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ARTICLES

CONSEQUENTIAL DAMAGES FOR COMMERCIAL LOSS: AN ALTERNATIVE TO *HADLEY v. BAXENDALE*

*THOMAS A. DIAMOND**
*HOWARD FOSS***

INTRODUCTION

Described as "a fixed star in the jurisprudential firmament,"[1] the English case of *Hadley v. Baxendale*[2] has been recognized in American jurisprudence as the definitive source for determining when consequential damages may be recovered for breach of contract.[3] Yet

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The authors thank their colleague David Welkowitz for his helpful comments on an earlier draft of this Article.

1. Grant Gilmore, The Death of Contract 83 (1974).

2. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

3. The decision is cited with approval by the highest court of 43 states. *See* Native Alaskan Reclamation & Pest Control, Inc. v. United Bank Alaska, 685 P.2d 1211, 1218-19 (Alaska 1984); Higgins v. Arizona Sav. & Loan Ass'n., 365 P.2d 476, 482-83 (Ariz. 1961); Carroll v. Jones, 373 S.W.2d 132, 135 (Ark. 1963); Hunt Bros. Co. v. San Lorenzo Water Co., 87 P. 1093, 1095 (Cal. 1906); Western Union Tel. Co. v. Trinidad Bean & Elevator Co., 267 P. 1068, 1069 (Colo. 1928); General Motors Corp. v. Martine, 567 A.2d 808, 811 (Conn. 1989); National Airlines, Inc. v. Edwards, 336 So. 2d 545, 547 (Fla. 1976); Amfac, Inc. v. Waikiki Beachcomber Inv. Co., 839 P.2d 10, 29 n.11 (Haw. 1992); White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1022 (Idaho 1986); Midland Hotel Corp. v. Reuben H. Donnelley Corp., 515 N.E.2d 61, 67 (Ill. 1987); Pirchio v. Noecker, 82 N.E.2d 838, 840 (Ind. 1948); Meyer v. Nottger, 241 N.W.2d 911, 920 (Iowa 1976); Enlow v. Sears, Roebuck & Co., 822 P.2d 617, 623 (Kan. 1991); Borden, Inc. v. Howard Trucking Co., 454 So. 2d 1081, 1098 (La. 1983); Dodge v. United Servs. Auto. Ass'n., 417 A.2d 969, 975 (Me. 1980); Stone v. Chicago Title Ins. Co., 624 A.2d 496, 501 (Md. 1993); Abrams v. Reynolds Metals Co., 166 N.E.2d 204, 207 (Mass. 1960); Stockdale v. Jamison, 330 N.W.2d 389, 392 (Mich. 1982); Lesmeister v. Dilly, 330 N.W.2d 95, 103 (Minn. 1983); Aetna Casualty & Sur. Co. v. Day, 487 So. 2d 830, 835 (Miss. 1986); Spruce Co. v. Mays, 62 S.W.2d 824, 828 (Mo. 1933); Laas v. Montana State Highway Comm'n, 483 P.2d 699, 704 (Mont. 1971); Birkel v. Hassebrook Farm Serv., Inc., 363 N.W.2d 148, 152 (Neb. 1985); Charlie Brown Constr. Co. v. City of Boulder, 797 P.2d 946, 952 (Nev. 1990); Hydraform Prods. Corp. v. American Steel & Aluminum Corp., 498 A.2d 339, 345 (N.H. 1985); Perini Corp. v. Greate Bay Hotel & Casino, Inc., 610 A.2d 364, 373 (N.J. 1992); Torrance County Mental Health Program, Inc. v. New Mexico Health & Env't Dept., 830 P.2d 145, 154 (N.M. 1992); Goodstein Constr. Corp. v. City of New York, 604 N.E.2d 1356, 1361 (N.Y. 1992); Pipkin v. Thomas & Hill, Inc., 258 S.E.2d 778, 783 (N.C. 1979); Glatt v. Bank of Kirkwood Plaza, 383 N.W.2d 473, 484 (N.D. 1986); Midvale Coal Co. v. Cardox Corp., 106 N.E.2d 556, 559 (Ohio 1952); Morris v. Sanchez, 746 P.2d 184, 190 n.1 (Okla. 1987); Welch v. United States Bancorp Realty & Mortgage Trust, 596 P.2d 947,

despite its widespread and enduring acceptance, the case remains the subject of ongoing scholarly debate,[4] and its underlying policies and precise meaning remain elusive. This Article re-examines when consequential damages for commercial loss should be recovered and begins by identifying and evaluating the relevant policies. Following the policy evaluations, the authors conclude that the application of a single, inflexible standard for liability, irrespective of the surrounding circumstances, is a fundamentally flawed approach. It is the authors' position that different contractual situations reflect different policy concerns necessitating different levels of liability. The authors propose, as an alternative to *Hadley*, a trifurcated standard that varies the scope of liability according to the situation.

I. THE CASE OF *HADLEY V. BAXENDALE* AND ITS EVOLUTION

A. *Summary of the Case*

In *Hadley*, a mill was shut down while the millers sought to replace a broken shaft. Lacking a spare, and needing to send the broken shaft to the manufacturer as the model for a new one, the millers hired defendant carrier to transport the broken shaft.[5] The carrier, however, was unaware that the millers had no spare and that they could not operate the mill until a new shaft was delivered.[6] The transport of the broken shaft was delayed through the neglect of the carrier, result-

963 (Or. 1979); Robinson Protective Alarm Co. v. Bolger & Picker, 516 A.2d 299, 303 n.9 (Pa. 1986); Quill Co. v. A.T. Cross Co., 477 A.2d 939, 943 (R.I. 1984); Drews Co. v. Ledwith-Wolfe Assocs., 371 S.E.2d 532, 535 (S.C. 1988); Turner v. Benson, 672 S.W.2d 752, 755 (Tenn. 1984); Mead v. Johnson Group, Inc., 615 S.W.2d 685, 687 (Tex. 1981); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985); Albright v. Fish, 422 A.2d 250, 254 (Vt. 1980); Roanoke Hosp. Ass'n. v. Doyle & Russell, Inc., 214 S.E.2d 155, 160 (Va. 1975); Gaglidari v. Denny's Restaurants, 815 P.2d 1362, 1373 (Wash. 1991); Kentucky Fried Chicken v. Sellaro, 214 S.E.2d 823, 827 (W. Va. 1975).

The rule of *Hadley* is accepted by the highest court of three states, but not by name. *See* Smalley Transp. Co. v. Bay Dray, Inc., 612 So. 2d 1182, 1189 (Ala. 1992); Mash v. Cutler, 488 N.W.2d 642, 651 (S.D. 1992); Mariner v. Marsden, 610 P.2d 6, 11 (Wyo. 1980).

In the remaining four states, appellate decisions have referred to and accepted *Hadley*. *See* Commercial Credit Corp. v. C.F. Schwartz Motor Co., 251 A.2d 353, 355 (Del. Super. Ct. 1969); Smith v. A.A. Wood & Son Co., 120 S.E.2d 800, 804-05 (Ga. Ct. App. 1961); Overstreet v. Greenwell, 441 S.W.2d 443, 446 (Ky. Ct. App. 1969); Ford Motor Co. v. Lyons, 405 N.W.2d 354, 383 (Wis. Ct. App. 1987).

4. *See, e.g.*, Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 101-18 (1989) (defending *Hadley* as a "penalty default" rule whose limitations upon liability serve to promote economic efficiency); Melvin A. Eisenberg, *The Principle of* Hadley v. Baxendale, 80 Cal. L. Rev. 563, 602-04 (1992) (condemning *Hadley* for undermining the policy goals of deterring breach and of compensating the victim of breach); Jason S. Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 Yale L.J. 615, 615-39 (1990) (condemning *Hadley* for failing to promote efficiency).

5. Hadley v. Baxendale, 9 Ex. at 341, 156 Eng. Rep. at 145-46.

6. *Id.* at 355-56, 156 Eng. Rep. at 151.

ing in breach of contract and the millers' extended loss of profits from the continued shutdown of their operations.[7]

The rule for recovery of contract damages was framed by the *Hadley* court as follows:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as 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. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract.[8]

The court found that the millers' inability to operate until the shaft was returned constituted special circumstances.[9] Because these special circumstances were not communicated to the carrier, the millers were not entitled to their lost profits. The court explained that "in the great multitude of cases of millers sending off broken shafts to third persons by a carrier under ordinary circumstances, such consequences would not, in all probability, have occurred."[10] The case altered prior law, which did not impose significant restrictions on the recovery of damages for breach of contract.[11]

Hadley has been interpreted to create two rules for the recovery of damages for breach of contract, the first for general damages and the second for consequential damages.[12] General damages are market-

7. *Id.* at 341, 156 Eng. Rep. at 146.

8. *Id.* at 354-55, 156 Eng. Rep. at 151.

9. *Id.* at 356, 156 Eng. Rep. at 151.

10. *Id.*

11. Prior to *Hadley*, the law was that "it is, in general, entirely the province of the jury to assess the amount, with reference to all the circumstances of the case." J. Chitty, A Practice Treatise on the Law of Contracts 768 (4th ed. 1850).

12. Roy R. Anderson, *Incidental and Consequential Damages*, 7 J.L. & Com. 327, 351 (1987); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821, 867-68 (1992); Eisenberg, *supra* note 4, at 565-66; Arthur G. Murphey, Jr., *Consequential Damages in Contracts for the International Sale of Goods and the Legacy of* Hadley, 23 Geo. Wash. J. Int'l L. & Econ. 415, 431-32 (1989); Eileen A. Scallen, Comment, *Sailing the Uncharted Seas of Bad Faith:* Sea-

measured damages[13] and are based on the value of the performance itself,[14] independent of the buyer's special circumstances, such as the difference between market price and contract price.[15] Consequential damages are those that arise as a secondary consequence of nonperformance resulting from the injured party's special circumstances,[16] and typically consist of the loss of profit that would have been made in transactions with third parties.[17] Under the first rule, general damages are recoverable even if unexpected[18] because they "may fairly and reasonably be considered . . . [as] arising naturally, i.e., according to the usual course of things, from such breach of contract itself."[19] Under the second rule, recovery for unexpected consequential losses is limited. *Hadley* used various terms to describe the scope of that limitation. The court stated that the damages must have been a "probable result"[20] of breach, that they must "ordinarily follow"[21]

man's Direct Buying Serv., Inc. v. Standard Oil Co., 69 Minn. L. Rev. 1161, 1166 n.23 (1985).

13. A buyer's general damages are market-measured, based either on the difference between market price and contract price (e.g., U.C.C. § 2-713(1) (1990)), the difference between cover price and contract price (e.g., U.C.C. § 2-712(2) (1990)), or the diminution in value of goods or services caused by breach of warranty (e.g., U.C.C. § 2-714(2) (1990)). A seller's general damages are also market measured, based on the difference between contract price and market price (e.g., U.C.C. § 2-708(1) (1990)) or the difference between contract price and resale price (e.g., U.C.C. § 2-708(2) (1990)). *See* 1 Dan B. Dobbs, Law of Remedies § 3.3(3), at 297 (2d ed. Practitioner Treatise Ser. 1993) ("General damages are market-measured damages. They value the plaintiff's entitlement by looking at its value on some real or supposed market.").

Professor Anderson has defined general damages as damages "based on the value of the goods, whether their value as measured by the available market, a substitute cover purchase, or on the worth warranted by the seller." Anderson, *supra* note 12, at 328.

14. *See* 3 Dobbs, *supra* note 13, § 12.4(1), at 62; Anderson, *supra* note 12, at 328-29.

15. *See, e.g.,* U.C.C. § 2-713(1) (1990) (providing that the buyer may recover "the difference between the market price at the time when the buyer learned of the breach and the contract price together with any incidental and consequential damages").

16. 3 Dobbs, *supra* note 13, § 12.4(1), at 62; Anderson, *supra* note 12, at 329; Eisenberg, *supra* note 4, at 565.

17. Eisenberg, *supra* note 4, at 565. Consequential damages may include lost profits from lost resale contracts, losses and expenses caused by defective or undelivered goods purchased for production, lost goodwill, third-party claims brought against the buyer of defective goods, loss of use of defective property (including the rental value of substitute goods), interest, attorney's fees, personal injury or property damage. *See* Anderson, *supra* note 12, at 399.

18. *See* sources cited *supra* note 12.

19. Hadley v. Baxendale, 9 Ex. 341, 354, 156 Eng. Rep. 145, 151 (1854). *See* Eisenberg, *supra* note 4, at 565 ("General damages are never barred by the principle of *Hadley v. Baxendale* because by their very definition such damages should 'reasonably be considered . . . [as] arising naturally, i.e., according to the usual course of things from the breach.' " (quoting Hadley v. Baxendale, 9 Ex. at 354, 156 Eng. Rep. at 151)).

20. Hadley v. Baxendale, 9 Ex. at 354, 156 Eng. Rep. at 151.

21. *Id.*

from breach, that they must occur in the "great multitude"[22] of cases, and that they must have been in "the contemplation of both parties."[23] By using these alternative, undefined terms, *Hadley* left unresolved the precise degree to which loss has to be predictable before consequential damages can be recovered.

B. *Modern Approaches to* Hadley

Among the various terms used by *Hadley*, most courts have adopted the one that limits recovery to those losses which, at the time of the formation of the contract, were "a probable result of the breach."[24] The Restatement (Second) of Contracts provides that consequential damages may be recovered if they were "a probable result of the breach when the contract was made . . . as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know."[25] But courts freely interchange these expressions with the statement that consequential damages may be recovered if they were a "foreseeable" result of breach.[26] By doing so, they keep shrouded in ambiguity the degree to which loss must be predictable in order to be recovered. While the term "probable" would appear to mean statistically probable, that is, more likely than not, the term "foreseeable" suggests a lower level of likelihood.[27]

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22. *Id.* at 355, 156 Eng. Rep. at 151.

23. *Id.* at 354, 156 Eng. Rep. at 151.

24. *See, e.g.*, Amfac, Inc. v. Waikiki Beachcomber Inv. Co., 839 P.2d 10, 29 n.11 (Haw. 1992); Enlow v. Sears, Roebuck & Co., 822 P.2d 617, 623 (Kan. 1991); Stone v. Chicago Title Ins. Co., 624 A.2d 496, 501 (Md. 1993); Drews Co. v. Ledwith-Wolfe Assocs., 371 S.E.2d 532, 535 (S.C. 1988); Gaglidari v. Denny's Restaurants, 815 P.2d 1362, 1373 (Wash. 1991); Ford Motor Co. v. Lyons, 405 N.W.2d 354, 383 (Wis. Ct. App. 1987).

25. Restatement (Second) of Contracts §§ 351(1), (2)(b) (1979). For a discussion of the term "reason to know" see *infra* note 132.

26. *See, e.g.*, White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1017 (Idaho 1986); Aetna Casualty & Sur. Co. v. Day, 487 So. 2d 830, 835 (Miss. 1986); Hydraform Products Corp. v. American Steel & Aluminum Corp., 498 A.2d 339, 345 (N.H. 1985); Welch v. United States Bancorp Realty & Mortgage Trust, 596 P.2d 947, 963 (Or. 1979); Turner v. Benson, 672 S.W.2d 752, 754-55 (Tenn. 1984); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985).

27. Several courts have stated that consequential damages may be recovered even though their occurrence was less than a probable result of breach. *See, e.g.*, Caspe v. Aaacon Auto Transp., Inc., 658 F.2d 613, 617 (8th Cir. 1981) ("The general rule does not require the plaintiff to show that the actual harm suffered was the *most* foreseeable of possible harms. He need only demonstrate that his harm was not so remote as to make it unforeseeable to a reasonable man at the time of contracting." (quoting Hector Martinez & Co. v. Southern Pac. Transp. Co., 606 F.2d 106, 110 (5th Cir. 1979), *cert. denied*, 446 U.S. 982 (1980))); Affiliated Foods, Inc. v. Puerto Rico Marine Management, Inc., 645 F. Supp. 838, 843 (D. P.R. 1986); Sun Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612, 616 (Ct. App. 1983) ("The possibility of 'disastrous' rain damage to the 1976 raisin crop was clearly foreseeable to appellants."); National Farmers Org., Inc. v. McCook Feed & Supply Co., 243 N.W.2d 335, 339 (Neb. 1976); Harbor Hill Lithographing Corp. v. Dittler Bros., Inc., 348 N.Y.S.2d 920,

Most courts have avoided the interpretational dilemma of reconciling these terms by leaving them undefined.

The Uniform Commercial Code[28] distinguishes consequential damages for commercial loss, such as lost profits caused by a shutdown of operations, from loss caused by injury to person or property.[29] With respect to personal injury and property damage, U.C.C. § 2-715(2)(b) permits recovery of all damages "proximately resulting"[30] from breach. With respect to economic loss, U.C.C. § 2-715(2)(a) permits recovery of consequential damages for "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know."[31] This language of section 2-715(2)(a) appears alien to *Hadley*, but the Official Comments to the Code state that it was intended to incorporate the common law rule.[32] The courts have agreed.[33] But rather than attempting to reconcile the Code language with that of *Hadley,* courts interpreting section 2-

923 (Sup. Ct. 1973)("[T]he possibility, if not probability, of anticipated profit from resale was reasonably within the contemplation of the parties.").

28. The Uniform Commercial Code is hereinafter referred to as the U.C.C. or the Code.

29. U.C.C. § 2-715(2)(a) governs recovery of commercial or economic loss, while U.C.C. § 2-715(2)(b) governs recovery of losses from personal injury or property damage. The statutory scheme is somewhat convoluted. An aggrieved buyer is accorded the right to recover consequential damages by §§ 2-712(2), 2-713(1), and 2-714(3), but those provisions permit recovery only of consequential damages as defined in § 2-715.

30. U.C.C. § 2-715(2)(b) defines consequential damages resulting from the seller's breach to include "injury to person or property proximately resulting from any breach of warranty." The "proximately resulting" language of § 2-715(2)(b) has been interpreted to invoke the comparatively forgiving standards of tort proximate causation. According to Professor Anderson: "The standard for recovery in a (2)(b) case is 'proximately resulting,' a tort standard conceptually broader than the contract standard in (2)(a) of 'reason to know.' " Anderson, *supra* note 12, at 450. *See* James J White & Robert S. Summers, Uniform Commercial Code 470 (3d ed. 1988) ("The crucial word is 'proximately,' a word that imports into the Code . . . the many tort cases on proximate cause which courts turn out in every jurisdiction of the United States every year.").

31. U.C.C. § 2-715(2)(a) provides:

> (2) Consequential damages resulting from the seller's breach include
>
> (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise.

U.C.C. § 2-715(2)(a) (1990). This provision is framed, not in the traditional terms of whether the seller had reason to know or foresee the buyer's loss, but rather in terms of whether the seller had reason to know the requirements and needs of the buyer from which the loss resulted. The inquiry is thus shifted from the foreseeability of the buyer's loss to the foreseeability of the buyer's requirements and needs.

32. The U.C.C. follows "the older rule at common law which made the seller liable for all consequential damages of which he had 'reason to know.' " U.C.C. § 2-715 cmt. 2 (1990).

33. *See, e.g.,* Troxler Elecs. Lab., Inc. v. Solitron Devices, Inc., 722 F.2d 81, 84-85 (4th Cir. 1983); Lenox, Inc. v. Triangle Auto Alarm, 738 F. Supp. 262, 266 (N.D. Ill. 1990); Anna Ready Mix, Inc. v. N.E. Pierson Const. Co., 747 F. Supp. 1299, 1304 (S.D. Ill. 1990); Sun Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612, 614 (Ct.

715(2)(a) have tended to adopt the common law approach[34] of addressing the issue of consequential damages under the Code as a question of foreseeability, allowing recovery if damages are foreseeable and denying recovery if they are not.[35]

It is possible that *Hadley* has remained the law of the land for more than a century not in spite of, but because of, its ambiguity. That is the position taken by Professor Anderson, who contends that:

> [W]hat is so often overlooked about the *Hadley v. Baxendale* standard is that we were never meant to understand its precise meaning. What more effective method of controlling jury discretion than placing a standard in the hands of the trial judge, which only he can apply?[36]

Professor Anderson may be correct. While *Hadley* would not be the only rule that was framed in ambiguity to create justice,[37] however, the idea that from obfuscation comes justice is not one of the accepted tenets of our legal system. Ambiguous rules have the capacity to achieve injustice with equal, if not greater, likelihood. They tend to endure not because of the value of their ambiguity but because their underlying policies have not been stated with sufficient precision to permit those rules to be discarded or clarified.[38]

App. 1983); Cricket Alley Co. v. Data Terminal Sys. Inc., 732 P.2d 719, 725 (Kan. 1987).

34. *See supra* note 26 and accompanying text.

35. *See, e.g.,* Hendricks & Assocs., Inc. v. Daewoo Corp., 923 F.2d 209, 214-15 (1st Cir. 1991); Step-Saver Data Sys., Inc. v. Wyse Technology, 912 F.2d 643, 653 (3rd Cir. 1990); Fidelity & Deposit Co. v. Krebs Eng'rs, 859 F.2d 501, 506-07 (7th Cir. 1988); Taylor & Gaskin, Inc. v. Chris-Craft Indus., 732 F.2d 1273, 1278 (6th Cir. 1984); Blue Circle Atl., Inc. v. Falcon Materials, Inc., 760 F. Supp. 516, 523 (D. Md. 1991); Brandon & Tibbs v. George Kevorkian Acct. Corp., 277 Cal. Rptr. 40, 48 (Ct. App. 1990); AM/PM Franchise Ass'n v. Atlantic Richfield Co., 584 A.2d 915, 921 (Pa. 1990).

36. Anderson, *supra* note 12, at 353.

37. For example, the term "scope of employment" as it applies to the doctrine of *respondeat superior* has been described as "so devoid of meaning in itself that its very vagueness has been of value in permitting a desirable degree of flexibility in decisions." W. Page Keeton et al., Prosser and Keeton on the Law of Torts § 70, at 502 (5th ed. 1984). *See* Jane B. Korn, *The Fungible Woman and Other Myths of Sexual Harassment*, 67 Tul. L. Rev. 1363, 1419 (1993); Rochelle R. Weber, Note, *"Scope of Employment" Redefined: Holding Employers Vicariously Liable for Sexual Assaults Committed by Their Employees*, 76 Minn. L. Rev. 1513, 1541 (1992).

38. *See generally* Christopher L. Kutz, Note, *Just Disagreement: Indeterminacy and Rationality in the Rule of Law*, 103 Yale L. J. 997 (1994). An example of an ambiguous term whose endurance in the law can be attributed to confusion rather than to design can be found in the doctrine of *res ipsa loquitur*, which has traditionally required that the defendant be in "exclusive control" of the instrumentality that caused the accident. *See* Keeton et al., *supra* note 37, § 39, at 248-53. Courts continue to pay homage to the term "exclusive control" despite their inability to agree on its meaning. *Id.* When it was understood and agreed that the purpose of the term was to assure that *res ipsa loquitur* would be limited to those defendants who were likely to be found at fault, it became apparent that proof of exclusive control, however defined, was an ill-suited means to achieve that end, and, as a result, the requirement of exclusive control is rapidly being rejected. *See* Restatement (Second) of Torts § 328D cmt. g (1965). *See also* Khirieh v. State Farm Mut. Auto Ins. Co., 594 So. 2d 1220,

It is suggested that such is the case with *Hadley* and its progeny. The reasons why the *Hadley* court imposed its novel rule never have been clearly understood. It has been asserted that the court's purpose was to promote predictability by restricting liability.[39] But most scholars have ignored this premise and instead have attempted to explain *Hadley* as a rule that promotes economic efficiency by encouraging the disclosure of risk-related information.[40] Despite scholarly contributions on the subject,[41] disagreement as to the meaning and value of *Hadley* continues. Without the guidance of clearly defined underlying policies, disagreement and ambiguity are inevitable.

C. *Focus*

This Article seeks to ascertain the extent to which commercial losses, including those that are unexpected or unusual, should be recovered as consequential damages. It focuses on consequential damages incurred by commercial buyers involving purely economic loss. It does not consider the appropriate standard for the recovery of general damages or consequential damages for injury to person or property. Nor does it cover consequential damages for economic losses not incurred in a commercial context, such as damages measured by fair rental value when consumers are deprived of the use of their goods.[42] The term "commercial loss" will be used interchangeably

1223-24 (Ala. 1992); Giles v. City of New Haven, 636 A.2d 1335, 1338 (Conn. 1994); Perkins v. Hausladen, 828 S.W.2d 652, 655 (Ky. 1992); Poulin v. Aquaboggan Waterslide, 567 A.2d 925, 926 (Me. 1989); Enrich v. Windmere Corp., 616 N.E.2d 1081, 1085 (Mass. 1993); Valley Properties Ltd. Partnership v. Steadman's Hardware, Inc., 824 P.2d 250, 254 (Mont. 1992); Konicki v. Lawrence, 475 A.2d 208, 210 (R.I. 1984).

39. *See* Richard Danzig, Hadley v. Baxendale*: A Study in the Industrialization of the Law*, 4 J. Legal Stud. 249, 277 (1975); Eisenberg, *supra* note 4, at 569.

40. *See, e.g.*, E. Allan Farnsworth, Contracts § 12.3, at 846-47 (2d ed. 1990); Richard A. Posner, Economic Analysis of Law 61 (2d ed. 1977); Ayres & Gertner, *supra* note 4, at 101-02; John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. Legal Stud. 277, 296 (1972); Juliet P. Kostritsky, *Bargaining With Uncertainty, Moral Hazard, and Sunk Costs: A Default Rule for Precontractual Negotiations*, 44 Hastings L.J. 621, 684 (1993).

This purported justification is not without its detractors, who contend that *Hadley*'s rule of restricted liability does not fairly and efficiently promote disclosure. *See* Eisenberg, *supra* note 4, at 602-04; Johnston, *supra* note 4, at 632-33.

41. *See* sources cited *supra* note 4; *see also* Barnett, *supra* note 12, at 867; Lucian A. Bebchuk & Steven Shavell, *Shared Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J. Law, Econ. & Org. 284 (1991); Danzig, *supra* note 39, at 249; Franco Ferrari, *Comparative Ruminations on the Foreseeability of Damages in Contract Law*, 53 La. L. Rev. 1257 (1993); Janet T. Landa, Hadley v. Baxendale *and the Expansion of the Middleman Economy*, 16 J. Legal Stud. 455 (1987); Posner, *supra* note 40.

42. *See* Anderson, *supra* note 12, at 431 ("Consumer buyers often incur consequential damages in the form of rental value of substitutes rented to accomplish the use for which the buyer purchased the contracted goods.").

with the term "economic loss"[43] and the term "commercial damages" will be used interchangeably with the term "economic damages."

In most cases, consequential economic loss, unlike personal injury, property damage and general damages, results only if the breaching party is the seller.[44] The buyer's breach ordinarily involves the late payment or nonpayment of money, seldom resulting in consequential economic damages. For this reason and for purposes of convenience, the breaching party will hereafter be referred to as the seller and the victim of breach as the buyer.

In re-evaluating the standard for the recovery of consequential damages for commercial loss, all relevant policies, not merely those that can be attributed to the rule of *Hadley*, are considered. From this broad perspective, it becomes apparent that there is a potential conflict among policies, that no single policy is of paramount importance in every situation, and that an inflexible rule that seeks to promote one policy in all situations is misguided.

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43. Judge Posner, in reference to the economic loss doctrine, explained why the term "commercial loss" may be preferable:

> It would be better to call it a "commercial loss," not only because personal injuries and especially property losses are economic losses, too—they destroy values which can be and are monetized—but also, and more important, because tort law is a superfluous and inapt tool for resolving purely commercial disputes.

Miller v. United States Steel Corp., 902 F.2d 573, 574 (7th Cir. 1990). *Accord* Theuerkauf v. United Vaccines Div., Inc., 821 F. Supp. 1238, 1242 (W.D. Mich. 1993); Neibarger v. Universal Coops., Inc., 486 N.W.2d 612, 616 (Mich. 1992).

44. Aside from difficulties of proof, the seller may be legally precluded from recovering consequential damages. Section 1-106 of the U.C.C. provides that "neither consequential or special nor penal damages may be had except as specifically provided in this Act or by other rule of law." U.C.C. § 1-106(1) (1990). The Code specifically provides for buyers' recovery of consequential damages (U.C.C. §§ 2-713(1), 2-714(3) and 2-715(2) (1990)), but it is conspicuously silent with respect to sellers' recovery of consequential damages. As a result, the courts have consistently concluded that the Code prohibits sellers from recovering consequential damages. *See, e.g.*, Afram Export Corp. v. Metallurgiki Halyps, S.A., 772 F.2d 1358, 1368 (7th Cir. 1985); Nobs Chemical, U.S.A., Inc. v. Koppers Co., 616 F.2d 212, 216 (5th Cir. 1980); Atlantic Paper Box Co. v. Whitman's Chocolates, 844 F. Supp. 1038, 1045-46 (E.D. Pa. 1994); Associated Metals & Minerals Corp. v. Sharon Steel Corp., 590 F. Supp. 18, 21-22 (S.D.N.Y. 1983), *aff'd mem.*, 742 F.2d 1431 (2d Cir. 1983); Petroleo Brasileiro, S.A., Petrobras v. Ameropan Oil Corp., 372 F. Supp. 503, 508 (E.D.N.Y. 1974); Florida Mining & Materials Corp. v. Standard Gypsum Corp., 550 So. 2d 47, 49 (Fla. Dist. Ct. App. 1989); S.C. Gray, Inc. v. Ford Motor Co., 286 N.W.2d 34, 43 (Mich. Ct. App. 1979); USX Corp. v. Union Pac. Resources Co., 753 S.W.2d 845, 856 (Tex. Ct. App. 1988); Sprague v. Sumitomo Forestry Co., Ltd., 709 P.2d 1200, 1205 (Wash. 1985). *See generally*, Roy R. Anderson, *In Support of Consequential Damages For Sellers*, 11 J.L. & Com. 123 (1992) (advocating remedies to balance current remedies available to both parties).

II. Criteria for Determining the Appropriate Limits on the Recovery of Consequential Damages for Economic Loss

A. *Distinguishing Tort Theory from Contract Theory*

The recovery of damages under tort law theory is evaluated from a different perspective than under contract law theory. By designating conduct as tortious, the law has made a conclusive determination that such conduct is so reprehensible or dangerous that it must be deterred through expansive liability, including punitive damages,[45] irrespective of whatever countervailing economic consequences to the tortfeasor or society may ensue.[46] In furtherance of this policy, the broad tort foreseeability doctrine, allowing the victim compensation for all but extraordinary injuries,[47] and the doctrine that the tortfeasor takes the

45. 1 Dobbs, *supra* note 13, § 3.11(3), at 476-82; Keeton et al., *supra* note 37, § 2, at 9; Charles T. McCormick, Handbook on the Law of Damages § 77, at 275 (1935); Robert D. Cooter, *Economic Analysis of Punitive Damages*, 56 S. Cal. L. Rev. 79, 90 (1982); Jason S. Johnston, *Punitive Liability: A New Paradigm of Efficiency in Tort Law*, 87 Colum. L. Rev. 1385, 1405-06 (1987) ("While the open-ended and to a large degree arbitrary magnitude of punitive damages may call into question the fairness of these damages, optimal deterrence is not inconsistent with unlimited and variable awards."); Amelia J. Toy, Comment, *Statutory Punitive Damage Caps and the Profit Motive: An Economic Perspective*, 40 Emory L.J. 303, 324-25 (1991) ("Concerns about unpredictable punitive damage awards become less significant when one remembers that such awards are intended not only to punish the present defendant, but also to deter future tortfeasors.").

46. "There is now a rich body of academic literature supporting the view that a primary purpose of tort law liability rules is to discourage inappropriate behavior on the part of accident causers." John W. Wade, *On the Nature of Strict Tort Liability for Products*, 44 Miss. L.J. 825, 826 (1973). *See also* Restatement (Second) of Torts § 901(c) (1979); Guido Calabresi, The Cost of Accidents: A Legal and Economic Analysis 68 (1970); Keeton et al., *supra* note 37, § 4, at 23; Richard A. Posner, Economic Analysis of Law 187, 202-04 (4th ed. 1992); G. Edward White, Tort Law in America—An Intellectual History 222-37 (1980); Philip H. Corboy, *Vicarious Liability for Punitive Damages: The Effort to Constitutionalize "Tort Reform"*, 2 Seton Hall Const. L.J. 5, 10 (1991) ("It is a fundamental aim of tort law not only to compensate the victims of tortious conduct, but also to deter such misconduct."); William H. Hardie, Jr., *Foreseeability: A Murky Crystal Ball for Predicting Liability*, 23 Cumb. L. Rev. 349, 406 (1993); David G. Owen, *Deterrence and Desert in Tort: A Comment*, 73 Cal. L. Rev. 665, 666-70 (1985); Richard Pierce, *Institutional Aspects of Tort Reform*, 73 Cal. L. Rev. 917, 930-31 (1985); Gary T. Schwartz, *The Beginning and the Possible End of the Rise of Modern American Tort Law*, 26 Ga. L. Rev. 601, 607, 617-19 (1992); Daniel W. Shuman, *The Psychology of Deterrence in Tort Law*, 42 Kan. L. Rev. 115, 115 (1993) ("Deterrence delineates tort law. Tort law seeks to reduce injury by deterring unsafe behavior and that goal informs tort standards for behavior.").

47. The proximate cause limitation for the tort of negligence has traditionally been expressed in terms of foreseeability. Injuries are deemed unforeseeable only if it appears highly extraordinary that the tortious conduct would have caused the type of injury suffered by the plaintiff. Williford v. L.J. Carr Invs., Inc., 783 P.2d 235, 240 (Alaska 1989); Jackson v. Ryder Truck Rental, Inc., 20 Cal. Rptr. 2d 913, 918 (Ct. App. 1993); *accord* Stahl v. Metropolitan Dade County, 438 So. 2d 14, 21 (Fla. Dist. Ct. App. 1983); Masotti v. Console, 552 N.E.2d 1292, 1297 (Ill. App. Ct. 1990); Mobley v. Rego Co., 412 So. 2d 1143, 1152 (La. Ct. App. 1982); Henley v. Prince George's County, 503 A.2d 1333, 1340 (Md. 1986); Rae v. Air-Speed, Inc., 435 N.E.2d

plaintiff as he finds her,[48] are designed to assure that only in the most exceptional cases will a victim's full compensation be denied.

When injury is caused by breach of contract, the analysis differs. Because breach of contract is not necessarily so reprehensible or dangerous as to constitute a tort,[49] it is improper to presume that as a matter of social policy breach must be deterred through expansive liability. Instead of permitting full recovery for all but extraordinary losses, irrespective of the consequences,[50] the countervailing economic consequences that are justifiably ignored in tort law must be considered.[51] These consequences may be sufficiently important to justify

628, 632 (Mass. 1982); Johnson v. Ruark Obstetrics and Gynecology Assocs., 365 S.E.2d 909, 915 (N.C. Ct. App. 1988); Brown v. Tinneny, 421 A.2d 839, 844 (Pa. Super. Ct. 1980).

The Restatement (Second) of Torts has formulated an alternative, victim-friendly limitation. It rejects foreseeability as a determinant, stating that "[i]f the actor's conduct is a substantial factor in bringing about harm to another, the fact that the actor neither foresaw nor should have foreseen the extent of the harm or the manner in which it occurred does not prevent him from being liable." Restatement (Second) of Torts § 435(1) (1965). It substitutes a hindsight approach: "The actor's conduct may be held not to be a legal cause of harm to another where after the event and looking back from the harm to the actor's negligent conduct, it appears to the court highly extraordinary that it should have brought about the harm." *Id.* § 435(2). *See* Keeton et al., *supra* note 37, § 43, at 298-99.

It is a conceptual challenge to comprehend how an injury can be highly extraordinary if the evaluation is made with full knowledge of the setting and all that occurred. From a hindsight perspective, the injury was not only predictable, it was inevitable. Ignoring this conundrum, a significant and growing number of courts have adopted the Restatement approach. *See, e.g.*, Cota v. Harley Davidson, 684 P.2d 888, 893 (Ariz. Ct. App. 1984); City of Pinellas Park v. Brown, 604 So. 2d 1222, 1228 (Fla. 1992); Lee v. Chicago Transit Auth., 605 N.E.2d 493, 503 (Ill. 1992); Stone v. Chicago Title Ins. Co., 624 A.2d 496, 500 (Md. 1993); Williams v. Taylor Mach., Inc., 529 So. 2d 606, 610 (Miss. 1988); Andor v. United Air Lines, 719 P.2d 492, 497 (Or. Ct. App. 1986); Bell v. Irace, 619 A.2d 365, 367 (Pa. Super. Ct. 1993); Musch v. H-D Coop., Inc., 487 N.W.2d 623, 624 (S.D. 1992); Banks v. City of Richmond, 348 S.E.2d 280, 283 (Va. 1986); Buckley v. Bell, 703 P.2d 1089, 1093 (Wyo. 1985).

48. "It is as if a magic circle were drawn about the person, and one who breaks it, even by so much as a cut on the finger, becomes liable for all resulting harm to the person, although it may be death." Keeton et al., *supra* note 37, § 43, at 291.

49. *See infra* note 52.

50. *See supra* note 46.

51. Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach,* 61 S. Cal. L. Rev. 629, 630 (1988); Thomas A. Diamond, *The Tort of Bad Faith Breach of Contract: When, If at All, Should It Be Extended Beyond Insurance Transactions?,* 64 Marq. L. Rev. 425, 436-40 (1981); E. Allan Farnsworth, *Your Loss or My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract,* 94 Yale L.J. 1339, 1380-81 (1985); M.N. Kniffin, *A Newly Identified Contract Unconscionability: Unconscionability of Remedy,* 63 Notre Dame L. Rev. 247, 250 (1988); W. David Slawson, *The Role of Reliance in Contract Damages,* 76 Cornell L. Rev. 197, 217 (1990); Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies,* 83 Mich. L. Rev. 341, 344 (1984); Louis E. Wolcher, *The Accommodation of Regret in Contract Remedies,* 73 Iowa L. Rev. 797, 802-03 (1988); Edward Yorio, *In Defense of Money Damages for Breach of Contract,* 82 Colum. L. Rev. 1365, 1369-70 (1982).

greater limits on liability than in tort law.[52] Furthermore, because contracts involve bargained-for exchanges[53] that allocate risk by agreement rather than by the will of society, the intent of the parties is relevant to determining the extent to which compensation for breach of contract should be allowed.[54] In tort law, however, it is the will of society, not the intent of the parties, that determines the scope of liability.[55]

The difference in perspective between tort theory and contract theory is exemplified by the "economic loss doctrine," which provides that a party suffering purely commercial or economic loss from a defective product is relegated to contract remedies, and that without personal injury or property damage there can be no independent tort flowing from a breach of contract.[56] The reasoning supporting this

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52. Contract rules regarding privity, punitive damages and disclaimers of liability reflect a policy in favor of limiting liability in contract law to a greater extent than in tort law. Traditional contract law required privity of contract between plaintiff and defendant for any recovery. Although the privity doctrine has been significantly eroded in contract law, a substantial body of case law continues to impose it for economic loss. *See* White and Summers, *supra* note 30, § 11-6, at 466-67. For a collection of cases denying recovery of economic loss for lack of privity see *infra* note 197. Unlike in tort law, punitive damages may not be recovered for breach of contract. 3 Dobbs, *supra* note 13, § 12.5(2). *See also* sources cited *supra* note 45. Contract law also recognizes the effectiveness of contractual disclaimers of liability to a greater extent than tort law. *See infra* note 170.

53. Restatement (Second) of Contracts § 71 (1979). The relationship between bargaining and the doctrine of consideration is discussed in E. Allan Farnsworth, Contracts § 2-2, at 43-45 (2d ed. 1990).

54. It has been recognized that in the context of commercial contracts the agreement of the parties is of major relevance in determining the extent of liability for economic loss resulting from breach. In Seely v. White Motor Co., 403 P.2d 145, 150-51 (Cal. 1965), Justice Traynor justified his view that commercial economic loss should be compensated only in contract and not in tort on the ground that in the context of commercial sales the agreement of the parties should determine the extent of liability undertaken by a seller. This thesis underlies the economic loss doctrine. *See infra* notes 57-58 and accompanying text.

55. Dean Prosser distinguished tort from contract along the same lines:

> The fundamental difference between tort and contract lies in the nature of the interests protected. Tort actions are created to protect the interest in freedom from various kinds of harm. The duties of conduct which give rise to them are imposed by the law, and are based primarily upon social policy, and not necessarily upon the will or intention of the parties. . . . Contract actions are created to protect the interest in having promises performed. Contract obligations are imposed because of conduct of the parties manifesting consent, and are owed only to the specific individuals named in the contract.

William L. Prosser, Handbook of the Law of Torts § 92, at 613 (4th ed. 1971) (citation omitted). *See also* Keeton et al., *supra* note 37, § 92, at 655-56 (discussing the distinctions between tort and contract liability); Dana Rae Landsdorf, *California's Detortification of Contract Law: Is the Seaman's Tort Dead?*, 26 Loy. L.A. L. Rev. 213, 217-22 (1992) ("Whereas the goal of contract actions is to enforce the intentions of the parties to the agreement, the goal of tort law is primarily to vindicate 'social policy.' ").

56. *See, e.g.*, East River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 871 (1986); Jones v. Childers, 18 F.3d 899, 904 (11th Cir. 1994); Purvis v. Consolidated Energy Prods. Co., 674 F.2d 217, 222-23 (4th Cir. 1982); Jones & Laughlin Steel Corp.

doctrine is that the threat of physical injuries from dangerous products justifies circumventing the parties' contractually agreed allocation of risks in order to impose expansive tort liability. "However, where the loss is purely economic, the manufacturer cannot be charged with the responsibility of ensuring that the product meet the particular expectations of the consumer unless it is aware of those expectations and has agreed that the product will meet them."[57]

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v. Johns-Manville Sales Corp., 626 F.2d 280, 285-90 (3d Cir. 1980); Morrow v. New Moon Homes, Inc., 548 P.2d 279, 283-86 (Alaska 1976); Moorman Mfg. Co. v. National Tank Co., 435 N.E.2d 443, 445-48 (Ill. 1982); A.J. Decoster Co. v. Westinghouse Elec. Corp., 634 A.2d 1330, 1332-33 (Md. 1994); Neibarger v. Universal Coops., Inc., 486 N.W.2d 612, 615-18 (Mich. 1992); Hapka v. Paquin Farms, 458 N.W.2d 683, 686-88 (Minn. 1990); Spring Motors Distribs., Inc. v. Ford Motor Co., 489 A.2d 660, 665-68 (N.J. 1985).

For a discussion of the economic loss doctrine see Alex Devience, Jr., *The Developing Line Between Warranty and Tort Liability Under the Uniform Commercial Code: Does 2-318 Make a Difference?*, 2 DePaul Bus. L.J. 295, 313-22 (1990); David B. Gaebler, *Negligence, Economic Loss, and the U.C.C.*, 61 Ind. L.J. 593 (1986); William K. Jones, *Product Defects Causing Commercial Loss: The Ascendancy of Contract over Tort*, 44 U. Miami L. Rev. 731, 752-58 (1990); Jane D. Quasarano, *Commercial Transactions and Contracts*, 39 Wayne L. Rev. 399, 400-06 (1993); Richard E. Speidel, *Products Liability, Economic Loss and the U.C.C.*, 40 Tenn. L. Rev. 309, 316 (1973); John W. Wade, *Tort Liability for Products Causing Physical Injury and Article 2 of the U.C.C.*, 48 Mo. L. Rev. 1, 24-26 (1983).

57. The economic loss doctrine has been explained in terms of the distinction between tort and contract policy:

> The distinction between tort recovery for physical injury and warranty recovery for economic loss derives from policy considerations which allocate the risks related to a defective product between the seller and the purchaser. A manufacturer may be held liable for physical injuries, including harm to property, caused by defects in its products because it is charged with the responsibility to ensure that its products meet a standard of safety creating no unreasonable risk of harm. However, where the loss is purely economic, the manufacturer cannot be charged with the responsibility of ensuring that the product meet the particular expectations of the consumer unless it is aware of those expectations and has agreed that the product will meet them. Thus, generally, the only recovery for a purely economic loss would be under a contract theory.

A.J. Decoster Co. v. Westinghouse Elec. Corp., 634 A.2d 1330, 1332-33 (Md. 1994) (citations omitted). In explaining why purely economic loss should be governed by contract law, one court emphasized the importance of permitting parties to rely on their contractual allocation of risk:

> This rule proceeds from the theory that courts must preserve well-defined conceptual and practical distinctions between the body of law relating to contract damages and tort damages, so that contracting parties may rely confidently on their allocation of risk without fear that their counterparts will seek to recoup contract damages through tort actions. . . . Accordingly, the economic loss doctrine provides that "parties to a contract can only seek tort damages if conduct occurs that establishes a 'tort "distinguishable from or independent of [the] breach of contract." ' "

Jones v. Childers, 18 F.3d 899, 904 (11th Cir. 1994) (citations omitted).

B. *The Relevant Policies*

The following policies are relevant in fashioning the appropriate standard for the commercial buyer's recovery of consequential economic damages: (1) compensating the victim of breach; (2) deterring inefficient breach; (3) promoting the reliability of contracts; (4) reducing subsidization of loss by the buying public; (5) promoting predictability; (6) encouraging disclosure of information concerning the buyer's special circumstances relevant to the consequences of breach; and (7) limiting liability consistent with the parties' likely allocation of risk. Because this Article is limited to commercial losses, the generally recognized policy of consumer protection[58] is not relevant in this context.

1. Compensating the Victim of Breach

An important principle of contract damages is to protect the aggrieved party's expectation interest by putting that party in the same position as though the contract had been performed.[59] Therefore, one must give due weight to the economic injuries of the buyer as the victim of breach, because only full compensation will put the buyer in the same position as if the seller had performed. A properly fashioned rule for consequential damages, however, will not necessarily provide

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58. The policy of consumer protection has been decisive in the development of product liability law to address personal injury or property damage caused by defective products. The Supreme Court of Minnesota expressed its concern for consumers in the following terms:

> Generally speaking, a consumer has neither the skill nor the bargaining power to negotiate either warranties or remedies. If a defective coffee pot causes a fire which destroys a consumer's home, the panoply of liability theory should be available to the consumer—strict products liability and negligence as well as breach of warranty . . . .
>
> On the other hand, the law is entitled to expect the parties to commercial transactions to be knowledgeable and of relatively equal bargaining power so that warranties can be negotiated to the parties' mutual advantage.

Hapka v. Paquin Farms, 458 N.W.2d 683, 688 (Minn. 1990). *See also* Spring Motors Distribs., Inc. v. Ford Motor Co., 489 A.2d 660, 670 (N.J. 1985) ("[S]trict liability evolved as a judicial response to inadequacies in sales law with respect to consumers who sustained physical injuries from defective goods made or distributed by remote parties in the marketing chain.").

59. Contract damages are ordinarily designed to protect the aggrieved party's expectation interest by putting the aggrieved party in the same position as though the contract had been performed. *See* Farnsworth, *supra* note 40, § 12.1, at 839-41. As observed by Professor Farnsworth:

> The basic principle for the measurement of those [contract] damages is that of compensation based on the injured party's expectation. One is entitled to recover an amount that will put one in as good a position as one would have been in had the contract been performed.

Id. § 12.8, at 871 (citations omitted).

The expectation measure of damages is the preferred measure under the U.C.C., which provides that its remedies should be interpreted so that "the aggrieved party may be put in as good a position as if the other party had fully performed." U.C.C. § 1-106 (1990). *See also* Restatement (Second) of Contracts § 344(a) (1979).

full compensation for all economic loss, even if failure to recover that loss will leave the buyer in a worse position than if the contract had been performed.[60] Other policy considerations might supply a reason for limiting such recovery.[61]

2. Deterring Inefficient Breach

Breaches will be deterred as liability for unexpected losses increases because sellers will be induced to take additional measures to assure performance and to avoid the potentially disastrous economic consequences of expansive liability. When a breach consists of selling a dangerous product, which results in personal injury or property damage, deterrence of such a breach has been recognized as a compelling goal, justifying broad liability irrespective of the adverse economic consequences.[62] In the context of breach resulting in purely economic loss, however, deterring breach is merely one of several policies that must be considered. In such cases, the weight to be afforded to the policy of deterrence depends on whether the economic benefits of a rule sufficiently draconian to deter breach exceed the resulting economic costs.[63] Deterrence would have an economically beneficial impact if it could be limited to inefficient breaches. An inefficient breach is one in which the buyer's losses from breach exceed or equal the seller's gains.[64] For example, if the seller breaches to take advantage

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60. As Professor Yorio observed in this regard:

> Since the compensation principle itself derives from considerations of fairness and efficiency, it may be appropriate to deny the promisee compensation whenever reasons of fairness or efficiency support the award of a lesser amount. . . . Thus, although compensation may be *a* goal—indeed an important goal—of our system of contract remedies, it is not the sole desideratum.

Yorio, *supra* note 51, at 1369-70.

61. *Id.* at 1370-76.

62. *See* cases cited *supra* note 57. In the words of the Supreme Court, "[P]ublic policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market." East River S.S. Corp. v. Transamerica Delaval, Inc., 476 U.S. 858, 866 (1986) (citation omitted).

63. The U.C.C. recognizes a dichotomy between personal injury and property damage on the one hand and economic loss on the other by imposing more expansive liability for personal injury and property damage than for purely economic loss. U.C.C. § 2-715(2) (1990). *See supra* notes 29-31.

64. The definitions of efficient breach and inefficient breach have been formulated in terms of whether there is a net benefit from breach, considering both the gains from breach and the losses:

> At the time the agreement is made, each party has reason to suppose that it will be profitable for that party. A party may, however, err in calculating the net benefit to be anticipated from performance of the agreement, or circumstances may change so as to disappoint that party's initial hopes. A contract that the party once thought would be profitable may turn out to be unprofitable. . . . If nonperformance of the agreement would result in a gain by the reluctant party at the expense of a loss by the other party, the result of nonperformance is economically efficient only if the value of the gain to the reluctant party is greater than the value of the loss to the other party. . . . The

of a market price that exceeds the contract price, the seller's resulting economic gains will be greater than or equal to the losses incurred by the buyer in obtaining equivalent goods or services at the increased price. Such a breach is inefficient and should be deterred.[65] It is not in the public interest to deter breaches that are efficient, however, because society benefits when the seller's economic gains from breach exceed the buyer's losses.[66] For example, if the seller chooses to reallocate its[67] resources in a manner that prevents performance of its contract with the buyer, but that reallocation allows the seller to profit in an amount greater than the buyer's loss, such a breach is efficient and should not be discouraged. Indiscriminately imposing liability for unexpected losses will have a chilling effect on sellers' willingness to commit efficient breaches due to fear of unknowable and potentially disastrous liability.[68] It is therefore preferable to limit expansive liability in a manner that deters only inefficient breaches.

> party in breach may gain enough from the breach to have a net benefit . . . . If this is so, nonperformance and the consequent reallocation of resources is socially desirable, and economic theory not only sanctions but encourages breach. The breach is often called an "efficient breach."

Farnsworth, *supra* note 40, § 12.3, at 846-47 (citation omitted). *See also* Richard A. Posner, Economic Analysis of Law 107-08 (3rd ed. 1986); Robert L. Birmingham, *Breach of Contract, Damages Measures, and Economic Efficiency*, 24 Rutgers L.J. 273, 284-86 (1970) (discussing the efficiency of a breach where the promisor is able to profit from his default after placing the promisee in as good a position as he would have been if performance had been rendered); Yorio, *supra* note 51, at 1369-70 (discussing efficiency generally).

65. Farnsworth, *supra* note 40, § 12.3, at 845-48; A.M. Polinsky, An Introduction to Law and Economics 25-36 (1983); Richard A. Posner, Economic Analysis of Law 93-95, 105-15 (3rd ed. 1986) (Contract law remedies have "the objective of giving the promisor an incentive to fulfill his promise unless the result would be an inefficient use of resources."); Birmingham, *supra* note 64, at 284-86; Frank J. Cavico, Jr., *Punitive Damages for Breach of Contract—A Principled Approach,* 22 St. Mary's L.J. 357, 371 (1990) ("In addition to permitting and encouraging contract parties to make efficient breaches, the law, by implication, should also deter inefficient breaches."); Diamond, *supra* note 51, at 453-54; George K. Gardner, *An Inquiry into the Principles of the Law of Contracts,* 46 Harv. L. Rev. 1, 32 (1932) ("[T]he law affords only such remedies for breach of promise as seem most likely to promote the orderly and efficient conduct of the community's economic life."); Andrew L. Merritt, *Damages for Emotional Distress in Fraud Litigation: Dignitary Torts in a Commercial Society,* 42 Vand. L. Rev. 1, 29 (1989) ("[T]he law does not wish to discourage 'efficient' breaches of contracts."); Joseph H. Sommer, *The Subsidiary: Doctrine Without a Cause?*, 59 Fordham L. Rev. 227, 254 (1990) ("Contract law is designed to foster efficient breach . . . .").

66. *See* sources cited *supra* note 65.

67. Because commercial buyers and sellers tend to be legal entities rather than individuals, each will be referred to by the pronoun "it."

68. Diamond, *supra* note 51, at 448; Alex Y. Seita, *Uncertainty & Contract Law,* 46 U. Pitt. L. Rev. 75, 83 (1984) ("Because the outcome of litigating a contract dispute may be uncertain, an inefficient breach may occur or an efficient breach may be discouraged."); Richard E. Speidel, *The Borderland of Contract,* 10 N. Ky. L. Rev. 163, 172 (1983); James L. Winokur, *The Mixed Blessings of Promissory Servitudes: Toward Optimizing Economic Utility, Individual Liberty, and Personal Identity,* 1989 Wis. L.

As liability for unexpected losses expands to deter breach, other relevant policies, discussed *infra*,[69] will be undermined. It is therefore important to limit expansive liability to those breaches that are most readily capable of being deterred. Intentional and willful breaches are more readily deterred than unintentional breaches. To the extent that the threat of expansive liability induces the desire to perform, intentional and willful breaches will necessarily be avoided.[70] Conversely, an unintentional breach is less likely to be avoided by the mere desire to perform because it is not the result of a conscious decision to breach.[71] Some unintentional breaches are unavoidable irrespective of reasonable efforts made to assure performance,[72] as, for example,

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Rev. 1, 37 (1989) ("[A]n efficient breach could well be thwarted by uncertainties in predicting the damage award.").

The effect of uncertain liability on efficient breach can be seen if one imagines a regime of absolute liability. It might appear that liability without limit would best deter inefficient breach. Such expansive liability would, however, have a chilling effect on the seller's decision to commit an efficient breach. If the seller reasonably calculates that its predicted gains would be greater than the buyer's predicted losses, the seller may be reluctant to commit what would have been an efficient breach if it will suffer completely indeterminate liability for unexpected buyer losses. By limiting the seller's liability in cases of apparently efficient breach to the buyer's losses that could reasonably be expected, and thereby allowing the seller to make its assessment based on reasonable appearances, efficient breach will be promoted.

69. As liability for unexpected losses expands, the effect will be to undermine the policy of reducing subsidization of loss by the buying public, *see infra* part II.B.4, and the policy of promoting predictability, *see infra* part II.B.5.

70. Conversely, a seller is less likely to be deterred from breaching as its liability for consequential damages decreases. Under a forgiving standard of liability for consequential damages, sellers will have less incentive to take precautions to reduce the risk of breach.

The extent of deterrence resulting from broad liability for consequential economic damages, however, is conjectural. There are already in place legal and market pressures for sellers to perform. Two rules—U.C.C. § 2-715(2)(b) (1990) and the doctrine of strict tort liability for defective products—already create wide liability, and accompanying deterrence, for the consequential personal injury and property damage. *See supra* notes 30 and 56. Only where the risk of economic damages induces measures to avoid breach not already induced by the risk of personal injury or property damage would a rule of broad liability for economic losses be an added deterrent. Additionally, the rules that are in place for the recovery of general damages have removed the incentive for sellers to breach in order to profit from increased market prices. *See supra* notes 13-19 and accompanying text. Furthermore, those sellers who do not deliver do not get paid, and those sellers who sell shoddy merchandise lose their customers. Market discipline therefore also constitutes an existing and significant deterrent to breach. *See infra* note 146 and accompanying text.

71. When inattentiveness causes an unintentional breach, it is unclear to what extent expanded liability would induce the caution necessary to avoid the breach. *See infra* note 73; *see also infra* note 158 and accompanying text.

72. Such a seller would be liable despite its efforts and the unavoidability of breach, because fault is not a required condition for liability for breach. As Professor Farnsworth stated, "[C]ontract law is, in its essential design, a law of strict liability, and the accompanying system of remedies operates without regard to fault." Farnsworth, *supra* note 40, § 12.8, at 875; *see* Album Graphics, Inc. v. Beatrice Foods, Co., 408 N.E.2d 1041, 1050 (Ill. App. Ct. 1980) ("Fault is irrelevant to breach of contract. Whether one intentionally, carelessly, or innocently breaches a contract, he is still

when a well-maintained delivery truck breaks down and causes a late delivery or when a product is defective even though the seller used the utmost care to assure high quality. The threat of liability will not deter these breaches. Even when an unintentional breach is reasonably avoidable, it is unclear to what extent expanded liability would induce the caution necessary to prevent it.[73]

In formulating the appropriate standard for the recovery of consequential economic damages, it is therefore necessary to distinguish those breaches that should be deterred through expansive liability from those that should not, and to distinguish those breaches that can be deterred through expansive liability from those that cannot.

3. Promoting the Reliability of Contracts

The reliability of contracts is essential to further economic efficiency because parties plan for the future on the assumption that their contracts will be performed.[74] Unless contracts are reliable, their value is greatly reduced.[75] By permitting the buyer to recover consequential economic losses in an amount that approaches the equivalent of full performance, expansive liability promotes the reliability of contracts. Furthermore, to the extent that the threat of expansive liability

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considered to be in breach of that contract and the extent of his liability is generally the same."), *quoted in* Wait v. First Midwest Bank/Danville, 491 N.E.2d 795, 802 (Ill. App. Ct. 1986); *see also* First Nat'l Bank of Akron v. Cann, 503 F. Supp. 419, 437-38 (N.D. Ohio 1980) (stating that whatever the cause of the breach, the measure of damages is the same).

73. Ward Edwards & Detlof von Winterfeldt, *Cognitive Illusions and Their Implications for the Law,* 59 S. Cal. L. Rev. 225, 229-44 (1986); Paul J. Heald & James E. Heald, *Mindlessness and Law,* 77 Va. L. Rev. 1127, 1137 (1991) ("The psychology of 'cognitive illusions' may suggest that legal rules do not deter efficiently because human beings are unable to process relevant information and draw the inferences necessary to make the desired (predicted) decision under a given rule."); Howard A. Latin, *Problem-Solving Behavior and Theories of Tort Liability,* 73 Cal. L. Rev. 677, 678-92 (1985).

74. It is important "that businessmen, who must make their arrangements in advance, can rely with certainty on their contracts." Lloyd v. Murphy, 153 P.2d 47, 50 (Cal. 1944) (Justice Traynor); *see also* Eisenberg, *supra* note 4, at 574 (recognizing the importance of the reliability of contracts in economic planning); John Danforth, Note, *Tortious Interference with Contract: A Reassertion of Society's Interest in Commercial Stability and Contractual Integrity,* 81 Colum. L. Rev. 1491, 1515 (1981) ("By guaranteeing future performance, a contract may engender reliance and facilitate long-term planning . . . .").

75. Professor Farnsworth has observed that contracts are of little use if they cannot be relied upon, and uses that insight to explain the importance of protecting the parties' expectation interests:

> Why, merely because the parties have exchanged promises, should the law protect one party's ephemeral expectation if the other repudiates before there has been any actual reliance on its promise? . . . One explanation is that it is justified as the most effective way of protecting reliance. Unless agreements can be relied upon, they are of little use. A rule of law that only protected a promisee who had actually relied upon a promise would, in practice, tend to discourage reliance.

Farnsworth, *supra* note 40, § 1.6, at 18.

encourages performance, reliability will be promoted by avoiding breach.[76]

In evaluating how much weight to give this policy in the context of consequential damages, it is important to understand how reliability is impacted by relief from unexpected burdens of performance as compared to relief from unexpected consequential losses caused by breach. Under the doctrine of impracticability,[77] relief from unexpected burdens of performance is afforded only when intervening events have caused those burdens of performance to be so unexpected as to be exceptional.[78] One of the primary purposes of a contract is the security given through a binding agreement that remains enforceable irrespective of unanticipated contingencies. That value would be undermined if the occurrence of those contingencies provided an excuse from the obligations of performance.

Furthermore, the courts have not found partial relief to be a viable alternative in this context.[79] Given the choice between full performance and complete excuse, it is understandable why courts insist on full performance in all but exceptional circumstances. With respect to the scope of liability for consequential economic losses, however, liability can be limited without being excused. Partial relief is possible so that even if recovery for abnormally large losses is precluded, the buyer could still recover for that portion of its losses that was not abnormally large. As a result, partial relief from liability for unexpected

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76. To the extent that liability for damages provides both parties with the incentive to perform, both gain assurance that the other party will perform and that the risks of nonperformance will be avoided. As stated by Professor Eisenberg:

> A contracting party, knowing that expectation damages give an adequate incentive to perform, will be more confident that his reliance on the terms of the contract will not expose him to undue risk. Accordingly, each contracting party can plan more reliably, and therefore more effectively, because he can order his affairs with confidence that he will realize the contract's value.

Eisenberg, *supra* note 4, at 574.

77. U.C.C. § 2-615 (1990); Restatement (Second) of Contracts § 261 (1979). *See generally*, White & Summers, *supra* note 30, § 3-9, at 155-68 (discussing when performance is rendered impracticable).

78. Commentators have observed that only in exceptional or unusual cases is the promisor excused under the doctrine of impracticability. According to Professor Farnsworth, "The new synthesis [manifested in U.C.C. § 2-615(a) and Restatement (Second) of Contracts § 261] candidly recognizes that the judicial function is to determine whether, in the light of *exceptional* circumstances, justice requires a departure from the general rule that a promisor bears the risk of increased difficulty of performance." Farnsworth, *supra* note 40, § 9.6, at 707 (emphasis added); *see also* John D. Wladis, *Impracticability as Risk Allocation: The Effect of Changed Circumstances Upon Contract Obligations for the Sale of Goods*, 22 Ga. L. Rev. 503, 593 (1988) ("[T]he normal commercial sales understanding is that, should an unusual general risk occur and make the seller's performance commercially impracticable, the deal is off.").

79. Scholars have suggested that the parties should share the losses when performance becomes impracticable. For a summary see Wladis, *supra* note 78, at 596-97 n.380. The courts, however, have not adopted the shared loss approach. *Id.* at 597 n.381.

consequential losses will not have the same drastic impact upon reliability as would relief for unexpected burdens of performance. Additionally, limiting liability for consequential economic losses will not undermine the reliability that is assured through the recovery of general damages, which allow full compensation for market-measured losses and which remove the incentive for sellers to breach in order to profit from increased market prices.[80]

4. Reducing Subsidization of Loss By the Buying Public

A rule for the recovery of consequential damages for commercial loss should take into account the negative consequences of compelling the buying public to cross-subsidize commercial buyers' losses through higher prices. The impact of imposing liability for such losses is that, in whole or in part, the cost of such liability will be passed on to the buying public.[81]

When a buyer's losses are not purely economic but involve personal injury or property damage, a rule that imposes liability can be understood as a type of public insurance rather than as subsidization. Because personal injury and property damage can befall any member of the buying public,[82] cost shifting caused by fully compensating the victims for such losses can be viewed as a form of mandatory insurance with the premiums paid by all buyers through higher prices.[83] "A firm

80. *See supra* notes 13-19 and accompanying text. Parties will be induced to perform, thereby making contracts reliable, by other factors in addition to the existence of general damages. Market discipline, that is, the seller's knowledge that nonperforming sellers lose customers, will promote the incentive to perform even if liability for consequential economic damages is limited. *See infra* note 146. Additionally, expansive liability for consequential damages in the nature of personal injury and property damage will also induce performance regardless of limits on liability for consequential economic damages. *See supra* note 30.

81. *See* 3 Dobbs, *supra* note 13, § 12.4(5); Posner, *supra* note 40, at 447; *see also* Joseph E. Linehan, Note, *The Recovery of Economic Loss Damages in Tort: Pennsylvania Law and "Social Adjustment"*, 51 U. Pitt. L. Rev. 203, 231 (1989) ("A seller who is required to pay breach of warranty damages . . . will ultimately pass this cost onto [sic] the consumer, either directly in the form of higher prices for products or indirectly through other commercial entities with whom the breaching enterprise deals.").

82. An exception would be personal injury caused by equipment used solely in a commercial enterprise. The risk of injury from such equipment would be limited to employees of the enterprise and would not extend to the general buying public.

83. John Cirace, *A Theory of Negligence and Products Liability,* 66 St. Johns L. Rev. 1, 66 (1992) ("Under strict liability . . . the product price includes a small premium for insurance against personal injuries that result from mismanufactured products . . . ."); Stephen F. Williams, Commentary, *Second Best: The Soft Underbelly of Deterrence Theory in Tort,* 106 Harv. L. Rev. 932, 934 (1993) ("In making a purchase under a strict liability system, the consumer assesses all competing products and services, each with some accident potential and each carrying an insurance policy that covers the costs of those accidents."); *see also* Becker v. IRM Corp., 698 P.2d 116, 123 (Cal. 1985) ("The paramount policy of the strict products liability rule remains the spreading throughout society of the cost of compensating otherwise defenseless victims of manufacturing defects.").

that compensates consumers for the harms its product causes will reflect the expected compensation cost in the purchase price. An element of the price thus is an insurance premium . . . ."[84]

Consequential damages for commercial losses are different because only commercial buyers incur them. Forcing the general public to pay higher prices in order to reimburse commercial buyers for diminished profits caused by breach cannot be viewed as a form of mandatory insurance, but instead as a form of mandatory subsidization.[85] The more recovery that is allowed for unusual economic losses, the greater will be the amount of the subsidy. The increased prices that the public must pay for such subsidization is economically counterproductive and inefficient.[86]

Even in a situation where all buyers are commercial buyers, subsidization will result if the seller is unable to distinguish high risk buyers from others.[87] If the seller is liable to commercial buyers whose situations cause them to incur abnormal economic losses, and the seller is unable to ascertain which commercial buyers will likely suffer such losses, the seller must engage in generalized risk shifting and thus charge higher prices to all commercial buyers.[88] For those commercial buyers who are not abnormally situated, higher prices constitute sub-

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84. Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 Yale L.J. 353, 362 (1988).

85. A similar rationale has been used to justify the economic loss doctrine. The Illinois Supreme Court observed that "it is preferable to relegate the consumer to . . . [contract remedies] rather than requiring the consuming public to pay more for their product so that a manufacturer can insure against the possibility that some of his products will not meet the business needs of some of his customers." Moorman Mfg. Co. v. National Tank Co., 435 N.E.2d 443, 448 (Ill. 1982).

86. The economic inefficiency of such increased prices has been noted. For example:

> [I]f the law were to hold the transferor liable for *all* the losses of the transferee, then transferors would increase their prices to reflect this increased risk of doing business. This result would be inefficient in that *all* customers would be obliged to contribute to this loss insurance.

Ulen, *supra* note 51, at 394. Even if such subsidization were economically efficient, reducing the standard of living of all buyers to benefit the few who have lost business profits is not necessarily in the public interest.

87. Ayres & Gertner, *supra* note 4, at 100; Craswell, *supra* note 51, at 659; Gwyn D. Quillen, Note, *Contract Damages and Cross-Subsidization*, 61 S. Cal. L. Rev. 1125, 1131 (1988); Daniel S. Schecter, Note, *Consequential Damage Limitations and Cross-Subsidization: An Independent Approach to Uniform Commercial Code Section 2-719*, 66 S. Cal. L. Rev. 1273, 1292 (1993).

88. From the risk-laden buyer's perspective, generalized risk shifting is preferable:

> A knowledgeable buyer . . . may prefer to remain indistinguishable from what the seller wrongly perceives to be the class of similarly situated buyers. By blending in with the larger class of contractors, a buyer or a seller may receive a cross-subsidized price because the other side will bargain as if she is dealing with the average member of the class. A knowledgeable party may prefer to remain in this inefficient, but cross-subsidized, contractual pool rather than move to an efficient, but unsubsidized, pool.

Ayres & Gertner, *supra* note 4, at 100.

sidization and not insurance. As is the case with the general buying public, compelling all commercial buyers to pay for some commercial buyers' abnormal losses is counterproductive and inefficient.[89] While sellers' expenses incurred through liability for consequential economic damages will ordinarily be passed on to buyers through higher prices, market forces will occasionally induce sellers to absorb these expenses.[90] Although it is not necessarily in the public interest to have sellers absorb these costs,[91] when they are so absorbed, subsidization of commercial buyers' losses by the buying public is avoided. If it were possible to assess which sellers absorb such costs and which sellers pass them on, a standard for the recovery of consequential damages for economic loss could be formulated to avoid subsidization. No such assessment, however, is possible.[92] Therefore, the appropriate standard for consequential economic damages should attempt to minimize subsidization in a manner compatible with the other relevant policies.

Short of a complete bar on recovery, no standard governing consequential damages for commercial loss can eliminate subsidization. As liability is limited by denying recovery for unexpected losses, however, subsidization will be reduced because fewer costs will be passed on to the buying public and to normally situated commercial buyers.[93] Furthermore, a standard more restrictive than the tort foreseeability standard would tend to exclude disproportionately large losses[94] and

89. As one commentator noted:

> Cross-subsidization results in a number of inefficiencies and inequities, most of which fall on the shoulders of the subsidizing party but many of which are felt by the rest of the commercial community. Cross-subsidization causes inefficient and inequitable behavior because it upsets the proper equilibrium of incentives and disincentives for efficient behavior.

Schecter, *supra* note 87, at 1292. *See* Ulen, *supra* note 51, at 394 (arguing that holding transferor liable for all transferee losses results in inefficient price increases by transferors).

90. Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power,* 41 Md. L. Rev. 563, 598 (1982); Bailey Kuklin, *Self-Paternalism in the Marketplace,* 60 U. Cin. L. Rev. 649, 712 (1992).

91. By reason of sellers' absorbing extra liability there may be plant closings, layoffs, and lost opportunities for expansion. *See* Posner, *supra* note 64, at 447.

92. Liability is only one of innumerable expenses incurred in the production of goods. Those expenses not passed on, if any, cannot be known in foresight or in hindsight.

93. "To completely eliminate the cross-subsidization problem in situations where the seller cannot distinguish among buyers according to risk and change the contract price to reflect that risk, the maximum damages that should be awarded are damages that are common to all buyers . . . ." Quillen, *supra* note 87, at 1132. *See also* Ulen, *supra* note 51, at 394-95 ("It would be less costly to relieve those with only ordinary losses from the cost of contributing to this special insurance fund and instead to place the full cost of insurance against extraordinary losses on the few who anticipate such losses.").

94. "Potential liability for consequential damages in commercial contexts, usually in the form of the buyer's lost profits from the use or resale of the goods in its busi-

would thereby have a relatively great effect in reducing subsidization.[95]

5. Promoting Predictability

Although the buyer might prefer full compensation even for unexpected loss, there is a recognized value in limiting liability for breach of contract to promote predictability.[96] If liability extends to unpredictable economic loss, the seller will not know how to allocate its resources in response to the threat of liability, resulting in inefficiency and waste.[97] The seller might raise prices too much or too little, or might take too many or too few precautions to avoid breach, thereby wasting valuable resources. As predictability increases, the seller can better decide how to incorporate future liability expenses into the price of all its goods and can better decide what quality controls should be taken to reduce these expenses efficiently.

Consequential economic losses among commercial buyers are, by their very nature, highly unpredictable.[98] This unpredictability stems from the fact that the economic consequences of breach tend to vary greatly among buyers because of each buyer's divergent special cir-

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ness, is enormous in comparison to the contract price of the goods." Roy R. Anderson, *Failure of Essential Purpose and Essential Failure on Purpose: A Look at Section 2-719 of the Uniform Commercial Code,* 31 Sw. L.J. 759, 774 (1977), *quoted with approval in* McKernan v. United Technologies Corp., 717 F. Supp. 60, 72 (D. Conn. 1989); Kearney & Trecker Corp. v. Master Engraving Co., 527 A.2d 429, 433 (N.J. 1987).

95. "The greater the deviation between 'ordinary' and minimum or maximum damages, the greater the severity of the cross-subsidization problem." Quillen, *supra* note 87, at 1134.

96. "The generally predictable and circumscribed damages available for breaches of contract reflect the importance of this value in the commercial context." Foley v. Interactive Data Corp., 765 P.2d 373, 398 n.33 (Cal. 1988); *accord* Vernon Fire & Casualty Ins. Co. v. Sharp, 349 N.E.2d 173, 180 (Ind. 1976); General Motors Corp. v. Piskor, 381 A.2d 16, 22 (Md. 1977); Gaglidari v. Denny's Restaurants, 815 P.2d 1362, 1373 (Wash. 1991); *see also* Larry Kramer, *Return of Renvoi,* 66 N.Y.U. L. Rev. 979, 1030 n.161 (1991) ("[P]roviding an efficient and profitable commercial environment depends on the parties' ability accurately to foretell their rights and liabilities under [the] contract." (quoting Larry Kramer, *Rethinking Choice of Law,* 90 Colum. L. Rev. 277, 330 (1990))); Karl L. Llewellyn, *What Price Contract?-An Essay in Perspective,* 40 Yale L.J. 704, 747 (1931); Tamar Frankel, *The Legal Infrastructure of Markets: The Role of Contract and Property Law,* 73 B.U. L. Rev. 389, 395 (1993) ("Thus the policies of both contract and property law include creating certainty and predictability to reduce the parties' planning and transaction costs.").

97. "When damage measures are uncertain, it will be difficult for a party contemplating breach to determine the rationally preferable course of action." Merritt, *supra* note 65, at 29 n.141.

98. It has been noted that:

> Potential consequential losses . . . can exceed, and most likely will exceed, the value of the goods by an unknown quantum, depending not so much on the actions and machinations of the seller as on the individual operating structure of the buyer and on the buyer's contracts and relationships with third parties.

Schecter, *supra* note 87, at 1306 (quoting Anderson, *supra* note 94, at 774).

cumstances.[99] Unpredictability also occurs because events after the formation of the contract may cause the buyer to suffer losses that were, at the time of the formation, not within the parties' expectations. While full predictability can never be achieved, it can be promoted by relieving the seller from liability for losses caused by the buyer's special circumstances that the seller was not aware of and for losses that are abnormally large because of unexpected events arising after the formation of the contract.

6. Encouraging Disclosure of Information Concerning the Buyer's Special Circumstances Relevant to the Consequences of Breach

When the seller is apprised of information concerning the extent of its liability in the event of breach, it has the ability to differentiate efficiently its contractual response among its buyers according to the risks presented.[100] If the seller knows it is dealing with a high risk buyer, the seller can choose to forego the contractual relationship, increase the contract price, limit liability by contract, or take individualized precautions to avoid breach. Without the ability to differentiate among buyers, the seller must take generalized and inaccurate measures in response to the threat of liability.[101]

The seller can attempt to determine the likely extent of its liability in the event of breach either through the buyer's disclosure of pertinent information or from the seller's independent investigation. When the information concerns the buyer's special circumstances, the seller cannot reasonably acquire such information through independent investigation, and the only effective means for the seller to acquire it is through the buyer's disclosure,[102] unless these special circumstances are self-evident. For example, if the seller's breach would deprive the buyer of an unusually large resale profit, the seller can be made aware of the expanded risk of liability posed by such an unusual situation only if the buyer informs the seller of this fact.[103] The standard for the recovery of consequential damages for economic loss

99. *Id.*; *see also* Anderson, *supra* note 12, at 329 ("It is often said that such damages arise because of the special circumstances of the aggrieved party.").

100. Posner, *supra* note 40, § 4.11, at 94-95; Ayres & Gertner, *supra* note 4, at 101-03; Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. Chi. L. Rev. 89, 117 (1985) ("Disclosure . . . allows the other party to take extra precautions or to charge appropriate compensation for bearing increased risk."); Kostritsky, *supra* note 40, at 687-88.

101. Ayres & Gertner, *supra* note 4, at 102; Kostritsky, *supra* note 40, at 687-88.

102. Ayres & Gertner, *supra* note 4, at 101-03; Kostritsky, *supra* note 40, at 684-88.

103. In explaining the reason behind the rule that limits a seller's liability to those losses that would ordinarily follow based upon the circumstances known to both parties, the Hadley court stated, "For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them." Hadley v. Baxendale, 9 Ex. 341, 355, 156 Eng. Rep. 145, 151 (1854).

should therefore be formulated to encourage the buyer to disclose such special circumstances.[104] Imposing significant limitations on the buyer's recovery in the absence of disclosure is the most effective method for achieving this result.[105]

When information concerning the extent of the buyer's loss does not concern the buyer's special circumstances, the seller ordinarily has equal access to such information[106] and is able to acquire it through independent investigation. For example, the seller ordinarily has the same ability as the buyer to discover through independent investigation the market conditions that might affect its potential liability.[107] There is no equivalent need for limiting the buyer's recovery when the seller's liability is greater than expected due to its failure to discover such conditions. If the seller were allowed expansive relief when the buyer failed to disclose such equal-access information, the buyer that acquired the information through its own diligence would be induced

104. Most scholars justify *Hadley* on the ground that it promotes disclosure. *See supra* notes 40-41 and accompanying text.

105. Professors Eisenberg and Johnston disagree with the premise that limiting the buyer's recovery in the event of nondisclosure will efficiently promote disclosure. Professor Eisenberg asserts that the cost of assembling and communicating the relevant information can exceed the expected value of communication and that sellers frequently will not alter contract terms or the method of performance even when there is disclosure. Eisenberg, *supra* note 4, at 592-96, 605-06. Eisenberg's assertions actually support the efficiency of a disclosure rule. In cases of marginally increased risk of loss caused by complicated circumstances, perhaps the cost of communicating such information will exceed the value of added protection resulting from disclosure. In such cases the efficient buyer will not disclose. But in situations where the cost of communication is exceeded by the added protection against the risk of monumental losses, efficiency will be promoted through disclosure. And if the seller will not alter its course of conduct in the event of disclosure, then it would be incumbent upon the buyer to get added protection at no additional cost. Often the seller will want to take special precautions against unusually large risks, however, and only disclosure will allow the seller the opportunity to take those special precautions.

Professor Johnston contends that disclosure is not effectively promoted because sellers have an incentive to convince buyers that the probability of breach is very low and a convinced buyer will perceive little benefit in disclosing and paying a higher price for protection against the risk of unusually large losses. Johnston, *supra* note 4, at 632-33. There are several flaws in this analysis. First, while a risk of breach may be low, the risk nonetheless exists. To avoid catastrophe, a reasonable buyer might prefer to pay a price for protection against that highly unlikely catastrophe. The existence of a thriving insurance industry demonstrates that individuals will pay to protect themselves from the risk of low-probability catastrophes. Second, disclosure will not necessarily result in an increase in price. The seller may simply take special precautions to avoid breach. Third, if the seller truly is a high-risk seller, then it may well prefer to refuse to contract with a high-risk buyer rather than subject itself to a high risk of great liability or may impose such restrictive or exorbitant terms as to encourage disclosing buyers to find another, more reliable seller.

106. Reasonably equal access to information does not mean that the parties will achieve equal results through investigation. It means that both parties have enough access so that it is fair to expect them to acquire the information through investigation rather than relying on disclosure.

107. *See* Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. Legal Stud. 1, 13-15 (1978).

to disclose it to assure recovery, thereby denying the buyer its reward for diligence and reducing the incentive for the seller to investigate accessible information.[108]

7. Limiting Liability Consistently With the Parties' Likely Allocation of Risk

A contract involves an agreed allocation of risks.[109] Default rules are imposed when the parties fail to expressly allocate particular risks.[110] While default rules are properly influenced by relevant policy concerns, they should also attempt to reflect how the parties would likely have allocated risks had they expressly so provided.[111] Therefore, in formulating the default rule for consequential economic dam-

108. The buyer may have developed through its own efforts an information network through which it has sole access to relevant market conditions unknowable by the seller. Because access to this information has arisen from the efforts of the buyer, it would be unfair to force disclosure of such information. As a matter of policy, the buyer should be allowed to retain the benefits of its diligence. *Id.*

109. Anthony T. Kronman & Richard A. Posner, The Economics of Contract Law 4 (1979); Michael B. Kelly, *The Phantom Reliance Interest in Contract Damages,* 1992 Wis. L. Rev. 1755, 1772 (1992) ("Contract law revolves around agreements among parties allocating the risks of a business transaction.").

Viewing a contract as risk allocation indicates that the price term is the most basic form of risk allocation and that pricing can serve as an indicator of how parties might have allocated other risks. H. Ward Classen, *Judicial Intervention in Contractual Relationships Under the Uniform Commercial Code and Common Law,* 42 S.C. L. Rev. 379, 416 (1991).

110. Default rules in contract law have been analogized to the default settings on a computer:

> Recently . . . the rhetoric of gap-filling has been increasingly supplanted by a new and powerful heuristic device: the concept of default rules. . . . The default rule approach analogizes the way that contract law fills gaps in the expressed consent of contracting parties to the way that word-processing programs set our margins for us in the absence of our expressly setting them for ourselves. A word-processing program that required us to set every variable needed to write a page of text would be more trouble than it was worth. Instead, all word-processing programs provide default settings for such variables as margins, type fonts, and line spacing and leave it to the user to change any of these default settings to better suit his or her purposes.

Barnett, *supra* note 12, at 823-24.

111. "A default rule is applied when the parties' contract is silent, and resolves disputes according to the contract that most well-informed persons would have adopted if they were to bargain about the matter." Schwartz, *supra* note 84, at 361; *see also* Frank H. Easterbrook & Daniel R. Fischel, *Contractual Freedom in Corporate Law,* 89 Colum. L. Rev. 1416, 1433 (1989) ("The gap-filling rule will call on courts to duplicate the term the parties would have selected, in their joint interest if they had contracted explicitly."); Kostritsky, *supra* note 40, at 627-28; Andrew Kull, *Mistake, Frustration, and the Windfall Principle of Contract Remedies,* 43 Hastings L.J. 1, 43 (1991) ("The standard approach to the choice of default rules recommends that they be those the parties of a typical contract would be most likely to select for themselves.").

By choosing default rules to reflect the parties' likely intent, the parties are relieved of the burden of contracting around the rules. Posner, *supra* note 64, at 68 (arguing that default rules should economize on transaction costs by supplying the terms that the parties would otherwise have adopted by agreement).

ages it is appropriate to consider how the parties, bargaining reasonably,[112] would allocate risk with respect to those damages.[113]

On the question of relief from liability for consequential economic damages, the parties do not perceive their interests to be in common. The seller, being the only party likely to be liable for such damages,[114] would favor expansive relief from liability while the buyer would favor no relief. In such a situation of divergent interests, it must be assumed that the contracting parties, bargaining fairly and reasonably, would compromise. The point of compromise would vary depending on whether the unexpected damages were the result of undisclosed special circumstances, changed market conditions, or intentionally or willfully inefficient breach.

The seller has a compelling reason to insist on relief from liability for consequential economic losses when the buyer has failed to disclose its special circumstances, thereby preventing the seller from accurately assessing its risk of liability in the event of breach.[115] Without this information,[116] the seller is deprived of the ability to take specific protective measures[117] when dealing with high risk buyers. To prevent liability that was unexpected due to the buyer's nondisclosure, it can be assumed that at the seller's insistence the parties would compromise in a manner that would afford the seller expansive relief from its mistaken risk assessment by substantially limiting the buyer's recovery for consequential economic losses.[118]

Professors Ayres and Gertner have persuasively argued that the imputed intent of the parties should not be the sole criterion because penalty defaults, which by definition give to one party what the other party did not want to give, may be appropriate to further legitimate social or economic ends. Ayres & Gertner, *supra* note 4, at 97-100.

112. "[W]hat would have been rational for the parties ex ante is extremely strong evidence of the terms to which they would have agreed." Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law,* 12 Harv. J.L. & Pub. Pol'y 639, 645 (1989). "Since the object of most voluntary exchanges is to increase value or efficiency, contracting parties may be assumed to desire a set of contract terms that will maximize the value of the exchange." Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis,* 6 J. Legal Stud. 83, 89 (1977).

113. When parties choose to define the scope of their liability they are free within policy limits such as unconscionability to do so. When the parties are silent regarding the extent of liability, a default rule must supply the terms of that liability.

114. *See supra* note 44 and accompanying text.

115. *See supra* text accompanying notes 100-01.

116. The seller can obtain information concerning the buyer's special circumstances only through the buyer's disclosure because the seller lacks independent access to it. *See supra* notes 102-03 and accompanying text.

117. If the seller acquires such information, it can protect itself by declining to enter the contract, increasing the price, limiting its liability by contract or taking special precautions to avoid breach.

118. The precise manner in which reasonable parties would allocate these losses is not capable of accurate determination. The point at which the seller will be relieved of liability must therefore be based not on allocation of risk alone but on a consideration of all relevant policies.

Conversely, the seller has little reason to insist on relief from liability when its breach is intentionally or willfully inefficient. In this situation, it is appropriate to presume that the parties, at the buyer's insistence, would compromise by allowing the buyer expansive recovery for all economic losses.

In cases that fall between these two extremes, involving neither the buyer's nondisclosure nor the seller's intentionally or willfully inefficient breach, it is likely that the parties' compromise as to the scope of liability would occupy a middle ground, because there is a dichotomy between the buyer's interest in expansive recovery for unexpected losses and the seller's interest in limiting liability for such losses.[119]

III. AN ALTERNATIVE TO *HADLEY*: A SITUATIONAL APPROACH TO LIABILITY

A. *Introduction*

The above described policies are not in complete harmony and cannot be equally accommodated in all situations. Some are promoted by expansive liability, while others are promoted by limited liability. The policies of compensating the victim of breach, deterring inefficient breach and promoting the reliability of contract are all furthered by subjecting the seller to expansive liability for unexpected losses. The policies of reducing subsidization of loss, promoting predictability and encouraging disclosure of information concerning the buyer's special circumstances, however, are furthered by substantially limiting the buyer's recovery for unexpected economic losses. The relevance of, and the weight to be afforded to, these policies in determining the scope of the seller's liability depend upon the circumstances surrounding the formation and breach of the contract. For example, the seller's commission of an intentionally or willfully inefficient breach directly conflicts with the policy of deterring such breaches, and therefore the need to promote deterrence through expansive liability is especially important in such a situation. But if the breach was not intentionally or willfully inefficient, the need to promote deterrence through expansive liability is not a matter of concern. By way of further example, if

119. The dichotomy of interest between the seller and buyer in the context of consequential damages does not exist in the context of general damages, obviating the need for a compromise. It is in both parties' interests to allow full recovery for general damages. The purpose of general damages is, *inter alia*, to compensate the victim of breach for fluctuations in the market, allowing it to obtain equivalent goods or services without ultimately paying more than the contract price. The need for such protection is applicable to all buyers and sellers irrespective of their special circumstances and stems from the fact that a primary purpose of entering into a contract is to eliminate the risk of post-formation fluctuations in the market price for the goods, property or services covered by the contract. Because this need is fundamental and is shared equally by both parties, it is appropriate to assume that, unlike consequential damages, full compensation for general damages was intended irrespective of the extent to which such damages were unanticipated.

the buyer fails to disclose its special circumstances to the seller at the time of the contract formation, the policy of encouraging such disclosure has special relevance, justifying substantial limitation of the buyer's recovery. In cases of full disclosure, however, this policy should not be a factor in limiting the extent of the seller's liability.

Because different situations emphasize different policies, a single, invariable standard of liability is inappropriate. As an alternative, a flexible standard with three levels of liability is proposed. The applicable level of liability would depend upon the type of case. In those cases where the buyer has failed to disclose at the time of the contract formation the special circumstances concerning the extent of its potential loss in the event of breach, the seller's liability would be most limited, and it would be liable only for those consequential economic losses that it should have known were the probable result of breach. In cases where the seller has committed an intentionally or willfully inefficient breach, the seller's liability would be most expansive, and it would be liable for those losses that it should have known were a significantly possible result of breach. In all other cases, an intermediate level of liability would apply, and the seller would be liable for those losses that it should have known were a normal result of breach.

B. *The Probability Standard*

The buyer's recovery should be most limited in cases where, prior to the formation of the contract, the buyer failed to disclose its special circumstances to the seller. The term "special circumstances" refers to information known by the buyer that differentiates the buyer's vulnerability to economic loss on account of breach from that of other buyers and is of such significance that disclosure might reasonably have induced the seller to take additional protective measures in response.[120] It is proposed that a nondisclosing buyer's recovery should be limited to those consequential economic losses that were a probable result of breach.[121] Losses would be considered probable if, at

120. See *infra* notes 130-31 and accompanying text.

121. It could be argued that subjecting the seller to any liability at all for consequential economic damages is unfair in a case of material nondisclosure because, had there been disclosure, the seller might have avoided liability altogether by taking additional protective measures. The purpose for requiring disclosure of material information, however, is not to protect the seller against risks of which it should already be aware, but to allow the seller to take protective measures against the risks concealed by nondisclosure. By limiting the seller's liability in the event of nondisclosure to those damages against which it was already especially alerted to take protective measures (i.e., probable damages), the probability standard satisfies the purpose underlying the disclosure requirement.

It could also be argued that, because the seller is in breach, denying recovery for consequential economic damages inappropriately punishes the buyer, but this is not the case. Because the buyer has denied the seller the opportunity to take protective measures that might have avoided liability, it is appropriate to limit the buyer's recovery in response.

the time of the creation of the contract, the seller should have known that they were more likely than not to result from breach.[122]

An example of a situation covered by this standard would occur when the buyer fails to disclose to the seller that if delivery of goods is not precisely on the date provided by the contract the buyer will lose a substantial resale profit. Disclosure might reasonably have induced the seller to take protective measures in response—either by refusing to enter into the contract, by contractually limiting liability for consequential damages, by increasing the price to this buyer, or by taking special precautions to assure timely delivery. The buyer's damages for lost profits caused by late delivery would be limited to those that the seller should have known were a probable result of breach. If such loss were so typical in the industry that disclosure could not reasonably be expected to cause the seller to take additional precautions, however, the undisclosed information would not constitute special circumstances, and therefore the probability standard would not apply.

By imposing severe limitations on the nondisclosing buyer's recovery, the probability standard would promote the policy of encouraging disclosure of the buyer's special circumstances relevant to the consequences of breach.[123] This standard would reduce subsidization of loss by the buying public by allowing the seller to differentiate among its buyers and individualize its responses according to the particular risks presented, and to charge the highest prices to the buyers presenting the highest risk, thereby reducing the need for generalized risk shifting.[124] Furthermore, by apprising the seller of the risk of expansive liability in the event of breach, disclosure would frequently induce the seller either to forego the contract, limit liability for consequential economic damages, or take effective precautions to avoid breach, all of which would reduce liability and thereby reduce subsidization.[125] Even if buyers fail to disclose their special circumstances, subsidization would still be reduced because of the substantially reduced liability that would follow, thereby lowering the cost that would be passed on to the buying public.

The probability standard would also promote predictability[126] by relieving the seller from liability for unexpected losses, thereby avoiding inefficiency and waste[127] by obviating the need for the seller to pre-

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122. Some case law has defined a "probable" result to mean something less likely than the statistically "more likely than not" standard adopted herein. *See* cases cited *supra* note 24. These more lenient standards are rejected because when the buyer fails to disclose its special circumstances the more demanding standard is necessary to promote the relevant policies mentioned in the textual discussion of the probability standard.

123. *See supra* part II.B.6.

124. *See supra* part II.B.4.

125. *See supra* text accompanying notes 87-89.

126. *See supra* part II.B.5.

127. *See supra* note 97 and accompanying text.

pare for speculative contingencies. Furthermore, this standard would limit liability consistent with the parties' likely allocation of risk in that parties bargaining fairly and reasonably would likely agree that the seller's liability for unexpected loss caused by the buyer's failure to disclose its special circumstances should be substantially limited.[128]

This standard would impose no burden on the buyer to disclose information that does not pertain to its special circumstances, such as information concerning market conditions. If the buyer acquires knowledge of information through its own diligence, not pertaining to its special circumstances and to which the seller therefore had relatively equal access, imposing the probability standard for nondisclosure of such information would thwart the incentive for diligence.[129]

Even if undisclosed information pertained to the buyer's circumstances, there would be no burden of disclosure unless the information was material, that is, it so increased the apparent magnitude of the buyer's potential loss in the event of breach that, had the information been disclosed, the seller might reasonably have been expected to take additional protective measures in response.[130] Limiting disclosure to such information would allow the seller a reasonable opportunity to take protective measures against high-risk buyers without imposing on buyers the undue and inefficient burden of disclosing apparently irrelevant information.[131]

For the same reason, this standard would not apply when, from the nature of the transaction or the information disclosed by the buyer, a reasonable seller would have been aware of the buyer's special cir-

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128. *See supra* notes 115-18 and accompanying text.

129. *See supra* note 108 and accompanying text.

130. Under this standard, disclosure would be required if the information was "material" as that term is generally defined in a nondisclosure context. *See, e.g.*, Basics, Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (applied to nondisclosure under § 10(b) of the Securities Exchange Act of 1934); TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (applied to nondisclosure under § 14(a) of the Securities Exchange Act of 1934); Canterbury v. Spence, 464 F.2d 772, 786-87 (D.C. Cir. 1972) (applied to nondisclosure in cases of negligent failure of a physician to obtain patient's informed consent), *cert. denied*, 409 U.S. 1064 (1972); Van Schaack Holdings, Ltd. v. Van Schaack, 867 P.2d 892, 899 (Colo. 1994) (applied to nondisclosure in cases of breach of fiduciary duty).

The United States Supreme Court explained the meaning of the term "material" in the context of disclosure of material information to shareholder investors:

> It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 449.

131. If buyers' recovery were limited because of nondisclosure of immaterial information, buyers might bury sellers "in an avalanche of trivial information—a result that is hardly conducive to informed decisionmaking." TSC Indus., Inc. v. Northway, Inc., 426 U.S. at 448-49.

cumstances without disclosure by the buyer.[132] For example, if the buyer, whom the seller knows to be a wholesaler, has contracted for custom manufactured goods not otherwise available on the market, the seller should be aware from that information alone that nondelivery would cause a loss of resale profits to the buyer. Because the seller should already have been aware that the buyer would suffer these losses, the buyer's failure to disclose that it would lose profits in the event of nondelivery should not invoke the probability standard.[133]

It has been suggested that incentives for disclosure serve no practical purpose because sellers do not respond to information even when it is disclosed.[134] The proposed standard takes this theory into consideration because, if it can be established that a reasonable seller would

132. Alternatively stated, in order for the buyer to avoid the constraints of the probability standard, the seller must have "reason to know" of the buyer's special circumstances.

> "Reason to know" means that the actor has knowledge of facts from which a reasonable man . . . would either infer the existence of the fact in question or would regard its existence as so highly probable that his conduct would be predicated upon the assumption that the fact did exist.

Restatement (Second) of Torts § 12 cmt. a (1965). *See also* Restatement (Second) of Agency § 9 cmt. d (1958) ("A person has reason to know of a fact if he has information from which a person of ordinary intelligence . . . would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence."); Restatement (Second) of Contracts § 19 cmt. b (1979) ("A person has reason to know a fact . . . if he has information from which a person of ordinary intelligence would infer that the fact in question does or will exist."); U.C.C. § 1-201(25)(c) (1990) ("A person has 'notice' of a fact when . . . from all the facts and circumstances known to him at the time in question he has reason to know that it exists."). It is to be distinguished from the term "should know" in that the latter imposes a duty of due care to inquire as to the true state of facts, which "reason to know" does not impose. *See* Restatement (Second) of Torts § 12 cmt. a (1965).

133. The seller is imputed with knowledge of the buyer's circumstances if a reasonable seller would have been aware of them. For example, if a seller of hardware knows that the buyer is a wholesaler of hardware, the seller cannot invoke the probability standard on the ground that the buyer failed to disclose its intention to resell the hardware. From this perspective there are two kinds of special circumstances: those that the seller can be deemed to know and those that must be disclosed by the buyer. U.C.C. § 2-715(2)(a) draws a similar distinction between "general" and "particular" needs of the buyer. Under that provision the seller is liable for "any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know." Under § 2-715(2)(a) only unique or particular needs of the buyer need to be disclosed to charge the seller. U.C.C. § 2-715 cmt. 3 (1990). The seller is imputed with knowledge of the buyer's general needs. U.C.C. § 2-715 cmt. 3 (1990); Anderson, *supra* note 12, at 355. Comment 6 to § 2-715 provides an example of a general need of the buyer that can be charged to the seller: "In the case of sale of wares to one in the business of reselling them, resale is one of the requirements of which the seller has reason to know within the meaning of subsection (2)(a)." U.C.C. § 2-715 cmt. 6 (1990).

134. *See, e.g.*, Eisenberg, *supra* note 4, at 592-96, 605-06 (discussing how the cost of processing the information can exceed the benefits to the seller).

not have taken additional protective measures had there been disclosure, the probability standard would not apply.

The proposed standard would apply only when the buyer has knowledge of its special circumstances. In most cases the buyer would know its own special circumstances, but it is possible that the buyer would not.[135] For example, the buyer may be unaware that a defect in ordered operating equipment that is innocuous to most buyers would result in a shutdown of this buyer's operation. The threat of expansive liability would not induce the buyer to disclose these special circumstances because it is unaware of them. To limit the impact of this "penalty default"[136] rule to cases where disclosure would be clearly promoted by expansive liability, the probability standard would not apply when the buyer is unaware of the special circumstances.[137]

Because the purpose of disclosure is to allow the seller the opportunity to select from among the full panoply of protective measures,[138] the standard would require the buyer's disclosure prior to the contract formation to avoid the probability standard.[139] Unless disclosure is made prior to the contract, the seller would be denied the opportunity to contractually limit liability, raise the price or decline the contract.[140] If the buyer could avoid the probability standard by post-formation disclosure, the incentive for pre-formation disclosure would be eliminated.

When this standard applies, determining whether the seller should have known that the buyer's consequential economic losses would be

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135. Theoretically the seller could ascertain the buyer's special circumstances by asking the buyer. To impose such a burden of inquiry on the seller would require it in every contract to engage in a fishing expedition to protect itself from unexpected liability. It would be more efficient for the buyer, who knows the relevant information concerning its special circumstances, to disclose that information rather than for the seller to engage the buyer in an unfocused and frequently fruitless inquiry. Such a burden of inquiry merely imposes an unnecessary and inappropriate precondition to the buyer's disclosure. By the same token, in determining what information to disclose, the buyer could theoretically inquire of the seller as to whether particular information would have a significant impact on the seller's risk assessment. To impose such a burden of inquiry on the buyer would require a fishing expedition as inefficient and inappropriate as the seller's burden.

136. Ayres and Gertner coined the phrase "penalty default" to describe a rule that would encourage desired conduct or discourage undesired conduct by use of a penalty. An example would be a rule of liability for consequential damages that seeks to encourage disclosure of information by reducing recovery for nondisclosure. Ayres & Gertner, *supra* note 4, at 97-104.

137. A party is far more likely to be deterred when it is aware of the operative facts as compared to when, as a reasonable person, he or she should have been aware. *See supra* note 73 and accompanying text.

138. *See supra* notes 100-01 and accompanying text.

139. The probability standard would not apply when the buyer fails to disclose special circumstances that arose subsequent to the formation of the contract. To impose post-formation burdens on the buyer is inconsistent with principles of contract law in which rights and obligations are created by the contract, not by subsequent events.

140. The only protective measure remaining available to the seller after the formation of the contract is to take additional precautions to avoid breach.

a probable result of breach[141] should be based on information available to the seller at the time of the formation of the contract. The probability standard encourages disclosure at a time when the seller can take appropriate, responsive measures.[142] In determining whether the seller should have known that the buyer's losses would be a probable result of breach, therefore, information disclosed by the buyer after the formation of the contract would not be considered. Otherwise, the incentive for pre-formation disclosure would be eliminated, and the value of the probability standard would be negated.

The probability standard would not restrict the buyer's recovery if, from the nature of the transaction or from the buyer's limited disclosure, the seller already knew or should have known that the buyer's loss would be a probable result of breach. Such a situation could occur if the undisclosed risk failed to materialize, and the buyer suffered losses that most buyers in similar circumstances could be expected to suffer. The seller should not be protected from liability arising from risks against which it should already have taken precautions.

It is true, of course, that the probability standard, by denying recovery for unexpected consequential economic losses, would frequently result in less than full compensation to the buyer,[143] and thus would undermine the reliability of contracts.[144] The impact of this result, however, is mitigated because the buyer can circumvent this limitation on its recovery by disclosing relevant information and because the buyer's recovery of general damages, personal injury or property damages will not be altered. Furthermore, to the extent the probability standard induces disclosure, the policies of fully compensating the buyer and promoting reliability of contracts will be promoted because sellers will be induced to take special precautions to avoid breach.

Limiting liability in the manner proposed will not significantly undermine the policy of deterring breach.[145] Because the seller will be unaware prior to breach of the buyer's failure to disclose material information, the seller will not make a decision to breach based on the

141. For the buyer's losses to be deemed the probable result of breach, the focus should be upon the particular transaction at issue. If probability were measured from a global perspective by the cumulative likelihood that such a loss would occur once among all of the seller's contracts, then for high volume sellers most losses would be probable and the standard would become meaningless. For example, assume a buyer has failed to disclose material information to a high volume seller resulting in the imposition of the probability standard. If the buyer suffered unusual losses, it should be denied recovery for those losses even though, among all of the seller's customers, at least one of them would probably suffer damages in such an amount.

142. After the formation of the contract the seller can no longer take the protective measures of altering contract terms, raising the price or declining to contract. It can still take steps to assure performance even after the contract has been formed.

143. *See supra* part II.B.1.

144. *See supra* part II.B.3.

145. *See supra* part II.B.2.

assumption that its liability will be limited to probable losses. Furthermore, the seller will remain motivated to perform by nonlegal sanctions, such as competitive market pressures,[146] and by its full liability for general damages[147] and expansive liability for consequential personal injury and property damages proximately caused by the breach.[148]

C. *The Significant Possibility Standard*

The seller's liability should be least limited when it commits a willfully inefficient breach because it engaged in a course of conduct[149] that it knew would likely result in an inefficient breach.[150] Under the significant possibility standard, the authors propose that the buyer's recovery for inefficient breach should include all consequential economic loss resulting from breach where its occurrence was a significant possibility.[151] Loss would be considered a significant possibility if, at the time of its breach,[152] the seller should have known that the occurrence of that loss would not be so extraordinary as to be extremely unusual. The term "significant possibility" is intended to encompass loss approaching that covered by the foreseeability standard of tort law.[153] The term "foreseeability" is not used to define this standard because in contract law it has become inextricably intertwined with the rule of *Hadley*.[154]

The significant possibility standard would include cases of late delivery, as for example when the seller, knowing that the buyer needs immediate delivery to avoid a shutdown of operations, intentionally chooses an inexpensive method of shipment and declines a more relia-

146. "[N]onlegal sanctions—particularly the manufacturer's reputation in consumer markets—are the major determinant of the manufacturer's adherence to commitments to maintain product quality above minimal standards." David Charny, *Nonlegal Sanctions in Commercial Relationships*, 104 Harv. L. Rev. 375, 394 (1990). *See generally* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. Pol. Econ. 615 (1981). *See also* Thomas M. Palay, *Comparative Institutional Economics: The Governance of Rail Freight Contracting*, 13 J. Legal Stud. 265, 275 (1984) (noting the incentive posed by possible future businesses on conduct); Ulen, *supra* note 51, at 347 ("The most important nonlegal market force is probably reputation.").

147. *See supra* notes 13-19 and accompanying text.

148. *See supra* note 30 and accompanying text.

149. The course of conduct covered by this standard would include omission as well as commission.

150. *See supra* note 64 and accompanying text.

151. For the buyer's losses to be deemed a significantly possible result of breach, the focus should be upon the particular transaction at issue. If the determination of whether the buyer's losses were a significant possibility were measured from a global perspective by reference to whether such a loss could occur among all of the seller's buyers, then for high-volume sellers virtually all losses would be significantly possible and the standard would be the equivalent of absolute liability.

152. *See infra* notes 163-64 and accompanying text.

153. *See supra* note 47.

154. *See supra* notes 26 and 35 and accompanying text.

ble method, knowing that its choice will likely result in late delivery and that the savings from late delivery will likely be less than the buyer's losses. The standard would include breaches of warranty caused by the seller's deliberate failure to institute efficient quality controls. It would also include cases of nondelivery. For example, assume a raisin grower in California has a contract to deliver its output of raisins to a commercial buyer, knowing the buyer intends to resell them. Further assume that because of the ongoing effects of a draught, the market price of raisins has increased since the formation of the contract. To take advantage of this increase, the grower, in breach of contract, sells its supply to other purchasers at the increased price, knowing that the buyer's cost to purchase substitute raisins will at least equal the grower's profits from the breach.[155] Subsequently the buyer learns of the grower's breach, but because the supply of raisins has dried up as a result of the continuing draught, the buyer is unable to contract for substitute raisins. While the evaporation of the supply of raisins was not a probable or even a normal consequence of breach when measured at the time of the formation of the contract, it was a significantly possible result at the time of breach and therefore the grower would be liable for the buyer's lost resale profits.[156]

The significant possibility standard is designed to deter, through expansive liability, conduct that is economically unjustifiable because it is willfully inefficient.[157] This standard seeks to accomplish this goal in a narrowly confined manner consistent with the underlying policies. It is limited to conduct that can readily be deterred through the imposition of expansive liability. The threat of expansive liability will increase the incentive to perform, which is all that is necessary to avoid the breaches covered by this standard, as they stem from a conscious decision to breach. Because the breaches covered by this standard are limited to those that the seller knows will likely result from its conduct, the seller knows what conduct to change in order to avoid

155. This is a clear example of an inefficient breach. *See supra* note 64.

156. The facts of the hypothetical are borrowed from Sun Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612 (Ct. App. 1983).

157. It could be argued that unlimited liability should be adopted to deter such conduct. Even when conduct is so reprehensible as to be tortious, however, unlimited liability is not applied. *See supra* note 47. Unlimited liability could have potentially devastating effects on the buying public and on commerce.

breach.[158] This "penalty default" rule[159] would thereby be limited to situations in which deterrence would be especially effective.[160]

This proposed standard would promote the reliability of contracts either by discouraging breach, and thereby assuring full performance, or, in the event of breach, by putting the aggrieved party, except in extraordinary circumstances, in the same position as if the contract was performed. The correlative is that this standard would most fully compensate the victim. The proposed standard would expand liability consistently with the parties likely allocation of risk; parties bargaining fairly and reasonably can be assumed, at the buyer's insistence, to have intended that the seller who knowingly committed an inefficient breach would be subject to expansive liability.

It is true that the imposition of expansive liability carries the risk of increased subsidization by the buying public. By limiting the significant possibility standard to breaches that can readily be deterred, however, it is more likely that subsidization by the buying public would be decreased rather than increased. Liability under this standard, by allowing recovery for all but extremely unusual losses, would undermine, to some extent, the policy of promoting predictability. This negative impact, however, is substantially outweighed by the positive results achieved by applying this standard to willfully inefficient breach.

The determination of whether the buyer's losses were a significantly possible result of breach should be based on information available to

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158. A rule that deters conduct where the party to be deterred is aware of the negative consequences that will flow from its conduct is far more likely to be effective as a deterrent than a rule that seeks to deter conduct where the party should know, but does not know, of those consequences. The premise that rules can deter conduct is based upon

> a series of behavioral hypotheses that must all be correct before imposition of tort liability will achieve the predicted results: typical actors must know the liability rules associated with various forms of conduct; they must possess sufficient information and evaluative skills to assess potential risks; they must pay attention to risks and corresponding liability rules when they engage in risky activities; and the category of actors assigned liability must evaluate the costs and benefits of alternative choices in a meaningful manner. In short, liability rules will promote social engineering objectives only to the extent that prospective injurers and victims can, and typically do, undertake *informed problem-solving behavior* with respect to the risks for which they may be liable.

Latin, *supra* note 73, at 678 (footnote omitted).

By limiting the significant possibility standard to cases in which the seller knows that its conduct will likely result in an inefficient breach, most of the above-mentioned hypotheses will exist before the rule will apply. The seller will possess sufficient information to assess the consequences of its conduct and will possess sufficient evaluative skills to engage in that assessment because it will in fact have made the assessment that the likely value of its conduct is outweighed by the likely harm. *See supra* note 73.

159. *See supra* note 136.

160. *See supra* note 158.

the seller at the time of the breach.[161] This timing would modify the prevailing approach that invariably measures consequential economic damages by information reasonably available to the seller at the time of the formation of the contract.[162] Because the breaches covered under the significant possibility standard are willful and, therefore, can be avoided by the seller's conscious decision to perform, the seller retains the ability until the time of breach to respond to new risk-related information and protect itself by choosing to perform. Measuring the scope of liability from this period of time is similar to the approach imposed under the foreseeability standard of tort law, which measures foreseeability at the time of breach of duty.[163] Both approaches are intended to accomplish similar objectives—to afford broad compensation to the injured victim and to deter inefficient and reprehensible conduct.[164]

Were it not for the economic loss doctrine of tort law,[165] the conduct that would subject the seller to expansive lability under the significant possibility standard would also subject it to liability for compensatory and punitive damages under tort law. The seller, by engaging in conduct that it knew would likely result in an inefficient breach, acted so unreasonably as to be both negligent[166] and reck-

161. Professor Eisenberg has suggested a unitary, inflexible rule that would always apply the tort foreseeability standard in determining consequential damages and would in all cases measure foreseeability from the time of breach. *See* Eisenberg, *supra* note 4, at 599-600.

162. According to the Restatement (Second) of Contracts: "A contracting party is generally expected to take account of those risks that are foreseeable at the time he makes the contract. Hé is not, however, liable in the event of breach for loss that he did not at the time of contracting have reason to foresee as a probable result of such a breach." Restatement (Second) of Contracts § 351(1) cmt. a (1979).

The U.C.C. makes the seller liable only for those consequential losses arising from requirements and needs of which the seller had reason to know "at the time of contracting." U.C.C. § 2-715(2)(a) (1990).

163. *See, e.g.*, Johnson v. Bender, 369 N.E.2d 936, 939-40 (Ind. Ct. App. 1977); Gibbs v. Petroleum Helicopters, Inc., 629 So. 2d 437, 442 (La. Ct. App. 1993); Duvall v. Goldin, 362 N.W.2d 275, 279 (Mich. Ct. App. 1984); Park v. Hoffard, 826 P.2d 79, 82 (Or. Ct. App. 1992); Overseas Tankship (U.K.) Ltd. v. Morts Dock & Eng'g Co., Ltd., 1961 A.C. 388 (Austl. P.C. 1961).

164. *See supra* notes 45-46 and accompanying text.

165. *See supra* notes 56-57 and accompanying text. The rationale for the economic loss doctrine has been stated succinctly by the United States Supreme Court: "The increased cost to the public that would result from holding a manufacturer liable in tort for . . . [purely economic losses] is not justified." East River S.S. Corp. v. Transamerica Delaval Inc., 476 U.S. 858, 872 (1986).

166. If the defendant knows or should know that its conduct is subjecting others to an unreasonable risk of harm, because the magnitude of the risk outweighs its utility, its conduct is negligent. *See, e.g.*, Casebolt v. Cowan, 829 P.2d 352, 356 (Colo. 1992); Knodle v. Waikiki Gateway Hotel, Inc., 742 P.2d 377, 380 (Haw. 1987); Patton v. Hutchinson Wil-Rich Mfg. Co., 861 P.2d 1299, 1310 (Kan. 1993); Goza v. Cornwell, 622 So. 2d 704, 707 (La. Ct. App. 1993); Moning v. Alfono, 254 N.W.2d 759, 762 (Mich. 1977); Lunar v. Ohio Dep't of Transp., 572 N.E.2d 208, 210 (Ohio Ct. App. 1989); Edco Prod., Inc. v. Hernandez, 794 S.W.2d 69, 72 (Tex. Ct. App. 1990); Dellapenta v. Dellapenta, 838 P.2d 1153, 1161 (Wyo. 1992); *see also* Restatement (Sec-

less.[167] Tort law imposes more expansive liability for reckless misconduct than for negligent misconduct because recklessness is recognized as more reprehensible and more readily deterrable than simple negligence.[168] The fact that the economic loss doctrine relegates such conduct to contractual sanctions when it results in purely economic loss does not mean that expansive liability must be precluded. It only means that tort law would not apply, and therefore the seller would not be sanctioned with punitive damages.[169] Further, the seller may avoid liability with a disclaimer clause[170] or because of the absence of

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ond) of Torts §§ 289, 291 (1965) (stating that actor must use care of a reasonable person in assessing whether "the risk is of such magnitude as to outweigh what the law regards as the utility of the act"); Keeton et al, *supra* note 37, § 31 (defining negligence as conduct which involves an "unreasonably great risk of causing damage"); Richard A. Posner, *A Theory of Negligence,* 1 J. Legal Stud. 29, 29 (1972) ("Negligence—the failure to exercise the care of an ordinarily prudent and careful man—has been the dominant standard of civil liability . . . for the last 150 years or so . . . .").

In the cases covered by the significant possibility standard, the seller actually knows that its conduct is subjecting the buyer to an unreasonable risk of harm because it knows that the risk (the likely loss to the buyer) outweighs the utility (the likely gain to the seller).

167. Most cases under state common law, although varying in their precise terminology, have adopted more or less the same rule, recognizing that punitive damages in tort cases may be awarded not only for actual intent to injure or evil motive, but also for recklessness, serious indifference to or disregard for the rights of others, or even gross negligence.

Smith v. Wade, 461 U.S. 30, 47-48 (1983).

In the cases covered by the significant possibility standard, the seller has exhibited an indifference to and disregard for the rights of the buyer in that the seller was aware that its conduct would likely result in an unjustifiable breach.

168. In tort law, the expansive liability for such reckless conduct takes the form of punitive damages. *See supra* note 45.

169. *See supra* note 45.

170. In tort law, disclaimers of liability may be invalid as a matter of law. For example, the majority of courts hold that sellers' disclaimers from strict products liability are invalid. *See* Haynes v. Kleinewefers & Lembo Corp., 921 F.2d 453, 458 (2d Cir. 1990); Weiner v. Mt. Airy Lodge, Inc., 719 F. Supp. 342, 346 (M.D. Pa. 1989); Pratt & Whitney Canada, Inc. v. Sheehan, 852 P.2d 1173, 1180 (Alaska 1993); Westlye v. Look Sports, Inc., 22 Cal. Rptr. 2d 781, 799 (Ct. App. 1993); Garcia v. Edgewater Hosp., 613 N.E.2d 1243, 1249 (Ill. App. Ct. 1993); Elite Professionals, Inc. v. Carrier Corp., 827 P.2d 1195, 1201 (Kan. Ct. App. 1992); Washington Water Power Co. v. Graybar Elec. Co., 774 P.2d 1199, 1203 (Wash. 1989); *see also* Restatement (Second) of Torts § 402A, cmt. m (1965) (stating that a consumer's tort cause of action is not affected by any disclaimer or other agreement).

In sales law, disclaimers of liability are permitted under U.C.C. § 2-719, whereby remedies may be limited unless the limitation is unconscionable (U.C.C. § 2-719(3)) or unless the limitation fails of its essential purpose (U.C.C. § 2-719(2)). *See generally* Jonathan A. Eddy, *On the "Essential" Purposes of Limited Remedies: The Metaphysics of UCC Section 2-719(2),* 65 Calif. L. Rev. 28, 28 (1977) (finding that "a 'talismanic' approach, focusing more on the form of a limited remedy than on its intended purpose, characterizes the current case law dealing with section 2-719(2)"); Howard Foss, *When to Apply the Doctrine of Failure of Essential Purpose to an Exclusion of Consequential Damages: An Objective Approach,* 25 Duquesne L. Rev. 551, 594 (1987) (concluding that the problem of when to apply the doctrine "is best resolved by a consideration of the objective facts and circumstances").

privity of contract.[171] Expansive liability under contract theory for breaches that are not only negligent, but coupled with malice, should be imposed to deter conduct that is so wrongful as to be reprehensible and to allow broad compensation to the victim.

If the buyer failed to disclose its special circumstances to the seller and therefore would otherwise be subject to the probability standard, the significant possibility standard would apply when the seller engaged in a course of conduct that it knew would likely result in an inefficient breach. If, even without the buyer's disclosure, the seller knew its breach would be inefficient, it should not be exempted from expansive liability under the significant possibility standard when it engaged in reprehensible and economically unjustifiable conduct. Absolving the buyer from the constraints of the probability standard in such a situation would not discourage disclosure because the buyer, at the time of the contract formation, cannot reasonably assume that the seller will thereafter commit a willfully inefficient breach that would permit the buyer expansive recovery despite nondisclosure.

Expanding liability when the breach is willful is not a novel concept in contract law. For example, in cases involving willful breach of warranty in service and construction contracts, courts have frequently stated that the damages for such breach are the cost of repairs even though they exceed the diminution in value and even though awarding such damages would entail economic waste.[172] In cases involving nonwillful breach of warranty in service and construction contracts, however, diminution in value is the ceiling on recovery if the awarding of repair costs would entail economic waste.[173] The dichotomy of treatment between willful and nonwillful breaches has not met with

171. "The requirement of privity in negligence actions, an unfortunate amalgam of tort and contract principles, was for the most part laid to rest by Justice Cardozo's famous opinion in McPherson v. Buick Motor Co., 217 N.Y. 382, 111 N.E. 1050 (1916), and we are not disposed to resurrect it . . . ." Clark v. International Harvester Co., 581 P.2d 784, 794 (Idaho 1978). *See also* Hanna v. Fletcher, 231 F.2d 469, 473 (D.C. Cir.), *cert. denied,* 351 U.S. 989 (1956); Johnson v. Equipment Specialists, Inc., 373 N.E.2d 837, 841 (Ill. App. Ct. 1978); Saylor v. Hall, 497 S.W.2d 218, 223 (Ky. 1973); Fazzolari v. Portland School Dist., 734 P.2d 1326, 1329 (Or. 1987). *See generally* Mark A. Kaprelian, Note, *Privity Revisited: Tort Recovery by a Commercial Buyer for a Defective Product's Self-Inflicted Damage,* 84 Mich. L. Rev. 517, 539 (1985) (concluding that "[s]trict tort liability should apply only when the buyer and seller are not in privity").

In contract law, however, the absence of privity may be a bar to the recovery of consequential economic damages. *See infra* note 197.

172. *See* Haden v. Krupp Asset Management Corp., 776 F. Supp. 1151, 1157 (S.D. Miss. 1990); Shell v. Schmidt, 330 P.2d 817, 825 (Cal. Dist. Ct. App. 1958); Kangas v. Trust, 441 N.E.2d 1271, 1276-77 (Ill. App. Ct. 1982); Groves v. John Wunder Co., 286 N.W. 235, 236-38 (Minn. 1939); Kaiser v. Fishman, 525 N.Y.S.2d 870, 872 (App. Div. 1988); Fidelity & Deposit Co. v. Stool, 607 S.W.2d 17, 22 (Tex. Ct. App. 1980); *see also* 5 Arthur L. Corbin, Corbin on Contracts § 1089 (1964); Hal J. Perloff, *The Economic-Waste Doctrine in Government Contract Litigation,* 43 DePaul L. Rev. 185, 199 (1993).

173. *See* sources cited *supra* note 172.

general approval.[174] This is understandable when the dichotomy of treatment promotes economic waste, which is manifestly inconsistent with the policies underlying the recovery of damages for breach of contract.[175] The standard proposed herein seeks to avoid this pitfall by imposing expansive liability only when the seller knew that its conduct would likely result in inefficient breach. Thus, the proposed standard is designed to avoid, not promote, economic waste by deterring inefficient breaches.

D. *The Intermediate Standard*

The intermediate standard is the residual standard that would apply in all cases not covered by the probability or the significant possibility standard. It applies when the buyer has disclosed its special circumstances prior to the formation of the contract and the seller has not committed a willfully inefficient breach. In cases covered by this standard, the seller would be liable for losses that at the time of the formation of the contract it should have known would be a normal consequence of breach.[176] Under this standard, the term "normal" encompasses losses that are not irregular or uncommon. It covers losses where the likelihood of occurrence is conceptually halfway between the polar positions of the probability standard and the significant possibility standard.

The reasons for limited liability under the probability standard and for expansive liability under the significant possibility standard are not present in cases covered by the intermediate standard. The need to substantially limit the buyer's recovery to encourage disclosure[177] is lacking, as is the need for the diametrically opposite response of expanding the seller's liability to deter willful inefficient breaches.[178] Therefore, the scope of liability in this middle category of cases should fall between the limits established under the probability and significant possibility standards.

Because no policy is of paramount importance in the situations covered by the intermediate standard, there is an evident conflict among

174. 3 Dobbs, *supra* note 13, § 12.19(1), at 441-42; Craswell, *supra* note 51, at 667; Michael H. Cohen, Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 Cal. L. Rev. 1291, 1300-01 (1985); Kenneth J. Goldberg, Note, *Lender Liability and Good Faith*, 68 B.U. L. Rev. 653, 667-68 (1988).

175. *See* sources cited *supra* note 174; *see also supra* notes 64-66 and accompanying text.

176. "Normal" refers to loss that is normal for the particular buyer, not for all buyers. Whether the buyer's loss was a normal consequence of breach would be based on information that the seller knew or should have known, including information concerning the buyer's special circumstances that was disclosed to the seller.

177. *Cf. supra* text accompanying notes 102-05 (discussing probability standard example where encouraging disclosure is necessary).

178. *Cf. supra* text accompanying notes 157-60 (discussing significant possibility standard where deterring inefficient breach is necessary).

policies of relatively equal weight. Expansive liability will promote the reliability of contracts[179] and afford full compensation to the buyer,[180] but it will undermine the policies of promoting predictability[181] and reducing subsidization of loss by the buying public.[182] Restrictive liability will conversely promote predictability and reduce subsidization while undermining reliability and full compensation to the buyer. For these reasons a compromise between expansive liability and restrictive liability is in order. The intermediate standard achieves such a compromise.

Under the intermediate standard, the buyer in most cases will be able to recover all of its consequential economic losses. Only when there have been significant post-formation changes in market conditions or in the buyer's special circumstances would the buyer's losses not be a normal consequence of breach. In the absence of such changes, the seller would have knowledge or notice of all facts necessary to accurately assess the buyer's loss in the event of breach, such as knowledge of the buyer's special circumstances[183] and notice of relevant market conditions.[184] Even when there have been significant post-formation changes in the buyer's special circumstances or in market conditions, the buyer would still recover unless the changes that occurred so impacted the buyer's losses that they no longer could be regarded as a normal result of breach.[185] For example, assume the buyer contracted to purchase sugar from the seller for purposes of resale to profit from a spot shortage in the local market, and the seller through inadvertence delivered late. During the delay the spot shortage was eliminated because other sellers delivered sugar into the same market. The resultant drop in the price of sugar caused the buyer to lose significant resale profits. Assuming the sugar market was

179. *See supra* part II.B.3.

180. *See supra* part II.B.1.

181. *See supra* part II.B.5.

182. *See supra* part II.B.4.

183. For the buyer to avoid the probability standard, the buyer must have disclosed its special circumstances to the seller. Under the intermediate standard, therefore, the seller will have actual knowledge of the buyer's special circumstances gained from the buyer's disclosure.

184. The seller has notice of facts, such as existing market conditions, even if the seller does not actually know those facts, as long as the seller should have known the facts from the surrounding circumstances. *See, e.g.*, U.C.C. § 1-201(25)(c) (1990) (explaining that knowledge of surrounding circumstances may be sufficient for notice).

185. Although nondisclosure of information other than the buyer's needs and circumstances will not cause the probability standard to be invoked, there are circumstances where it would be prudent for the buyer to disclose such information. For example, if the buyer is aware that market conditions will likely prevent the buyer from recovering in the event of breach, and the seller should not reasonably be expected to be aware of that fact, it would be advisable for the buyer to disclose that information if the failure to recover would result in greater than ordinary damages. If the seller is made aware of that information, those damages would more likely have appeared as an ordinary consequence of breach.

volatile and that neither a drop nor an increase in the market price was probable, the buyer nevertheless would be entitled under the intermediate standard to full compensation for its lost profits because a drop in price in the volatile sugar market was not uncommon or abnormal.[186]

Because the intermediate standard would allow full compensation to the buyer in most cases, it would substantially promote the reliability of contracts. Further, the claims denied full recovery under this standard would include those that are far greater than the norm, and therefore disproportionately large,[187] and by denying such claims, subsidization of loss by the buying public would be substantially reduced.[188] Moreover, the standard would promote the policy of predictability by precluding relief for abnormal and thus unpredictable losses.[189] Finally, the intermediate standard, by occupying a middle ground, most closely approaches how the parties, with a dichotomy of interests, bargaining fairly and reasonably, would likely have allocated the risk of loss.[190]

Determining whether the buyer's losses were the normal result of breach should be based on the information available to the seller at the time of the formation of the contact.[191] The policy reasons that justify determining whether the buyer's losses were a significant possibility as of the time of its breach are not present in cases covered by the intermediate standard. To promote the policies served by this standard, determining whether losses were a normal result of breach should be evaluated when the seller can still select among its full panoply of protective measures.

E. *The Nature of Loss: Type or Amount*

In determining whether the buyer's loss was the probable, normal or significantly possible result of breach, the focus should be on the amount of, rather than the type of, the buyer's loss. As long as the

186. The example is based on the celebrated English House of Lords case Koufos v. Czarnikow, Ltd. (The Heron II), 3 All E.R. 686 (H.L. 1967). In that case, the defendant carrier delivered sugar late. By the time the sugar arrived, intervening events, including the arrival of another shipment of sugar, had caused the market price to fall during the delay. This caused the buyer to suffer damages greater than would otherwise have occurred. The change in market conditions and the resulting losses to the buyer were not at the time of the formation of the contract the probable consequence of breach because it was just as likely that the market would rise or not change at all. Nevertheless a drop in price would be a normal occurrence in the sugar market.

187. *See supra* note 94.

188. *See supra* notes 93-95 and accompanying text.

189. *See supra* part II.B.5.

190. *See supra* note 119 and accompanying text.

191. The efficient acquisition of information is promoted by holding the seller responsible for all information the buyer has disclosed and all other information, including market conditions, that the seller reasonably should have known whether through inquiry or otherwise.

seller could reasonably have predicted under the appropriate standard the amount of the buyer's loss, the seller should be liable for that loss, even if the type of loss was unpredictable. This proposal would modify current law, which considers the likelihood of the type of loss to be of crucial significance to the scope of the seller's liability for consequential economic damages[192] but generally disregards the likelihood of the extent of that loss.[193] By focusing on the amount of, rather than the type of, loss predictability is promoted, as the seller can accurately

192. *See, e.g.*, Florida Power & Light Co. v. Westinghouse Elec. Corp., 597 F. Supp. 1456, 1474-75 (E.D. Va. 1984) ("The language of the Restatement—focusing as it does on the foreseeability of the *loss* rather than the foreseeability of the *damages*—supports the Court's interpretation that the *Hadley* foreseeability test is to be applied to the kind, not the amount, of damage."); Swatek, Inc. v. North Star Graphics, Inc., 587 A.2d 629, 632 (N.J. Super. Ct. App. Div. 1991) ("Plaintiff need only demonstrate, however, that the damage was of a type that a reasonable man would realize to be a probable result of his breach.").

Even if courts do not expressly state that the "type" of the buyer's loss must be foreseeable, they nevertheless typically analyze the issue of foreseeability in terms of whether the seller had enough information to make foreseeable the type of injury that was suffered by the buyer. For example, if the buyer suffered lost resale profits as a result of the seller's breach, the court typically inquires into whether that type of loss (i.e., lost resale profits) was foreseeable. *See* Taylor & Gaskin, Inc. v. Chris-Craft Indus., 732 F.2d 1273, 1278-79 (6th Cir. 1984) (stating that buyer's recall of its boats caused by seller's sale of defective gas tanks was foreseeable); Blue Circle Atl., Inc. v. Falcon Materials, Inc., 760 F. Supp. 516, 523 (D. Md. 1991) (stating that it was not foreseeable that defective product would cause loss of value to buyer's business when business sold four years later); Anna Ready Mix, Inc. v. N.E. Pierson Constr. Co., 747 F. Supp. 1299, 1304-05 (S.D. Ill. 1990) (proclaiming that loss caused by buyer's being deprived of performance bond in construction business was not foreseeable from information available to seller); Fortin v. Ox-Bow Marina, Inc., 557 N.E.2d 1157, 1165 (Mass. 1990) (holding that interest paid on purchase money loan is a recoverable type of consequential loss); Harbor Hill Lithographing Corp. v. Dittler Bros., Inc., 348 N.Y.S.2d 920, 923-24 (Sup. Ct. 1973) (holding seller liable for loss because he could foresee the existence of lost profits, despite the fact there was no evidence seller knew the precise extent of contemplated profits); AM/PM Franchise Ass'n v. Atl. Richfield Co., 584 A.2d 915, 923 (Pa. 1990) (finding that inquiry into whether type of injury characterized as "loss of secondary profits" was foreseeable); Cook Assocs., Inc. v. Warnick, 664 P.2d 1161, 1166-67 (Utah 1983) (finding that lost manufacturing profits caused by seller's late delivery of parts was foreseeable).

193. Most authority addressing the issue has held that it is not a defense that the seller could not foresee the amount of the loss. *See, e.g.*, Harmon Cable Communications of Neb. Ltd. Partnership v. Scope Cable Television, Inc., 468 N.W.2d 350, 362 (Neb. 1991) (holding that seller's premise that amount of damages must be foreseeable was "fallacious"); Barnard v. Compugraphic Corp., 667 P.2d 117, 120 (Wash. Ct. App. 1983) ("It is not necessary that the *specific* injury or *amount* of harm be foreseen, but only that a reasonable person . . . would foresee that in the usual course of events, damages would follow from its breach."); Anderson, *supra* note 12, at 364 ("[A]s a general proposition, there is no requirement that the seller have reason to know of the potential magnitude of the buyer's loss."). Other authorities have held that loss was foreseeable even if the amount of loss was not. *See, e.g.*, Sun Maid Raisin Growers v. Victor Packing Co., 194 Cal. Rptr. 612, 616 (Ct. App. 1983) (holding defendant liable despite its assertion that the amount of plaintiff's lost profits must be foreseeable); Harbor Hill Lithographing Corp. v. Dittler Bros., Inc., 348 N.Y.S.2d 920, 923 (Sup. Ct. 1973) (proclaiming that "resale circumstances put the seller on notice of potential exposure to liability for lost resale profits").

estimate its liability for consequential economic damages and take appropriate protective measures in response. The prospective type of the buyer's loss should be, and under this proposal would be, relevant only to the extent that it is indicative of the amount of the seller's prospective liability.[194]

Emphasis on the type of the buyer's loss rather than on the amount is not only misguided, but unjust. It denies all recovery to the buyer who suffers an economic loss in an amount that is fully within the reasonable expectation of the seller if that loss was of an unexpected type. For example, the buyer who suffers a $10,000 loss by being denied a profitable resale because of the seller's late delivery of industrial equipment is denied all recovery if the only type of loss the seller reasonably expected to arise from breach was a temporary shutdown of operations, irrespective of the fact that the seller reasonably expected the buyer to lose at least $10,000.

By shifting the focus to the amount of, rather than the type of, the buyer's loss, the buyer who suffers loss in an amount equalling the seller's reasonable expectations, as defined under the applicable standard, would be fully compensated,[195] and the buyer who suffers loss in an amount exceeding those reasonable expectations would merely be denied recovery of the excess.[196] If, for example, the seller's liability

Some decisions implicitly adopt the premise that if the amount of loss is unpredictable the seller is relieved from liability. *See, e.g.*, Fidelity & Deposit Co. v. Krebs Eng'rs, 859 F.2d 501, 508 (7th Cir. 1988) (stating that the plaintiff's unreasonably large attorney's fees raise issue of foreseeability); Lenox, Inc. v. Triangle Auto Alarm, 738 F. Supp. 262, 268-69 (N.D. Ill. 1990) (holding seller of failed burglar alarm not liable for theft of $125,000 of jewelry from buyer's car because dollar amount so unexpectedly large). The Restatement (Second) of Contracts implicitly adopts the same premise, suggesting that a buyer's lost resale profit would be foreseeable and therefore recoverable if it were in a reasonable amount but not if it were in an extraordinarily large amount. Restatement (Second) of Contracts § 351 cmt. b, illus. 3-7 (1979). Even under the Restatement, however, it is not clear that the extent of the buyer's loss is relevant. Florida Power & Light Co. v. Westinghouse Elec. Corp., 597 F. Supp. 1456, 1474-75 (E.D. Va. 1984) ("The language of the Restatement—focusing as it does on the foreseeability of the *loss* rather than the foreseeability of the *damages*—supports the Court's interpretation that the *Hadley* foreseeability test is to be applied to the kind, not the amount, of damage.").

194. The type of loss may be relevant in the sense that if the seller can reasonably predict the type of the buyer's loss, the seller may use that information to predict the amount or extent of loss more accurately. For example, if, based on the buyer's circumstances, the seller should have expected that its breach would result in a lost resale profit, this information would help the seller to estimate the amount of loss caused by breach.

195. For example, if, based on the nature of the transaction, the seller should have expected that late delivery of goods would cause a shutdown of the buyer's operation resulting in damages of at least $10,000, then it would be irrelevant to the seller that such amount of damages was caused instead by the buyer's loss of a resale contract instead.

196. Among the few authorities that impliedly require the amount of loss to be foreseeable, in cases where not all of the buyer's losses were foreseeable there is disagreement as to whether all recovery is barred or whether only that portion that is

is governed by the intermediate standard, the buyer suffers loss of $12,000, and loss in excess of $10,000 is abnormal, the buyer would be allowed recovery for $10,000, but not for the remaining $2,000.

F. *The Effect of the Trifurcated Standard on Remote Buyers*

Current law is divided as to whether the absence of privity of contract should be a bar to a remote buyer's recovery of consequential damages for economic loss caused by the remote seller's breach.[197]

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unforeseeable is barred. *Compare* Lenox, Inc. v. Triangle Auto Alarm, 738 F. Supp. 262, 270 (N.D. Ill. 1990) (seller of failed burglar alarm not liable for any of buyer's $125,000 theft loss) *with* Restatement (Second) of Contracts § 351 cmt. b, illus. 6 (1979) (seller is not liable for buyer's loss of profits to the extent that loss exceeded what was foreseeable).

197. Although the privity doctrine may be in retreat on some fronts, courts have divided on the question of whether privity is required when a buyer claims economic loss resulting from a breach of an implied warranty.

Cases requiring privity for the recovery of economic loss arising from breach of implied warranty include: Mt. Holly Ski Area v. U.S. Electrical Motors, 666 F. Supp. 115, 120 (E.D. Mich. 1987) (privity required for economic damages, not for personal injury damages); Wellcraft Marine v. Zarzour, 577 So. 2d 414, 419 (Ala. 1990) (privity required for recovery of economic damages, not personal injury damages); Flory v. Silvercrest Indus., 633 P.2d 383, 387 (Ariz. 1981) (privity required for recovery of economic damages); U.S. Roofing v. Credit Alliance Corp., 279 Cal. Rptr. 533, 538 (App. 3d 1991) ("Vertical privity is a prerequisite in California for recovery on a theory of breach of the implied warranties of fitness and merchantability"); GAF Corp. v. Zack Co., 445 So. 2d 350, 351 (Fla. Dist. Ct. App. 1984) (privity required for economic losses); Szajna v. General Motors Corp., 503 N.E.2d 760, 767 (Ill. 1986) (privity required for economic damages); Prairie Prod., Inc. v. Agchem Div.-Pennwalt Corp., 514 N.E.2d 1299, 1301-02 (Ind. Ct. App. 1987) (stating that "implied warranties, as they relate to economic loss from the bargain, cannot ordinarily be sustained between the buyer and a remote manufacturer); Schiavone Constr. Co. v. Elgood Mayo Corp., 436 N.E.2d 1322 (N.Y. 1982) (privity required for economic loss). In support of this view, the Oregon Supreme Court stated the following:

> But to allow a nonprivity warranty action to vindicate every disappointed consumer would unduly complicate the code's scheme, which recognizes the consensual elements of commerce. Disclaimers and limitations of certain warranties and remedies are matters for bargaining. Strict-liability actions between buyers and remote sellers could lend themselves to the proliferation of unprovable claims by disappointed bargain hunters, with little discernable social benefit. . . . Where the purchaser of an unmerchantable product suffers only loss of profits, his remedy for the breach of warranty is against his immediate seller unless he can predicate liability upon some fault on the part of a remote seller.

State *ex rel.* Western Seed Prod. Corp. v. Campbell, 442 P.2d 215, 217-18 (Or. 1968), *cert. denied*, 393 U.S. 1093 (1969).

Cases holding that privity is not required for the recovery of economic damages arising from breach of implied warranty include: Patty Precision Prods. Co. v. Brown & Sharpe Mfg. Co., 846 F.2d 1247, 1254 (10th Cir. 1988) (applying Oklahoma law); Henry Heide, Inc. v. WRH Prods. Co., 766 F.2d 105, 110 (3rd Cir. 1985) (applying New Jersey law); TCF Bank & Sav. v. Marshall Truss Sys., 466 N.W.2d 49, 52 (Minn. Ct. App. 1991); Spring Motors Distribs., Inc. v. Ford Motor Co., 489 A.2d 660, 663 (N.J. 1985); Moscatiello v. Pittsburgh Contractors Equip. Co., 595 A.2d 1198, 1201-02 (Pa. Super. Ct. 1991); Spagnol Enters., Inc. v. Digital Equip. Corp., 568 A.2d 948, 952 (Pa. Super. Ct. 1989); Nobility Homes of Texas, Inc. v. Shivers, 557 S.W.2d 77, 81 (Tex. 1977); Taylor v. Ford Motor Co., 408 S.E.2d 270, 272 (W. Va. 1991); Sunnyslope

Scholars have cogently argued that the absence of privity of contract should not bar recovery.[198] To the extent privity of contract is not a requirement for recovery,[199] a special application of the trifurcated standard would govern the remote buyer's rights against the remote seller. For purposes of this discussion, the remote seller will be referred to as the manufacturer and the immediate seller as the retailer.

The same policies that justify a trifurcated standard of liability when the parties are in privity of contract apply when they are not. The remote buyer that fails to disclose its special circumstances to the retailer should have the least recovery, and the manufacturer that has committed a willfully inefficient breach should incur the broadest lia-

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Grading, Inc. v. Miller, Bradford & Risberg, Inc., 437 N.W.2d 213 (Wis. 1989). The Supreme Court of Texas supported this view as follows:

> There is a split among both Texas courts and courts of other jurisdictions as to whether privity should be abolished in implied warranty actions for economic loss. . . . Today, a consumer, without regard to privity, can recovery against a manufacturer whose defective product causes the consumer to suffer the slightest physical injury. It would be inconsistent to demand privity as a prerequisite to the same consumer's recovery against a manufacturer whose defective product causes the consumer to lose his entire life savings. Consequently, we hold that privity is not a requirement for a Uniform Commercial Code implied warranty action for economic loss.

Nobility Homes of Texas, Inc. v. Shivers, 557 S.W.2d 77, 81 (Tex. 1977).

198. Professor Speidel has argued effectively based on exchange theory that the privity defense should be abolished in economic loss cases. Richard E. Speidel, *Warranty Theory, Economic Loss, and the Privity Requirement: Once More Into the Void*, 67 B.U. L. Rev. 9 (1987). *See also* Norman Deutsch, *Seller's Liability to Remote Purchasers and Nonpurchasers for Physical and Economic Loss in Breach of Warranty Actions in New York: An Analysis of the Privity Defense and the Views of Professor Speidel and the Article 2 Study Group*, 54 Alb. L. Rev. 35, 86 (1989) (agreeing with Professor Speidel's analysis and suggesting the abolition of the privity requirement in all contexts); John E. Murray, Jr., *Products Liability v. Warranty Claims: Untangling the Web*, 3. J. L. & Com. 269, 274 (1983); Gary T. Schwartz, *Economic Loss in American Tort Law: The Examples of J'Aire and of Products Liability*, 23 San Diego L. Rev. 37, 51-78 (1986).

199. There are two kinds of privity that might be required—"vertical" privity and "horizontal" privity. The distinction is explained by Professors White and Summers:

> There are two basic kinds of "non-privity" plaintiffs. The "vertical" non-privity plaintiff is a buyer within the distributive chain who did not buy directly from the defendant. For example, a man who buys a lathe from a local hardware store and then later sues the manufacturer is a "vertical" non-privity plaintiff. The "horizontal" non-privity plaintiff is not a buyer within the distributive chain but one who consumes or uses or is affected by the goods. For example, a woman poisoned by a bottle of beer that her husband purchased from a local grocer is a horizontal non-privity plaintiff. So, too, is a son who is injured by the new lawnmower his father bought, and the employee hurt by equipment purchased by her employer, and so on.

White & Summers, *supra* note 30, at 456. *See also* Devience, *supra* note 56, at 306.

The accompanying textual discussion deals only with the effect on the trifurcated standard if the requirement of vertical privity were abolished for commercial or economic loss. No opinion is expressed with regard to how the proposed trifurcated system would operate if the requirement of horizontal privity were abolished.

bility. In all other cases, the remote buyer's rights against the manufacturer should be governed by the intermediate standard.[200]

The probability standard would apply in the remote buyer's action against the breaching manufacturer when the remote buyer did not disclose its special circumstances to the retailer. It can be argued that the probability standard should not apply to the manufacturer despite the buyer's nondisclosure to the retailer because the manufacturer executed its contract and delivered the goods to the retailer prior to the buyer's nondisclosure. Therefore, the manufacturer would have had no opportunity to take additional protective measures even if the buyer had disclosed its special circumstances to the retailer. If the probability standard did not apply, however, the buyer would have no incentive to disclose its special circumstances to the retailer because it would be entitled to more expansive recovery against the manufacturer under the intermediate standard. Therefore, to encourage the disclosure of such information to the retailer, it is essential to limit the nondisclosing buyer's recovery against the manufacturer.[201]

The significant possibility standard would apply in favor of the remote buyer when the manufacturer commits a willfully inefficient breach of its contract with the retailer. It should be irrelevant whether the seller knew that the breach would likely be inefficient with regard to the remote buyer. The deterrent effect of the significant possibility standard would be substantially and unnecessarily diminished if proof were required to show that the manufacturer's breach was willfully inefficient with regard to remote buyers. For this standard to apply, it should be enough that the manufacturer engaged in a reprehensible, economically unjustifiable breach of its contract with the retailer.

G. *Applying the Trifurcated Standard to* Hadley

Hadley involved the buyers' nondisclosure of their special circumstances; it therefore would have been governed by the probability standard. The millers in *Hadley* never informed the carrier that the mill would be shut down until the shaft was returned; hence they failed to disclose their special circumstances.[202] The disclosure of that information might reasonably have induced the carrier to take additional protective measures in response. As the court noted, "[H]ad

200. The determination of whether the buyer's losses were a probable, significantly possible or normal consequence of breach should be made at the time of the formation of the manufacturer's contract with the retailer.

201. The determination of whether the remote buyer's losses were a probable result of breach would require showing that the seller should have known either that, in the event of breach, this particular buyer would probably suffer those losses or that each of retailer's buyers would probably suffer those losses. If probability were measured from a global perspective by the cumulative likelihood that such a loss would occur once among all of the seller's remote buyers, the probability standard would be meaningless. *See supra* note 141.

202. *See supra* notes 8-9 and accompanying text.

the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them."[203] Under the probability standard, the millers would be denied recovery for their lost profits caused by the shutdown of the mill because the carrier should not have known that such losses would result as a probable consequence of breach.

If the millers had disclosed their special circumstances, the more lenient intermediate standard would apply and they would be entitled to recover all lost profits that, at the time of the formation of the contract, the carrier should have known would be a normal result of the shutdown.[204] Because there is no indication of changed circumstances subsequent to the formation of the contract, the millers would be entitled to full recovery under the intermediate standard.[205] Even if the circumstances had changed, the millers would still be entitled to full recovery unless those changes caused the millers to suffer abnormally large losses.[206]

In the absence of the millers' disclosure of their special circumstances, it would be difficult to prove that the carrier's breach was willfully inefficient.[207] For example, if the carrier intentionally delayed delivery to reduce its expenses by shipping the crankshaft in bulk with other merchandise,[208] it would be difficult for the millers to prove that the carrier should have known that the carrier's cost savings through bulk delivery were likely to be exceeded by the millers' losses caused by the delay. Even with nondisclosure, however, the carrier's breach might have been willfully inefficient if, for example,

203. Hadley v. Baxendale, 9 Ex. 341, 355, 156 Eng. Rep. 145, 151 (1854).

204. *Hadley* may have intended to create a bifurcated system of liability consistent with the probability and intermediate standards proposed herein. In cases where special circumstances "were communicated by the plaintiffs to the defendants" the court states that damages would be the amount of injury that would "ordinarily follow" as a result of breach. But in cases where such special circumstances have not been disclosed, the court states that damages should be limited to those that arise in "the great multitude of cases." Whether such a distinction was intended depends on whether the court meant the phrase "great multitude of cases" to be more restrictive than the phrase "ordinarily follow."

There is some case authority supporting the possibility of a bifurcated standard of liability depending on whether the buyer has disclosed special circumstances. Cencula v. Keller, 536 N.E.2d 93, 95-96 (Ill. App. Ct. 1989); Long Island Lighting Co. v. City of Glen Cove, 315 N.Y.S.2d 656, 658-59 (Sup. Ct. 1970).

205. *See supra* text accompanying notes 183-86.

206. *See supra* text accompanying note 185.

207. The buyer has an incentive to disclose its special circumstances because, to the extent that all costs of breach are disclosed to the seller, the buyer can more easily invoke the significant possibility standard by proving that the seller knew that its breach would be inefficient.

208. There is some indication that the carrier delayed delivery while awaiting a full shipload of items to ship. Such a knowing delay would involve an inquiry as to whether the carrier reasonably thought its breach would be efficient. *See* Danzig, *supra* note 39, at 251 & n.5.

the carrier breached simply because of a personal conflict with the millers. Under this scenario, the carrier would be liable for the losses which at the time of breach it should have known were significantly possible. The *Hadley* court acknowledged that a shutdown was one of at least three possible consequences of late delivery, implicitly conceding that its occurrence was a significant possibility. Therefore, despite the millers' nondisclosure, they would be entitled to recover as damages all lost profits from the shutdown that were not so extraordinary as to be extremely unusual.

CONCLUSION

By adjusting the level of liability according to the policy concerns presented, the trifurcated standard will promote, fairly and efficiently, the relevant underlying policies of contract law to an extent not achievable under the unitary, inflexible standard of *Hadley v. Baxendale.* The authors have sought to explain why different situations demand variant standards of recovery. The proposed trifurcated standard is not the only model that could achieve that result. For example, it might be possible to have a continuum of liability—a sliding scale with no precise demarcations—expanding recovery in response to the seller's fault and limiting recovery in response to the buyer's fault. Such a sliding scale has the value of avoiding the precise fact finding that the trifurcated standard demands. But a sliding scale also leaves sellers and buyers without clear guidance as to the consequences of their actions and leaves the courts without clear guidance as to how to resolve a particular case. Regardless of the approach ultimately taken, the authors hope that this Article will stimulate discussion about the standard for the recovery of consequential damages for economic loss and direct that discussion toward a new, more flexible perspective.