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The Shadow Code

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THE SHADOW CODE

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I. INTRODUCTION

Lying in the shadow of contract law are unifying principles for calculating damages. These principles integrate the purposes motivating rules formalized in Article 2 of the Uniform Commercial Code[1] (U.C.C.) and the Restatement (Second) of Contracts[2] (Restatement) and their computational methods. Neither the U.C.C. nor the Restatement rules reflect these principles in any way that is apparent on their face. On the contrary, for each type of contract breach, the damage rules in Article 2 of the U.C.C. offer apparently distinct formulas, the applications of which depend on whether the non-breaching party was a buyer or seller, obtained partial performance, or arranged a substitute performance. The Restatement offers different formulas depending on the unhelpful and ultimately irrelevant distinction between the expectation and reliance interests. The Shadow Code offers an approach to contract damage calculations that explicitly reflects the well-recognized compensatory goal.

The Shadow Code restates the law of damages in a single section applicable to all breaches of contract. That section is based on the notion that people contract in order to improve their well-being. Each party ordinarily hopes for some improvement, or "surplus" of benefits over costs, as a result of contracting. The principle that a party injured by another's breach is entitled to be put in the position he or she would have occupied had the other performed as promised is not novel, but lies at the heart of the U.C.C. and the Restatement.[3] 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 that applies to all types of parties—whether

1. U.C.C. §§ 2-702-2-715 (2002).
2. RESTATEMENT (SECOND) OF CONTRACTS §§ 347-349 (1981) [hereinafter RESTATEMENT].
3. *See* U.C.C. § 1-106(1) (2002) ("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 had fully performed. . .") *and* RESTATEMENT § 347 cmt. a (1981) ("Contract damages are 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.").

consumers or merchants, buyers or sellers—who are injured in all types of partial and total contract breaches.

The surplus-based approach requires no inventive types of information. While reflecting a consideration of costs and benefits, the surplus-based approach alters neither the philosophic orientation of damages rules nor the bottom line amount of damages awarded. The Shadow Code yields damages awards mathematically equivalent to both U.C.C. Article 2 and the Restatement.

The Shadow Code reveals goals of legal remedies for breach of contract that have long been buried in the details of the U.C.C. and the Restatement and for that reason, reveals the intuition behind both of them. The key to the surplus-based approach is distinguishing between "anticipated surplus," the improvement in well-being (potentially negative for a losing contract) the injured party would have realized had the other performed as promised, and "actual surplus," the improvement in well-being (often negative) resulting from the breach. The Shadow Code follows its basic principle of Section 1 ["SC § 1"] with only two explanatory sections, Sections 2 ["SC § 2"] and 3 ["SC § 3"], defining, respectively, anticipated and actual surplus. The principle of lost surplus relies on a comparison of the benefits and costs of contracting and recognizes as broad a definition of benefits 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."[4] Costs may similarly be defined as subtracting from the other's security or advantage. The comments and illustrations to SC § 2 and SC § 3 of The Shadow Code display the broad range of costs and benefits relevant to calculating lost surplus. With its general principle in SC § 1 and explanations in SC § 2 and SC § 3, The Shadow Code draws together hugely disparate rules. 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.

The Shadow Code may also be used in conjunction with existing codes to resolve difficult cases and to check the application of any of the myriad of rules arising from the U.C.C. and Restatement. Our position is that any computation arising from application of one of the rules in the U.C.C. or Restatement giving a damage award that is not equal to the difference between anticipated and actual surplus must be the result of an incorrect understanding of the U.C.C. or Restatement, or an understanding inconsistent with the U.C.C.'s or Restatement's

4. RESTATEMENT OF RESTITUTION § 1 cmt. b (1937) states:
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.

underlying goals.[5] The surplus-based approach is mathematically equivalent to an interpretation of those rules consistent with their acknowledged purposes.

Section 4 of The Shadow Code codifies generally recognized limitations on contract damages. Section 4 ["SC § 4"] recognizes that claimed losses must not be too speculative in either their existence or amount, that injured parties must take reasonable steps to mitigate their losses, and that damages are limited to those that

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5. Local rules and special exceptions sometimes cause the U.C.C. or common law to depart from the principle that the injured party is entitled to be placed in the position he or she would have occupied had the other performed and from strict equivalence with application of The Shadow Code. They are easily accommodated in application of the surplus-based approach by imposing additional limitations on what are cognizable losses. For instance, occasional blanket prohibitions, such as a prohibition against recovery of subjective or psychic losses, apply "even if the limitations of unforeseeability and certainty can be overcome." E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 12.17, at 934 (2d ed. 1990). In the rare cases where the limitations could be overcome, the blanket prohibition would produce a different result from that anticipated by The Shadow Code. The Shadow Code relies, in SC § 4, on the rules of evidence requiring proof of losses with reasonable certainty and reasonable foreseeability to govern such cases, consistent with the approach of many courts. *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"); Hatfield v. Max Rouse & Sons N.W., 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 [owner] might suffer emotional distress upon its breach."). Several exceptions exist to the rule denying recovery for emotional distress. "Some courts have looked to the nature of the contract and made exceptions where breach was particularly likely to result in serious emotional disturbance." FARNSWORTH, *supra* § 12.17, at 934. Other courts have allowed recovery where the nature of the breach was "so reprehensible as to amount to a tort, or caused bodily harm." *Id.* at 935. Recognizing these specialized rules does not alter the fundamental structure of The Shadow Code.

A U.C.C. example of an unlikely but potential diversion of The Shadow Code's result may be found in the May 2003 revisions to Article 2 of the U.C.C. While recognizing some sellers' ability to recover consequential damages, the revised U.C.C. denies merchant sellers the ability to recover lost profits from consumers beyond those arising from the breached contract. *See* U.C.C. § 2-710(3) (Proposed Final Draft 2003, approved on May 13, 2003) [hereinafter REV. U.C.C.]. Under the common law, any loss of surplus beyond that included in the contract would be recoverable only if reasonably foreseeable (as required by SC § 4(c)). Consumers are unlikely to foresee any additional loss of surplus anyway, so the explicit U.C.C. limitation is unlikely to make a practical difference. *See* REV. U.C.C. § 2-710 cmt. 2 (noting that "[s]ellers rarely suffer compensable consequential damages.").

Similarly, The Shadow Code (in SC § 4(a) and related comments) takes the position that a party's unreasonable failure to arrange a substitute transaction in the event of breach reduces his or her recovery, and an aggrieved party who resells or covers may not recover greater damages based upon market price. The common law is consistent with this approach, see RESTATEMENT § 350 cmt. b (1981), but courts differ on treatment of such cases under the U.C.C. Some courts, based on the U.C.C.'s literal language permitting free election of remedies, permit an injured party to choose a market price proxy for the actual price of cover or resale even if the injured party arranged such a substitute transaction. 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 damages awards based upon the actual substitute transaction (§ 2-706), not upon a hypothetical estimate of relief (§ 2-708(1)), and § 2-708(1)'s market formula should only be used as an estimation of damages in cases in which a more exact measure of the seller's expectation is not possible. *See* JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE § 7.7, at 376-83 (4th ed. 1995); Roy Ryden Anderson, *Damage Remedies Under the Emerging Article 2—An Essay Against Freedom*, 34 HOUS. L. REV. 1065, 1070-71 (1997). An election of damages based on market price under the former approach might result in recovery of a greater amount than permitted under The Shadow Code, but that is not the dominant position of the courts.

are reasonably foreseeable. These limitations are well established in contract law.[6] The purpose of SC § 4 is to clarify ambiguities in the rules governing limitations on recovery and describe how damages calculated using the surplus-based approach account for these limitations.

In a companion article, we give detailed justifications for offering such an alternative code.[7] Aside from its ability to reveal what lies beneath the established approaches and to provide a check on the accurate application of the established rules, The Shadow Code has three types of advantages over current contract damages rules that might be summarized as: (1) changing the jurisprudential and methodological orientation of damages remedies to align goals with rules, (2) refining terminology to eliminate confusion, and (3) facilitating analysis of the incentives created by remedies.

At the most fundamental level, The Shadow Code alters the jurisprudential perspective of the Restatement and methodology of the U.C.C. The Restatement distinguishes between cases in which an injured party seeks only to recover out-of-pocket expenses (the "reliance" interest) and those in which an injured party also seeks to recover its improvement in well-being (the "expectation" interest).[8] The only case in which a party would choose the former, given that anticipated losses are deducted when calculating reliance damages,[9] is where the existence or extent of any anticipated improvement cannot be proved with sufficient certainty. Well-recognized evidentiary rules (embodied in SC § 4 and demonstrated by the comments and illustrations therein) requiring proof of loss with reasonable certainty address both cases without need for recognizing the "interest-based" approach.

The U.C.C. approach is to offer a different rule for each type of circumstance in which a breach occurs. There are different rules for buyers and sellers;[10] different rules for buyers who reject goods, who accept defective goods, or who arrange substitute transactions when the seller breaches;[11] different rules for sellers who resell and those who do not; and different rules for those who cannot collect the purchase price.[12] The welter of rules creates ambiguities in interpretation, wasting

6. Damages generally must be established with reasonable certainty. *See* FARNSWORTH, *supra note* 5, § 12.15, at 922-23; RESTATEMENT § 352 (1981). Damages must also be reasonably foreseeable. *See* Hadley v. Baxendale, 156 Eng.Rep.145 (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 (1981) (stating that loss may be foreseeable if it follows "(a) in the ordinary course of events, or (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know."); U.C.C. § 2-715(2)(a) (2002) (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 (1981).

7. David W. Barnes and Deborah Zalesne, *A Unifying Theory of Contract Damages*, 55 SYR. L. REV. (forthcoming 2005).

8. *See* RESTATEMENT § 344 (1981) (identifying goals underlying award of damages for breach of contract).

9. RESTATEMENT § 349 (1981).

10. Damages rules applying to sellers are contained in U.C.C. §§ 2-702-2-710, while rules for buyers appear in §§ 2-711-2-716.

11. Damages for buyers who rightfully reject goods are calculated according to a formula in U.C.C. § 2-711, while recovery by buyers who accept defective goods is governed by § 2-714.

12. Damages for sellers who resell are treated under U.C.C. § 2-706, for those who do not resell under § 2-708, and for sellers who cannot collect the purchase price under § 2-709.

the time of courts.[13] This observation is hardly new to the literature on contract damages. Professor Peters observed that "the interrelationship 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 considered by another section."[14] By clearly relating the goal of its provisions to the language of the rules, The Shadow Code is designed to eliminate ambiguity.

In addition to a variety of different rules for different circumstances, U.C.C. § 2-714 allows damages to be "determined in any manner which is reasonable." The Shadow Code offers a single rule covering all types of breach. It defines what is reasonable. Because The Shadow Code produces an equivalent computational result, the U.C.C. formulas may be used when availability of evidence recommends them. The U.C.C. approach, however, conceals, while the surplus-based approach reveals, the fundamental principle on which each rule is based: the principle that an injured party is entitled to its lost surplus. The Shadow Code eliminates the unnecessary multiplicity of specialized rules while preserving their availability.

Of particularly practical import, The Shadow Code eliminates conflicting definitions of terms used in the U.C.C. and the Restatement. Perhaps most significant is the substitution of the term "surplus" for "profit." Courts sometimes use the word "profit" to refer to the extent to which contracting would improve a party's well-being. Courts are often conflicted, however, in their terminology, with great variation in use of the terms "profit," "gross profit," "net profit," and "clear

13. Numerous articles have been written about the ambiguities in Article 2's remedial provisions, attempting to reconcile them with the remedial goal articulated in U.C.C. § 1-106(1), reproduced *supra* in note 3. *See, e.g.*, 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); Anderson, *supra* note 5, at 1066 (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."); Henry Gabriel, *The Seller's Election of Remedies Under the Uniform Commercial Code: An Expectation Theory*, 23 WAKE FOREST L. REV. 429 (1988) (illuminating ambiguities in the Code through his argument in favor of free election of remedies even to the extent it would permit the court to ignore an actual substitute transaction); Ellen A. Peters, *Remedies for Breach of Contracts Relating to the Sale of Goods Under the Uniform Commercial Code: A Roadmap for Article Two*, 73 YALE L.J. 199 (1963) (discussing ambiguities and conflicts inherent in Article 2's damage provisions); John A. Sebert, Jr., *Remedies Under Article Two of the Uniform Commercial Code: An Agenda for Review*, 130 U. PA. L. REV. 360 (1981) (highlighting the lack of uniformity among Article 2's damages sections); 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); Roy Ryden Anderson, *An Overview of Buyers' Damage Remedies*, 21 U.C.C. L.J. 28 (1988) (discussing opposing interpretations of Section 2-713); David J. Leibson, *Anticipatory Repudiation and Buyer's Damages—A Look Into How the U.C.C. Has Changed the Common Law*, 7 U.C.C. L.J. 272 (1975) (explaining differing interpretations of Section 2-713); George I. Wallach, *Anticipatory Repudiation and the U.C.C.*, 13 U.C.C. L.J. 48 (1980) (discussing various interpretations of Section 2-713); John D. Clark, Comment, *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."); David Simon & Gerald A. Novack, *Limiting the Buyer's Market Damages to Lost Profits: A Challenge to the Enforceability of Market Contracts*, 92 HARV. L. REV. 1395, 1403 (1979) (outlining various arguments in favor of contract market damages and others in favor of awarding lost profits).

14. Peters, *supra* note 13, at 203.

profit."[15] "Surplus" refers to the excess of benefits over costs[16] either anticipated, in the sense that the injured party would have realized them had the other party performed, or actual, as a measure of the state of affairs given the other party's breach.[17] This excess is a measure of any improvement in well-being resulting from the contract in question, including a negative improvement. In the case of a contract for which the anticipated surplus was positive, the party would have been able to use the surplus to, for instance, take a vacation, pay for overhead expenses that were not incurred as a result of this contract, or invest in other ventures. Also standing in the way of a uniform rule for contract damages is the fact that consumers do not contract in order to derive a "profit" in the customary sense at all. Rather, consumers, like businesses, contract in order to improve their well-being, which the concept of "surplus" captures.

Also of practical significance is The Shadow Code's avoidance of the terms "consequential" and "incidental" costs. The U.C.C. and Restatement differ on the definition of "consequential losses," with the former including lost profits[18] and the latter referring to personal injury and property damage.[19] In the contract remedies literature, beginning with an influential article by Lon Fuller and William Perdue, incidental costs are costs incurred by a party, not because he or she was obliged by contract to incur them, but because incurring them enhances the surplus hoped for from the other's performance.[20] It is analytically helpful to distinguish the costs of performance ("performance costs" in The Shadow Code) from "surplus enhancing

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15. The underlying goal of restoring the injured party to the position he or she would have been in if the other had performed as promised requires that "profit" refers to the excess of benefits ("total revenues" in the commercial context) derived from a contract over costs resulting from the contract ("variable costs"). Nevertheless, some courts refer to parties being entitled to "net" profits, which sounds like something less than profits, but in various cases are different. In some cases, they are greater than profits. *See, e.g.*, Roth v. Speck, 126 A.2d 153, 155 (D.C. 1956) (describing net profits as being total revenues less only some portion of the variable costs resulting from the contract). In other cases, they are equal to profits. *See, e.g.*, Bead Chain Mfg. Co. v. Saxton Prods., Inc., 439 A.2d 314, 320, n.4 (Conn. 1981) (defining net profit to be the excess of revenues over variable and fix costs). In yet other cases, they are less than profits. *See, e.g.*, Teradyne, Inc. v. Teledyne Indus., Inc., 676 F.2d 865 (1st Cir. 1982) (using the term "net profit" apparently to mean the difference between total revenues associated with a contract and all costs, whether variable or overhead). While "gross profits" must logically mean something greater than profits, such as total revenues without deduction for costs, some courts use it to describe the difference between revenues and variable costs, *id.* at 867, which is properly understood as "profits" (unmodified). Other courts use the term "clear profit," apparently referring to the excess of revenues over variable costs and an allocated portion of overhead. *See, e.g.*, Vitex Mfg. Corp. v. Caribtex 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.*, Tex. 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 in 10% 'clear' profit; that is, profit after taxes, insurances, and hidden costs"); Messina v. Koch Indus., Inc., 267 So. 2d 221, 225 (La. Ct. App. 1972) (identifying the key issue as whether a 10% fixed fee in the contract was "intended to be 'clear' profit or to include profit and some or all overhead expenses").

16. "Surplus" is defined with greater specificity in SC § 1 and its comments.

17. SC §§ 2 and 3 and their comments respectively define "anticipated" and "actual" surpluses with greater specificity.

18. *See* U.C.C. § 2-715(2)(a) (2002). Professors White and Summers' leading commercial law treatise explains that the most common claim for consequential damages in cases involving goods never accepted involves lost profits. WHITE & SUMMERS, *supra* note 5, § 6-5 at 324.

19. RESTATEMENT § 347 cmt. c (1981). The illustrations under § 347 Comment c all involve a tort-like injury or damage to property resulting from a defective machine. *Id.* Illus. 4.

20. L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52, 55 (1936).

costs" (in The Shadow Code). Modern scholars have adopted Fuller and Perdue's terminology.[21] However, the usage bears no relationship to the Restatement's or the U.C.C.'s meaning of "incidental costs," which refers to the costs a party incurs in order to minimize the losses resulting from another's failure to perform.[22] In the comments and illustrations to The Shadow Code, costs incurred only from the other party's breach are called "breach-related costs." The black letter of The Shadow Code avoids distinguishing among types of costs incurred as a result of contracting because all losses are recoverable, subject to well recognized limitations described in SC § 4. This terminology is useful in explaining (as shown in the comments and illustrations) the variety of expenditures that might reduce anticipated or actual surplus.

Finally, the analytical structure of the surplus-based approach to contract damages facilitates theoretical analysis of contract damages rules. For several decades, scholars have attempted to derive models of legal remedies for breach of contract in order to evaluate incentives. Over time, these models have evolved from a very general mathematical form that was useful for analysis of incentives to make and break promises, to rely on promises, and to mitigate losses.[23] They were not particularly subtle and failed to capture the variety of circumstances in which contracts are breached. Unlike The Shadow Code, they were not designed to be universally applicable tools for calculating damages. Subsequent models based the foundation of their approaches on total benefits[24] rather than on surplus, as The Shadow Code does, or, if they focused on surplus, presented a series of formulas, in the manner of the U.C.C., applicable to breaches of different types.[25] The universality of a complex model based on lost surplus[26] provided the foundation for The Shadow Code. While it captured the variety of circumstances in which contracts might be breached, it was cumbersome and unwieldy in application. The Shadow Code presents a straightforward version of that model.

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21. For recent examples, see Christopher W. Frost, *Reconsidering the Reliance Interest*, 44 ST. LOUIS U. L.J. 1361, 1365 n.27 (2000) (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); 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).

22. *See* RESTATEMENT § 347 cmt. c (1981). Under the U.C.C., for sellers, incidental costs 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." U.C.C. § 2-710 (2002). 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." U.C.C. § 2-715(1) (2002).

23. *See* Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 469, nn.12-13 (1980).

24. *See* Robert Cooter, *Unity in Tort, Contract, and Property: The Model of Precaution*, 73 CAL. L. REV. 1, 3 (1985).

25. *See* Robert Cooter & Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 CAL. L. REV. 1434, 1438-42 (1985) (presenting formulas for five different circumstances in which contracts may be breached); E. ALLAN FARNSWORTH, WILLIAM F. YOUNG & CAROL SANGER, CONTRACTS 469-71 (6th ed. 2001) (offering a formula based on the right of a seller to recover lost profits plus net costs incurred, reflecting the RESTATEMENT approach).

26. David W. Barnes, *The Anatomy of Contract Damages and Efficient Breach Theory*, 6 S. CAL. INTERDISC. L.J. 397, 470-80 (1998).

Analytically, the surplus-based approach requires only a comparison of the anticipated and actual surplus:

Damage Award =
Anticipated Surplus
minus
Actual Surplus

Because each surplus is affected by anticipated and actual benefits and costs, and because all types of costs fall under one of the headings of performance, surplus-enhancing or breach-related, the surplus-based damages rule may be applied in various ways. The structure of the surplus-based rule invites one to compare the injured party's position after the breach (actual surplus) with the position that party would have occupied following performance (anticipated surplus):

Damage Award =
(Anticipated Benefits – Anticipated Performance Costs – Anticipated Surplus-Enhancing Costs)
minus
(Actual Benefits – Actual Performance Costs – Actual Surplus-Enhancing Costs – Breach-Related Costs)

There are many variations on this formula. One of the most useful is one that compares anticipated and actual revenues on one hand and anticipated and actual costs on the other:

Damage Award =
(Anticipated – Actual Benefits)
minus
(Anticipated – Actual Costs).

For instance, the surplus-based rule provides that an injured party who incurred no costs and derived no benefit from the breaching party is entitled to her lost surplus (anticipated benefits less anticipated costs). More complicated cases involving partial performance (some actual benefit), cover or resale (some actual benefit and actual cost), and breaches of warranty may similarly be analyzed without recognizing any distinction between buyers and sellers in the basic structure of the rule. The comments and illustrations to The Shadow Code provide computations for every category of circumstances in which contracts are breached.

II. THE SHADOW CODE WITH COMMENTS AND ILLUSTRATIONS[27]

A. Shadow Code § 1: General Rule for Recovery of Damages for Breach of Contract

When another's performance does not conform to the contract, an injured party may recover damages as measured by that party's lost surplus, which is the difference between anticipated surplus and actual surplus.

27. The signal "see" indicates that the facts in the illustration are roughly based on the facts in the case cited, that the court discussed the issue presented in the illustration, and that the opinion supports the treatment offered by The Shadow Code. The signal "see, e.g.," indicates a case with analogous facts or analogous treatment of the issue that the comment discusses. The abbreviation "SC § __" signifies a reference to that particular section of The Shadow Code.

1. Comments

a. Consistency with U.C.C. § 1-106

These proposed rules are to be interpreted in a manner consistent with U.C.C. § 1-106, which requires that remedies be liberally administered to the end that the aggrieved party may be put in as good a position as if the other had fully performed. The adjective "anticipated," used in The Shadow Code to modify "surplus," "revenue," and "cost," thus refers to what would have happened had the other fully performed. It does not refer to a result a party hoped for or projected at the time of contracting.

b. Surplus and Lost Surplus Defined

"Surplus" is a monetized measure of the improvement in wealth or well-being a contracting party obtains from another's performance. "Lost surplus" is a monetized measure of the difference between the improvement in wealth or well-being the injured party would have obtained had the other performed as promised[28] and the improvement that party actually obtained from the other's nonconforming performance, its own expenditures in relation to the contract, and its own arrangements of substitute performance.[29] For business enterprises, profits and enhanced goodwill are often measures of improvements in well-being. For individuals, surplus measures the improvement in well-being or satisfaction the individual would have obtained, or did obtain, as a result of either performance or breach. Losses are compensable only to the extent they meet the requirements of mitigation, foreseeability, and certainty described in SC § 4.

Illustrations:

1. *A* contracts to sell *B* timber. *B* repudiates the contract. Because *B* breaches the contract, *A* does not obtain profits of $66,000, but rather, suffers a loss upon resale of approximately $150,000. A damages award of $216,000 is appropriate, because it is the monetized measure of the improvement in wealth *A* would have obtained had *B* performed less the improvement actually obtained ($0).[30]

2. *A* contracts to sell *B* three tanks made to *B*'s specifications for $64,350, which normally would have cost *A* $40,000 to manufacture. *A* has not incurred any of the costs of manufacturing the tanks when *B* repudiates the contract. *A* is entitled to recover in damages the surplus *A* would have obtained ($24,350) less the surplus actually obtained ($0). That amount is sufficient to ensure that *A* obtains the

28. *See* SC § 2.
29. *See* SC § 3.
30. *See* Stanfill v. TAT (U.S.A) Corp., 709 P.2d 717 (Or. Ct. App. 1985).

monetized measure of improvement in wealth *A* would have obtained had *B* performed.[31]

3. *B*, a college sorority chapter, contracts for $3,612 to buy from *A*, 168 custom-designed sweaters to be worn at a sorority function the day after delivery is due. *A* repudiates the contract. Subject to general limitations on recovery[32] *B* is entitled to recover in damages the surplus *B* would have obtained, measured by the improvement in well-being *B* would have realized, which may have been a subjective benefit, less the actual surplus of zero.[33]

c. Lost Surplus with Costs Incurred

The surplus actually obtained from the other's non-conforming performance may be negative, as in cases where the injured party incurred costs in anticipation of the other's performance. To restore the lost surplus, courts must award sufficient damages to compensate for that loss plus the anticipated improvement in well-being. Failure to include both elements results in undercompensation because such costs must be covered before any improvement in well-being can be realized.

Illustration:

4. Same as Illustration 2 except that *A* has already manufactured the tanks when *B* repudiates the contract. If efforts to resell the tanks or obtain value from salvage are unavailing, *A* is entitled to the full contract price as damages. This measure of damages would provide compensation to reimburse *A* for costs *A* incurred plus an amount equal to the anticipated improvement in wealth *A* would have obtained had *B* performed.[34]

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31. *See, e.g.*, Royal Jones & Assocs. v. First Thermal Sys., Inc., 566 So. 2d 853 (Fla. Dist. Ct. App. 1990) (holding that seller was entitled to damages in the amount of the full contract price where tanks were already manufactured and could not be resold at a reasonable price).

32. *See* SC § 4.

33. *See* Furlong v. Alpha Chi Omega Sorority, 657 N.E.2d 866 (Bowling Green County Mun. Ct. 1993). Similarly, if *B* contracts to buy a custom-built houseboat from *A* for $160,000 and *A* breaches, *B*'s damages are based on the difference between anticipated and actual surplus. *B*'s damages are based on *B*'s benefits and costs if *A* had performed compared to if *A* had breached. The benefits are a monetized approximation of the well-being or satisfaction *B* would have obtained if *B* had been a consumer or of the revenues *B* would have obtained if *B* had been a business enterprise. *See* Tarter v. MonArk Boat Co., 430 F. Supp. 1290 (E.D. Mo. 1977).

34. Awarding lost profits plus costs incurred does not produce a windfall. Consider where *A* contracts to sell specially manufactured rolling steel doors to *B* for $16,000 and incurs all of the costs of performing for *B*, in the amount of $10,000. Where the doors have no salvage or resale value after *B*'s breach, an award of $16,000, the contract price ensures that *A* is placed in the position *A* would have occupied had *B* performed, but *A* does not receive a windfall. *See, e.g.*, Walter Balfour & Co. v. Lizza & Sons, 6 U.C.C. Rep. Serv. (CBC) 649, 650-51 (N.Y. Sup. Ct. 1969) (awarding the aggrieved seller of specially-manufactured rolling steel doors the contract price of $16,000 less a credit for doors used as scrap and for money saved).

d. Lost Surplus, Changes in Market Prices, and Windfalls

An increase in market price benefits a prudent or lucky buyer who contracted earlier for a lower price. A fall in market price benefits a seller who earlier contracted for a higher price. The surplus-based damages rule recognizes this reality by putting the injured party in the same position the other's performance would have done. The surplus-based rule focuses on the improvement in well-being the injured party would have received. Because the injured party's recovery is explicitly limited to the amount he or she would have obtained had the other performed, there is no chance for the injured party to earn a windfall from the other's payment of damages.

Illustrations:

5. *A* contracts to sell ten gallons of wholesale gasoline on the retail market to *B* for $1.30 per gallon. *A* acquired the ten gallons from a third party for $1.20 per gallon. *B* breaches when the retail market price falls to $1.25 per gallon. *A* resells the ten gallons of gasoline for $1.25 a gallon and seeks damages from *B*. At the time performance was due, *A*'s surplus would have been $1. The damages award is the difference between the anticipated surplus ($1) and the surplus realized from the resale ($.50). An award of $.50 ensures *A* does not earn a windfall because it restores *A*'s lost surplus, and places *A* in the position it would have occupied had *B* performed.[35]

6. *B* contracts to buy 2,000 steers for $67 per steer from *A* and to sell the steers on the retail market to C for $67.35 per steer, which would yield a surplus of $700. *A* breaches when the market price for steers increases dramatically. *B* seeks damages from *A*. The buyer benefits from having contracted before the change in market price. An award of $700 ensures *B* does not earn a windfall because it merely restores *B*'s lost surplus, placing *B* in the position *B* would have occupied had *A* performed. *B* is not undercompensated because the contract with C limited his anticipated surplus to $700.

35. *See, e.g.*, Tesoro Petroleum Corp. v. Holborn Oil Co., 547 N.Y.S.2d 1012 (N.Y. Sup. Ct. 1989). Nor is there a windfall where *A* has not yet acquired the gasoline from the third party when the wholesale price drops. Assume that at the same time the retail price drops to $1.25 per gallon, the wholesale price drops to $1.15 per gallon. An award of its lost surplus, $1.50, ensures that *A* does not earn a windfall. The damage award leaves *A* in the same position *A* would have occupied had *B* performed as promised. The lost surplus is the difference between the surplus *A* would have earned if *A* had purchased the gas on the wholesale market after the fall in wholesale price ($1.15 times ten gallons) and sold it to *B* at the contract price ($1.30 times ten gallons) and the actual surplus ($0). There is no windfall, because if *A* had bought at that lower price and sold at the contract price, *A* would have improved its well-being by $1.50.

Where there is no such resale contract, anticipated surplus depends on the market resale price.[36]

e. No Lost Surplus in Some Cases Involving Substitute Transactions

Under the lost surplus rule, an injured party may not enter into a substitute transaction that is more favorable than the underlying contract and still obtain damages from the breaching party.

Illustrations:

7. Because *A* is unable to perform, it breaches a contract to sell 100,000 gallons of gasoline to *B* for $.604 per gallon, for a total loss to *B* of $60,400. The market price at the time of breach has fallen to $.553 per gallon. If *B* obtains an equal or greater surplus by cover than *A*'s performance, *B* may not also recover damages from *A*. No lost surplus arises because actual surplus is greater than anticipated surplus.[37]

8. *B* breaches a contract to buy two molding machines from *A* for $1,290,871 per machine. Where *A* resells the machines on the market for a price of $1,398,592 each, *A* may not also recover from *B* and thereby obtain a surplus equal to or greater than the anticipated surplus. *A* has incurred no lost surplus.[38]

f. Lost Surplus Includes Larger Projects

The improvement in wealth or well-being of the injured party includes any benefits that will be obtained after improving, developing, modifying, or otherwise processing the goods. Just as a buyer for resale may recover the benefit of acting as a jobber and recover her lost surplus, a processor of raw materials must be put in the position he would have occupied had the other performed. Both types of buyers are buying the goods as part of a larger project that will produce benefits in

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36. *See, e.g.*, H-W-H Cattle Co. v. Schroeder, 767 F.2d 437 (8th Cir. 1985) (involving a contract for the sale of 2,000 steers for $67 per hundredweight and a court award of $1,371.83 to the aggrieved buyer for the lost resale commission for the 603 steers that were not delivered). Nor is there a windfall where *B* covers by purchasing similar steers on the retail market from a third party for $67.25. An award of $.25 per steer, or $500, ensures that *B* does not earn a windfall, because it merely restores *B*'s lost surplus and places *B* in the position it would have occupied had *A* performed. *See, e.g.*, Neibert v. Schwenn Agri-Prod. Corp., 579 N.E.2d 389, 393 (Ill. App. Ct. 1991) (awarding the difference between the cost of cover and the contract price where an aggrieved buyer of sunflower seeds covers so as to fill a contract with a repurchaser).

37. *See, e.g.*, Chronister Oil Co. v. Unocal Ref. & Mktg., 34 F.3d 462 (7th Cir. 1994) (applying the market/contract differential where the buyer took the gasoline from its own inventory rather than buying it on the open market). In some cases, covering at a lower price might result in recoverable damages. If, for example, in this illustration, *B* had covered by buying in the open market at the lower price, but had reasonably incurred costs of $6,000 in locating and effecting cover from a variety of sellers, *B*'s total cost of cover would be $55,300 plus $6,000, or $61,300. While the cover price is less than the contract price, the costs of effecting cover result in *B* obtaining a surplus $900 less than performance under the contract would have yielded. *B* may recover $900 in damages from *A*.

38. *See* The Colonel's, Inc. v. Cincinnati Milacron Mktg. Co., 910 F. Supp. 323, 327-28 (E.D. Mich. 1996).

excess of the contract price. Sellers may less frequently have larger projects of which the particular contract is a part, but comparable losses may result from thwarted arrangements made with third parties. Damages under the surplus-based rule must be sufficient to restore the injured buyer or seller to the position she would have occupied had the other performed. Awarding an amount sufficient to compensate for losses caused by the breach, including the surplus that would have resulted from the larger project, is an appropriate way to achieve this end. The monetized measure of the improvement in wealth or well-being the injured party would have obtained includes both immediate gains, such as primary and secondary profits, and future gains, such as goodwill.

Illustrations:

9. *B* contracts to purchase rough lumber from *A* for the purpose of finishing and reselling it. Performance would have resulted in *B* obtaining a surplus of $15.00 per thousand feet, or a total of $9,133.73. *A* fails to deliver the agreed amount of timber, and *B* is unable to cover. *B* may recover $9,133.73 in order to obtain the surplus *B* would have obtained had *A* performed as promised.[39]

10. *A* contracts to sell logs to *B*. *A* specifies its need to complete harvesting promptly in order to meet a scheduled logging commitment to another buyer, *C*. *B* delays and then repudiates. In addition to other losses, *A* is entitled to recover damages for the loss incurred in performing the contract with C to the extent attributable to *B*'s delay and repudiation. Awarding damages for this loss allows *A* to obtain the surplus associated with the logging for *C*, which *A* would have obtained had *B* performed as promised.[40]

11. *B*, a gas station and mini market, contracts to purchase unleaded blended gasoline from *A*. The gasoline is not merchantable, because it damages engines. *B* is entitled to recover the surplus lost from the sale of the nonconforming gasoline (loss of primary profits); from the lost sales of other items in its mini market during the period of time *A* supplied nonconforming gasoline (loss of secondary profits); and from

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39. *See* Jennings v. Lamb, 296 S.W.2d 828, 830-31 (Tenn. 1956) (relying on factual evidence showing that the lost surplus was proved with reasonable certainty). Recovery of all elements of loss is subject to the limitations in SC § 4.

40. *See, e.g.*, Sprague v. Sumitomo Forestry Co., 709 P.2d 1200, 1205-06 (Wash. 1985) (holding that the loss incurred from the delay was a consequential damage and thus not recoverable to an aggrieved seller under the U.C.C. rule then in effect). Subject to the general limitations on recovery, see SC § 4, a party may recover lost surplus due to financial inability to engage in other projects. Consider a case where, pursuant to *A*'s contract to sell machines to *B*, *A* takes out a loan to pay for the raw materials necessary to build the machines. When *B* repudiates, *A* is entitled to collect, among other things, the surplus *A* could have obtained from investing the post-breach interest payments *A* would not have had to make if *B* had performed. This amount compensates *A* for the surplus associated with the larger project *A* would have obtained had *B* performed as promised. *See, e.g.*, Firwood Mfg. Co. v. Gen. Tire, Inc., 96 F.3d 163, 170-71 (6th Cir. 1996) (holding aggrieved seller's lost use of money a consequential damage not recoverable under the then applicable U.C.C. rule).

the loss of future sales and reputation among customers (loss of goodwill).[41]

B. Shadow Code § 2: Anticipated Surplus

An injured party's anticipated surplus is the difference between the benefit that party would have received as a result of the contract (anticipated revenue) and cost that party would have incurred in relation to the contract had the contract been fully performed (anticipated cost).

1. Comments

a. Anticipated Revenue and Cost Defined

"Anticipated revenue" equals total benefits a party would have received.[42] "Anticipated cost" equals the total burdens that party would have incurred as a result of contracting with the other had the other performed as promised. The extent to which revenues were actually obtained or costs were actually incurred is irrelevant to the calculation of anticipated surplus. Thus, benefits and costs associated with substitute performances arranged by the injured party and those associated with part or defective performance by either party are irrelevant to anticipated surplus. For claims brought by sellers based on consumer contracts for the sale of goods, a seller's anticipated revenue does not include benefits from larger projects.

b. Anticipated Surplus Distinguished from Hoped-for Surplus

Anticipated revenue, costs, and surplus are measured by what would have occurred rather than what the parties hoped would occur when they contracted. Changes in the projected revenue or projected cost from the time of contracting to the time of performance may change the relationship between revenues and costs and reduce the hoped-for surplus. The measure of damages does not depend on whether the anticipated revenue turns out to be less than the anticipated costs because of bad judgment, change of circumstance, or any other reason. The anticipated surplus is measured by the surplus that would have been realized had the other performed, not by the surplus hoped for or projected at the time of contracting.

Illustrations:

1. *A* contracts to sell 2,000 raincoats to *B*, a retailer, at $40 each. At the time of contracting, *A* expects the cost of manufacture to be $15 per raincoat in materials and labor. *B* breaches. By the time of performance (the time of delivery of the raincoats) *A*'s costs have risen to $45 per raincoat because of *A*'s poor management of labor and an increase in the market price of

41. *See* AM/PM Franchise Ass'n v. Atl. Richfield Co., 584 A.2d 915 (Pa. 1990).

42. One benefit that the party realizes from performance that is not realized in breach is the lost opportunity to enjoy the benefits immediately. Pre-judgment and post-judgment interest are a measure of damages designed to compensate the injured party for the loss of this benefit. Such losses are generally recoverable, but are not included in The Shadow Code illustrations.

the fabric used to manufacture the raincoats. Although *A* hoped for a surplus of $25 per raincoat at the time of contracting, *A*'s damages attributable to *B*'s breach are measured according to *A*'s anticipated surplus. *A*'s anticipated surplus is the surplus *A* would have earned if *B* had performed, which would have been a loss of $5 per raincoat.[43]

2. *B*, the buyer of raincoats at $40 each in the preceding illustration, anticipated reselling them for $60 each. As a result of an increase in the market price of fabric, the market retail price of such raincoats had risen to $80 each when *A*'s performance was due. If *A* breaches, *B*'s anticipated revenue is measured by the amount *B* would have obtained had *A* performed. Thus, *B*'s anticipated revenue is $80 per raincoat and *B*'s anticipated surplus is $40 per raincoat, despite the fact that *B* only hoped for $60 in revenues and $20 in surplus per raincoat at the time of contracting.

c. Seller's Anticipated Surplus

For a seller, the anticipated revenue generally includes the contract price and may also include benefits anticipated from larger projects in which the seller is engaged[44] unless the seller is claiming damages from a consumer contract for the sale of goods. For sale-of-goods cases where damages are limited in this way, the anticipated revenue and, as a consequence, the anticipated surplus includes only the surplus from the sale itself. For a seller, anticipated costs include all costs the seller would have incurred to perform as promised. The definition of "anticipated" in this section refers only to what would have happened, not what actually happened.[45] Whether the expected costs in fact had been incurred or other benefits actually were obtained is irrelevant to the calculation of anticipated costs or anticipated revenue. For a seller who has made a profitable arrangement, the contract price will be greater than the associated costs.

Illustrations:

3. *A*, a reseller of used equipment, buys a bulldozer from *B* for $2,000 and contracts to sell it to C for $10,000. *A*'s anticipated revenue is $10,000, its anticipated costs are $2,000, and its anticipated surplus is $8,000. *A* is the seller in this illustration. *A*'s anticipated revenue from the contract was greater than *A*'s associated costs, yielding a positive anticipated surplus.[46]

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43. *See, e.g.*, Burberrys (Wholesale) Ltd. v. After Six Inc., 471 N.Y.S.2d 235 (N.Y. Sup. Ct. 1984) (addressing the issue of whether a proposed resale of the raincoats not delivered to the buyer would be in good faith and commercially reasonable pursuant to U.C.C. § 2-706 and trademark infringement rules). For the lost surplus calculation, *see infra* SC § 3, cmt. e, illus. 14, n.69.

44. *See* SC § 1, cmt. f.

45. *See* SC § 2, cmt. b.

46. *See* McMillan v. Meuser Material & Equip. Co., 541 S.W.2d 911 (Ark. 1976).

4. Same as the preceding illustration except that *A*, the reseller, also promises to recondition the bulldozer and deliver the bulldozer to *C*. These additional performance costs of *A*'s would have amounted to $750, raising *A*'s anticipated cost to $2,750, and lowering *A*'s anticipated surplus to $7,250. The amount of the additional cost is relevant because that amount reflects costs *A*, the reseller, would have incurred if *C*, the buyer, had performed. Whether *A* actually incurred the reconditioning and delivery costs before *C*'s breach, whether *A* can resell to another, and whether the bulldozer has salvage value are irrelevant to this section.

d. Buyer's Anticipated Surplus

For a buyer, the anticipated cost generally includes the contract price and may include surplus enhancing costs or costs of engaging in larger projects of which the seller's performance is a part.[47] Buyers' anticipated costs potentially include both performance costs the buyer has promised the seller it will incur and costs it will incur to enhance its surplus. For a buyer, anticipated revenue often includes the benefits associated with using, reselling, or transforming the goods. For a buyer who has made a profitable arrangement, the anticipated revenue will be greater than the contract price.

Illustrations:

5. Same facts as Illustration 3, except *B* breaches its contract to sell the bulldozer to *A*, so *A* is unable to resell the bulldozer to *C*. *A* is the buyer in this illustration. The excess of *A*'s anticipated revenue ($10,000) over *A*'s anticipated cost (the $2,000 contract price) yields a positive anticipated surplus of $8,000.[48]

6. *B*, a college sorority chapter, contracts for $3,612 to buy from *A* 168 custom-designed sweaters to be worn at a sorority function the day after delivery is due. *A* repudiates the contract. Subject to general limitations on recovery,[49] *B*'s anticipated surplus is the monetized measure of improvement in well-being or satisfaction *B* would have realized from using the sweaters at the planned function had *A* performed as promised. It is the difference between the benefits *B* would have obtained and the costs *B* would have incurred in relation to the sweaters had *A* performed. The anticipated

47. *See* SC § 1, cmt. f.

48. Actual costs incurred are irrelevant to calculating anticipated surplus. Consider a case that is the same as this illustration, except *C* makes a down payment of $1,000. Whether *C* has made a down payment and the amount of any down payment are irrelevant to calculating the anticipated revenue or anticipated surplus because they reflect benefits actually received. The definition in this section does not refer to the time when the revenues are received or to what actual performance occurred. Compare SC § 3, which refers to the calculation of actual surplus. If *C* had performed as promised, *A*'s revenue would have been $10,000 regardless of the timing of the payments.

49. *See* SC § 4.

costs include both *B*'s performance cost ($3,612) and additional surplus-enhancing costs, such as additional individualized monogramming needed to enhance the surplus *B* would have obtained.[50]

e. Anticipated Surplus, Overhead, and Fixed Costs

The computation of anticipated surplus reflects only revenues and variable costs associated with the contract. Overhead or fixed costs, those the injured party would have incurred even if it had not entered into the contract, are not included, because, by definition, they were not increased by the breached agreement. A party pays the overhead or fixed costs of its enterprise out of the surplus it obtains from the complete performance of the contract by both parties. Complete performance improves a party's well-being by contributing to both payment of those fixed expenses that do not vary regardless of performance of the contract in question or the party's wealth. Because the anticipated surplus calculated according to this rule includes an amount that is available to contribute to the payment of overhead expenses, overhead and fixed expenses may not be included with variable performance and surplus-enhancing costs in the calculation of anticipated (or actual) costs.

Illustration:

7. *A*, which manufacturers a wide variety of electronics systems in its factory, contracts to sell *B* a transistor test system for $10. When *B* breaches, *A*'s anticipated costs do not include such overhead expenses as the cost of factory maintenance, insurance, and property taxes. These are expenses *A* would have incurred regardless of whether *A* had contracted with *B*. *A*'s anticipated costs do include the variable performance cost of raw materials used to build the transistor test system as well as direct labor costs such as wages paid to testers, shippers, and installers, to the extent those costs were incurred in order to perform for *B*. If *A*'s anticipated cost is $8, its anticipated surplus would be $2. If the parties had performed as promised, *A* could have used a portion of this $2 surplus to contribute to its overhead expenses. If *B* breaches and *A* is awarded an amount equal to *A*'s lost surplus ($2 per system), *A* is thereby placed in the same position as if *B* had performed because *A* may still use the same portion of this amount to contribute to its overhead expenses.[51]

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50. *See, e.g.*, Furlong v. Alpha Chi Omega Sorority, 657 N.E.2d 866 (Bowling Green County Mun. Ct. 1993). The buyer in this illustration is a consumer, but the same analysis applies to a business enterprise. Consider a case where *B* contracts for $160,000 to buy from *A*, a custom-built houseboat that *A* delivers in a defective condition. *B*'s anticipated surplus is a monetized approximation of the excess of benefits over costs associated with producing those benefits. *B*'s status as a consumer or business enterprise does not affect the approach to calculating *B*'s damages, though it may affect how *B* proves its losses. *See* Tarter v. MonArk Boat Co., 430 F. Supp. 1290 (E.D. Mo. 1977).

51. *See* Teradyne, Inc. v. Teledyne Indus., Inc., 676 F.2d 865 (1st Cir. 1982). The term "anticipated surplus" avoids the business-centered and often confused term "profit." In *Unique Sys., Inc. v. Zotos Int'l, Inc.*, 622 F.2d 373 (8th Cir. 1980), *A*, a manufacturer of hair-spray systems, entered into a contract to sell spray systems to *B*. *B* subsequently repudiated the contract, and *A*, without having

f. Anticipated Surplus, Breach of Warranty

In the event of a breach of warranty, the anticipated surplus is equal to the revenue the injured party would have realized had the contract been fully performed less the anticipated variable costs.

Illustration:

8. Pursuant to an express warranty, *A* contracts to sell "spring wheat" seed to *B* for $10.00 per pound. *B*, in turn, intends to sell the mature crop to a third party for $15.00 per pound. *A* breaches the warranty and delivers to *B* "winter wheat" seed that does not produce a harvestable crop. *B*'s anticipated surplus is the revenue that *B* would have received from its contract with the third party ($15.00), less variable costs, including the purchase price of the wheat seed as warranted ($10.00), which is a performance cost, and farming expenses related to planting and harvesting the crop, which are surplus-enhancing costs.[52]

C. Shadow Code § 3: Actual Surplus

An injured party's actual surplus is the difference between the benefits that party received (actual revenue) and cost that party incurred (actual cost) as a result of the parties' performances under the contract or from substitute performance arranged by the injured party.

1. Comments

a. Actual Surplus Defined

"Actual surplus" is the difference between actual revenue and actual cost. It is a measure of the improvement in wealth or well-being the injured party obtained from having contracted with the other person, considering both the costs and benefits of having done so and incorporating the costs and benefits associated with transactions arranged to substitute for the other's promised, but defective, performance.

Illustrations:

1. *A* contracts to sell 12,000 yards of specially manufactured fabric to *B* for $36,705. After *A* manufactures all the fabric at a cost of $27,414, the market price drops, and *B* repudiates. *A* is able to sell 7,000 yards from the order to a third party for

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incurred any of the costs of manufacturing the systems, filed suit for damages. *A* recovered what the court termed "gross profits," an amount that reflected the difference between the contract price and the variable costs *A* would have incurred had *B* not repudiated. Under the surplus-based rules, this difference is called the anticipated surplus and includes any residual over variable costs, because this surplus would have been available to contribute to fixed–overhead expenses or for any other use.

52. *See* Albin Elevator Co. v. Pavlica, 649 P.2d 187 (Wyo. 1982).

$10,119, but is unable to sell the remaining 5,000 yards. *A*'s anticipated revenue is $36,705, and *A*'s actual revenue from resale is $10,119. Anticipated and actual costs were $27,414. Lost surplus is the difference between anticipated surplus ($9,291) and actual surplus (-$17,295), and equals $26,586.[53]

2. *B* contracts for $3,612 to buy from *A* 168 custom designed sweaters to be worn at a sorority function, the day after the delivery date. *B* pays $2,000 in advance before *A* breaches. If *B*'s anticipated revenue is $8,000 (based on the benefits *B* would have derived from having the 168 sweaters available for the function) and *B*'s anticipated cost is $3,612 (the contract price), then *B*'s anticipated surplus is $4,388. If actual revenue was $0 and actual cost was the $2,000 down payment, then actual surplus is -$2,000. Accordingly, lost surplus is $6,388 ($4,388 minus -$2,000).[54]

b. Actual Revenue from Preparation to Receive or Deliver Performance

Actual revenue is a measure of the total benefits obtained by a party due to contracting with the other or arranging transactions to substitute for the other's promised performance. Benefits may be derived from many sources, including the injured party's preparation for the other's performance, such as by a seller's manufacturing goods and holding them in preparation for delivery to the breaching buyer or a buyer's preparations to receive goods from a breaching seller.

Illustrations:

3. *B* contracts to purchase twenty-six hog farrowing houses and nurseries from *A*. *B* incurs installation costs preparing its property for *A*'s delivery of the huts. If *B*'s preparation makes the property ready for another seller's performance, it creates a benefit to *B* and is included in actual revenue, despite *A*'s breach.[55]

4. *A* contracts to sell cumene to *B*. *A* purchases a large quantity of benzene for use in manufacturing the cumene, but *B* repudiates before *A* begins work. If the benzene will still yield a benefit to *A* by use in another manufacturing process, that

53. *See* Foxco Indus., Ltd. v. Fabric World, Inc., 595 F.2d 976 (5th Cir. 1979).

54. *See, e.g.*, Furlong v. Alpha Chi Omega Sorority, 657 N.E.2d 866 (Bowling Green County Mun. Ct. 1993) (awarding aggrieved buyer the amount of the purchase price paid, and allowing buyer to hold the sweaters until recovery of that payment, with no discussion of the benefit the buyer would have obtained from the sweaters).

55. *See* Nachazel v. Miraco Mfg., 432 N.W.2d 158 (Iowa 1988). For the lost surplus calculation, *see infra* SC § 3, cmt. e, illus. 10.

benefit is one that is associated with the contract and is therefore included in actual revenue.[56]

c. Actual Revenue from Partial or Defective Performance

Actual revenue includes the benefits derived by the injured party from the breaching party's partial or defective performance and from the injured party's own performance. For instance, when a breaching buyer makes a deposit or prepayment, the injured seller's actual revenue includes the amounts of those payments. When a breaching seller delivers less than promised under a contract, including an installment contract, the buyer's benefit from the performance delivered is included in actual revenue. Breach of warranty cases are also examples of defective performance where the actual revenue is the benefit obtained from the goods received.

Illustrations:

5. Before breaching, *B* makes a $4,250 deposit on a contract to purchase a boat from *A*. The contract price is $12,587.40. *A* anticipated buying the boat from the manufacturer and preparing it to supply to *B* for $10,008. When calculating damages, the deposit of $4,250, a partial performance by *B*, is actual revenue to *A*.[57]

6. *A* contracts to sell *B* 1,300 tons of coal for $2.45 per ton. *B* intends to resell for $4 per ton. *A* delivers 937 tons, and *B* resells as intended. *A* refuses to deliver the remaining 363 tons. *B*'s actual revenue is $3,748 ($4 times 937 tons).[58]

7. *A* contracts to sell a custom built houseboat under warranty to *B* for $160,000. *B* takes delivery of the boat and discovers

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56. *See* USX Corp. v. Union Pac. Res. Co., 753 S.W.2d 845 (Tex. App. 1988). The same analysis applies to resales and to installment sales contracts. Consider a case where *A* contracts to sell *B* 2,000 raincoats at $40 each. *B* accepts and pays for 400 of the raincoats and subsequently breaches, refusing to pay for or accept the remaining 1,600 raincoats. *A*'s actual revenue is $16,000 ($40 times 400). The benefit *A* derives from those raincoats in resale or salvage is also actual revenue, as it is a benefit received by the injured party as a result of the contract. *See, e.g.*, Burberrys (Wholesale) Ltd. v. After Six Inc., 471 N.Y.S.2d 235 (N.Y. Sup. Ct. 1984) (addressing whether a proposed resale of the raincoats not delivered to the buyer would be in good faith and commercially reasonable pursuant to U.C.C. § 2-706 and trademark infringement rules). Consider also an installment sales case where *B* contracts to purchase a fixed quantity of sugar from *A* in installments over three months. Each delivery of sugar is to follow immediately upon *A*'s receipt of shipping orders from *B*. A portion of the sugar is delivered and paid for within the three month time period, but *B* stops sending shipping orders in the middle of the contract, with remaining installments left unpaid. The total payments made by *B* are *A*'s actual revenue associated with the contract. The benefit to *A* of the sugar that *A* does not deliver is also actual revenue to *A*, as it is a benefit received by the injured party as a result of the contract. If, however, that sugar cannot reasonably provide any benefit to *A* (for instance because of a glut of sugar on the market) no actual revenue is associated with that produced, but undelivered, sugar. *See* Great W. Sugar Co. v. Pennant Prods., Inc., 748 P.2d 1359 (Colo. Ct. App. 1987). For the lost surplus calculation, *see infra* SC § 3, cmt. e, illus. 11, n.66.

57. *See* Neri v. Retail Marine Corp., 285 N.E.2d 311 (N.Y. 1972) (holding that foreseeable, actual costs of storage and upkeep are added to damages). For the lost surplus calculation, *see infra* SC § 3, cmt. i, illus. 25, n.68.

58. *See* Pittsburgh Coal Co. v. Northy, 123 N.W. 47 (Mich. 1909).

that it is deficient in numerous respects and does not conform to the warranty. *B*'s actual revenue is $123,000, the benefit obtained from receiving the boat in defective condition. That actual revenue is the monetized approximation of the level of satisfaction or well-being a consumer derives or the revenues a commercial enterprise obtains from a boat in that defective condition.[59]

d. Actual Revenue from Substitute Transactions

Actual revenue includes the benefit to the injured party of any transactions the injured party arranges to substitute for the promised performance. Examples include benefits derived from cover and resale transactions.[60] Where an injured party declines to arrange a substitute transaction, that party may recover damages based on a hypothetical reasonable transaction the injured party could have arranged at a reasonable market price. In such cases, the market price is treated as actual revenue for sellers and part of actual cost for buyers. In this hypothetical transaction, the costs the injured party would have incurred are treated as actual costs, and the revenues the injured party would have obtained are treated as actual revenues.[61]

Illustrations:

8. *B* breaches a contract to purchase 1,000 tons of imported European steel from *A* at $300 per ton. *A* resells the 1,000 tons of steel for $200 per ton. Subject to the rules regarding lost volume sellers[62] the $200,000 obtained from the resale is actual revenue because it reflects the benefit of any transactions the injured party arranged to substitute for the promised performance.[63] If *A* elects not to resell, the market price at which *A* could reasonably have resold the steel, perhaps $200 per ton, would be treated as actual revenue.

9. *A* contracts to deliver 229,000 pounds of confection sunflowers to *B* for $.1125 per pound. Because of severe weed infestation and drought, *A* is unable to deliver the sunflowers to *B*, who purchases replacements at a cost of $.26 per pound. *B*'s actual revenue is the benefit *B* obtains from the replacement goods.[64] If the buyer elects not to cover, the market price at which the buyer could reasonably have covered, presumably $.26 per pound, would be treated as actual cost, and the benefit *B* would have obtained is treated as actual revenue.

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59. *See* Tarter v. MonArk Boat Co., 430 F. Supp. 1290 (E.D. Mo. 1977).

60. *But see infra* cmt. h, Actual Revenue, Lost Volume Seller.

61. *See also infra* SC § 3 cmt. g. For treatment of substitute transactions that are not reasonable, *see infra* SC § 4, cmt. d.

62. *See infra* SC §3, cmt. h.

63. *See* Harlow & Jones, Inc. v. Advance Steel Co., 424 F. Supp. 770 (E.D. Mich 1976). For the last surplus calculation, *see infra* SC § 3, cmt. g, illus. 20.

64. *See* Red River Commodities, Inc. v. Eidsness, 459 N.W.2d 811 (N.D. 1990).

e. Actual Cost Associated with Performance or Enhancing Surplus

Actual cost is a measure of the total burdens incurred by a party due to contracting with the other. Burdens include the injured party's cost of preparing or beginning to perform or performing in full as well as its surplus-enhancing costs. The benefit from those expenditures is not relevant to the computation of actual cost, but rather to the computation of actual revenue.

Illustrations:

10. As in Illustration 3, *B* incurs expenses of $4,591 before the delivery date to prepare the property for farrowing houses promised by *A*. When *A* breaches, *B* is entitled to recover those expenses associated with preparing to receive the other's performance even if *B* has not promised *A* that *B* would incur those expenses, as they are surplus-enhancing costs (actual costs associated with performance of the contract) and are burdens to *B*. If *B*'s anticipated revenue was $100,000 and anticipated costs, including the contract price of $50,000, the installation costs of $4,591, and other variable costs of $25,409, totaled $80,000, then its anticipated surplus would be $20,000. If *B* has not yet paid the contract price and has incurred no costs aside from the installation expenses, *B*'s actual surplus is -$4,591 (actual revenue of $0 minus actual cost of $4,591). *B*'s lost surplus is $24,591 ($20,000 anticipated surplus minus -$4,591 actual surplus).[65]

11. *A* contracts to design and manufacture lawn mower grass catcher bags for *B*. *B* breaches after *A* has purchased raw materials but before *A* begins manufacturing the bags. The costs of those materials purchased in preparation to deliver performance are a burden to *A* and are thus included in actual costs associated with performance of the contract, without regard to whether the materials yield any benefit to *A* as salvage. That benefit is relevant only to actual revenue. If *A*'s anticipated revenue was $241,000 (20,000 bags times $12.05 per bag) and its anticipated costs were $213,600 (20,000 bags times $10.68 per bag), then *A*'s anticipated surplus is $27,400. If *A* has spent $18,442 at the time of breach on raw materials, which have no other use and cannot be resold, then *A*'s actual revenue is $0 and actual costs are $18,442, yielding an actual surplus of -$18,442. Accordingly, *A*'s lost surplus is $45,842 (anticipated surplus of $27,400 minus actual surplus of -$18,442).[66]

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65. *See* Nachazel v. Miraco Mfg., 432 N.W.2d 158 (Iowa 1988).

66. *See* C.R. Daniels, Inc. v. Yazoo Mfg. Co., 641 F. Supp. 205 (S.D. Miss. 1986). The same logic applies to installment contracts. Consider a case where *A* refines a quantity of sugar in preparation for delivery to *B* under an installment contract with *B*. *B* breaches after accepting delivery of and paying for a portion of the quantity. The $375,000 *A* spent acquiring the raw materials and refining both the delivered and the undelivered sugar for *B* is an actual cost. The cost of producing the undelivered portion is an actual cost, because it was incurred in preparation of performance to *B*. The

12. *B* contracts to buy 2,000 steers from *A* for $67 per steer and makes a $50,000 down payment toward the purchase price of $134,000. *A* delivers only 500 of the promised cattle. The down payment is a cost *B* incurred as a result of contracting with *A* and performing *B*'s promise to *A* and is considered an actual cost. The benefits *B* obtains from the delivered cattle and would have obtained from the undelivered cattle are irrelevant to the calculation of actual cost, though they are relevant to calculating actual revenue and anticipated revenue. *B*'s anticipated revenue was $67.35 per steer, totaling $134,700, yielding an anticipated surplus of $700 after subtracting anticipated costs of $134,000. *B*'s actual surplus is -$16,325, the difference between actual revenues ($33,675 = 500 times 67.35) and actual cost ($50,000). The appropriate damages award is $700 minus -16,325, or $17,025.[67]

13. Pursuant to a warranty, *A* contracts to sell a computer system with specified capabilities to *B* for $46,020. *B* takes delivery of the system and pays the contract price. *B* discovers that it does not perform the specified functions as warranted. *B*'s actual cost of performing its contractual obligation is $46,020. If *B* can obtain $7,000 in benefits from the defective computer system for an expenditure of $5,000 in labor to operate the system, that $7,000 measures *B*'s actual revenue. The actual surplus of -$44,020 ($7,000 minus $5,000 minus $46,020) is compared to the anticipated surplus, which would be the monetized value of any benefits *B* would have obtained from the computer system if it had performed as warranted less the costs (including the purchase price and the cost of operating the system) of obtaining those benefits.[68]

14. *A* contracts to sell 1,000 customized greeting card display racks to *B* for $100,000. After *A* begins production, but before completion, *B* breaches. *A*'s production costs incurred in partial performance of the contract are $15,000. These are actual costs. Completing production would have cost an additional $35,000 and would have produced a surplus of

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cost of producing the delivered portion is an actual cost, because it was incurred in performance of the promise to *B*. *A*'s ability to resell the undelivered sugar to another is irrelevant to the computation of actual cost, though relevant to the calculation of actual revenue. If *A*'s anticipated revenue was $414,000 (900,000 pounds times $.46 per pound) and *A*'s anticipated costs were $375,000, then *A*'s anticipated surplus would be $39,000. If *B* had received and paid $170,890 for 371,500 pounds, and the remaining sugar produced by *A* had no value, *A*'s actual revenue would be $170,890. *A*'s actual surplus is -$204,110 ($170,890 minus $375,000). Accordingly, *A*'s lost surplus would be $243,110 ($39,000 minus -$204,110). *See, e.g.*, Great W. Sugar Co. v. Pennant Prods., Inc., 748 P.2d 1359, 1361 (Colo. Ct. App. 1987) (addressing whether efforts to resell the sugar would have been unavailing).

67. *See, e.g.*, H-W-H Cattle Co. v. Schroeder, 767 F.2d 437 (8th Cir.1985) (involving a contract for the sale of 2,000 steers for $67 per hundredweight and a court award of $1,371.83 to the aggrieved buyer for the lost resale commission for the 603 steers that were not delivered).

68. *See* Chatlos Sys. Inc. v. Nat'l Cash Register Corp., 670 F.2d 1304, 1307 (3d Cir. 1982).

$50,000. If there is no market or salvage value for the unfinished goods, the actual revenues are zero. *A*'s lost surplus, $65,000, is the difference between anticipated surplus of $50,000 and actual surplus of -$15,000 ($0 actual revenue minus $15,000 actual cost). An award of $65,000 provides $15,000 to repay costs incurred plus $50,000 in anticipated surplus.[69]

f. Actual Cost Associated with Breach

Among the burdens imposed on the injured party by contracting with the other are the actual costs the injured party would not have incurred had the other performed as promised. Compare these costs to those costs associated with performing and enhancing surplus, described in comment e. These breach-related costs include: injury to person and property from defective performance; foreseeable liability to third parties resulting from breach; charges, expenses, or commissions incurred in stopping delivery; transportation, care, and custody of goods after a buyer's breach; inspection, receipt, transportation, care, and custody of goods rightfully rejected after a seller's breach; and costs incurred in connection with reasonable attempts to minimize the losses associated with breach, such as cover or resale, and including any commercially reasonable charges, expenses, or commissions associated with those efforts. Costs incurred in fulfilling the obligations of substitute transactions are discussed *infra* in comment g. The effect of characterizing an injured seller as a lost volume seller is discussed *infra* in comments h and i. Costs associated with breach do not include so-called "opportunity costs," the revenues lost from failing to pursue another transaction in lieu of the contract with the breaching party or from the inability, due to delay or other reason, to pursue an additional opportunity. Revenues lost are accounted for in the comparison of actual and anticipated revenues and are not relevant to actual costs.

Illustrations:

15. *B* suffers personal injuries and harm to personal property when the sports utility vehicle *B* purchases from *A* rolls over. On a breach of warranty claim, *B* is entitled to compensation for the costs imposed by *A*'s breach. *B* did not anticipate

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69. *See* Cesco Mfg. Corp. v. Norcross, Inc., 391 N.E.2d 270 (Mass. App. 1979). Projected costs and surplus at the time of contracting are irrelevant to the actual cost. Again, consider the case where *A* contracts to sell *B* 2,000 raincoats for $65 each. At the time of contracting, *A*'s anticipated cost of manufacturing the raincoats is $15 each and *A* projects a surplus of $100,000. By the time *A* begins production, *A*'s performance costs have risen to $45 per coat, leaving an anticipated surplus of only $40,000 (2,000 times $20). *A* manufactured all 2,000 coats by the time *B* repudiates the contract; therefore, *A*'s actual performance cost is $90,000 ($45 times 2,000 raincoats). *A* disposes of the raincoats as salvage for $16,000. *A*'s lost surplus is $114,000, which is the difference between anticipated surplus (the surplus *A* would have realized had *B* not breached), $40,000, and actual surplus, -$74,000 ($16,000 minus $90,000). An award of $114,000 pays for actual costs ($90,000) and leaves $24,000, which, together with the actual revenue of $16,000, improves *A*'s well-being by $40,000, as anticipated. The hoped-for, or projected, surplus based on costs at the time of contracting are irrelevant. *See, e.g.*, Burberrys (Wholesale) Ltd. v. After Six Inc., 471 N.Y.S.2d 235 (N.Y. Sup. Ct. 1984) (addressing whether a proposed resale of the raincoats not delivered to the buyer would be in good faith and commercially reasonable pursuant to U.C.C. § 2-706 and trademark infringement rules).

incurring those costs when contracting with *A* and would not have incurred those costs had *A* not breached. If *B* purchased the car for $20,000 and expected to obtain $30,000 in benefits from the car after incurring surplus-enhancing costs (for example, gas and insurance) of $7,000, *B*'s anticipated surplus is $3,000. If *B* gets no benefit from the defective car, incurs $2,000 in surplus-enhancing costs, and incurs $1,195,000 in breach-related costs for personal injury and property damage to the car, *B*'s actual surplus is -$1,197,000, yielding a lost surplus of $1.2 million.[70]

16. *B* purchases steel coils from *A* and, upon inspection, discovers that they are defective. The coils require $10,000 in additional transportation and labor charges to repair. The additional transportation and labor expenses are expenses *B* would not have had to bear if *A* had performed as promised and are therefore included as part of actual costs. If the repaired goods have the same value to *B* as if the goods had been delivered as promised, then *B*'s anticipated and actual revenue are equal, and *B*'s lost surplus is $10,000, the difference between the anticipated and actual costs.[71]

17. *B* breaches a contract to purchase a boat from *A* for $12,587.40. The boat is specially ordered and delivered by the manufacturer to *A*. *A* incurs $674 in storage, upkeep, financing, and insurance costs associated with having the boat in *A*'s possession until another customer is found in order to mitigate its potential damages from *B*'s breach. Because *A* specially orders boats and would not, without *B*'s breach, have incurred those mitigation costs, they are actual costs associated with *B*'s breach.[72]

18. *A*, a British antiques seller, is entitled to recover the cost of transporting candelabras and a centerpiece from the United States back to London after *B*, an American buyer, improperly refuses to accept them. *A*'s transportation cost, a burden *A* would not have had to bear had *B* not breached, and

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70. *See* Denny v. Ford Motor Co., 662 N.E. 2d 730 (N.Y. 1995).

71. *See, e.g.*, Bethlehem Steel Corp. v. Chi. Metal Mfg., No. 84C7208, 1986 WL 1588 (N.D. Ill. Jan. 17, 1986) (refusing to award such incidental damages because they were excluded by the contract terms). The same reasoning applies where delayed delivery imposes costs on the injured party. Consider a case where *B* contracts to purchase window shutters from *A*, to be delivered by July 22. *A* knows that *B* has contracted to install the shutters for *C* by August 4. *A* breaches the contract by delivering the shutters late on July 28. *B* incurs $9,405 in overtime expenses to avoid breaching its contract with *C*. The overtime charges are a reasonable attempt to minimize the costs associated with *A*'s breach and included as actual costs associated with *A*'s breach. Where the contract price is $45,328.62, if *B*'s anticipated revenue from the contract is $50,000, *B*'s anticipated surplus is $4,671.38. If *B* is able to garner the same $50,000 benefit despite *A*'s breach, incurring only the additional $9,405 in overtime expenses, *B*'s actual surplus is -$4,733.62 [actual revenue of $50,000 minus actual cost of $54,733.62 ($45,328.62 plus $9,405)]. Thus, *B*'s lost surplus is $9,405 ($4,671.38 minus -$4,733.62). *See* Ohline Corp. v. Granite Mill, 849 P.2d 602 (Utah Ct. App. 1993).

72. *See* Neri v. Retail Marine Corp., 285 N.E.2d 311 (N.Y. 1972). For the lost surplus calculation, *see infra* SC § 3, cmt. i, illus. 25, n.80.

is included as an actual cost. If the contract price of $45,000 was unpaid by *B*, and *A*'s anticipated cost was $30,000, *A*'s anticipated surplus is $15,000. *A*'s actual cost of transporting the goods back to London is $499.85, yielding an actual surplus of -$499.85. *A*'s lost surplus is $15,499.85 ($15,000 minus -$499.85).[73]

19. *A* contracts to sell *B* 1,000 pounds of sunflower seeds for $13 per hundredweight, $1,300 total, knowing that *B* is a reseller of seeds. *B* has a contract to resell the seeds to *C* for the same price, plus a $0.55 per hundredweight handling fee, $1,355 total. The market price rises to $26 per hundredweight, and *A* breaches the contract with *B*. Thereafter, *C* buys seeds directly from *A* at a negotiated price of $20 per hundredweight, $2,000 total. *B* is still liable to *C* on their contract. Because *B* is liable to *C* for breaching the resale contract, the amount *C* paid for seeds in excess of their contract price, $645, is included as an actual cost associated with *A*'s breach of *A*'s contract with *B* when computing damages for *B*'s suit against *A*. *B*'s anticipated surplus is $55 ($1,355 minus $1,300), *B*'s actual surplus is -$645 ($0 minus $645), and *B*'s lost surplus is $700 ($55 minus -$645).[74]

g. Actual Cost Associated with Substitute Transaction

The cost to a party of arranging and fulfilling the obligations of a substitute transaction in order to mitigate the losses associated with breach, as in cases of cover and resale, are actual costs to be included in the calculation of actual surplus. In cases of resale, the resale price is part of actual revenue, while additional expenses are part of actual cost. In cases of cover, the cover price and the costs of arranging cover are both part of actual cost. Where a party has performed in part before breaching, that party may be entitled to a refund if the injured party arranges a favorable substitute transaction. Where an injured party declines to arrange a substitute transaction, that party may recover damages based on a hypothetical

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73. *See, e.g.*, N. Bloom & Son (Antiques) Ltd. v. Skelly, 673 F. Supp. 1260 (S.D.N.Y. 1987) (holding that buyer accepted the goods and that seller was entitled to the full contract price). The same logic applies to other costs imposed on a seller because of the buyer's breach. Consider a case where, having delivered fuel oil under a contract with *B*, *A* incurs a late fee from a financial institution, *C*, when *B* fails to pay *A* the purchase price on the date due under the contract. Although *A* incurred this cost from a transaction with *C*, a third party, it is nonetheless a cost incurred as a result of contracting with the other. The fee was associated with the breach and would not have been incurred had *B* performed as promised. Subject to the limitations on damages in SC § 4, the penalty is a component of actual cost. Where the contract price was $865,415.16, and *A* expected to spend $800,000 on the fuel, *A*'s anticipated surplus was $65,415.16. Where *B* has paid $225,000 toward the purchase price, *A* pays the $800,000 contract price in advance, and *A* incurs a $25,000 penalty imposed as a result of *B*'s failure to pay on the date due, *A*'s actual surplus is -$600,000 ($225,000 actual revenue minus $825,000 actual costs), yielding a lost surplus of $665,415.16 ($65,415.16 minus -$600,000). *See, e.g.*, Petroleo Brasileiro, S.A. v. Ameropan Oil Corp., 372 F. Supp. 503 (E.D.N.Y. 1974) (holding such costs incurred were consequential damages and thus not recoverable to an aggrieved seller under the U.C.C. rule then in effect, and awarding seller $640,415.16 in lost revenues).

74. *See, e.g.*, Tongish v. Thomas, 829 P.2d 916 (Kan. Ct. App. 1992) (remanding case so damages could be awarded to buyer based on difference between market price and contract price, despite fact that buyer had protected itself from market price fluctuations through contract with third party).

reasonable transaction it could have arranged at a reasonable market price. In such cases, the market price is treated as actual revenue for sellers and part of actual cost for buyers. In this hypothetical transaction, the cost the injured party would have incurred had the other party performed is treated as actual cost, and the revenue the injured party would have obtained had the other party performed is treated as actual revenue.[75]

Illustrations:

20. *B* enters a contract to purchase 1,000 tons of imported European steel from *A* for $300 per ton. When *B* breaches, *A* has incurred $100,000 to produce the steel. After *B* breaches, *A* incurs $2,000 in storage and handling costs that *A* would not otherwise have incurred. To ship the steel to a new buyer, *A* incurs a cost of $5,000, an amount identical to the anticipated cost of shipping to *B*. The $100,000 production cost is an actual cost associated with performing for *B*. *B*'s breach imposed $2,000 in storage and handling costs and $5,000 in shipping costs. Both are actual costs associated with arranging the substitute transaction (the resale to the third party). *A* resells 1,000 tons of steel for $200 per ton, obtaining $200,000 in actual revenue from the substitute performance. *A*'s anticipated surplus is $195,000 ($300,000 in anticipated revenue less $105,000 in anticipated costs). *A*'s actual surplus is $93,00 ($200,000 in actual revenue from the resale less $107,000 in actual costs). The lost surplus is $102,000, the difference between anticipated and actual surplus. Having received $200,000 from the resale and $102,000 in damages (a total of $302,000) and spent $107,000 in actual costs, *A* is left with $195,000, an amount that places *A* in the position *A* would have occupied had *B* performed.[76]

21. If the seller in Illustration 20 does not resell, the market price at which the seller could have resold, perhaps $200 per ton,

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75. *See also supra* SC § 3 cmt. d.

76. *See* Harlow & Jones, Inc. v. Advance Steel Co., 424 F. Supp. 770 (E.D. Mich. 1976). An aggrieved seller may have actual revenue and actual cost from a variety of sources. The structure of the surplus-based damages rule requires only identification of all of those sources of revenue and cost that are associated with the breached contract. Consider a case where revenue was obtained from both the breaching party and another buyer and where the seller incurred costs performing for both. In *In re Rooster, Inc.*, 127 B.R. 560 (Bankr. E.D. Pa. 1991), *B*, the original buyer, breached a contract to buy silk fabric from *A*. Assume that *A* spent $1,000 to store the fabric until it was resold (the actual amount was somewhere between $1,000 and $2,000) and paid $10,000 for a new screen to prepare the fabric to sell to *C*, a new buyer. *Id.* at 564. These reasonable additional expenses are recoverable as actual costs of arranging a substitute transaction that is necessary only due to *B*'s breach. Where *B* has paid $22,137 toward the $44,274 purchase price in advance, but *A* is able to resell the goods to a third party for the same price, *A*'s actual revenue includes both the $44,274 from the second buyer and the $22,137 from the breaching party. *A*'s actual cost includes the original cost of manufacturing the silk for $30,000 plus the breach-related cost of $11,000, including remanufacturing for *C*. The actual surplus of $25,411 ($66,411 minus $41,000) exceeds the anticipated surplus of $14,274 ($44,274 minus $30,000) by $11,137. The lost surplus is a negative amount, -$11,137, indicating that the breaching party is entitled to a return of that portion of its deposit.

is treated as actual revenue to the extent that it is a reasonable estimate of the price at which the seller could have resold. The cost actually incurred to produce the steel, which is a performance cost, and any reasonable cost to store and handle the steel, which is a breach-related cost, are treated as actual costs. Including the shipping cost in this case is inappropriate, because the seller declined to resell. The actual surplus, when treating the market price as actual revenue ($200,000) and the performance and breach-related costs as actual costs ($102,000), is $98,000. The lost surplus is then the difference between the anticipated surplus, $195,000, and the actual surplus of $98,000, which equals $97,000. Having a stock of steel worth $200,000 and damages of $97,000 (a total of $297,000) and having spent $102,000 in actual costs, *A* is left with $195,000, an amount sufficient to place *A* in the position *A* would have occupied had *B* performed.

22. *A* breaches a contract to sell 400,000 extruded aluminum blanks to *B* for $.145 each after providing 37,500 blanks. As a result of *A*'s partial breach, *B* covers by buying the remaining 362,500 blanks from a third party for $.271 each. In seeking the substitution goods, *B* incurs $1,159.94 in extra freight costs because the new seller's plant is farther away. The seller's breach imposed $1,159.94 in shipping costs that are actual costs associated with arranging the substitute cover transaction. Where *B*'s anticipated and actual revenue are equal and surplus-enhancing costs (using the blanks in some manufacturing process, for instance) are unchanged, *B*'s lost surplus is $46,834.94. This lost surplus is the difference between the $104,834.94 in actual costs other than surplus-enhancing costs (37,500 blanks at $.145 per blank plus 362,500 blanks at $.271 per blank plus $1,159.94 freight costs) and the $58,000 in anticipated costs other than surplus-enhancing costs (400,000 times $.145). Having paid an extra $45,675 for blanks and incurred extra freight costs of $1,159.94 (totaling $46,834.94), a damage award of that amount (the lost surplus) makes *B* whole.[77]

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77. *See* R.L. Pohlman Co. v. Keystone Consol. Indus., 399 F. Supp. 330 (E.D. Mo. 1975) (awarding smaller amount because of money owed to the seller). In many cover cases, the lost surplus is simply the difference between anticipated and actual cost because anticipated and actual revenues are equal. *In re Fran Char Press*, 55 B.R. 55 (Bankr. E.D.N.Y. 1985), for instance, involved a contract for *B* to buy printed posters from *A*. *B* finds half of the posters produced are defective and discards them. *B* hires a new printer at a cost of $30,590 to replace the defective posters and is entitled to recover the full amount of the cover. The cover price is an actual cost associated with *A*'s breach, the cost of fulfilling the obligations of a substitute transaction. Since the anticipated and actual revenue are equal, *B*'s lost surplus is $30,590, the difference between the anticipated and actual costs. Consider another case in which *A* contracted to deliver 229,000 pounds of sunflowers to *B* for $.1125 per pound. When *A* was unable to deliver the sunflowers, *B* purchased replacements at a cost of $.26 per pound. *B*'s lost surplus is the difference between anticipated surplus and actual surplus. Because *B* was able to satisfy its requirements by cover, anticipated and actual revenues are equal. Accordingly, the difference between anticipated surplus and actual surplus is equal to the difference between anticipated cost and actual cost, which is -$33,205 ($26,335 minus $59,540). An award of $33,205 will place *B*

23. In Illustration 22, if *B* does not cover, the market price at which *B* could reasonably have covered, perhaps $.271 per blank, totaling $98,237.50 (362,500 blanks at $.27 per blank), and the other anticipated costs, excluding surplus-enhancing costs, totaling $5,437.50 (37,500 blanks at $.145 per blank), are treated as actual costs. The extra shipping costs are not treated as actual costs in this example because, by hypothesis, they did not occur. Where *B*'s anticipated and actual revenue are equal, and surplus-enhancing costs are unchanged, *B*'s lost surplus is the difference in costs treated as actually incurred and anticipated costs. Here, the costs treated as actually incurred include performance cost, $5,437.50, and the market price for 362,500 blanks ($98,237.50), totaling $103,675. Lost surplus of $45,675 is the difference between anticipated performance cost, $58,000, and the actual performance cost, $103, 675. Because anticipated and actual revenues and anticipated and actual surplus-enhancing costs are unchanged, *B* is made whole.

h. Actual Revenue, Lost Volume Seller

A lost volume seller is one whose willingness and ability to supply is, as a practical matter, unlimited in comparison to the demand for the product. When, upon the buyer's breach, the seller resells the good intended for the first buyer to a second buyer, the remedial issue is whether that resale is a substitute transaction to the original sale[78] or a separate sale. The lost volume seller's claim is that the transaction is not a substitute transaction, the actual revenue of which reduces the damages award based on lost surplus. The seller's claim is that the sale is a separate transaction that the seller would have arranged even if the buyer had not breached. Because there is no "substitute" under this logic, the lost volume seller is permitted to claim lost surplus unreduced by any surplus obtained on the turnaround sale. Where the injured party is a lost volume seller who possesses capacity to make an additional sale, would have profited from that additional sale, and the sale was probable, the revenue from the additional sale is excluded from actual revenue.

Illustration:

24. As in Illustration 17, *B* contracts to buy a boat from *A*, a boat retailer, for $12,587.40 and makes a down payment of $4,250. *A*'s anticipated and actual cost of acquiring the boat from the manufacturer and supplying it to *B* was $10,008. *B* breaches the contract. *A* sells the boat originally intended for *B* to *C*, an additional consumer, for the same price. If *A* is a lost volume seller, the revenue from the sale to *C* is excluded from actual revenue in the calculation of lost surplus. Thus, the actual revenue related to the contract with *B* is $4,250, not $4,250 plus the resale price. It is incorrect to treat the price

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in the position it would have occupied had *A* performed as promised. Red River Commodities, Inc. v. Eidsness, 459 N.W. 2d 811 (N.D. 1990).

78. *See infra* § 3, cmts. d and g.

for the resale of the boat as actual revenue if *A* would have earned that revenue even if *B* had not breached. The revenue is not actual revenue related to the contract because *A* is a retailer and there is no practical limit on *A*'s willingness or capacity to sell boats. Without the breach, *A* would have sold one more boat.[79]

i. Actual Cost, Lost Volume Seller

Where the injured party is a lost volume seller that made an addition sale, the costs associated with fulfilling the obligations of the second sale are not included as an actual cost of the original contract.

Illustrations:

25. *B* contracts to buy a plane from *A* for $20 million and pays a deposit of $250,000. *A* would have earned a surplus of $1.8 million given full performance. However, *B* breaches, and *A* sells a modified version of the same plane to *C* for $22 million, at a cost of $1,325 more to produce, thus yielding a surplus of $1.9 million. *A* is a lost volume seller, because *A*'s factory was operating at 60% capacity during the relevant time period and could have profitably accelerated its production schedule to produce additional models of that plane. Neither the revenue nor the cost associated with fulfilling the contract with *C* is relevant to calculating damages owed by *B* to *A*. The production costs, including the modifications for *C*, are not costs associated with *B*'s contract where the modifications were not necessitated by the breach. Where anticipated surplus is $1.8 million and actual surplus is $250,000, lost surplus is $1,550,000.[80]

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79. *See* Neri v. Retail Marine Corp., 285 N.E.2d 311 (N.Y. 1972). For the lost surplus calculation, *see infra* SC § 3, cmt. i, illus. 25, n.80. To be a lost volume seller, the seller must be willing and able profitably to satisfy additional demand. That is not always the case, even in commercial contracts. For example, in *Ragen Corp. v. Kearney & Trecker Corp.*, 912 F.2d 619 (3d Cir. 1990), *B* contracted to buy an automated computerized machining center from *A*. *B* then breached the contract. *A* sold the machining center to *C*, a third party, for the same price. Where *A* has more orders than it can fill and could not have supplied both *B* and *C*, *A* is not a lost volume seller. *B*'s cancellation did not harm *A* because it enabled *A* to sell machines to a buyer it was otherwise unable to supply. Thus, the revenue from the sale to *C* is included as actual revenue and reduces *A*'s recovery. If there is no increase in cost to effect the resale, anticipated and actual revenues are equal, and anticipated and actual costs are equal, so there are no damages.

80. *See, e.g.*, Rodriguez v. Learjet, Inc., 946 P.2d 1010 (Kan. Ct. App. 1997) (affirming an award of liquidated damages). Where the breaching buyer has made a down payment, a lost volume seller might be required to return a portion of it, despite the fact that profits from the resale are not credited to the breaching buyer. In *Neri v. Retail Marine Corp.*, 285 N.E.2d 311 (N.Y. 1972), *A*'s cost of selling the boat for $12,587.40 to *B* would have been the $10,008 wholesale price. *B* pays a deposit of $4,250. After *B* breaches, *A* resells the boat to *C* for the same price. Despite having been originally incurred in order to fulfill the contract with *B*, the $10,008 wholesale cost is not an actual cost under the lost surplus calculation in *A*'s suit against *B*, because they are costs ultimately associated with a separate transaction. *A* also incurred $674 in storage, maintenance, insurance, and financing costs that would not have been incurred had *B* not breached and which would not ordinarily be incurred in completing the transaction for *C*. In *A*'s suit against *B*, these breach-related costs are actual costs under the lost surplus rule. *A* may recover damages, as calculated by the surplus-based rule, from *B* without

26. *B* breaches a contract to purchase a machining center from *A*. *A* is not a lost volume seller. Since the sale of the automated computerized machining center to *C* is a substitute transaction rather than an additional sale, *A*'s costs of selling to *C* are included in actual costs of performing for *A*, and the revenues from selling to *C* are included in the actual revenues for *A*. *A*'s lost surplus is equal to any shortfall in actual revenue compared to anticipated revenue and any increase in actual costs over anticipated costs. Because *A* resold for the same price, produced at the same cost, and incurred no other actual costs, anticipated and actual surpluses are identical, and no lost surplus arises.[81]

D. Shadow Code § 4: Losses Compensable

Losses are compensable only to the extent that:

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

(b) they are reasonably foreseeable in the ordinary course of events or as a result of special circumstances the parties had reason to know; and

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

1. Comments

a. Limits on Liability Generally

Lost surplus may result from a shortfall in actual compared to anticipated revenue, actual cost in excess of anticipated cost, or a combination of both. Limits on liability enumerated in this section apply to all sources of revenue and all types of costs.

b. Avoidability

An injured party will not be compensated for loss that the party could have avoided by making reasonable efforts appropriate to the circumstances.

c. Avoiding Lost Revenue

An injured party often can take many steps to avoid lost revenue. An injured buyer frequently can cover by obtaining a suitable substitute on the market.

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any consideration of the transaction with *C*. Anticipated surplus is anticipated revenue ($12,587.40) less anticipated cost ($10,008), which in this case equals $2,579.40. Actual surplus is actual revenue (the down payment of $4,250) less the actual cost ($0 performance cost, because that cost is associated with the resale, plus the breach-related cost of $674), which equals $3,576 in this case. The total lost surplus is anticipated surplus of $2,579 minus actual surplus of $3,576 which equals - $997. After returning $997 of the down payment to the breaching buyer, the seller will have $3,576 from the down payment to provide full compensation for the breach-related cost of $674 and the anticipated surplus of $2,579.

81. *See* Ragen Corp. v. Kearney & Trecker Corp., 912 F.2d 619 (3d Cir. 1990).

Similarly, an injured seller can often dispose of the goods that were to have been delivered under the contract on the market. In some cases, an injured seller can avoid some loss by salvaging and reallocating some or all of the resources that otherwise would have been devoted to performance of the contract. Similarly, an injured buyer, in some cases, can limit losses by using any salvageable goods where the seller delivers non-conforming goods.

d. Avoiding Lost Revenue—Substitute Transactions

An injured party is not obliged to arrange a substitute transaction in order to minimize its losses. However, when a party fails to arrange a substitute transaction, even where a reasonable opportunity to do so is available, damages are based on a hypothetical substitute transaction. In such cases, the market price at which a substitute transaction could have been arranged may be used to estimate lost surplus.[82] If the injured party arranges a substitute transaction, actual revenues and actual costs associated with the substitute transaction are used to calculate damages, but only to the extent that the substitute transaction is reasonable.[83]

Illustrations:

1. *A* breaches a contract to sell a jet aircraft to *B* for $985,000 by selling it to *C*, an unrelated third party. Where *B* has the opportunity, on two occasions, to purchase the original aircraft from *C* for $987,500, but instead buys a different but comparable aircraft on the open market for $96,664 more than the original contract price, such substitute purchase is not reasonable cover. The market price of $987,500 (evidenced by the price at which *C* offered to sell the aircraft to B), rather than the cover price, is treated as part of actual costs, pursuant to SC § 3, cmt. g. Since *B*'s anticipated and actual revenue are the same, *B*'s lost surplus is $2,500, the difference between its reasonable actual costs ($987,500) and anticipated costs ($985,000). Without this limitation on damages, *B*'s recovery would be $96,664. The limitation reduces *B*'s recovery to the surplus it could not reasonably avoid losing, which is $2,500.[84]

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82. *See supra* in SC § 3 cmts. d and g.

83. An aggrieved party may arrange a substitute transaction to avoid lost revenue, but may recover losses only to the extent the substitute was a reasonable attempt to mitigate losses. For a buyer's cover transaction to be reasonable, replacement goods need not be identical to the goods identified in the contract, but they must be commercially usable as reasonable substitutes under the circumstances of the particular case. In addition, the buyer must obtain the substitute in good faith, in a reasonable manner, and without unreasonable delay. Commercial reasonableness of a buyer's delay is determined by examining the surrounding nature, purpose, and circumstances of the underlying transaction. To be reasonable, a seller's resale should be made as soon as practicable after breach, in good faith, in a commercially reasonable manner, and at a commercially reasonable price. Commercial reasonableness of a seller's delay depends upon the nature of the goods, the condition of the market, and the other circumstances of the case. If no reasonable market exists at the time of breach, a delay in resale may be proper.

84. *See* Scherman v. Kansas City Aviation Ctr, Inc., 1994 U.S. Dist. LEXIS 12309 (D. Kan. Aug. 30, 1994). Where an aggrieved buyer does not have the resources to cover immediately following the breach, a delay may be reasonable. Consider a case where *B*, a buyer, receives non-conforming goods from *A*. Due to limited resources as a result of the transaction, *B* cannot immediately enter the market

2. *B* breaches a contract to purchase a bulldozer for $9,825 from *A*. *A* makes no effort to resell the bulldozer for more than a year, during which time the market for bulldozers declines due to a recession in the construction industry and high fuel prices. *A*'s resale for $7,230, in excess of fourteen months after the breach, is commercially unreasonable because of its slight probative value as an indication of the market price at the time of the breach. If the market value of the bulldozer at the time of breach was $9,200 and *A* incurred no actual costs other than relinquishing the machine, damages are based on the hypothetical reasonable transaction: a resale for $9,200. Because the cost of the anticipated and (hypothetical) actual transaction are the same, damages equal the difference between the anticipated and actual revenues, which is $625 ($9,825 minus $9,200).[85]

e. Avoiding Lost Revenue—Salvage

To mitigate revenue losses from another's breach, buyers and sellers may sometimes use or salvage any part of the other's performance that was delivered or any part of their own performance or surplus-enhancing expenditures. For example, a seller aggrieved by a buyer's repudiation of unfinished goods may, in the exercise of reasonable commercial judgment and in order to avoid loss, either complete the manufacture and wholly identify the goods to the contract, or cease their manufacture and resell them at their salvage value. In some cases, where a seller delivers non-conforming goods, an injured buyer can limit losses by using or reselling any salvageable goods. A party's failure to use or resell some salvageable goods precludes recovery of damages to the extent reasonable salvage would have prevented the loss.

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and purchase substitute goods. As a result, *B* uses the non-conforming goods until cover can be effected. *B*'s delayed cover is reasonable. *See* Mobile Home Mgmt., Inc. v. Brown, 562 P.2d 1378 (Ariz. Ct. App. 1977). A delay may also be reasonable as a result of a limited or volatile market. Suppose *A* breaches a contract to sell chipping potatoes in installments to *B* during the upcoming shipping season. To effect cover, *B* purchases multiple lots over a thirty-eight day period in a rapidly rising market. Where, because of a volatile market, no seller will commit to delivery at a later date, and because of the perishable nature of potatoes, *B* cannot take delivery of all its potato needs at once, *B*'s delay of thirty-eight days is commercially reasonable. *See* Dangerfield v. Markel, 278 N.W.2d 364 (N.D. 1979).

85. *See* McMillan v. Meuser Material & Equip. Co., 541 S.W.2d 911 (Ark. 1976). However, where resale is not possible immediately following the breach, a delay may be reasonable. Consider a case where *B* breaches a contract to purchase certain knitted fabric goods from *A* in October 1974. *A* does not resell the goods identified to the contract until September 1975. Although the market price of this material declined fifty percent from the time of the breach until September 1975, *A*'s delay in reselling the goods is reasonable, because the sale of *A*'s spring fabric after the spring buying season has ended is difficult. *See* Foxco Indus., Ltd. v. Fabric World, Inc., 595 F.2d 976 (5th Cir. 1979). A delay of many years may, indeed, be reasonable in some cases. Suppose *B* breaches a contract to purchase certain machines from *A*. *A* does not resell the goods identified in the contract until three years after the breach. *A*'s delay in reselling the goods is reasonable where, after the breach, there is no market for custom-ordered machines costing over $30,000 that have a very specialized use and where *A* makes a continuing good faith effort to locate other purchasers. *See* Firwood Mfg. Co. v. Gen. Tire, Inc., 96 F.3d 163 (6th Cir. 1996).

Illustrations:

3. *A* contracts to sell cumene to *B* for $2,100,000. *A* purchases 10 million pounds of benzene for $.10 per pound for use in manufacturing the cumene. *B* repudiates the contract before *A* begins work. *A* is able to use the pre-purchased benzene in a manufacturing process for a subsequent contract to sell cumene to *C*. As a result of changes in market conditions, the market price for benzene has dropped, and, as a result, the contract price with *C* is $500,000 lower than the contract price with *B*. The $1 million spent on the benzene is actual cost, and the $1,600,000 from sale of benzene to *C* is actual revenue. If *A* expected to obtain a $2,100,000 benefit from the contract with *B* by incurring $1.5 million in costs (including $1 million for the benzene), *A*'s anticipated surplus is $600,000 ($2,100,000 minus $1,500,000). *A*'s actual surplus is $100,000 ($1,600,000 minus $1,500,000). Accordingly, *A*'s lost surplus is $500,000 ($600,000 anticipated surplus minus $100,000 actual surplus).[86]

4. *A* breaches a contract to sell a car to *B* for $1,300 by supplying a defective car. *B* resells the car for $600, which is reasonable salvage given *A*'s refusal to cure the defect. The $600 is actual revenue in the lost surplus calculation. If *B* anticipated obtaining $10,000 in benefit from the car by incurring $2,000 in surplus-enhancing expenses, *B*'s anticipated surplus is $6,700 ($10,000 minus $1,300 minus $2,000). *B*'s actual surplus was -$700 ($600 minus $1,300). *B* is entitled to recover $7,400 of lost surplus ($6,700 minus -$700). Had *B* unreasonably failed to resell in order to realize the salvage value, *B*'s actual surplus would be -$1,300, and, without this limitation on damages, *B*'s recovery would be $8,000 ($6,700 minus -$1,300). The limitation, however, reduced *B*'s recovery to the surplus it could not reasonably avoid losing, which is $7,400.[87]

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86. *See, e.g.*, USX Corp. v. Union Pac. Res. Co., 753 S.W.2d 845 (Tex. App. 1988) (holding the decline in value of benzene was a consequential damage not available to sellers under the U.C.C. rule then in effect, and that the seller could not recover the expense of the benzene that it would have incurred regardless of buyer's breach).

87. *See* Woods v. Secord, 444 A.2d 539 (N.H. 1982). Such failure to resell salvageable goods occurred in *Borman's, Inc. v. Olympic Mills, Inc.*, 91 Civ. 4244 (LJF), 1993 U.S. Dist. LEXIS 7332 (S.D.N.Y. June 2, 1993). In that case, a seller entered into a contract to sell 800 cases of solid-colored hand towels to a chain of supermarkets that planned to resell the hand towels. The seller breached by delivering hand towels with patterns. Although the buyer could have reduced its damages by selling the patterned towels in its stores, it did not do so. The buyer, prior to the breach, rented space to store the goods. Such a buyer is entitled to recover the rental costs incurred only until the time that failure to resell the salvageable goods becomes unreasonable. *See id.* Where salvage is not possible, full recovery will be awarded. Consider, for example, a case where *A* breaches a contract to sell a mobile home to *B* by supplying a mobile home with a leaking roof. Where *B* claims the mobile home is unhabitable, the failure to attempt salvage by selling or renting to another does not prevent full compensation. *See, e.g.*, Vreeman v. Davis, 348 N.W.2d 756 (Minn. 1984) (awarding return of purchase price and remanding for evidence on valuation).

f. Avoiding Anticipated Costs

Once a party has reason to know that the other's return performance will not be forthcoming, the former cannot recover for costs that result from an unreasonable failure to stop performance.

Illustrations:

5. *A* enters a contract to sell airplane parts to *B*. Based on that contract, *B* advertises the parts for resale. After *A* breaches, *B* does not make reasonable effort to cancel the advertising. *B* is not entitled to the cost of advertising or damages for loss of goodwill incurred after becoming aware that *A* did not intend to perform, because *B* could have reasonably avoided such damages. *B* may still, however, recover the surplus lost by its inability to resell the parts, if such loss is reasonably foreseeable and can be calculated with reasonable certainty.[88]

6. *B* breaches a contract to buy 3,000 photocopiers from *A*. *A* fails to terminate a purchase order with its supplier of components used to produce the goods for the contract with *B*, which *A* could reasonably have done. *A* is not entitled to the cost of those components.[89]

g. Avoiding Breach-Related Costs

Once a party has reason to know that the other's return performance will not be forthcoming, the former cannot recover for out-of-pocket breach-related expenses that reasonably could have been avoided.

Illustration:

7. *B* breaches a contract with *A* by refusing to purchase a car for $2,000. *A* is able to resell the car at the same price to another buyer, but instead opts to advertise in hopes of receiving a higher price. *A* is not entitled to advertising costs of $40. Because *A* could have received the same benefit in a hypothetical resale transaction and incurred no additional recoverable costs, *A* has no recoverable damages.[90]

h. Unforeseeability

In order to be recoverable, losses for breach of contract must have been reasonably foreseeable at the time of contract formation. The injured party need not prove that the parties had specifically contemplated that the damages might result or that the breaching party explicitly assumed the risk of such damages. The injured

88. *See* Selig v. Wunderlich Contracting Co., 69 N.W.2d 861 (Neb. 1955).

89. *See, e.g.*, Copymate Mktg., Ltd. v. Modern Merch., Inc., 660 P.2d 332 (Wash. Ct. App. 1983) (holding that seller acted in a commercially reasonable manner when, upon buyer's repudiation, it terminated its purchase order with its supplier).

90. *See* Smith v. Joseph, 31 U.C.C. Rep. Serv. (CBC) 1560 (D.C. Super. Ct. 1981).

party need only show that the damages ordinarily follow a breach of the contract in the usual course of events, or that a reasonable person would have foreseen them as a probable result of the breach.

i. Unforeseeable Lost Revenue

If, as a result of the other party's breach, a party is deprived of a surplus associated with a larger project that would not be a foreseeable result of the breach, that party is not entitled to recover such lost surplus.

Illustrations:

8. *B* contracts to purchase from *A* one tank car of prime tallow for the purpose of processing it and making triple pressed stearic acid. *A* erroneously delivers tallow adulterated with hydrogenated fat, which precludes *B* from obtaining triple pressed stearic acid. *B* is not entitled to the surplus (associated with its larger project) lost as a result of *A*'s breach, where *A* had no knowledge of the specific intended use of the particular material.[91]

9. *A* enters a contract to sell airplane components to *B*, which *B* wrongfully terminates. The termination caused other parts buyers, *C* and *D*, to stop negotiating with *A*. *A* seeks recovery, inter alia, of lost surplus from the contract with *B*, lost surplus on parts *A* would later sell to *B* to maintain the components, and lost surplus on the contracts with *C* and *D*, for which negotiations were stopped. If sufficient evidence shows that the lost surplus on the contract with *B* and on future contracts for sales of parts to *B* was foreseeable, such damages are recoverable. Damages for the loss of the third party contracts, however, are unforeseeable, and thus not recoverable, where there was no indication that *B* knew or had reason to know that its breach could lead to *A*'s loss of

91. *See* W.C. Hardesty Co. v. Schaefer, 139 S.W.2d 1031 (Mo. Ct. App. 1940). Lost surplus associated with a larger project is recoverable where the seller has actual knowledge of the intended use of the goods. Consider, for example, a case where *B* enters a contract to purchase rough lumber from *A* for the purpose of finishing it and reselling it. *A* fails to deliver the agreed amount of timber, and *B* is unable to cover. Where *A* has knowledge that *B* is an established dealer in finished lumber, *B*'s lost revenue associated with its larger project is reasonably foreseeable and recoverable. *See* Jennings v. Lamb, 296 S.W.2d 828 (Tenn. 1956). Consider also a case where *A* contracts to sell a tract of timber to *B*. After a delay, *B* repudiates. Where *A* specified its need to complete harvesting promptly in order to meet a scheduled logging commitment to another buyer, *C*, the loss *A* incurred as a result of *A*'s delay in performing the contract with *C* is reasonably foreseeable, and therefore, recoverable. *See, e.g.*, Sprague v. Sumitomo Forestry Co., 709 P.2d 1200 (Wash. 1985) (holding that the loss incurred from the delay was a consequential damage and thus not recoverable to an aggrieved seller under the U.C.C. rule then in effect). Revenue lost as a result of the breach may also be foreseeable where the use of the goods is apparent from the very nature of the buyer's business. Consider, for example, a case where *A*, a seller, breaches a contract to deliver gas to *B*, a gas station owner. *B* may claim secondary damages for lost sales at the mini-mart, because those losses are foreseeable. Because mini-mart customers are primarily gasoline customers, it is reasonably foreseeable that, if gasoline sales dropped dramatically, there would be a ripple effect on mini-mart sales. *See* AM/PM Franchise Ass'n v. Atl. Richfield Co., 584 A.2d 915 (Pa. 1990).

those contracts.[92] *A*'s damages are limited to lost surplus from contracts with *B*.

j. Unforeseeable Anticipated Costs

A breaching party is not liable for performance or surplus-enhancing costs incurred by the other if the losses associated with those expenditures were not, at the time of contracting, reasonably foreseeable results of the breach.

Illustrations:

10. *B* contracts to purchase certain steel dies from *A* to be used in the manufacture of lanterns. Prior to breach, *B* incurs surplus-enhancing costs by hiring employees and providing for their lodging. *A* breaches, and *B* seeks damages. *B* may not recover the costs associated with idle employees or their lodging, since such costs could not have been contemplated as the natural and proximate consequence of a breach of contract. Actual costs used in the calculation of *B*'s lost surplus do not include these surplus-enhancing costs.[93]

11. *A*, a seller, borrows money in order to purchase specific raw material necessary for the production of a product it contracts to sell to *B*. *B* breaches. *A* is not entitled to recover interest on the borrowed money, because the interest was not a cost that *B* could reasonably have foreseen. In calculating lost surplus, *A*'s actual costs are limited to freight charges *A* had to bear in order to resell the goods, costs of re-advertising the goods, and inspection and certification costs relating to resale of the goods to a third party.[94]

k. Unforeseeable Breach-Related Costs

If a party incurs costs that would not have been incurred had the other performed as promised, and, at the time of contracting, the breaching party did not have reason to foresee such costs as a probable result of the breach, the injured party is not entitled to recover such costs incurred.

Illustrations:

12. *A* breaches the title warranty in its contract with *B* when *A* delivers a truck with multiple vehicle identification numbers. Law enforcement officers subsequently impound the truck. In the calculation of lost surplus, the costs of towing the truck from the impoundment lot (the truck was inoperable due to damages while in control of the highway patrol) are included

92. *See* Rogerson Aircraft Corp. v. Fairchild Indus., Inc., 632 F. Supp. 1494 (C.D. Cal. 1986).
93. *See* Rochester Lantern Co. v. Stiles & Parker Press Co., 31 N.E. 1018 (N.Y. 1892).
94. *See* Afram Exp. Corp. v. Metallurgiki Halyps, S.A., 592 F. Supp. 446 (E.D. Wis. 1984) (finding such interest payments were an ongoing cost of doing business and not included in an award as incidental damages).

in actual costs, since such costs were reasonably foreseeable. However, the high cost of storing the truck until *B* had the finances to repair the damage caused while impounded is excluded from actual costs, since the causal link between the breach and the damages had become so attenuated that such costs were unexpected and therefore unforeseeable.[95]

13. *B* breaches a contract to purchase crushed car bodies from *A* for $14,065. After the breach, *A* resells the car bodies to a third party for $9,080, incurring $600 in expenses, and also incurring $2,200 in costs resulting from vandalism to equipment used to load the crushed cars. *A* is entitled to recover the expenses in arranging for resale, since such expenses are reasonably foreseeable. *A* is not entitled to the vandalism damage, since such vandalism was unforeseeable by either party and did not stem from circumstances which were reasonably contemplated by *B* at the time the agreement was made. If *A*'s anticipated cost was $10,000, then its anticipated surplus is $4,065 ($14,065 anticipated revenue minus $10,000 anticipated costs) and its actual surplus is -$1,520 ($9,080 actual revenue minus $10,600 actual costs). The breach-related costs associated with the vandalism are not included as an actual cost in the lost surplus calculation. Accordingly, *A*'s lost surplus is $5,585.[96]

l. Uncertainty

Damages must be calculable with a reasonable degree of certainty and specificity, but need not be calculable with mathematical precision. Claimed losses must not be too speculative in either their existence or amount.

Illustrations:

14. *A* breaches a contract authorizing *B* to enter and remove from *A*'s lot certain trees that *B* plans to resell as saw timber and firewood. *B* is not entitled to recover lost revenue where *B* cannot establish the amount lost with reasonable certainty, even though *B* produces reasonably certain proof that it lost

95. *See* Colton v. Decker, 540 N.W.2d 172 (S.D. 1995). Breach-related costs are recoverable where they can be expected to flow naturally from the breach as a result of the nature of the goods being sold or the expected use to which they will be put. For example, *A* breaches a contract to sell computerized cash registers to *B*, a chain of women's clothing stores, by delivering registers which are not compatible with *B*'s existing equipment. Where the failure of the cash registers to communicate with *B*'s computers would foreseeably create additional labor costs for the afflicted retail merchant, such costs are recoverable. *See* Cricket Alley Corp. v. Data Terminal Sys., Inc., 732 P.2d 719 (Kan. 1987). Where, however, the costs incurred would not naturally be expected to flow from the breach, such costs are not recoverable. Consider a case where *A*'s delivery of a defective mobile home to *B* in violation of their contract results in exposure to rain and freezing of pipes during cold spells. Damages for aggravation of *B*'s pre-existing heart condition, pain and suffering, and emotional distress could not have been reasonably foreseen by the parties at the time of contracting and are, therefore, not recoverable. *See* Burnell v. Morning Star Homes, Inc., 494 N.Y.S.2d 488 (N.Y. App. Div. 1985).

96. *See* Carl Weissman & Sons, Inc. v. Pepper, 480 F. Supp. 1364 (D. Mont. 1979).

revenue as a result of the breach. Accordingly, absent evidence of any additional costs incurred, *B* is not entitled to any damages, because *B* cannot establish anticipated surplus with sufficient certainty. There being no provable anticipated surplus and no actual surplus, there is no provable lost surplus.[97]

m. Uncertain Lost Revenue

Problems of proof typically arise when the injured party is a buyer who cannot cover or a seller who cannot resell, making damages depend on loss of surplus in collateral transactions that have been disrupted by the breach. While showing a history of past profitability is one method of establishing revenue loss with reasonable certainty, lost revenue may also be recovered by new businesses for breach of a sales contract if it can be proved with reasonable certainty. The evidence necessary to establish lost revenue with reasonable certainty will depend on the circumstances of the particular case. Loss of goodwill, as a type of anticipated revenue, must also be proved with reasonable certainty.

Illustrations:

15. *A* breaches a contract to deliver goods to *B*, who owns a new business. *B* alleges lost surplus because of the breach. *A* challenges these damages, because *B* recently entered this new line of business. *B* can only recover lost surplus by proving the existence and amount of anticipated surplus with reasonable certainty. *B*'s failure to prove a previous pattern of actual surpluses precludes recovery. Proof is insufficient as to either the existence or the amount of anticipated surplus. In the lost surplus calculation, no demonstrable difference exists between anticipated and actual revenue. If *B* has incurred no costs associated with *A*'s performance, *B* has no actual surplus and, therefore, no provable lost surplus. If *B* has incurred costs associated with *B*'s contract with *A* and can prove them with reasonable certainty, those actual costs are recoverable because *B* can prove a negative amount of actual surplus equal to those costs.[98]

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97. *See, e.g.*, Fitz v. Coutinho, 622 A.2d 1220 (N.H. 1993) (remanding for an assessment of nominal damages). Lost revenue is similarly not recoverable where a party cannot prove that the breach was the cause of the loss. For example, *A* contracts to supply *B* with a quantity of masterbatch, a primary ingredient of retread rubber manufactured and sold by *B*. *A* breaches when it is unable to produce the required quantity of masterbatch because of a shortage of raw materials. *B* cannot prove the fact of lost revenue due to the breach with sufficient certainty to permit recovery, because a number of principal raw materials other than masterbatch needed to produce tread rubber were also in short supply. *See* B.B. Walker Co. v. Ashland Chem. Co., 474 F. Supp. 651 (M.D.N.C. 1979).

98. *See* Jewell-Rung Agency, Inc. v. Haddad Org., 814 F. Supp. 337 (S.D.N.Y. 1993). In some cases, a new business may have sufficient evidence of lost revenue, in which case such losses are recoverable. Consider a case where *A* breaches a contract to sell airplane parts to *B*. Despite the fact that *B*'s division responsible for the production of the parts is a new venture, *B* is entitled to recover lost surplus where *B* offers detailed evidence as to the projected cost per unit to manufacture parts and as to *B*'s historical profit margin on the aircraft parts contracts of its other divisions. This provides a sufficiently certain basis for calculating lost surplus. *See* Rogerson Aircraft Corp. v. Fairchild Indus., Inc., 632 F. Supp. 1494 (C.D. Cal. 1986).

16. *B*, the owner of a fish ranch, enters a contract to purchase fish from *A*. *A* breaches by delivering diseased fish. Forced to destroy all the fish at its ranch as a result of the diseased fish in the shipment from *A*, *B* claims its customer base is decimated. *B* offers no evidence that the enterprise is profitable and insufficient evidence to estimate the value of goodwill lost as a result of the breach. The sole evidence advanced is testimony that plaintiff's customers became afraid to buy fish from the plaintiff because of the outbreak of the disease and that *B*'s customer base fell drastically as a result. *B*'s damages would otherwise be the difference between anticipated and actual surplus, but because *B* does not prove anticipated surplus with sufficient certainty, *B*'s recovery is limited to its actual surplus, which is equal to actual costs.[99]

n. Uncertain Anticipated Costs

If, at the time of the other party's breach, a party has incurred performance or surplus-enhancing costs that can not be calculated with reasonable certainty, that party is not entitled to recover such incurred costs.

o. Uncertain Breach-Related Costs

If a party incurs costs that would not have been incurred had the other performed as promised, but those costs cannot be calculated with reasonable certainty, the injured party is not entitled to recover those actual costs.

Illustration:

17. *A* breaches a contract to sell an Angus bull to *B* by delivering a bull that is sterile. As a result, 38 of *B*'s cows do not become pregnant with calves from that bull, though they become pregnant later in the year from other bulls. The delay in pregnancy means that the calves are born later in the year and will be weaned later in the year. The consequence is that these cows will be delivering calves outside of the normal schedule for some years into the future, and their calves, which would normally have been sold immediately after weaning, will have to be fed through the winter, at some unanticipated cost to *B*. This breach-related cost is neither recoverable nor included among actual costs, because *B* cannot establish with reasonable certainty either how many of

99. *See* Roundhouse v. Owens -Illinois, Inc., 604 F.2d 990 (6th Cir. 1979). Damages for loss of goodwill are also unrecoverable if their existence can not be proved with reasonable certainty. For example, *B* enters a contract to purchase scuba regulator hoses from *A*. After incorporating the regulator hoses into its products, *B* discovers the hoses are defective and conducts a product recall. Where *B*'s business is new, *B* is not entitled to damages for the loss of goodwill caused by *A*'s breach, because the existence of such loss of potential customers is too speculative. *See, e.g.*, Dacor Corp. v. Sierra Precision, 753 F. Supp. 731 (N.D. Ill. 1991) (holding that loss of goodwill is never compensable in a contract action under Illinois law).

the cows will continue to deliver outside the normal schedule, or how many calves will actually have to be fed through the winter. Accordingly, these breach-related costs are not included among actual costs when computing lost surplus.[100]

100. *See* Hanes v. Twin Gable Farm, Inc., 714 S.W.2d 667 (Mo. App. Ct. 1986).