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AN ECONOMIC ANALYSIS OF THE LOST-VOLUME RETAIL SELLER

VICTOR P. GOLDBERG*

Suppose that a customer agrees to buy a boat and before it is delivered, he reneges. The dealer subsequently resells the boat to another customer at the same price. Has the seller suffered damages (aside from incidental damages)¹ and, if so, should he be compensated? This question, dubbed the lost-volume seller problem, has been the subject of considerable legal analysis, usually in the context of explicating section 2-708(2) of the Uniform Commercial Code (U.C.C.).² There have been a number of attempts to apply economic analysis to this difficult question, the most recent by Professors Goetz and Scott.³ Unfortu-

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1. The Uniform Commercial Code provides for recovery of incidental damages by the seller in § 2-710.

2. The Code language is as follows:

§ 2-708. Seller's Damages for Non-acceptance or Repudiation

(1) Subject to subsection (2) and to the provisions of this Article with respect to proof of market price (Section 2-723), the measure of damages for non-acceptance or repudiation by the buyer is the difference between the market price at the time and place for tender and the unpaid contract price together with any incidental damages provided in this Article (Section 2-710), but less expenses saved in consequence of the buyer's breach.

(2) If the measure of damages provided in subsection (1) is inadequate to put the seller in as good a position as performance would have done then the measure of damages is the profit (including reasonable overhead) which the seller would have made from full performance by the buyer, together with any incidental damages provided in this Article (Section 2-710), due allowance for costs reasonably incurred and due credit for payments or proceeds of resale.

U.C.C. § 2-708 (1978).

The legal literature is summarized in Goetz & Scott, *Measuring Seller's Damages: The Lost-Profits Puzzle*, 31 STAN. L. REV. 323, 323-33 (1979).

3. Goetz & Scott, *supra* note 2. For other discussions applying economic analysis to the lost-volume seller, see Speidel & Clay, *Seller's Recovery of Overhead Under UCC Section 2-708(2): Economic Cost Theory and Contract Remedial Policy*, 57 CORNELL L. REV. 681 (1972); Comment,

nately, the economic analysis thus far employed has not helped. The analysis has fundamentally misrepresented the problem. While the Goetz-Scott policy conclusion is quite probably correct, the path to that conclusion is not.

This Article presents an alternative analysis that better captures the economics of the problem. This analysis concerns those issues that logically precede questions of what the rule ought to be or how section 2-708(2) ought to be applied. The focus is on how the problem should be analyzed rather than on what the correct rule ought to be. There will be room for reasonable people to disagree on the rule's content and on its application.

The central error of the Goetz-Scott analysis (and the others) is the failure to recognize explicitly that the seller in our boat example is a retailer.⁴ Once this point is recognized and models are chosen accordingly, the analysis becomes quite simple. That analysis will be developed in Parts II and III. First, however, this Article presents a simplified summary of the Goetz-Scott analysis.

I. THE GOETZ-SCOTT ANALYSIS

Professors Goetz and Scott build their analysis around the paradigm case of *Neri v. Retail Marine Corp.*⁵ They summarize the *Neri* facts and decision concisely:

Retail Marine, a dealer in marine equipment and supplies, contracted to sell a new boat to Neri for \$12,500. Marine then ordered and received the boat from its supplier. Six days after the agreement Neri repudiated the contract. Four months later Marine sold the boat to another buyer for the same price. When Neri sued to recover his downpayment, Marine counterclaimed for lost profits of \$2,500 under U.C.C. § 2-708(2), arguing that absent Neri's default it would have earned two profits rather than one. The New York Court of Appeals sustained Marine's lost-volume claim, holding that "the conclusion is clear from the record—indeed with mathematical certainty—that [market damages are] inadequate to put the seller in as good a position as performance . . . and hence . . . the seller is entitled to its [profit]." The court categorized Retail Marine's situation as

A Theoretical Postscript: Microeconomics and the Lost-Volume Seller, 24 CASE W. RES. L. REV. 712 (1973).

4. Section 2-708(2) does, however, apply to situations other than those involving retail sales. See U.C.C. § 2-708 comment 2 (1978) (recovery of lost profits permitted in all appropriate cases). The Goetz-Scott analysis is not confined solely to the retailer situation.

5. 30 N.Y.2d 393, 334 N.Y.S.2d 165, 285 N.E.2d 311 (1972).

that of a dealer with an "inexhaustible" supply of boats; consequently, the second buyer did not replace the first.⁶

Goetz and Scott begin their analysis of the effects of a breach by assuming that the seller is in a competitive industry. In Figure 1 (a simplified version of their Figure 1⁷), prior to a breach the firm equates price to marginal cost and produces quantity Q . What would the firm do if Neri breached his agreement to purchase one unit? It would still supply Q units, and because demand is perfectly elastic with respect to price, it would still sell Q units. The "lost sale" is perfectly replaced. So long as the firm has a unique optimal scale ($P=MC$) and the firm has an inexhaustible pool of customers willing to pay the market price, breach is irrelevant.

FIGURE 1

Goetz and Scott acknowledge that "[t]he perfectly competitive model is too simple for the real world."⁸ They therefore shift their attention to the case in which the seller has market power and isolate two effects—the cost effect and the demand effect. Their argument is confusing and unnecessarily complex.⁹ The following summary is a greatly simplified version which captures the essence of their analysis.

6. Goetz & Scott, *supra* note 2, at 332 (footnote omitted).

7. *Id.* at 334.

8. *Id.* at 335.

9. Their model involves a seller selling in two distinct markets—contract and spot. Goetz and Scott are not very clear as to what they mean by these terms. I presume that the former involves goods ordered from the dealer to be delivered at a later date, at which time title changes hands and the contract is consummated; the latter would involve goods sold off-the-lot or out of inventory. A breach is possible only for the contract purchasers. A spot contract is executed so quickly, presumably, that there is no time to breach. This distinction does not appear to be helpful. The discussion in the text makes all their points while avoiding some of the analytical complications arising from the spot/contract dichotomy.

A. THE COST EFFECT

Suppose that Marine initially faces a downward sloping demand curve. If a buyer (Neri) decides that he no longer wants the good and breaches his contract, this can be treated as a leftward shift of the demand curve and of the marginal revenue curve (from MR_0 to MR_1 in Figure 2A).¹⁰ What happens to the equilibrium quantity? This depends upon the shape of the marginal cost curve (see Figure 2B).

FIGURE 2A

FIGURE 2B

If marginal costs were constant (MC_1), the quantity decreases by ($Q_3 - Q_1$); if vertical (MC_3), the firm produces the same quantity as before (Q_1); and if it is in between (MC_2), the quantity change is between these two extremes ($Q_2 - Q_1$). Goetz and Scott conclude the discussion of this "cost effect" by observing that the breached contract will result in more lost sales volume the less steep the cost curve.¹¹

Oddly, Goetz and Scott do not consider the effect of the breach on market price. The new equilibrium would entail a reduced market price for all the firm's sales in this model; this should be considered a cost of breach borne by the seller. Since Goetz and Scott do take a similar price effect into account in their discussion of the demand effect, such treatment would seem to be dictated by symmetry considerations.

B. THE DEMAND EFFECT

Instead of breaching, Neri could have accepted the boat, even

10. If the demand curve is linear, then the shift in the marginal revenue curve is half the shift of the demand curve.

11. Goetz & Scott, *supra* note 2, at 339.

though he no longer wanted it, and then resold it. Goetz and Scott compare the effects on the seller when the buyer breaches versus when he accepts and then acts as a reseller. To isolate the demand effect, they assume that marginal costs are constant.¹² They assume initially that resale is costless.¹³ Their paradoxical conclusion is that the seller would be better off if the buyer breached rather than if the buyer fulfilled the contract and then resold.¹⁴ Their argument is as follows.

FIGURE 3

In Figure 3 (which is their Figure 2B)¹⁵ the market demand (D_2) is drawn on the assumption that Neri has already contracted for the boat, but no longer wants it. They then compare what would happen if Neri were to breach and the boat were to remain under the control of Marine with what would happen if Neri does not breach and takes responsibility for disposing of the boat. The model is generalized to cover the case in which the initial contract was for B units; in *Neri*, B equals one. If Neri breaches, the profit-maximizing monopolist would equate marginal revenue (MR_2) with marginal cost and sell Q_2 units at a price of P_2 . If Neri does not breach, then Marine would face a "residual demand curve" (D_1), derived by subtracting the units under Neri's control that could be resold in the same market. Nonbreach results in sales by Marine of Q_1 (in addition to the B units of the original sale). Thus, if the contract is breached, the seller's volume is Q_2 ; if it is not breached, the seller's volume is $Q_1 + B = (Q_2 - .5B) + B = Q_2 + .5B$. With the special assumptions of constant marginal costs, linear

12. *Id.* at 341.

13. *Id.* at 341 n.45.

14. *See id.* at 347-48 (breach permits expansion in seller's market for additional sales by removing risk that he "may lose one of [his] limited noncontractual buyers").

15. *Id.* at 340.

demand, and costless resale, breach results in a loss on one-half of the breached quantity.

The key feature driving the result is the treatment of Marine as a price leader and Neri as a price taker. When the seller owns the boat(s), he acts like a monopolist. When Neri owns the boat(s), Marine sets a monopoly price with regard to the residual demand curve, which results in a different profit-maximizing quantity and price.

Unlike their discussion of the cost effect, Goetz and Scott's discussion of the demand effect does recognize that there could be an effect upon price. Breach results in revenues of P_2Q_2 and nonbreach of $P_1(Q_2 - .5B) + P_cB$, where P_c is the initial contract price. If nonbreach would have led to a reduction in the market price, then the breach results in a higher price for the units sold. Note that this formulation presumes that the monopolist would allow a small fixed supply of the good in the hands of another (Neri) to affect the overall price level. If Marine really were concerned about this possibility, it could buy the boat back from Neri or hire someone to do so.

Notwithstanding the dubious applicability of their particular argument, Goetz and Scott do raise a valid issue. The buyer could resell rather than breach. Unfortunately, this insight has been obscured by the choice of a modelling strategy that focuses on an arcane point. Section II of this Article explores the resale argument from a different angle. Marine's role as a retailer providing *retailing services* receives some, but not much, notice. It is of much greater import in Section III.

II. THE RESALE MARKET

Suppose that once Neri has placed his order, he is legally bound to take the boat for his own use or to arrange for its resale to another buyer. In Calabresi-Melamed terminology, Neri's placement of the order gives Marine an entitlement protected by a property rule.¹⁶ Conceivably, Neri could sit outside Marine's showroom and try to convince potential buyers to purchase his boat rather than the dealer's boat. Obviously, this is costly to Neri, but it would be feasible. Alternatively, Neri could pay a retailer to resell the boat for him. If Neri could choose from a number of equally attractive dealers, he would pay a fair

16. See Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1092 (1972) (an entitlement protected by a property rule must be purchased from its owner in a voluntary transaction).

market price for the reselling service. Whether that price is one percent, ten percent, or twenty percent of retail price depends upon the anticipated costs of retailing. Thus, even if Neri has access to a competitive market of resellers, he could find disposing of the boat a very expensive proposition. Neri's situation is complicated if the initial seller—Marine—is better situated than others to resell the boat. This would be so, for example, if Neri's purchase and resale converts the boat from a new to a used one and results in instant depreciation of, say, twenty percent.

Initially, when buying his boat, Neri has a choice from a number of boat retailers, some of whom carry brands that he prefers. After he has placed the order with one, however, that dealer has an advantage that it could exploit in bargaining to determine the price of reselling. The legal damage rule—if unmodified by the initial contract—serves as a backdrop for bargaining to determine the price of the reselling services. That price would depend upon such considerations as Neri's vulnerability to Marine's opportunism (the costs of the next best alternative), Marine's interest in maintaining customer good will, the costs of using the legal system (the status quo determines whether one party must invoke the costly legal system), the existence and amount of any down payment, and the like.

Alternatively, Marine's entitlement could be protected only by a liability rule (damages rather than specific performance).¹⁷ This is the more customary rule for breach of contract. What are Marine's damages? A reasonable approximation would be the competitive price for the service of renegotiating the sale of a new boat. This damage rule would not permit the retailer to take advantage of his unique *ex post* situation in the post-breach bargaining. The competitive price of the reselling service is, roughly, the gross margin (retail minus wholesale price) of the dealer.¹⁸ This measure of damages is precisely what the

17. See *id.* (an individual may destroy an entitlement protected by a liability rule if he is willing to pay an objectively determined value for it).

18. A similar damage rule is often used by private parties enforcing selective distribution systems. If one retailer "steals" a customer from another, the manufacturer will sometimes require the offending retailer to compensate the loser, with the compensation being roughly equal to the gross margin. Magnavox, for example, utilized this tactic in enforcing its resale price maintenance policy. Goldberg, *Resale Price Maintenance and the FTC: The Magnavox Investigation*, 23 WM. & MARY L. REV. 439, 481 (1982) (former Magnavox dealer had to pay difference between wholesale and retail value to dealer who lost sale).

There is a parallel with the treatment of deficiency claims of secured creditors. The secured creditor must set off the resale price against the prospective recovery. U.C.C. § 9-504(1). Although there is no allowance for lost profits, the courts frequently accept a resale in the wholesale market and allow the creditor to recover as his damages the wholesale-retail spread. For example,

drafters of the U.C.C. had in mind under section 2-708(2):

The provision of this section permitting recovery of expected profit including reasonable overhead where the standard measure of damages is inadequate . . . [is] designed to eliminate the unfair and economically wasteful results arising under the older law when fixed price articles were involved. This section permits the recovery of lost profits in all appropriate cases, which would include all standard priced goods. The normal measure there would be list price less cost to the dealer or list price less manufacturing cost to the manufacturer.¹⁹

It would appear then that the arguments of the proponents of the lost profit notion are vindicated. This conclusion, however, would be premature. The following section considers other aspects of the economics of retailing and relates them to the damages problem.

III. THE ECONOMICS OF RETAILING AND LOST PROFITS

Why would a manufacturer choose not to sell directly to consumers? The simple answer is that it would cost too much. Retailers provide services to manufacturers and customers, reducing the costs of distributing the goods. The retailer's revenue minus the costs of goods sold will compensate for the costs of retailing, including a normal rate of return on the retailer's investment. While it would be possible for a retailer to sell retailing services separately (for example, by charging an admission fee or by selling a catalogue), the typical retailer's compensation is directly tied to the sale of its output. The gross margin is set high enough so that the costs will be covered by sales revenue. Thus, regardless of which customers use the retail services, the retailer's com-

Shuchman found that in his sample of cars repossessed by the General Motors Acceptance Corporation, "[a]ll or nearly all the resales in [the sample] were at wholesale, to others in the business of buying and selling used cars, and not to retail buyers in the usual retail market for used cars." Shuchman, *Condition and Value of Repossessed Automobiles*, 21 WM. & MARY L. REV. 15, 30 (1979). See also Shuchman, *Profit on Default: An Archival Study of Automobile Repossession and Resale*, 22 STAN. L. REV. 20, 30 (1969) (in studied cases, secured party sold car back to original dealer or another used-car dealer at or below the wholesale price). White and Summers note that the law is vague on this point: "With a few exceptions, the opinions discussing 9-504(3) do not provide much guidance for determining whether the resale price should be measured against the wholesale or retail market." J. WHITE & R. SUMMERS, *UNIFORM COMMERCIAL CODE* 1117 (2d ed. 1980) (footnote omitted). They note the similarity between this question and the lost profit question and put forth the standard rationale for recovery of lost profits: "Even one who normally sells at retail could argue that one of the costs of selling repossessed autos on his lot is the profit he loses because he has so lost the opportunity to sell another car to the customer who bought the repossessed one." *Id.* at 1118 (footnote omitted).

19. U.C.C. § 2-708 comment 2 (1978).

pensation comes solely from the buyers of his goods. If Mr. Jones buys, he pays for the product and for a share of the retailing services; if Mr. Smith does not buy, he pays nothing for the retailing services, regardless of how much selling effort was exerted on his behalf. If Mr. Neri orders a boat and then reneges, should he bear any of the costs of retailing in the absence of specific contract language on this point? If we hold him liable for lost profits, then the answer is yes.

A. THE PRICE OF OPTIONS

When Neri orders the boat, he can be viewed as purchasing an option.²⁰ If the boat is delivered, he pays the contract price which, of course, includes a share of the overall costs of retailing. If between the contract date and the delivery date Neri changes his mind, the option is cancelled (*i.e.*, the contract is breached). Neri would then pay the price of the option (*i.e.*, contract damages). What would be a reasonable measure of the value of the option? The retailer's gross margin is one possibility. If one has doubts that reasonable customers know or ought to know the extent of their commitment when making an option contract, then one should be uncomfortable about assessing the customer for lost profit damages. Most buyers of boats and cars probably would be shocked to learn that the price of their option exceeds fifteen percent of the retail price.²¹ Fortunately, there exists a relatively simple device to determine an accurate measure of the value of the option—a nonrefundable deposit. The law should encourage the parties to use this device, by denying recovery for lost profits in the absence of explicit contract language to the contrary.

This policy conclusion is not inevitable. Reasonable people might agree with the analytical approach, yet conclude that a different policy is in order. The remainder of this section develops the argument in more detail. As a byproduct, the argument uncovers a significant conceptual error in the Goetz-Scott analysis that has thus far been ignored.

20. This conceptualization is like that of Justice Holmes: "The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass." O. HOLMES, *THE COMMON LAW* 301 (1881).

21. Retail margins vary considerably across goods. In *Neri*, the retail markup was approximately 27%. See Record on Appeal at 19-21, *Neri v. Retail Marine Corp.*, 30 N.Y.2d 393, 285 N.E.2d 311, 334 N.Y.S.2d 165 (1972) (total cost to Retail Marine was \$9409; profit was to be \$2579). Markups on Magnavox phonographs in the 1960's ranged from 20% to 48%. See Goldberg, *supra* note 18, at 455, n.61 (in 1967 markup ranged from 20% to 43%; in 1968 eight radio-phonographs had margin of 48%). According to Lawrence White, the list price on subcompact cars exceeded the wholesale price by 17% and on full sized cars by 25%. L. WHITE, *THE AUTOMOBILE INDUSTRY SINCE 1945* 106 (1971).

B. A FISH STORY

A retailer can influence his sales volume by his price or his selling effort. To simplify the discussion, assume that price is fixed.²² Selling effort includes a broad mix of activities: advertising, maintaining high ratios of inventory or salespeople to sales, locating in places that generate a high volume of foot traffic, maintaining elegant facilities, providing high quality service departments, developing high levels of consumer good will, and so forth. Diminishing returns to selling effort reflect the increased difficulty of reaching additional customers. For example, an advertisement targeted to an audience within a one mile radius of a boat dealership is likely to result in a larger percentage of recipients responding to the ad than would one aimed at customers within a 100 mile radius. With the retail and wholesale prices fixed, the profit-maximizing firm sets marginal selling costs equal to the gross margin (Figure 4).

FIGURE 4

Suppose that one customer, Neri, breaches. What are the effects on the dealer's sales and costs? The seller, Marine, loses the sale and his costs are reduced roughly by the wholesale price of the boat—his loss from the breach is approximately the gross margin. Goetz and Scott, however, would argue either that another sale would replace the Neri sale, or that Marine's cost saving would be the marginal cost,

22. The Code commentators explicitly consider the "fixed price good" in their discussion of § 2-708(2). See U.C.C. § 2-708(2) comment 2 (1978) (the provision is "designed to eliminate the unfair and . . . wasteful results arising under the older law when fixed price articles were involved").

which is equal to the retail price.²³ Hence, there would be no lost profit. The difference lies in the interpretations of the marginal cost concept. Marginal cost should not relate to actual output, *ex post*, as Goetz and Scott's analysis implies; rather, it concerns planned output, *ex ante*.

An analogy is helpful. Think of the customers as fish and the retailer as a fisherman. The fisherman makes decisions on boat size, crew, equipment, et cetera, on the basis of the relationship between these inputs and expected catch. For a given combination of inputs (a given level of fishing—or retailing—expense) on a normal day the fisherman might anticipate a catch of, say, 1000 pounds. On a good day he might land 2000 pounds and on a bad day he might do no more than drown a lot of worms. The fisherman's optimal level and mix of expenditures depends upon the distribution of expected outcomes and their relationship to the input mix. There is no unique marginal cost concept in this formulation. But if we had to have a single, summary marginal cost measure, it would almost surely be the cost of increasing the *expected* catch by one pound. Thus, if on a particular day, a fish is hooked and then is lost, the fisherman loses the revenue from that fish and avoids virtually no costs—the *ex post* marginal costs are roughly zero. The fish that got away, like Neri, constitutes a net loss of revenue for the business. So long as the probability of a fish getting away is not positively correlated with the probability of hooking the next fish, the lost fish constitutes a net loss to the fisherman. Likewise, so long as the customer's renegeing does not increase the likelihood of making the next sale, the breach results in a net loss of revenue to the business.²⁴

This analogy captures the notion that the lost profits proponents were trying to convey—the typical retailer can expand sales in the short run with little cost beyond the wholesale price in the sense that, if he has a lucky month, then he could fill the additional orders. Commentators, however, have used awkward terminology, such as an ability to “supply all probable customers”²⁵ and the “seller has an unlimited supply of goods,”²⁶ to describe this concept.

23. See Goetz & Scott, *supra* note 2, at 333-35 (in the event of breach, seller will sell same number of units, or breach will save seller costs it would have incurred on performance).

24. If the probabilities are negatively correlated, then the problem is exacerbated. This is, in fact, likely. Deteriorating economic conditions would result in an increased probability of buyer breach and would also result in lower demand; finding a new customer would be harder.

25. 5 A. CORBIN, CORBIN ON CONTRACTS § 1100, at 541 (1964).

26. W. HAWKLAND, SALES AND BULK SALES 183 (3d ed. 1976).

C. WHO SHOULD BEAR THE LOSS?

By now the reader should be convinced that the breach does impose a loss upon the retailer and that the gross margin is an approximation of the magnitude of that loss. That does not mean, however, that the breacher should be held liable. In the absence of a nonrefundable deposit or explicit contract language to the contrary, the retailer ought to bear the loss.

Suppose initially that the customer's decision to breach was a random event.

FIGURE 5A

FIGURE 5B

In Figure 5A, the industry supply and demand curves (S_1 and D_1) are drawn on the assumption that the customer pays no damages if he breaches. The supply curve reflects the sellers' costs of doing business, including the expected costs of buyers breaching. Compare the equilibrium price/quantity combination with what would happen if customers were liable for damages arising from the breach. Under the new liability rule, represented by D_2 and S_2 , the supply curve shifts to the right since the firm no longer bears the expected costs of breach. On the other hand, since the buyers now bear the costs, they are willing to pay less for the good; the demand curve shifts to the left. If the expected level of breach is independent of the legal regime, if attitudes toward the risk of breach are the same for buyers and sellers, and if the perceived likelihood of breach is the same on both sides of the market, then the demand shift would completely offset the shift in the supply curve. The quantity would be the same in both regimes and the price difference ($P_1 - P_2$) would be exactly equal to the expected unit cost of

breach. The rule does not matter. This might appear surprising at first glance, but, in fact, it is nothing more than Demsetz' variation on the Coase Theorem.²⁷

Now, consider the hypothetical with the retail price constant (Figure 5B). (In Figure 5A the price is allowed to adjust, while in Figure 5B the retail price is held constant; the basic analytical result remains unchanged.) The typical firm's marginal costs are shown by MC, drawn under the assumption that the firm bears the costs of breach. Shifting liability to the customers has two effects. First, it lowers the firm's costs in the same manner as in Figure 5A, to MC'. Second, since the customers now value the good less than before, the firm will have to work harder to persuade customers to buy the good at the constant price; this results in a shift in the marginal cost curve in the opposite direction back to MC.

The idealized conditions posited above do not hold. Information about the probability of breach is not the same for buyers and sellers at the formation stage of the contract. The individual customer has more knowledge about his own tendencies to adhere to contracts, and some scholars are inclined to emphasize this information asymmetry.²⁸ I, however, would be inclined to put more weight on the dealer's superior ability, gathered from his business experience, to assess the probability that an individual customer will back out of a deal.²⁹ Dealers are in a better position to know the magnitude of damages in the event of a

27. See Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1, 2-8 (1960) (value of production maximized regardless of legal position if pricing system is assumed to work without cost); Demsetz, *Wealth Distribution and the Ownership of Rights*, 1 J. LEGAL STUD. 223, 225-26 (1972) (analyzing the problem of liability for on-the-job accidents, concluding that the distribution of wealth between workers and shareholders is unaffected by legal position).

The transaction can be viewed as having two parts—the sale of the good and insurance against breach. Under the assumptions, the consumer pays for the insurance either directly or indirectly in the product price. Analytically, the problem is identical to the question of who bears a sales tax or social security tax. In both instances, the formal assignment of the tax liability is irrelevant.

28. When individuals know more of the relevant facts about themselves than the parties with whom they are dealing, there is a problem of "adverse selection." If an insurance company sells a life insurance policy available to anyone at a fixed price, those people who knew that they were less healthy than the average person would be more likely to buy the insurance. See Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. OF ECON. 488, 492-94 (1970) (as price level rises, those who insure themselves are those increasingly certain that they will need the insurance).

29. In *Neri*, the buyer had no intention of backing out at the time of contracting; after signing the contract he learned that he required hospitalization and surgery. 30 N.Y.2d 393, 396, 334 N.Y.S.2d 165, 167, 285 N.E.2d 311, 312 (1972).

breach, as noted in the discussion of options.³⁰ Dealers also would appear to be in a better position to spread the risk of a breach over similar transactions than would a customer. Moreover, both Figures 5A and 5B are drawn on the assumption that enforcement of the law is equally costly regardless of which way the right is assigned, which is not the case.³¹

A nonrefundable deposit has considerable attraction. First, it is cheap to arrange, given that the parties are already entering into a contract. Second, it provides evidence that the customer has been apprised of the extent of his liability in the event that he fails to take delivery.³² Third, it forces the customer to value explicitly the option he purchases. Conversely, it induces the seller to state *ex ante* the price he is willing to put on that option.³³ Finally, a policy of finding no damages in the absence of a nonrefundable deposit has low enforcement costs. Other things equal, a policy of leaving the losses where they lie is very attractive.³⁴

A nonrefundable deposit is, in effect, a prepaid penalty. It would not be fruitful to explore here the courts' historic distaste for contractual penalties.³⁵ It is sufficient to note that a proper resolution of the legal issues involving the lost profit puzzle will inevitably involve some of the same questions raised in the debates about the enforceability of

30. See *supra* text accompanying notes 20-21.

31. If there were no deposit and the seller had the legal right to recover lost profits, the seller would have to use the legal system (or at least threaten to do so) to vindicate his right. If the law did not grant lost profits, the breaching buyer would not have to use the legal process. The existence of a deposit would change the relative costs of protecting the parties' rights. The general point is that the costs to the parties would not be the same, nor would they be invariant to the legal regime.

32. In *Neri*, it appears that the buyer was not aware that the deposit was meant to be nonrefundable; indeed, the court ruled that it was refundable. See *infra* text accompanying notes 37-39.

33. Some retailers have adopted extremely liberal policies on customer returns; a no-questions-asked returns policy is even more liberal than a policy of not recognizing lost profits damages, and goes well beyond what the law requires of a seller. Such a liberal returns policy would be unlikely for "big-ticket" items that lose value as soon as they are reclassified as "used."

34. One obvious drawback of the deposit is that it subjects the buyer to the risk of loss in the event that the seller fails to perform.

35. A penalty clause is not enforceable unless the courts deem it a liquidated damages clause. See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* 565 (2d ed. 1977) (parties may not provide for penalties in event of breach, but may determine in advance damages to be assessed); RESTATEMENT (SECOND) OF CONTRACTS § 356(1) (1979) ("A term fixing unreasonably large liquidated damages is unenforceable on grounds of public policy as a penalty."); U.C.C. § 2-718 comment 1 (1978) (same). Regardless of whether the parties call the nonrefundable deposit a penalty or liquidated damages, the courts will not allow it if the stipulated amount is out of proportion to the probable damage. J. CALAMARI & J. PERILLO, *supra*, at 566.

penalty clauses. The best policy would probably be to have no liability for lost profits unless the agreement so provides. The provision would probably take the form of a nonrefundable deposit, but there is no *a priori* reason to restrict the parties' choice to this device.

The *Neri* contract did utilize a deposit, and its fate was interesting. *Neri's* initial deposit was only \$40, but when the dealer arranged for "immediate delivery on the basis of 'a firm sale'" the deposit was increased to \$4250, even though the dealer's margin was only around \$2500.³⁶ On the back of the contract, in small print, the following term appeared: "If the within agreement is cancelled by mutual consent, the seller shall retain the deposit paid hereunder, whether paid in cash or other consideration, as liquidated damages."³⁷ In his complaint, the plaintiff alleged: "The said provision of the contract appeared on the reverse side in fine print and is fraud."³⁸ The trial court judge did not agree, but did rule that "[t]he liquidated damage clause . . . does not apply to the instant case since the contract was not cancelled by the mutual consent of the parties. Accordingly an assessment of damages must be had, at which time it may be determined whether the plaintiffs are entitled to the return of any portion of the down payment previously made."³⁹ This ruling was not appealed. Consequently, the magnitude of the deposit was not a relevant factor in the determination of damages.⁴⁰ The court only allowed Marine to keep the \$2579, expected profit plus an additional \$674 for incidental expenses of storage, upkeep, finance charges, and insurance.⁴¹

CONCLUSION

The lost profit question is not litigated often, as Goetz and Scott note.⁴² The dearth of reported cases probably reflects the widespread

36. *Neri v. Retail Marine Corp.*, 30 N.Y.2d 393, 396-97, 334 N.Y.S.2d 165, 166-67, 285 N.E.2d 311, 312 (1972).

37. Record on Appeal at 79, *Neri v. Retail Marine Corp.*, 30 N.Y.2d 393, 334 N.Y.S.2d 165, 285 N.E.2d 311 (1972). I am grateful to plaintiff's counsel, George Razis, for providing me with the *Neri* record.

38. *Id.* at 13a.

39. *Id.* at 9a.

40. It is surprising that the "mutual consent" language would be interpreted in this manner. This finding is most likely another manifestation of the courts' hostility to penalties. See *supra* note 35. Subsequent contracts were probably modified to allow liquidated damages in the absence of mutual consent to cancellation.

41. *Neri v. Retail Marine Corp.*, 30 N.Y.2d 393, 401, 334 N.Y.S.2d 165, 171, 285 N.E.2d 311, 315 (1972).

42. See Goetz & Scott, *supra* note 2, at 351 and n.65 (no retail lost-volume cases litigated under U.C.C.; automobile dealers have not litigated lost volume claims for over 20 years).

use of deposits for purchases of expensive items; for less expensive items, the expense of litigation, the relatively small stakes, and the possible adverse effects on the retailer's goodwill all tend to discourage legal action.

If a customer reneges on a contract for future delivery, the least cost method of mitigating damages will be to purchase reselling services at the fair market price. That price is, roughly, the retailer's gross margin. An alternative way of making the same point is to view the retailer as a fisherman and ask what he loses if someone liberates a fish from his catch. The loss is the net revenue from that fish which is, again, roughly the gross margin. The lost sale (or fish) does result in damages of the sort described in U.C.C. section 2-708(2).

This, however, does not mean that the losses should be borne by the breaching party. In the idealized world which serves as a straw man for Coase and Demsetz, it makes no difference which party bears the losses. The outcomes are identical. When one leaves that world, a strong case could be made for holding customers not liable unless there is explicit contract language to the contrary. Sellers would probably find the nonrefundable deposit a low cost, effective tool for establishing damages.