. The Restatement and the U.C.C. are in accord on the definition of incidentals. The Restatement uses “incidental” to include “costs incurred in a reasonable effort, whether successful or not, to avoid loss” from breach. These are clearly breach-related costs, expenses the injured party would not have incurred, but for the breach. The U.C.C. is in accord, permitting sellers and buyers to recover incidental damages. These examples are all breach-related costs. Because legal treatment of the two types of costs are identical, there is no particular utility to distinguishing between them in the black letter rules. It is, nevertheless, analytically useful to distinguish between these unanticipated breach-related costs and costs that would have been incurred even if the contract had been performed. When the Shadow Code refers to “costs,” it includes all types of out-of-pocket expenses.

B. Damage Computations Under the Shadow Code

The Shadow Code, designed to ensure recovery of an amount sufficient to guarantee the injured party her anticipated level of improvement in wellbeing, focuses on the difference between anticipated and actual surplus. Using general cost language, Shadow Codes sections 2 and 3 elaborate on the calculation of lost surplus:

153. See RESTATEMENT § 347 cmt. c (defining consequential damages).
154. See supra text accompanying notes 96-102.
155. RESTATEMENT § 347 cmt. c.
157. Both types of breach-related costs are, for instance, subject to the traditional limitations on damages. See infra Part III.C, SC § 4.
158. Examples of breach-related costs and their treatment in computation of damages appear in comments and illustrations in Barnes & Zalesne, supra note 27.
§ 2 Anticipated Surplus

The anticipated surplus of an injured party is the difference between the benefits that party would have received as a result of the contract and costs that party would have incurred in relation to the contract had the contract been fully performed.

§ 3 Actual Surplus

The actual surplus of an injured party is the difference between the benefits the injured party received because of the contract and losses the injured party suffered because the contract was not fully performed.

Either of these surpluses may be positive or negative. In a simple case of contract breach, where the injured party had incurred costs related to the contract (paid the contract price or produced the good or service) but not received the promised performance, the actual surplus will be negative—costs incurred but no benefits received. In a partial or defective performance case, the actual surplus may be negative if the performance falls seriously short of complete or positive if only slightly defective. Anticipated surplus is generally a positive amount, since people expect to be made better off by their exchanges. Consistent with well-recognized contract damage principles,159 this “anticipation” is the improvement in wellbeing the party would have obtained had the other performed. Similarly, anticipated costs and profits are those that would have resulted from full performance by both parties, not those that either party “hoped for” or “expected” at any previous time. The anticipated surplus is the improvement in wellbeing the injured party reasonably anticipated at the time of performance, not at the time of contract formation. Thus, there may be losing contracts, in which the anticipated surplus is negative despite the optimism of the injured party at the time of contract formation. The general language of the Shadow Code accounts for all of these possibilities.

The anticipated costs associated with a particular contract may be of two types: performance costs,160 those costs a party was obliged to incur by the contract’s terms, and surplus-enhancing costs,161 those investments a

159. See, e.g., supra note 5.
160. Fuller and Perdue described these as “essential reliance” costs. Fuller & Perdue, supra note 26, at 78. Their terminology was adopted by the RESTATEMENT § 349 cmt. a. “The term good performance cost seems more straightforward and helps distinguish these costs from other expenses incurred in reliance on the other’s promise.” Barnes, Net Expectation Interest, supra note 26, at 1147 n.31 (citation omitted).
161. The term “surplus enhancing reliance” appears to have been used first by Robert Cooter and Melvin A. Eisenberg. See Cooter & Eisenberg, supra note 109, at 1465. In their
party is not obliged to make, but incurs in order to increase its anticipated surplus. This distinction appears nowhere in the black letter of the Shadow Code as these costs are treated in an equal fashion by the law.162

C. Limitations on Recovery and Equivalence of the Shadow Code

The only addition to the one general rule in Shadow Code section 1 and the two explanatory provisions in sections 2 and 3 is a codification of generally recognized limitations on damage recovery:

§ 4 Losses Compensable

Losses are compensable only to the extent that:

(1) the injured party could not have avoided them using reasonable methods

(2) the parties contemplated or could reasonably have foreseen that the losses would result from the breaching party's failure to perform; and

(3) the fact of the loss and the amount of the loss are provable with reasonable certainty.

This codification does not change current law limiting recovery of damages.163 The Shadow Code is substantively equivalent to the Restatement and U.C.C. approaches, giving the same result in virtually every case while eliminating the conflicts identified in this Article. It preserves the convenient methods of proof inherent in the diverse sections of the U.C.C.'s Article 2. It recognizes one difference between the Revised U.C.C. and the common law of contract damages related to the ability of injured parties to recover lost revenues from future contracts with third parties. This difference is relatively unimportant in practical terms. It also

162. The distinction between performance and surplus-enhancing costs is of computational utility and employed in the comments and illustrations to the Shadow Code, reminding those applying the formula of different types of compensable expenses. See Barnes & Zalesne, supra note 27, § 3 cmt. e.

163. Note, however, the discussion of election of remedies immediately following. While this section does not alter the substantive law, the comments and illustrations to this section indicate how the damage limitations articulated in it affect the computation of damages awards. See id. § 4 and comments.
addresses the election of remedies issue in the U.C.C. by adopting an approach that closely adheres to the compensation goals of U.C.C. section 1-106.

1. Revised U.C.C. Limits on Recovery of Lost Surplus

The difference between the common law and the Revised U.C.C. arises from a provision in the latter that denies sellers recovery from consumers of any lost surplus beyond that included in the contract price.164 Under the common law, any loss of surplus beyond that included in the contract price would be recoverable only if reasonably foreseeable (as required in Shadow Code section 4(2)). A consumer is unlikely to foresee any additional loss of surplus, so the explicit U.C.C. limitation is unlikely to make a practical difference. The Revised U.C.C. recognizes that sellers are unlikely to recover additional lost surplus, even from merchants.165 This difference does not affect the underlying design of the surplus-based approach reflected in the Shadow Code.

2. Election of Remedies

Neither the U.C.C. nor the common law requires an injured party to arrange a substitute transaction to minimize losses associated with the other’s breach. In the U.C.C. context, this means that a buyer is not required to cover and a seller is not required to resell in order to mitigate its losses.166 The law imposes no such duty on the injured party.167 However,

164. The revision allows a seller to recover consequential damages, but states that “[i]n a consumer contract, a seller may not recover consequential damages from a consumer.” Rev. U.C.C. § 2-710(3).

165. See id. § 2-710 cmt. 2 (noting that “[s]ellers rarely suffer compensable consequential damages.”).

166. The revised U.C.C. provides that an aggrieved buyer is not obligated to cover, and is free to recover damages based on the market price under section 2-713 where he chooses not to cover. Id. § 2-712(3) “Failure of the buyer to effect cover within this section does not bar him from any other remedy.” Id. Before the recent revisions, it was not clear whether sellers were obliged to arrange substitute transactions to minimize losses due to breach, since no parallel provision existed for sellers. The revisions clarify that “[f]ailure of a seller to resell under this section does not bar the seller from any other remedy.” Id. § 2-706(7).

167. See Restatement § 350 cmt. b.

b. Effect of failure to make efforts to mitigate damages. As a general rule, a party cannot recover damages for loss that he could have avoided by reasonable efforts. Once a party has reason to know that performance by the other party will not be forthcoming, he is ordinarily expected to stop his own performance to avoid further expenditure. See Illustrations 1, 2, 3 and 4. Furthermore, he is expected to take such affirmative steps as are appropriate in the circumstances to avoid loss by making substitute arrangements or otherwise. It is sometimes said that it is the “duty” of the aggrieved party to mitigate damages, but this is misleading because he incurs no liability for his failure to act. The amount of loss that he
if an injured party does not mitigate by availing itself of a reasonable substitute transaction, avoidable losses are deducted from its recovery. While this is explicit in the Restatement, the U.C.C. recognizes that the market price at which the buyer could have covered or the seller could have resold can be used as a proxy to estimate what losses were reasonably avoidable. The election of remedies approach allows the injured party to choose the market price proxy even if it actually arranged a reasonable substitute transaction and no proxy is needed. The more popular approach is one that looks to the actual (reasonable) substitute transaction as the best estimate of what compensation is necessary to place the injured party in the position it would have occupied had the other performed, as U.C.C. section 1-106 requires. The Shadow Code reflects this more popular approach by recognizing that the best estimate of both lost revenues and costs actually incurred is found in the reasonable substitute transaction, if there was one, and in other evidence, such as the market price, if no substitute transaction occurred. Reliance on the market price as evidence must always reflect the underlying principles of full compensation.

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could reasonably have avoided by stopping performance, making substitute arrangements or otherwise is simply subtracted from the amount that would otherwise have been recoverable as damages.

Id. (emphasis added).

168. Id.
169. See id. cmt. c.

In the case of the sale of goods, this principle [limiting recovery to avoidable losses] has inspired the standard formulas under which a buyer’s or seller’s damages are based on the difference between the contract price and the market price on that market where the injured party could have arranged a substitute transaction for the purchase or sale of similar goods. See Uniform Commercial Code §§ 2-708, 2-713. Similar rules are applied to other contracts, such as contracts for the sale of securities, where there is a well-established market for the type of performance involved, but the principle extends to other situations in which a substitute transaction can be arranged, even if there is no well-established market for the type of performance. However, in those other situations, the burden is generally put on the party in breach to show that a substitute transaction was available, as is done in the case in which an employee has been fired by his employer.

Id.

170. See supra text accompanying notes 53-59.
171. Id.

172. An award based on the difference between the market price and the contract price where an aggrieved party has not covered or resold is, in principle, an acceptable measure of lost surplus, where the market price is a good estimate of the cost of or revenue associated with a reasonable substitute transaction. A simple-minded comparison that ignores the underlying compensation principle is inappropriate. For example, a buyer may choose not to cover because she has changed her mind and no longer wants or needs the contract goods.
3. *Equivalence of the Shadow Code*

As the next section demonstrates, the Shadow Code’s articulation of the surplus-based approach yields damage awards equivalent to each U.C.C. Article 2 section as well as section 347 of the Restatement. To promote this equivalence and to promote ease in proving damages, it is permissible to refer to either the U.C.C. or Restatement formulas. When an injured party, for whatever reason, is unable or unwilling to reveal actual or anticipated costs, revenues, or surplus, for instance, the formulas for damage recovery in sections 2-706 through 2-715 of the U.C.C. are available to establish damages otherwise calculated by the surplus-based rule. When properly understood, those specific formulas always give a result consistent with the mandate in section 1-106 and the surplus-based approach. In addition, other definitions, rights, and obligations established in the damages sections of Article 2 supplement the Shadow Code, to the extent they do not conflict.

**Summary**

The Shadow Code eliminates ambiguities in interpreting and reconciling the array of damage rules in the U.C.C. and Restatement, and offers a unified approach to computing damages closely connected to the foundational compensatory principle. It avoids ambiguities by focusing on the extent to which the injured party has improved its wellbeing. It avoids conflicting definitions and expands the applicability of rules by substituting “surplus,” the measure of that improvement, for “profit” and recognizes that an injured party either incurs anticipated costs (of performance or surplus-enhancing) or breach-related costs. It unifies damage rules by offering a single rule that applies to all cases of contract breach.

A simplistic application of the rule granting the difference between the contract price and the market price would overcompensate the buyer because it fails to reflect the change in the improvement in her wellbeing the buyer would have realized had the seller performed. The U.C.C.’s availability of market based damages may encourage buyers, based on market fluctuations, to speculate as to the best time to cover, rather than encourage the more commercially reasonable behavior of covering as soon as reasonably possible. See Anderson, Damage Remedies, supra note 47, at 1099. Certainly the drafters did not intend for section 2-713 to “offer an incentive ... which would influence buyers not to [cover],” White & Summers, supra note 54, § 6.4 at 198, but its very existence often achieves such a result. The Shadow Code’s approach recognizes the market price as an estimate of the characteristics of a reasonable substitute transaction and gives no advantage to the buyer who does not cover, an incentive already minimized by the requirement that the non-covering buyer must sue to recover greater losses than had it arranged a substitute transaction. Because the market price is viewed as an estimate, it must be scrutinized to see if it is a reasonable estimate. This reduces the injured party’s opportunity to speculate.
The surplus-based approach to damages simplifies understanding of the relationship between rights and remedies and the computation of damages. In every case, the surplus-based damage rule compares the surplus the injured party would have obtained but for the other’s breach to the surplus the injured party actually realized:

\[
\text{Lost Surplus} = \text{Anticipated Surplus} - \text{Actual Surplus}.
\]

Whether anticipated or actual, the surplus is the difference between benefits (or revenues) and costs:

\[
\text{Anticipated Surplus} = \text{Anticipated Benefits} - \text{Anticipated Costs}.
\]

\[
\text{Actual Surplus} = \text{Actual Benefits} - \text{Actual Costs}.
\]

The actual surplus may, of course, be positive (when partial or defective performance produces a net benefit) or negative (as where the injured party incurs costs without realizing any benefit). The anticipated surplus may also be positive (as when the other’s performance would have produced a profit for the injured party) or negative (in the case of losing contracts). The surplus-based rule has sufficient flexibility to apply to all cases.

If either buyer or seller actually incurs costs or realized benefits different in amount from those he or she would have incurred had the other performed, those are also reflected in the difference between anticipated and actual benefits and costs. Benefits may be realized from the other’s partial or defective performance, one’s own expenditures in performance, or from one’s own surplus-enhancing expenditures. Costs may include the costs of performance, of surplus-enhancing expenses, or unanticipated breach-related costs as shown in Table 1.

<table>
<thead>
<tr>
<th>Table 1: Sources of Benefit and Cost</th>
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<tr>
<td><strong>Sources of Benefit</strong></td>
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<tr>
<td>Other’s Performance</td>
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<tr>
<td>(anticipated or actual for partial or defective performance cases)</td>
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<tr>
<td>Own Performance</td>
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<tr>
<td>(actual, where one’s preparations for performance have salvage value)</td>
</tr>
<tr>
<td>Own Surplus-Enhancing Expenses</td>
</tr>
<tr>
<td>(actual, where one’s investments have salvage value)</td>
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The relationship between the surplus-based damage rule and prominent U.C.C. provisions can easily be seen by comparing the approach for simple cases. In some cases, such as where breach is induced by a change in market prices after contracting, damages are simply the difference between anticipated and actual costs or anticipated and actual benefits. The lost surplus for the injured buyer of a standardized good, for instance, may simply be the difference between the contract price the buyer would have paid had the seller performed as promised, and the market price at which the buyer may obtain identical substitute goods after breach:

\[
\text{Buyer's Lost Surplus} = \text{Anticipated Benefits} - \text{Contract Price} - (\text{Actual Benefits} - \text{Market Price}).
\]

If identical goods are reasonably available, the anticipated and actual benefits are the same and lost surplus is simply the difference between market (or cover) and contract prices, reflecting the foundation for U.C.C. sections 2-712\textsuperscript{173} and 2-713.\textsuperscript{174}

---

173. Section 1 of the Shadow Code can be expressed as three equivalent formulas:

\[
\begin{align*}
\text{Damages} &= \text{Anticipated Surplus} - \text{Actual Surplus} = \\
&= (\text{Anticipated Benefits} - \text{Anticipated Costs}) - (\text{Actual Benefits} - \text{Actual Costs}) = \\
&= (\text{Anticipated Benefits} - \text{Actual Benefits}) - (\text{Anticipated Costs} - \text{Actual Costs}).
\end{align*}
\]

For section 2-712, "cost of cover" for buyers is an actual cost, "contract price" for buyers is an anticipated performance cost. The difference between cost of cover and contract price reflects losses from the buyer's increased cost of obtaining goods, a difference between anticipated and actual performance costs. Surplus may also be lost in the case of cover because of either or both increased cost of processing inferior substitute goods and reduced benefits due to covering with a less than perfect substitute (as in a purchase for resale). There may also be breach-related costs classified as incidental or consequential losses.

To translate this section, recognize that lost revenues are a component of consequential damages and all other parts of the U.C.C. formula refer to changes in costs. The difference between "cost of cover" and "contract price" is Anticipated Performance Cost - Actual Performance Cost. "Incidental losses" are breach-related costs, a component of actual costs. "Consequential losses" that are not losses in revenues or benefits received are increased enhancing costs (Anticipated Enhancing Costs - Actual Enhancing Costs). Where the cost of cover is less than the contract price, as in partial cover cases, "expenses saved," reflects the difference between anticipated and actual performance costs. "Expenses saved" may also reflect reduced enhancing costs. In the translation below, the change in the benefits or revenues received is reflected in the difference between anticipated and actual benefits. The changes in costs (the difference between anticipated and actual costs) come from (a) the difference between cover and contract price, (b) differences in enhancing costs, (c) expenses saved, and (d) breach-related costs. Thus, for section 2-712: Damages = Cost of Cover - Contract Price + Incidentals + Consequentials - Expenses Saved. In translation, Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Performance and Enhancing Costs - Actual Performance, Enhancing, and Breach-Related Costs), equivalent to the formula.
Buyer’s Lost Surplus =

The lost surplus for a seller, for instance, may simply be the difference between the contract price for which the seller would have sold had the buyer performed as promised, and the market price at which the seller transacts with another:

Seller’s Lost Surplus =

If the seller can resell without any additional costs, anticipated and actual costs are equal and lost surplus is simply the difference between contract price and market (or resale) price, reflecting U.C.C. sections 2-706\textsuperscript{175} and 2-708.\textsuperscript{176}

\textsuperscript{174} As for section 2-712, lost benefits in section 2-713 are captured by consequential damages. All other parts of the formula capture changes in cost, from the difference in market and contract prices, incidentals, other consequentials, and expenses saved. Thus, for section 2-712: Damages = Market Price - Contract Price + Incidental + Consequential - Expenses Saved. In translation, Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Performance and Enhancing Costs - Actual Performance, Enhancing, and Breach-Related Costs), equivalent to the formula above.

\textsuperscript{175} For sellers pursuing damages under section 2-706, the “contract price” should be understood as an anticipated benefit and the “resale price” as an actual benefit. “Expenses saved” are the difference between anticipated and actual performance and enhancing costs. Actual costs may, therefore, be either actual performance or enhancing costs or breach-related costs and section 2-706 can be rewritten as: Damages = Contract Price - Resale Price + Incidental - Expenses Saved. This translates to the Shadow Code rule as follows: Damages = Anticipated Benefits - Actual Benefits + Breach-Related Costs - (Anticipated Performance and Enhancing Costs - Actual Performance and Enhancing Costs). This can be rearranged as: Damages = (Anticipated - Actual Benefits) - (Anticipated Costs - Actual Costs), equivalent to the general formula above.

\textsuperscript{176} For sellers pursuing damages under section 2-708(1), “contract price” should be understood as an anticipated benefit. “Market price” measures actual benefits that could reasonably have been obtained by the seller. “Expenses saved” are the difference between anticipated and actual performance and enhancing costs. Actual costs may, therefore, be either actual performance or enhancing costs or breach-related costs. Thus, for section 2-708(1): Damages = Contract Price - Market Price + Incidental - Expenses Saved. In translation, Damages = Anticipated Benefits - Actual Benefits + Breach-Related Costs - (Anticipated Performance and Enhancing Costs - Actual Performance and Enhancing Costs). This can be rearranged as (Anticipated Benefits - Actual Benefits) - (Anticipated Costs - Actual Costs), equivalent to the formula above.

“Profit” in section 2-708(2) is properly understood as anticipated surplus, which is anticipated benefits less anticipated costs. “Due credit for payments and resale” for sellers reflects actual benefits. “Expenses incurred” are actual costs other than breach-related costs. Thus, section 2-708(2), Profit - Due Credit for Payments and Resale + Incidental + Expenses Incurred, translates as: Damages = (Anticipated Benefits - Anticipated Costs) - Actual Benefits + Breach-Related Actual Costs + Actual Performance and Enhancing Costs. This can be rearranged as: Damages = (Anticipated Benefits - Anticipated Costs) - (Actual
The surplus-based rule applies to all cases of breach of contract. For instance, in a seller’s action for the price where the seller has fully performed, as described in U.C.C. section 2-709, the seller’s anticipated and actual costs are unchanged, but the seller has realized no actual benefit:

\[
\text{Seller’s Lost Surplus} = \text{Contract Price - Market Price.}
\]

In a buyer’s action for breach of warranty who has paid the contract price, the diminished value to the buyer of the seller’s performance is reflected in the difference between the anticipated and actual benefit, as reflected in the “difference in value” rule of U.C.C. section 2-714 or the “loss in value” approach of Restatement section 347(a):

\[
\text{Buyer’s Lost Surplus} = \text{Anticipated Benefit - Actual Benefit.}
\]

If either buyer or seller actually incurs costs or realized benefits different in amount from those he or she would have incurred had the other performed, those are also reflected in the difference between anticipated

Benefits - Actual Costs), equivalent to the formula above.

177. “Price of goods” in section 2-709(1) for sellers is a measure of anticipated benefits for goods accepted or conforming goods lost or damaged and identified to the contract. “Resale price of goods” is an actual benefit. For section 2-709(1): Damages = Price of Goods + Incidentals - Resale Price of Goods. In translation: Damages = Anticipated Benefits + Breach-Related Actual Costs - Actual Benefits. Because anticipated and actual performance and enhancing costs, i.e., all costs other than incidentals (breach-related costs), are unchanged, this can be rearranged as: Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Costs - Actual Costs), equivalent to the formula above.

178. The first of two formulas in section 2-714 allows recovery of damages determined in any manner that is reasonable. For this approach the translation to the surplus-based formula is obvious. To translate the second approach, recognize that “value of goods as warranted is the difference between anticipated benefits and anticipated costs, while the “value of goods accepted” is the difference between actual benefits and actual costs (aside from breach-related costs, which are captured in incidentals and consequential)). Thus, for section 2-714: Damages = Value of Goods as Warranted - Value of Goods as Accepted + Incidentals + Consequential. In translation, because incidental and consequential losses are included as actual costs and the lost profit component of consequential is already captured in the difference between value as warranted and value as accepted, Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Costs - Actual Costs), equivalent to the formula above.

179. The “loss in value” in Restatement section 347(a) refers to the difference between anticipated and actual benefits. “Other losses caused by the breach” in (b) refers to the breach-related cost component of actual costs. “Costs and other losses avoided” in (c) refers to changes in performance and enhancement costs. Sections 347 (b) and (c) together make up the difference between anticipated and actual benefits. Thus, for section 347: Damages = Loss in Value + Other Losses - Costs Avoided. In translation, Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Costs - Actual Costs), equivalent to the formula above.
and actual benefits and costs. Whether costs are anticipated or actual, the surplus-based rule reflects the impact on damages of "expenses saved," as in U.C.C. sections 2-706, 2-708, 2-712,\(^{180}\) and 2-713, of "other costs incurred," as in Restatement section 347(c), costs heretofore labeled as "incidental" and "consequential," in U.C.C. sections 2-710 and 2-715 and Restatement section 347(b). The essence of the surplus-based rule is that identifying differences between anticipated and actual benefits and between anticipated and actual costs permits consideration of all cases within the single formula:

\[
\text{Lost Surplus} = \text{Anticipated Benefit} - \text{Actual Benefit} - (\text{Anticipated Cost} - \text{Actual Cost}), \text{which is equivalent to:} \quad \\
\text{Lost Surplus} = \text{Anticipated Surplus} - \text{Actual Surplus} \\
(\text{as shown in section 1 of the Shadow Code}).
\]

Because the surplus-based rule reflects the approach to damage calculation lying in the shadow of U.C.C. and Restatement rules, the old rules still apply, as long as they are interpreted in a way that is consistent with the underlying compensatory goal. The old rules may be useful, for instance, where a seller does not wish to reveal her anticipated profit from the sale or a buyer does not wish to reveal his anticipated profit from resale. A seller's action for the price, as in U.C.C. section 2-709, for instance, produces the same damages as the surplus-based rule without requiring that potentially sensitive revelation. The Shadow Code expressly permits resort to those rules.

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\(^{180}\) As for section 2-712, lost benefits in section 2-713 are captured by consequential damages. All other parts of the formula capture changes in cost, from the difference in market and contract prices, incidentals, other consequentials, and expenses saved. Thus, for section 2-712: Damages = Market Price - Contract Price + Incidentsals + Consequentials - Expenses Saved. In translation, Damages = (Anticipated Benefits - Actual Benefits) - (Anticipated Performance and Enhancing Costs - Actual Performance, Enhancing, and Breach-Related Costs), equivalent to the formula above.