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The New Business Rule and Compensation for Lost Profits

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In the late 1960's, the movers and shakers of Buffalo determined that their football team, the Bills, needed a new domed stadium. The County entered into a contract with Kenford, a firm owned by a local landowner, Ed Cottrell, who teamed up with Judge Roy Hofheinz (the creator and operator of the Houston Astrodome, the first domed stadium). They would provide the land for the stadium in exchange for a management contract. They also owned the adjacent land and intended to develop it after the stadium was built. The expected cost of the stadium was $50 million; however, when the construction bids came in, the low bid was $72 million. That was too much for the County, so it cancelled its plan to build the stadium, whereupon Kenford sued for breach of contract. Kenford won on liability and the damage issue went to trial—a very long (nine-month) trial.[1] Kenford hired a team of economic experts to determine damages. Had the stadium been built, it argued, it would have developed the peripheral land with a theme park, three hotels, four office buildings, a golf course, and a specialty retail center. The team of experts spent months testifying giving their projections of future costs and revenues on a year-by-year basis for twenty years, concluding that the lost profits from this component of damages alone was over $380 million. Total claims exceeded $500 million.[2] When the dust had cleared, Kenford received $10 million, none of that for those lost profits.[3]

As a matter of sound policy the denial was correct, although the trial judge got there with a dubious argument, which I need not reproduce here.[4] Kenford's lost profit claim faced a doctrinal hurdle—the so-called new business rule. If a business did not have a history of profitable operations, it would have been denied recovery for lost profits. Not so long ago, most American jurisdictions followed this per se rule. That has changed. In his treatise, Robert Dunn summarized the change: "The first edition of this book described the new-business rule as a 'majority rule' and the rejection of the new-business rule as a 'minority rule.' The trend in the cases since 1978 is unmistakable. The modern decisions … demonstrate an increased rejection of the traditional new business rule. The majority and minority rules are now the other way around."[5] Likewise, Farnsworth stated that the rule "has been largely abandoned."[6] The per se rule still exists in some jurisdictions, notably New York (although, as we shall see, the New York courts have tied themselves up in knots in an effort to apply the per se rule).

[1] The litigation dragged on for eighteen years. For details, see Goldberg, Rethinking Contract Law and Contract Design, ch. 9.
[2] They also argued that if the stadium had been built they would have been able to entice a major league baseball team (possibly the New York Yankees) to come. The expert opined that the lost profits arising from the failure to buy the Yankees was $146 million.
[3] Kenford Company v. Erie County 73 N.Y. 2d 312 (1989).
[4] For details see Rethinking 102-3.
5 Robert Dunn, *Recovery of Damages for Lost Profits*, § 4.3 at 391.
6 Farnsworth treatise, § 12.15 at 272.

The prevailing wisdom nowadays accepts Dunn's notion that a new business is no different than an existing one. "What the earlier cases perceived as a rule of law has been replaced in the cases cited by a rule of evidence. The rule of evidence is far preferable. . . . The trend in the modern cases is plainly toward replacing the old rule of law with a rule of evidence—the unquestionable principle that damages for loss of profits must be proven with reasonable certainty."[7]

However, I want to argue, the prevailing wisdom is wrong. The damages for a new business ought not be viewed as merely a matter of whether the evidence is sufficient to surmount the "reasonable certainty" hurdle. By not appreciating the underlying economics, the courts have lumped together a disparate set of problems under the new business rubric and attempted to treat them all alike. For some, like the Kenford claimants, I would argue, the zero compensation result would be appropriate; for others not. Unpacking the concept results in a more nuanced approach to measuring damages. In particular, it calls into question a common refrain in contracts discourse, namely, that the damage rules result in systematic undercompensation.[8] I will argue that the increased liberality in awarding lost profits to new businesses has, in many instances resulted in overcompensation. All the errors are not, however, in one direction; in other contexts application of the rule has (or would have) resulted in undercompensation.

To get a better handle on this, I will break down the case law into four categories. These are stylized in that actual cases might not fit completely within a single box. There is a class of cases in which the appropriate new business award is zero, but the courts have drawn the line in the wrong place. The crucial issue is not the lack of a track record or whether damages can be proved with "reasonable certainty"; rather the focus should be on the expected return on a new investment (whether by a new or existing business). These cases can be characterized by Terry Malloy's plaintive cry: "I could've been a contender."[9] Following a breach, the plaintiff, who has done nothing in reliance, claims that, but for the breach, I would have done X and I would have made a lot of money by doing so. As one court said: "Most contracts are motivated by the expectation of future profits. If such profits are within the contemplation of the parties at the time the contract is made, they may form the measure of damage."[10] Why then should the plaintiff not be compensated? The simple answer is that the damage remedy has to take account of the opportunity cost of capital. Since there is no reason to believe that this particular investment would have been more profitable than any alternative use of the funds that the plaintiff saved because the deal cratered, there would be no loss. Thus, returning to the

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7 Dunn, § 4.3 at 392. "[T]he distinction between established businesses and new ones …goes to the weight of the evidence." Dobbs. __.

8 Alan Schwartz, The Case for Specific Performance, 89 Yale L.J. 271, 275-76 (1979); Steven Shavell, Is Breach of Contract Immoral? 56 Emory L.J. 439, 451 (2006); Douglas G. Baird, The Young Astronomers, 74 U. Chi. L. Rev. 1641, 1650 (2007); Melvin Aron Eisenberg, The Principle of Hadley v. Baxendale, 80 Cal. L. Rev. 563, 610-11 (1992); Tess Wilkinson-Ryan & David A. Hoffman, Breach Is for Suckers, 63 Vand. L. Rev. 1003, 1006 (2010); David W. Carroll, A Little Essay in Partial Defense of the Contract-Market Differential As A Remedy for Buyers, 57 S. Cal. L. Rev. 667, 680-81 (1984).

9 Terry Malloy (aka Marlon Brando), On the Waterfront.

10 Larsen v. Walton Plywood Co., 65 Wash. 2d 1, 15, 390 P.2d 677, 686 adhered to sub nom. Larsen v. Walton Plywood Co., 65 Wash. 2d 1, 396 P.2d 879 (1964).

domed stadium that wasn't, Kenford still had the funds it would have invested in the hotels, golf course, and other projects. It could have invested the funds in other projects and there was no reason to believe that one set of projects was better or worse than the other.[11] This argument will be developed (and qualified) in Section I.

In the second category of cases, the owner of some intellectual property licenses it to a party who fails to exploit it. Suppose that part of the licensor's compensation was contingent, perhaps in the form of a royalty, and the licensor proved that the licensee breached by failing to exploit the property. The damages would be the royalties on the projected sales. Unlike in the first case, the licensor *has already made its investment*. Unless the contract has a liquidated damages clause or some other restriction on recovery (and contracts often do) the damages should be recoverable. As we shall see below, the New York per se rule against awarding lost profits for new businesses has conflated these cases with the first category resulting in some very convoluted reasoning. These cases, and their interplay with the other categories, will be analyzed in Section II.

Third, the promisor could have delayed performance or provided a defective product. Perhaps a construction project comes on line a few months late, a delivery arrives late, or the seller breaches a warranty. In these cases, performance eventually does take place. This category puts us squarely in the *Hadley v. Baxendale* world. Depending on the facts, one could make a strong case for outcomes ranging from no compensation to expectation damages.[12] This class of case will be analyzed in Section III.

Finally, I will consider the buyer's anticipatory repudiation of a long-term contract in which the seller has partially performed. The seller's ability to recover lost profits should, I will argue, depend on neither the newness of the business nor the reasonable certainty of the damage calculations. If there had been no change in market conditions there should be no recovery for lost profits. If market conditions had changed, lost profits should be recoverable. However, the recovery should be for direct, not consequential, damages. In Section IV, I will elaborate on why that makes a difference.

The "new business rule," therefore, should not be thought of as a single rule. By stuffing these different types of problems into a single box, courts and commentators undermined the rationale for the rule, even for those cases in which the rule made sense. The courts have deployed some devices on an ad hoc basis—notably "reasonable

[11] The two principals were highly leveraged so that their future spending would most likely have been funded by debt. The principals did own, or have options on, adjacent land. As I note in the next section, owning a complementary asset can make the investment more valuable than alternatives. However, the value of the new structures would have been reflected in the land value. The experts also claimed the potential appreciation in value of that land as a separate source of damages; including both would have been double counting. In the end, the Court of Appeals denied recovery for the lost land value appreciation as well; see *Kenford Co., Inc. v. Erie Cnty.,* 73 N.Y. 2d 312 (1989).

12 Judge Posner recognized this in his decision in Mindgames v. Western Publishing Co. 218 F.3d 652, 655. "The rule of *Hadley v. Baxendale,* 9 Ex. 341, 156 Eng. Rep. 145 (1854), often prevents the victim of a breach of contract from obtaining lost profits, but that rule is not invoked here. Neither the 'new business' rule nor the rule of *Hadley v. Baxendale* stands for the *general* proposition that lost profits are never a recoverable item of damages in a tort or breach of contract case."

certainty" determining whether the claimant's business is truly new—as wild cards to justify awarding damages to some plaintiffs but not others.

I. Opportunity Cost

Suppose that when the promisor breached a contract the promisee had done nothing at all in reliance. The promisee then claims that, but for the breach, it would have done something that would have been profitable and it has lost the profits from that activity. Suppose further that the promisee has no complementary assets that would have made this activity uniquely valuable. At the time of the breach it had not yet invested any money, but it was going to do so and, it claims, it would have been successful. It would then bring in expert witnesses who would testify as to how much would have been earned. These foregone earnings for these "stillborn enterprises" would be the "lost profits."[13]

The relevant question should not be whether the project would make money but whether it would make more money than the next best alternative. The investment might have turned out to be wildly successful or a dismal failure, but there is no a priori reason to believe that the expected rate of return would exceed the going market rate. After the breach the promisee still has the money that it would otherwise have invested in the project and it would be free to do anything it wants with those funds. The expected value of the specific project would be the same as the market rate, so the promisee's loss would be zero. I need not qualify this by comparing the riskiness of the particular project with the market rate since the opportunity cost of the funds takes the relative riskiness into account. For this class of cases the per se rule—no compensation—makes sense.

By not recognizing this simple point, the courts have allowed plaintiffs, like Kenford, to introduce evidence of losses that would substantially overcompensate them. Since the damage claims are usually treated as questions of fact, not law, the courts, with no coherent theory to deal with the claims, allow many of them to succeed, or at least to get to the jury. Even if the claims would ultimately be denied they could have significant effects. They raise the costs of litigation if expert testimony can be given to prove the alleged loss.[14] In the Kenford litigation hundreds of thousands of dollars (millions today, adjusted for inflation) and months of juror's time were wasted by expert witness

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13 The term is from Roger I. Abrams Donald Welsch Bruce Jonas, "Stillborn Enterprises: Calculating Expectation Damages Using Forensic Economics," 57 Ohio St. L.J. 809.

14 In an antitrust case Judge Posner disparaged the damage claims by the expert witness:

> The projection of lost profits that Olympia's expert witness made to the jury bore no relation to Olympia's internal business planning or to economic reality. . . . It is thus one more illustration of the old problem of expert witnesses who are "often the mere paid advocates or partisans of those who employ and pay them, as much so as the attorneys who conduct the suit. There is hardly anything, not palpably absurd on its face, that cannot now be proved by some so-called 'experts.' " . . . The expert in this case dazzled the jury with "an array of figures conveying a delusive impression of exactness,"—delusive because the figures had no relation to reality. (Olympia Equipment Leasing Co. v. Western Union Telegraph Co., 797 F.2d 370 (1986)).

Of course, not all expert witnesses behave this way; I am occasionally in that role and I hope that I am objective. Nonetheless, as we shall see in some of the cases discussed below, the experts do often engage in stretching the truth.

testimony. In addition, uncertainty over whether a court (trial or appeal) would accept the evidence would affect the settlement value.[15] In the remainder of this subsection, I will provide some examples from the case law of attempts by plaintiffs to assert lost profit claims for stillborn projects.

1. **Fera v. Village Plaza**[16]

The case appears in a number of casebooks and is oft-cited by other courts as an illustration of a modern court recognizing the lost profits of a business that had not yet begun to operate.[17] Fera intended to open a "book and bottle" shop[18] and executed a ten-year lease. For reasons unimportant, the landlord leased the property to someone else; there was no indication that the lease terms were any different—the court gave no indication that there might have been a change in the market value of the leasehold. Fera sued, arguing that had it been able to lease the property it would have made profits over the ten years. Fera, testifying as an expert on his own behalf, claimed $270,000 in lost profits. The landlord's expert testified that Fera would probably have lost money. The jury awarded Fera $200,000 in lost profits.

The Michigan Supreme Court upheld the jury verdict, asserting that the claim for lost profits by a new business is no different from the general rules regarding claims for lost profits generally:

> These cases and others since should not be read as stating a rule of law which prevents every new business from recovering anticipated lost profits for breach of contract. The rule is *merely an application of the doctrine* that '(i)n order to be entitled to a verdict, or a judgment, for damages for breach of contract, the plaintiff must lay a basis for a reasonable estimate of the extent of his harm, measured in money'. 5 Corbin on Contracts, s 1020, p. 124. The issue becomes one of sufficiency of proof. 'The jury should not (be) allowed to speculate or guess upon this question of the amount of loss of profits.'[19]

Thus framed, Fera's recovery hinged on the sufficiency of proof. The court used the fact that both parties spent a considerable amount of effort on proving damages as evidence that the damage measure would not be speculative. It quoted the trial judge:

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15 There is some behavioral evidence that introducing a high number, even a nonsense one, could have an impact on the fact-finder's decision, biasing it upward; for a good non-technical introduction to the "anchoring" effect, see Daniel Kahneman, Thinking Fast and Slow, ch. 11.
16 242 N.W.2d 372, 92 A.L.R.3d 1278.
17 See E. Allan Farnsworth et al, Contracts: Cases and Materials (8th ed.); John P. Dawson et al, Contracts: Cases and Comment (10th ed.); Daniel Markovits, Contract Law and Legal Methods; Gerald E. Berendt, et al, Contract Law and Practice (2d ed.); George W. Kuney and Robert M. Lloyd, Contracts: Transactions and Litigation (3rd ed.).
18 A book store with a liquor license. Probably not a great business idea.
19 At 373-374. (emphasis added)

> The loss of profits are often speculative and conjectural on the part of witnesses. When this is true, the Court should deny loss of profits because of the speculative nature of the testimony and the proofs. However, the law is also clear that where lost profits are shown, and there is ample proof on this point, they should not be denied merely because they are hard to prove. In this case, both parties presented testimony on this issue for days. This testimony took the lost profits issue out of the category of speculation and conjecture. The jury was given an instruction on loss of profits and what the proofs must show, and the nature of the proofs, and if they found them to be speculative they could not award damages therefor. The jury, having found damages to exist, and awarded the same in this case in accord with the proper instructions, the Court cannot, now, overrule the jury's finding.[20]

This is a funny argument. Because the parties tried to prove lost profits, the results were not speculative, and, therefore, the jury should be allowed to find lost profit damages. I don't believe any other court has made that argument, although many of them do cite *Fera* when justifying their conclusion that lost profits should be awarded.[21]

These jurors only had to sit through days of nonsense as opposed to the poor jurors in *Kenford* who had to endure months. Still, the only purpose of the "factual" inquiry was to mislead the jury. The estimates were not speculative; they were silly. Fera's claim was that he had taken a ten-year lease on a space in a shopping center for a "book and bottle" shop and because the shopping center leased the space to someone else, he had lost profits for the ten-year period. After the breach, he still had the concept, his cash, and other potential spaces to lease. Awarding any lost profit damages assumes that spending money on this shop in this location was better than any alternative he might have had, which makes no sense.[22]

My colleague, Robert Scott, upon reading this, suggested that I was just cherry picking "lousy lawyering" cases; the defendant's lawyer should have been guilty of malpractice. Unfortunately, it was the law, not the lawyering, that was the problem. As I note below, *Fera* is cited with approval in a number of cases; none question the outcome. It shows up in the treatises, without any questioning of the reasoning. I searched Westlaw for scholarly articles citing *Fera*. There were 33, and, again, none questioned the reasoning. The Farnsworth treatise includes it in a string citation, without comment, for the proposition that the "rule of law which prevents *every* new business from recovering anticipated lost profits" is rejected.[23] The Corbin treatise trumpeted the fact that *Fera* had

20 At 646-647.

21 Citations.

22 For another instance in which the court allowed recovery of lost profits for a lease that wasn't, see S. Jon Kreedman & Co. v. Meyers Bros. Parking-Western Corp., 58 Cal.App.3d 173 (1976).

23 Citation.

cited the previous edition;[24] it was silent on the merits. Without a framework for analysis, the decision has passed without criticism into the body of law.

2. Super Valu Stores, Inc. v. Peterson[25]

Super Valu also concerned the breach of a promise to award a lease, but it adds one twist—the disappointed promisee gave up a well-paying job in anticipation of getting a fifteen-year lease. Peterson had been an employee for 24 years, had been president of a division of Super Valu, and earned $100,000 per year (in Alabama in 1984). Since Super Valu would not allow an employee to own a retail outlet he had to retire. The deal fell through and Peterson succeeded in his claim that Super Valu had breached.

The trial court awarded damages for lost profits and the award was upheld on appeal. Rejecting Super Valu's argument that Alabama had a per se rule against awarding lost profits for an unestablished business, the court adopted the "reasonable certainty" standard and concluded that Peterson's evidence was sufficient to meet that standard.[26] What was that evidence? The court began with what seemed a promising statement:

> The fundamental basis for Peterson's evidence as to damages was *Super Valu's own projections of profits*, produced in its normal course of business long before this dispute arose. These projections were the product of an intense, exhaustive process involving many different Super Valu personnel. Super Valu's projections resulted from the application of a scientific methodology that for many years had accurately predicted the future performance of stores associated with Super Valu.[27]

The court emphasized the fact that the lost profits estimate was "based on pre-dispute projections prepared by the *defendant*.[28] The expert then took Super Valu's projected profit and loss statements for the first three years ($124,684, $619,267 and $750,198) as the basis for projections for the remaining twelve years of the lease. Unfortunately, there is a gap in the court's exposition, so we do not know how the expert went from these numbers to his conclusion. He concluded that over the fifteen years the lost profits would be over $19 million.[29] There must have been an assumption that the

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24 "The court cited the prior edition of this section to show that a plaintiff must lay a basis for a reasonable estimate of the extent of his harm, but held that lost profits could be recovered in a new business if they could be proven with reasonable certainty, just as for any other business. The court cited the prior edition of § 1023 (now § 15.20) to show that it is just easier to establish a reasonable certainty of lost profits in the case of an established business. The court cited the prior edition of § 1022 (now § 15.19) to show that mathematical precision is not required, where by the nature of the circumstances, precision cannot be attained, and particularly this is true where the defendant's breach caused the imprecision." ARTHUR L. CORBIN, CORBIN ON CONTRACTS §56.16 n.19 (no. 16S1, 2016).

25 506 So.2d 317 (1987).

26 It cited *Fera*, amongst others in support of this position.

27 At 330. (emphasis in original)

28 At 331 (emphasis in original)

29 At 332. "The sophistication of these projections of lost profits, we believe, equals or exceeds that of the projection methodology approved by this Court [in another case]."

growth in profits substantially exceeded the discount rate (assuming that the expert even bothered to apply any discount rate). Having certified the $19 million estimate as credible, the court then approved the jury verdict of $5 million. There was no hint as to why $19 million had shrunk to $5 million.

Of course, there was no basis for the $5 million either. There is no reason to believe that a lease to operate a small supermarket would be a better investment opportunity than any other. The expert's estimate did not presume that Peterson brought something exceptional to the project—the estimate was apparently based on Super Valu's projections with a generic operator. Peterson's "lost profits" should have been zero. That does not mean that he should not have been compensated at all. His compensation should have been based on his reliance. He gave up a $100,000 per year job and, according to the court, "Peterson expended time, energy, and money in undertaking the necessary actions to properly equip, staff, and outfit the County Market."[30] Compensation for at least some of Peterson's reliance would be plausible.[31] How much is unclear, but it would certainly have been a lot less than the $5 million awarded by the jury.[32]

4. **Beverly Hills Concepts, Inc. v. Schatz and Schatz, Ribicoff and Kotkin**[33]

What makes this case of particular interest is the dissent by a very knowledgeable contracts scholar, Ellen Peters. That she was fundamentally wrong adds to its significance. Technically, the case was for lawyers' malpractice, not breach of contract, but that can be ignored. The malpractice, the court found, resulted in the failure of a new firm, Beverly Hills Concepts (BHC). BHC's primary business would have been the sale of franchises for fitness clubs. Lost profits for a new business were, the court held, recoverable, subject to the reasonable certainty standard. "The plaintiff argues that the present value of a stream of expected future profits is an appropriate way to value a business and that it is therefore an appropriate measure of damages. We conclude that it is proper to award damages for the destruction of an unestablished enterprise and that lost profits may constitute an appropriate measure of damages for the destruction of such an enterprise."[34] However, the majority concluded, the plaintiff failed to prove the damages with

30 At 335.

31 The decision does not indicate whether he was employed in the interim (or whether he should have been employed); if so, any recovery would have to be reduced to take that into account.

32 For another case in which a potential lessee that had made some expenditures in reliance, was improperly awarded lost profits and see Chung v. Kaonohi Center Co., 62 Haw. 594, 597 (1980). ("In anticipation of operating the Chinese kitchen, plaintiffs arranged for financing, ordered equipment and furnishings, hired chefs and workers, advertised in the yellow pages of the telephone book for the to-be-built kitchen, and incurred other expenses.") In *Energy Capital Corp. v. U.S.*, 302 F.3d 1314 (2002), HUD breached a contract with a firm that was supposed to make up to $200 million worth of loans to owners of HUD properties to install energy efficient heating systems. Rejecting the per se rule, the court found damages of over $10 million. The court remanded because the trial court had used a risk-free discount rate, holding that it should have used a risk-adjusted discount rate instead. The opportunity cost of this hypothetical loan portfolio would be an alternative loan portfolio with an equivalent risk profile. Lost profits should, therefore, have been zero. Energy Capital did incur costs in reliance and could have been compensated for those.

33 247 Conn. 48 (1998)

34 At 63.

reasonable certainty. The majority, I should note, cited both *Super Valu* and *Fera* as examples of the successful use of the reasonable certainty standard.

The plaintiff's expert witness projected sales of franchises (and resultant fees) over a twelve-year period and concluded that the plaintiff had suffered a loss of $15.9 million. The majority concluded that the plaintiff had not produced sufficient evidence that it would become profitable. It also asserted that "the trial court abused its discretion in failing to limit the recovery of lost profits to a reasonable time period."[35]

The opinion included sufficient information to buttress the conclusion that BHC had suffered no loss (except for costs incurred in reliance). BHC first contacted the law firm in late October 1987.[36]

> The plaintiff's financial statement, prepared by Coopers, revealed that it was insolvent as of November 30, 1987, and its situation had deteriorated even further by January, 1988. It is particularly telling that the plaintiff had attempted to obtain financing from a number of banks as well as from the Small Business Administration and that it had been rejected by all of these institutions. According to Charles Remington, one of the plaintiff's officers, this financing was necessary to the proposed franchising operation. Additionally, the model franchise opened by the plaintiff in East Hartford quickly failed. Finally, despite several months of trying, the plaintiff never sold a single franchise. Moreover, its own damages expert, Ferreira, characterized the plaintiff as a poor credit risk. These facts serve to indicate that the plaintiff was not financially stable and that its prospects for earning profits in the future were, at best, questionable.[37]

Why would a firm be a poor credit risk unable to find a lender if it had available to it a project worth $15.9 million? Because no one in their right mind believed it. There was no basis for claiming that the project would exceed the opportunity cost; given the market evidence, it was more likely that the expected present value was negative. Of course, even expected negative present value projects can succeed. In her dissent Judge Peters invoked Apple to illustrate how startups with sketchy finances sometimes succeed:

> [T]he majority opinion starts out with an accurate description of the rocky state of the plaintiff's finances when it came to the defendants for legal representation. To my mind, it is not surprising that start-up companies, in the first years of their operation, would have a difficult time making ends meet. It is not far-fetched to assume that Steve Jobs, when he started

35 At 77.The court made this odd argument: "We agree with the plaintiff that there is nothing inherently improper about allowing damages for lost profits over a twelve year period. What is improper, however, is to award damages over such a long time span when there is no evidence that the plaintiff would have survived for twelve years, let alone that it would have remained profitable for that length of time." (At 76) The court did not indicate how one could possibly demonstrate that a new firm could survive for a particular length of time.

36 At 52.

37 At 60-61.

> Apple Computers, might have had difficulty in obtaining financing for so untested an idea as a personal computer. At that time, how could he have projected future profits with analytic precision?[38]

That simply reinforces the notion that ex post some investments are great successes (and some are not). For projects that were aborted, we have only the ex ante information and, unless there is a credible reason to believe otherwise, the expected value of the loss would be zero.

Judge Peters had a legitimate concern. The wrongdoer should not be allowed to get away with its bad behavior without any liability. "We condone professional misconduct if we discharge these defendants of all liability to a plaintiff that has tried, as best it could, to quantify the loss that the defendants' misconduct has caused it to suffer."[39] The difficulty was that the doctrine had boxed the court in. It appeared to allow for only two choices: either let experts dispute over "lost profits" or hold that the measures were not reasonably certain and, therefore, damages would be zero. There was a third way. By recognizing that the lost profit measure was spurious, we can focus instead on what the plaintiff actually lost, namely, expenditures in reliance upon the defendant's not engaging in malpractice.

Judge Peters quoted an earlier opinion that would have limited the reviewing court's discretion in reviewing a damage award: "The amount of a damage award is a matter peculiarly within the province of the trier of fact . . . . The size of the verdict alone does not determine whether it is excessive. The only practical test to apply to this verdict is whether the size of the verdict so shocks the sense of justice as to compel the conclusion that the [trier of fact] was influenced by partiality, prejudice, mistake or corruption."[40] If reviewing courts were to so constrain themselves, the likelihood is high that juries would overcompensate plaintiffs.

5. Franchise Cases

In his treatise on the Recovery of Lost Profits, Robert Dunn argued in favor of awarding lost profit damages to an aspiring franchisee:

> The supposed rule that lost profits damages of an unestablished business are not recoverable would seem to be least justifiable when the business to be established is a location for a national franchise. Each store is cast from the same mold. The locations are rigidly controlled by the national franchisor. Projections are available based on extensive experience in other stores from which sales and profits can be derived with a high

38 At 87.
39 At 95. She criticized the majority: "As a matter of principle, the majority opinion subscribes to the position advanced by the defendants that, no matter how egregious and protracted their professional misconduct, it is more appropriate for this court to take an unnecessarily rigorous view of proof of damages than to provide relief for the plaintiff." (At 80)
40 At 89. Quoting *Grayson v. Wofsey, Rosen, Kweskin & Kuriansky*, 231 Conn. at 183–84, 646 A.2d 195.(Internal quotation marks omitted.)

> degree of certainty. These projections are the basis for the franchisor's selection of the new location and the franchisee's investment in it. If the figures are good enough for the parties to invest their money, it would seem that they should be good enough for a court.
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> * * *
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> If plaintiff can demonstrate that its operations at the new location would be comparable to those at its existing location, then adequate probative evidence may be introduced to demonstrate damages with the requisite reasonable certainty.[41]

That sounds plausible, and many courts have bought it. But the relevant question should not be whether the franchisee would do as well in this location as anywhere else. Rather it should be whether there is reason to believe that it would do better, and the answer to that should be negative. Indeed, the very notion of basing the compensation on the earnings of comparable franchises presumes that the plaintiff would not do better. Nor should the plaintiff have expected to do better than the opportunity cost of his capital or his time. That does not mean that the plaintiff should not be compensated. The basis for the compensation would not, however, be the lost profits as defined by Dunn.

As his illustration, Dunn chose a case that did not pit a franchisor against a disappointed franchisee. In *Smith Development Corp. v. Bilow Enterprises, Inc.,*[42] McDonald's was the plaintiff. The defendant had, it was alleged, tortuously interfered with MacDonald's contractual relations. McDonald's had entered into a conditional lease of a parcel of property to add a franchised outlet. A competitor attempted to prevent the entry of the competing restaurant. At trial the court held that there had been interference with McDonald's contract with the landowner. While the landowner did receive compensation, McDonald's was denied. The Rhode Island Supreme Court remanded for errors in the charge to the jury, but it also considered whether McDonald's would have had a valid claim for damages. It first noted McDonald's history of success:

> McDonald's marketing research manager had testified. He described the uniformity of procedures utilized at all McDonald's restaurants, its training and national advertising programs, and the efforts made to maintain standards and quality. This witness informed the judge and jury that while in 1962 there were 800 units in operation, this number had increased at trial time to 1,200. He also reported an amazing record of successes—not one restaurant has failed. The trial justice ordered this testimony be stricken.[43]

The court then concluded that compensation would be appropriate:

> Having in mind America's acceptance of McDonald's method of

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41 §§4.7-4.8. At 398-400.
42 112 R.I. 203 (1973).
43 At 213.

> merchandising, we believe the requisite evidentiary basis had been established so that the jury could with 'reasonable certainty' make a determination of the profit loss sustained as the result of McDonald's lengthy preoccupation with litigation, rather than the distribution of hamburgers, at its Middletown location.[44]

The court did not indicate whether McDonald's ever opened the outlet. That would not matter for lost profits damages calculated a la Dunn. But it would make a difference if we recognize that Dunn's standard (and implicitly the court's) is the wrong one. If the outlet did open, then a plausible measure of the harm caused by the delay would be based on the actual earnings; damages for delay are discussed in more detail in Section III. If the outlet did not open, then damages should be based on McDonald's reliance—for example, legal costs incurred because of the defendant's wrongful behavior. Neither of these remedies bears any relationship to the "lost profits."

6. Brundige v. Sherwin-Williams Co.[45]

I am not arguing that the lost profit remedy should never be used. *Brundige* presents a situation in which the lost profit remedy would probably have been appropriate. Brundige, who had a non-compete agreement, had been employed by Sherwin-Williams for ten years at a particular location. Sherwin-Williams relocated, whereupon Brundige quit and opened the business at the old location. The firm obtained a TRO to prevent his operating the store; ultimately, the TRO was dissolved and Brundige sued for the losses incurred by not operating during the period the TRO was in force. Brundige brought many specific assets to the project, as the court noted:

> In the case before us . . . the appellant had substantial experience in the retail paint sales business; he undoubtedly had a reputation in the community as a man of experience; his place of business was the same building where a business like his had been located for some time; he did open his business almost immediately after the injunction was dissolved; and he made a profit his first month and every month thereafter for the first six months he was in business.[46]

One could argue that it is precisely these characteristics that would have led Sherwin-Williams to want to enforce the non-compete covenant in the first place. The court does not say whether there would have been competition between the old and new locations. Apparently, it concluded that any such competition did not justify enforcement of the covenant. Having so concluded it then had to determine Brundige's damages. Brundige was sitting with a bunch of assets that were valuable only at this location and for this purpose. The loss should be the return on these specific assets during the period the TRO was in effect, and the best evidence of that would be the actual earnings after the TRO was lifted. If Brundige had managed to earn anything during the interim period there

44 At 214.
45 551 S.W.2d 268 (1977)
46 At 271.

could be an offset, but the basic point is that the expected returns would be positive, taking into account the specific assets Brundige brought to the table.

Brundige illustrates an important qualification to the argument. If the plaintiff brings specific assets to the project, the expected returns would be positive. These could be assets that were acquired in reliance on this particular transaction, or they could simply be assets that the plaintiff happened to have, assets that would be of use on this particular project, but could not be easily deployed to another.

II. Royalties, Etc.

The recent treatment of the new business rule in New York revolves around the *Kenford* litigation. In the Appellate Court's first shot, it was confronted with two precedents. In 1918 the New York Court of Appeals took what was then the majority position, holding in *Cramer v. Grand Rapids Show Case Co.*[47] that a new business could not recover for lost profits. Over half a century later, in *Perma Research & Dev. Co. v. Singer Co.*,[48] the Second Circuit, interpreting a contract under New York law, refined the test: "Although lost profits in a new venture are not ordinarily recoverable (Cramer v. Grand Rapids Show Case Co., 223 N.Y. 63, 119 N.E. 227 (1918)), they may be awarded where: the loss of prospective profits are the direct and proximate result of the breach; profits were contemplated by the parties when they entered the contract; and there is a rational basis on which to calculate the lost profits."[49] The *Kenford* Appellate Court interpreted *Perma Research* as qualifying *Cramer*: "What the court did in *Perma Research,* in essence, was to add a third requirement for new businesses by requiring them to establish some rational basis on which to calculate the lost profits. By so holding, the court converted the *Cramer* rule of nonrecoverability into a rule of evidence."[50]

The "rational basis" test was soundly rejected by the Court of Appeals: "It is our view that the record in this case demonstrates the efficacy of the principles set forth by this court in [*Cramer*], principles to which we continue to adhere. In so doing, we specifically reject the 'rational basis' test enunciated in [*Perma Research*] and adopted by the Appellate Division."[51] And so, it would appear, New York continues to honor the per se rule. The Court of Appeals opinion was unanimous (indeed per curiam).

Less than a decade later the same court was confronted with another new business claim in *Ashland Management Inc. v. Janien*,[52] and again produced a unanimous opinion. The court invoked its *Kenford* decision, but instead of the per se rule, it characterized *Kenford* as holding that for "a new business seeking to recover loss of future profits, a *stricter standard* is imposed because there is no experience from which lost profits may

47 223 N.Y. 63 (1918).

48 402 F. Supp. 881, 898 (S.D.N.Y. 1975) aff'd sub nom. Perma Research & Dev. v. Singer Co., 542 F.2d 111 (2d Cir. 1976)

49 At ___.

50 At 140.

51 Kenford Co., Inc. v. Erie County, 67 N.Y.2d 257, 263; 493 N.E.2d 234, 502 N.Y.S.2d 131.

52 82 N.Y.2d 395 (1993).

be estimated with *reasonable certainty* and other methods of evaluation may be too speculative. . . . Whether the claim involves an established business or a new business, however, the test remains the same, i.e., whether future profits can be calculated with reasonable certainty."[53]

How can we reconcile the court's notion that, on the one hand, it is applying the *Kenford* per se rule (no lost profits for an unestablished business) while finding that the plaintiff only had to satisfy the reasonable certainty standard (and did so)? Logically, I don't think we can. If, however, we recognize that the new business rule lumped together very different types of claims, the outcome (if not the rationale) makes more sense. In the cases in Section I, the claim was for consequential damages—because you breached, I did not make an investment on which I would have made a lot of money. In *Perma Research* and *Ashland* and similar cases, the claim is for direct damages—I sold you an asset for a future stream of payments and you have not paid. The expected value in the former case (subject to the qualifications noted above) was zero; in the latter case, it was positive.

1. *Perma Research*

Perma Research assigned its patents for an automotive anti-skid device to Singer and was to receive royalty payments. Since the devices had not yet been perfected the agreement required continued collaboration. Singer decided not to proceed and the court held that by failing to use its best efforts Singer had breached the agreement. The trial judge found damages of about $7 million after prejudgment interest was included. The Court of Appeals approved, but it provided only generic language in support: "In simple terms, the measure of the damage is the amount necessary to put the injured party in exact position as he would have been if the contract had not been breached. If Singer had put its resources and ingenuity to the anti-skid device, it probably would have been successful in the marketing of the same. Nor are the damages too speculative to assess. At the outset, since Singer produced the damage, it must bear the uncertainty of proof."[54] The decision does not specify how the court arrived at the damage estimate, although it appears that it simply projected sales (presuming that the product would have been perfected), multiplied by the royalty rate, and, perhaps, found the present discounted value of the projected stream of royalty payments.

If we accept the court's conclusion on liability, then it is clear that Perma Research did suffer a loss. It had already incurred the costs of getting the product to the point of being nearly marketable. It still had some financial obligations, but these were minor. We could look at either the expected return on the investment or the costs it had incurred as a starting point in calculating damages. There is no reason to believe that a remedy based on either of these would yield the same result as the "lost profits," the projected stream of royalty payments. In the absence of any contract language to the contrary, Perma Research should have received compensation.

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53 At 404.
54 At 116.

But the contract was not silent as the dissent observed: “The contract provided that defendant ‘in its absolute discretion shall determine the method of manufacturing, exploiting and marketing the Product’ but gave plaintiff the right to reacquire its device if defendant failed to spend at least one hundred thousand dollars for ‘marketing, promoting and advertising’ in any year beginning with 1966.”[55] Moreover, Singer was obligated to pay roughly $500,000 even if it produced no units.[56] My concern is not whether the contract language supplanted the default damage rule. The point I want to emphasize is that when, as in this case, the bulk of the plaintiff’s costs have already been incurred, the expected value of the claim is positive, not zero as in the previous Section.

2. *Ashland Management Inc. v. Janien*

Janien was an employee of an investment advisory company. He developed a stock selection strategy, Eta, for the firm. There was some dispute as to whether the contract that he and the firm had been negotiating was binding and the court concluded that it was. That contract said that “if ‘for any reason’ Janien left Ashland’s employment he was entitled to ‘a royalty of the higher of $50,000 or 15% of gross revenues per annum of any and all existing or future accounts’ using the Eta model or ‘any derivative thereof’. The gross revenue was the 1% fee charged customers by Ashland for the funds under management.”[57] After he was fired, Ashland sought a permanent injunction to bar Janien from using Eta. Janien counterclaimed for damages, his lost profits under the contract.

After reaffirming the *Kenford* per se rule, the court then misapplied it, finding that Janien could recover lost profits, notwithstanding that this was a new business. The court concluded that “it is manifest from an examination of [the contract] that the parties contemplated that Janien could recover damages if the agreement was not completed and that those damages could include lost profits from accounts using Eta.”[58]

> [T]he issue of future earnings was not only contemplated but also fully debated and analyzed by sophisticated business professionals at the time of these extended contract negotiations, projections of the increments to be anticipated over the years were calculated and provisions made for Janien’s share of the anticipated profits. Inasmuch as Janien was entitled to damages based upon the revenues derived from “any and all existing or future” accounts, plaintiff must have foreseen that if it breached the contract defendant would be entitled to lost profits.[59]

The court then concluded that Janien had met the burden of proving lost profits with reasonable certainty. But, like *Perma Research*, the issue should not have been certainty. Janien had already developed Eta; the investment had already been sunk. His damage claim was only for the future stream of earnings from his investment. Had the

55 At 120.
56 At 120.
57 At 400-401.
58 At 404-05.
59 At 405.

court framed the question in this way it could have avoided the intellectual contortions it engaged in by attempting to conform the result to the *Kenford* per se rule.

3. *MindGames, Inc. v. Western Pub. Co., Inc.* [60]

MindGames is another case involving royalty payments for a preexisting item. The developer of a game, Clever Endeavor, licensed it to Western, a major marketer of games. Western would pay a 15% royalty for around four years. In addition, Western had an annual option to renew for $300,000 per year. In the first year the royalty payment was $600,000 but afterwards sales fell precipitously. Western, according to MindGames, breached the agreement by its inadequate promotional effort.[61] The opinion is unclear as to the nature of the plaintiff's damage theory. It appears to be that but for the alleged inadequate performance of Western, a lot more games would have been sold and (I think but the opinion is really unclear about this) the agreement would have been renewed so that even more games could have been sold in the future.

The trial judge, invoking a 75-year-old Arkansas decision,[62] held that the new business rule barred recovery of lost profits and granted summary judgment to Western. On appeal, Judge Posner concluded that, given the chance, Arkansas would overrule that precedent and would abandon the new business rule.[63] In its stead he would use "the serviceable and familiar standard of excessive speculativeness."[64] He rejected the new business *rule* and replaced it with a *standard* that would apply to new and existing businesses alike.

> Just as a start-up company should not be permitted to obtain pie-in-the-sky damages upon allegations that it was snuffed out before it could begin to operate (unlike the ice factory in *Marvell,* which did begin production, albeit a little later than planned), … capitalizing fantasized earnings into a huge present value sought as damages, so a novice writer should not be permitted to obtain damages from his publisher on the premise that but for the latter's laxity he would have had a bestseller, when only a tiny fraction of new books achieve that success. Damages must be proved, and not just dreamed.[65]

60 218 F.3d 652 C.A.7 (Wis.),2000.
61 According to the dissent: "MindGames' complaint alleged that a substantial number of games produced by Western failed to meet quality standards; Western failed to promote and make reasonable efforts to sell; and its efforts did not meet standards under the agreement or those recognized in the industry. It is MindGames' position that these failures caused loss of sales." (At 660)
62 *Marvell Light & Ice Co. v. General Electric Co.,* 162 Ark. 467, 259 S.W. 741 (1924).
63 In rejecting the new business rule, Judge Posner claimed that it could lead to an absurd result: "Suppose a first-time author sued a publisher for an accounting, and the only issue was how many copies the publisher had sold. Under the 'new business' rule as construed by Western, the author could not recover his lost royalties even though there was no uncertainty about what he had lost." (At 657) However, there is no reason to believe that the rule would prevent recovery of past due payments.
64 At 658.
65 At 658.

The plaintiff had claimed future royalties of $40 million, which would have required sales of about 10 million games.[66] In rejecting the claim, Judge Posner emphasized the plaintiff's lack of a track record. "He could not point to other games that he had invented and that had sold well."[67] Because "[i]t pointed to no evidence from which lost royalties could be calculated to even a rough approximation . . . [he found] its silence eloquent and Western's argument compelling, and so the judgment in favor of Western is affirmed."[68] Indeed, he asserted, "[w]hen the breach occurred, MindGames should have terminated the contract and sought distribution by other means . . . . The fact that it did not do so—that so far as appears it has made no effort to market 'Clever Endeavor' since the market for the game collapsed in 1991—is telling evidence of a lack of commercial promise unrelated to Western's conduct."[69] Since the contract gave Western a renewal option, and since it did not renew, MindGames' claim would have been based on future sales by an unidentified third party. The fact that it found no such third party does suggest that the future royalty stream would have not amounted to much.

But probably more than zero. MindGames might have been able to argue that Western had destroyed the brand image by producing a poor product; had it produced a quality product, the future sales would have been greater. Yes, projecting those sales would have been speculative, but it could be done; to reach that step MindGames would first have to show that the quality of the games was so substandard that industry experts would testify that the reputation could not be salvaged.[70] If it surmounted that hurdle, then the parties could put forth competing estimates of future sales and royalties. To be sure, some of the estimates would be absurd. If the parties did not constrain the damages ex ante, then a judge could impose some logic on the process ex post. Both the "new business" and the "reasonable certainty" approach give the judge one blunt weapon to rein in the experts—the threat of zero.

This was a classic case of a plaintiff winning the battle but losing the war. The court rejected the per se new business defense, but then held that because damages were too speculative, they would, therefore, be zero. Compounding the plaintiff's pain, Judge Posner noted: "Although the victim of a breach of contract is entitled to nominal damages, . . . MindGames does not seek them . . . . By not seeking nominal damages, incidentally, MindGames may have lost a chance to obtain significant attorneys' fees, to which Arkansas law entitles a prevailing party in a breach of contract case."[71] Had the case been remanded, as the dissent proposed, MindGames might at least have recovered its attorney fees.

In the well-known case of *Freund v. Washington Square Press, Inc*.[72] the court did award only nominal damages (six cents) to an author when a publisher chose not to

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66 At 654. The decision does not indicate the basis for this projection.
67 At 659.
68 At 659.
69 At 659.
70 I presume that the contract was silent on Western's meeting any quality standard and the consequences, if any, of a failure to do so.
71 At 654.
72 41 A.D.2d 371, 343 N.Y.S.2d 401 (1973) *modified*, 34 N.Y.2d 379, 314 N.E.2d 419 (1974).

publish his book. While not explicitly invoking the new business rule, the New York Court of Appeals held: "His expectancy interest in the royalties—the profit he stood to gain from sale of the published book—while theoretically compensable, was speculative. . . . . In these circumstances, his claim for royalties falls for uncertainty."[73] There are two problems with this. First, Freund did not attempt to prove lost royalties, nor did he even ask for them. The denial was pure dictum.[74] Second, the contract gave Freund a sizable advance against royalties, so he was implicitly compensated for the royalties on about 2,000 books.[75] Recovery could be denied, not because the claimant had a new business, but because it could not plausibly show that the future royalties would have exceeded the advance. Again, as in *Perma Research*, I do not claim that the ex ante payment does, or should, supplant the default rule. The essential point is that when the claim is for lost royalties, the expected loss would be positive.

III. Delay and Defect

In *MindGames*, Judge Posner noted: "The rule of *Hadley v. Baxendale,* often prevents the victim of a breach of contract from obtaining lost profits, but that rule is not invoked here. Neither the 'new business' rule nor the rule of *Hadley v. Baxendale* stands for the *general* proposition that lost profits are never a recoverable item of damages in a tort or breach of contract case."[76] In *Hadley*, of course, the breach caused a delay. Delay was also the issue in a number of new business cases. Interestingly, one of the earliest involved a contract entered into the year before the *Hadley* decision and it concerned the delayed construction of a flour mill (*Abbott v. Gatch*).[77]

1. ***Delay***

In *Abbott v. Gatch,* a contractor was found to have missed the contractual deadline for constructing a mill by about three months. The court rejected the owner's claim for lost profits:

> We cannot adopt any estimate of profits that Abbott might have realized from working the mill, because these were merely speculative, depending on the quantity of flour it might grind, the fluctuations of the market, as to prices of flour and grain, and the remote contingencies of his being able to procure wheat, labor and fuel, as well as the continuance of the mill in running order, free from accidents and loss of time from other causes.[78]

However, this did not mean that the owner would not receive any compensation. "Considering the uncertainties attending the milling business, and the difficulty of defining a safer guide for juries, we are of opinion, that a fair rent is the most reasonable

73 At 383.
74 It has misled many commentators; see, for example, Melvin Eisenberg, "Probability and Chance in Contract Law," 45 UCLA Law Review 1005, 1056-57 (1998).
75 For more detail on Freund, see Goldberg, Rethinking Contract Law and Contract Design, ch. 5.
76 At 655.
77 13 Md. 314 (1859).
78 At 333-34.

standard of the defendant's loss by reason of the plaintiff's failure to complete the mill."[79] The court gave no indication as to how a "fair rent" should be determined. There are a number of possible measures, none very good. One possibility, albeit unlikely, would be the expected revenues less the projected operating costs and cost of capital (which would amount to projected lost profits minus the cost of capital). That would entail the same problems the court recognized when rejecting "lost profits." A second possibility would be to apply a discount rate to construction costs (or the construction plus land acquisition costs). A third would find a comparable, although it is hard to imagine that there are any rented flour mills to compare with.

This was not just a nineteenth century anomaly. The rental value measure showed up again in *Evergreen Amusement Corp. v. Milstead*,[80] decided in 1955. A contractor was hired to clear a site for the construction of a drive-in theater. There was a delay, probably attributable to inaccuracies in the initial survey, which made the project much more difficult. There was a dispute over who should pay for the additional 8,000 cubic yards of dirt required to complete the project. Evergreen withheld payment for that work and the contractor sued. Evergreen then counterclaimed for lost profits as a result of the delay. The court denied the counterclaim, invoking the new business rule. Citing *Abbott v. Gatch*, the court concluded: "We think the [trial] court was right in basing the damages for delay in the completion of the site on fair rental value and the actual monetary losses incurred."[81] Again, the court was silent on how one might determine the fair market rental value of a drive-in theater.

Alternatively, the plaintiff could argue that since the mill or theater had been completed and was operable, a reasonable estimate of the harm could be based on the actual operations in a given period. That was the approach taken (unsuccessfully) by the claimant in *Cramer v. Grand Rapids Show Case Co*.[82] When it reasserted the per se rule in *Kenford*, the New York Court of Appeals harkened back to *Cramer*. That case involved the delayed delivery of furniture (price $1,376.75) necessary for opening a retail store. The trial judge instructed the jury: "If a man has arranged to start a business at a certain time, and is prevented from starting it by reason of wrong or breach of contract by somebody else, he is entitled to recover whatever profits he can show he would have made during that time for the breach of contract by the other party."[83] The plaintiff had relied on data on sales and costs after it finally opened in determining its lost profits, arguably for a comparable period of time. It claimed lost profits of about $6,000 and additional losses of around $800. The jury award did not break damages out by category. It awarded $3,310 and the trial judge reduced the award further to $1,500. The jury instruction, said the Court of Appeals, was reversible error. Only data from past performance would be allowed and it would be impossible for a new business to generate such data.

79 At 334.
80 206 Md. 610 (1955).
81 At 621.
82 223 N.Y. 63 (1918).
83 At 67.

If the only question was whether such data would be adequate for proving losses, the result was surely wrong. The parties might quibble about the appropriate time period for comparison and other issues, but the data would be just as real as the data that an existing firm would have presented. The more significant question is the *Hadley* question. Putting it in the "tacit assumption" framework, fashionable at that time (and still one that I prefer),[84] would a seller of furniture know that if it were late the buyer could not open its business, and would it agree that it would pay for all lost profits prior to the opening, even though it knows virtually nothing about the nature of the buyer's business? I would say No; others might disagree, but for my purposes in this paper the important point is that the fact that Cramer's was a new business was irrelevant for determining the damages.

Marvell Light & Ice Co. v. General Electric Co.[85] was similar to *Cramer. Marvell* was the Arkansas precedent cited in *MindGames*, for the notion that there was a per se rule against awarding lost profits for a new business. Judge Posner quite properly noted that it was a delay case and questioned why a court would have found computation of damages difficult.

> *Marvell* was a classic *Hadley v. Baxendale* type of case—in fact virtually a rerun of *Hadley,* except that the appellants alleged that they had notified the seller of the icemaking machinery of the damages that they would suffer if delivery was delayed, and the seller had agreed to be liable for those damages. The decision is puzzling in light of that allegation; it is doubly puzzling because, assuming that by the time of the trial the ice factory was up and running, it should not have been difficult to compute the damages that the appellants had lost by virtue of the five and a half month delay in placing the factory in operation. Presumably it would have had five and a half months of additional profits.[86]

He is, of course, correct. Unlike in the opportunity cost cases, the losses were real and easy to measure. The only question should have been whether the *Hadley* rule precluded recovery.

In *Cook Associates, Inc. v. Warnick*[87] the lost profits claim did succeed and the court specifically addressed the *Hadley* issue.[88] Cook was constructing a manufacturing plant which opened eight months late because the supplier, Chief, failed to deliver parts on time.[89] Cook sued and the jury awarded lost profits based on the actual operation in the

84 See Goldberg, Rethinking, ch. 8.
85 162 Ark. 467, 259 S.W. 741 (1924).
86 At 655.
87 664 P.2d 1161 (1983).
88 For another delay case in which the court rejected the per se rule, see Drews Co. v. Ledwith-Wolfe Associates, Inc., 296 S.C. 207, 214, 371 S.E.2d 532, 536 (1988). However, the court concluded that the claimant's proof was inadequate and awarded nothing.
89 Cook brought suit against both the manufacturer, Chief, and the dealer, Warnick. The latter was exonerated. (At 1164)

first two months, $56,908.[90] As in the previous two cases, there is no real question about the adequacy of proof—the actual profits after the plant was on line were a good enough proxy for the profits missed during the delay. Chief, urged "adoption of the 'tacit agreement test' of foreseeability."[91] However, the court noted that the tacit assumption test had been rejected by the UCC and concluded that the "evidence is sufficient to support a conclusion that Chief had reason to know that an inordinate delay on its part could prevent Cook's production and sale of slurry, thereby causing a loss of profits."[92] I am not concerned with whether or not the finding is correct; given its finding, the court framed the question in *Hadley* terms and held, in effect, that the seller bore the risk of the costs arising from delay.

2. Defects

In the delay cases where the plaintiff did subsequently operate, the actual earnings could provide a reasonable estimate of the damages. The recoverability of those damages would be subject to two qualifications. The first was the possibility that the *Hadley* rule would bar recovery.[93] The second was the possibility that the parties contracted over the issue with either a disclaimer or a damage limitation. Defect cases raise similar questions. I will focus on two in which the courts held that the lost profits were recoverable but then rejected the claim on measurability grounds.

a. Mid-America Tablewares, Inc. v. Mogi Trading Co., Ltd.[94]

In *Mid-America*, the defendant stipulated that there had been a breach of express warranty, breach of implied warranty of merchantability, and breach of implied warranty of fitness for a particular purpose, so the only issue was damages. The buyer had been in the table linen business and wanted to launch a dinnerware business to complement it. It entered into a contract with Mogi, a Japanese firm, to provide the ceramic dinnerware. Unfortunately, the dinnerware exceeded FDA regulatory guidance levels for leachable lead. Mid-America stopped shipping the dinnerware to its customers and recalled all that had already been shipped. The jury found incidental damages of around $57,000.[95] At issue was the claim for lost profits, about $300,000 in the first year (1994) and $2.6 million over the next decade.[96]

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90 At 1163-64) Cook had asked for $100,000. According to the court the average monthly profits for the first thirteen months of operation were $35,650, which would have meant lost profits of roughly $280,000. There is no discussion of the discrepancy.

91 At 1167.

92 At 1167.

93 The *Hadley* rule is typically referred to as "foreseeability." I find that to be an unhelpful and misleading term; see Rethinking, ch. 8-10. For those who feel comfortable with it, feel free to substitute it for *Hadley* in the text.

94 100 F.3d 1353 (1996).

95 The court did not say what was included under "incidental damages"; I presume that it included the costs of the recall and, perhaps, some of the costs of management time dealing with the problem.

96 Cite. The defendant did not contest the 1994 damages.

The Seventh Circuit panel, asserting that to deny recovery for lost profits "would be tantamount to holding that the defendant could breach this particular contract with impunity," held that Wisconsin would permit recovery of lost profits for a new business.[97] Invoking both *Fera* and *Super Valu,* it continued, "The determination as to whether future profits were within the contemplation of the parties when contracting necessarily turns on the specific facts established at trial. . . . There is no basis to conclude that evidence as to the foreseeability of Mid–America's lost future profits should be excluded as a matter of law."[98] The evidence presented by Mid-America's expert witnesses was the best available evidence and therefore it could not be excluded as a matter of law.

After arguing at length that the lost profits claim was not barred, the court then rejected the expert's damage estimate for the post-1994 period holding that it was "monstrously excessive."[99] It criticized the expert's sales projections as being wildly optimistic and remanded for further proceedings. The court did not say whether this component of damages should be determined on retrial or whether the claim was too speculative and should therefore be zero. The defense expert had attacked various elements of the projections, but even he conceded that "there clearly were lost profits."[100] However, this claim is basically the same as Fera's and others from Section I. There is no reason to believe that the rewards to future expenditure on this project would be any better than anything else Mid-America could have done with the same funds. The lost profits would be zero, not because of a per se rule, but because the expected value of the future expenditures on this project is the opportunity cost of the funds.[101]

b. *Olathe v Browning*[102]

In Mid-America, the buyer did not make further expenditures, hence the zero profit outcome. In *Olathe v Browning* the buyer did continue and that raised a different question. I must note first that, unlike Mid-America, the existence of a limitation on remedies was a significant issue. As is quite common, Browning sold its goods conditional on a repair and replace remedy limitation. Or, at least it tried to do so. A considerable portion of the opinion (about 8,000 words) dealt with whether the limitation was part of the contract and the court concluded that, as a matter of law, it was not.[103] Thus, it was open to Olathe to prove damages, including lost profits damages. However, the trial court and the Kansas Supreme Court ultimately rejected the expert witness's damage measurement, concluding that it was too speculative.

97 For an argument that this was an inaccurate statement of Wisconsin law, see L. Katie Mason, "Mid-America Tablewares, Inc. v. Mogi Trading Co.: The Seventh Circuit's Tasty Recipe For New Business Recovery Of Future Lost Profits Under Wisconsin Law, Or A Suspicious Side Dish Wisconsin Won't Try?" 2005 Wis. L. Rev. 1385
98 At 1362-3
99 At 1367.
100 At 1376.
101 Mid-America might have argued that because of its existing table linen business it had complementary assets which made the expected returns in the dinnerware market greter than the opportunity cost of capital.
102 259 Kan. 735 (1996).
103 I confess that I found the court's reasoning unpersuasive.

Browning manufactured bearings, which were a component part for a new product that Olathe designed and sold, the 866 Tub Grinder. Because the 866 Tub Grinder was a new product, this would be classified as a new business, potentially subject to the new business rule. The bearings failed causing the tub grinders to malfunction. Olathe sued for damages for the tub grinders that had been damaged and for lost profits on its future sales. Unlike Mid-America, it continued in the business. To understand the damage theories, it is necessary to note that the failure was on the 10-foot tub grinders and that this model was subsequently supplanted by the 12-foot tub grinder. Because the first trial ended in a mistrial, Olathe's expert presented two estimates. For the first trial, he argued that Olathe's damaged reputation resulted in a loss of sales; lost profits were $4.3 million.[104] However, at his deposition before the second trial, the economic expert "admitted that his planned testimony for the first trial—that Olathe lost $4.3 million in lost profits due to the lost sales of 10–foot tub grinders—was 100% wrong." [105] Olathe's market share (of 10-foot grinders) did not fall. In fact, it was greater than had been expected had the bearing problems not occurred. Undaunted, he proposed a different theory.[106] Because it had to put so much of its resources into redesigning the 10-foot grinders, its development of the12-foot grinders was delayed and the delay resulted in a loss of its share of the 12-foot grinder market.[107] This resulted in an estimate of lost profits of about $8 million.[108]

Olathe argued that under the "certainty" rule it only had to prove that it had actually suffered damages and that certainty was not necessary to prove the actual amount. In upholding the trial judge's decision to bar the expert's testimony, the court said: "Olathe's evidence regarding the new lost profit theory was based on rumors, guesses, and assumptions. Thus, the trial court did not abuse its discretion in holding that the lost profit evidence was speculative as a matter of law."[109] Note two things. First, it presumes implicitly that there is some boundary at which "rumors, guesses, and assumptions" are so egregious that there is a shift from a matter of *fact* to a matter of *law*. Second, the court's concern appears to be the quality of the inputs, not the damage theory itself. If only the expert had been more rigorous in assembling the data, the damage report would have been admissible.

The issue should not have been the certainty of the damage estimate; the expert was measuring the wrong thing. Olathe's expected damages, beyond the costs associated with the damaged grinders and the possible redesign effort, were the delay costs and, as noted above, these should be subject to the *Hadley* rule—what would be the expected cost of coming to the market a few months later (mainly, the time value of money).[110] The delay would entail a real loss and the contract would determine which

104 At 758.
105 At 761.
106 There was no explanation for Olathe's decision to use the same expert the second time around.
107 "[A]ccording to Olathe, . . . it was required to pour all of its resources into the redesign of the 10–foot tub grinder and that Olathe would have used these resources to develop a 12–foot tub grinder had the bearings in the 10–foot grinder not been faulty." (At 765-6)
108 At 760.
109 At 767.
110 That is the equivalent of the rental value in *Abbott* and *Evergreen*.

party would bear the risk. If recovery were to be denied, the reason should not be the newness of the business; rather it should be that by creating a forcing default, the parties would be induced to deal with the problem ex ante with a disclaimer or liquidated damages clause. Ironically, in this instance the court went out of its way to hold as a matter of law that these defenses were not available.

IV. Anticipatory Repudiation

Suppose that a seller has begun performance of a long-term contract, but it has not yet delivered any output. If the buyer were to breach, would the seller have a viable claim for lost profits? There are two different scenarios. In the first, at the time of the buyer's repudiation there had been no market change. In the second, market conditions had deteriorated.

In *Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc*.[111] the trial judge misused the new business rule in denying the plaintiff's recovery. To simplify the facts, the seller (AEP) agreed to build a power plant and the buyer agreed to a twenty-year take-or-pay contract. After the seller had spent about $500 million on the plant, but before it actually had produced any power, the market collapsed and the buyer (TEMI) repudiated. The trial judge denied recovery for lost profits on two grounds—the project was a new business and determination of lost profits was too speculative. I will come to the "speculative" question below, but first I want to consider the new business issue, with a variation on the facts.

Suppose, contrary to fact, that the market conditions had not changed at all—should the seller receive any compensation? In one sense the problem is the same as that in *Fera*. There is no reason to believe that subsequent performance of this contract would be any more profitable for AEP than its alternatives. The difference is that in *Fera* the plaintiff had not made any investments in reliance on the lease. Here, AEP had spent $500 million. There should be no recovery for *future* lost profits. Since market conditions had not changed, the expected value of the future stream of profits had not changed. However, compensation based on AEP's reliance would be relevant. That would depend on the alternative use of the power plant. If it had no feasible alternatives one could argue that the buyer should be liable for the entire $500 million and if instead it could seamlessly switch to selling to an alternative customer, the reliance damages would be zero.[112]

In the actual case the market had in fact collapsed; the expected value of the contract to the seller had risen, reflecting the change in the market. Here, there are damages and their existence has nothing to do with the newness of the business. Damages were assessed by dueling experts. The seller's expert witness concluded that damages were $520 million while the buyer's concluded that there had been no loss at all. The trial judge was not impressed by either expert: "I found both experts provided unreliable testimony and worse yet, it appeared to be clouded by their obvious advocacy, to paraphrase a popular show tune, on behalf of the lady they came in with."[113] But even if

111 2006 WL 147586. This is the trial court decision.
112 See the discussion of *Brundige*, Section I. 6.
113 Trial court, 2006, p. 3. Reconsideration Order.

they had done impeccable work, he would not have accepted it; it would have been too speculative:

> In order to know what AEP's revenues would be over the next twenty years, one would have to be able to presage a vast and varied body of facts. Any projection of lost profits would necessarily include assumptions regarding the price of electricity and the costs of operating over twenty years. One would also need to surmise what competing forms of energy such as coal and nuclear energy would cost over the same time period. Also factoring into this calculation are the political and regulatory developments over twenty years, population growth in the Entergy region, and technological advances affecting the production of power and related products. With so many unknown variables, these experts might have done as well had they consulted tealeaves or a crystal ball.[114]

So, he concluded, the damages were zero.[115]

The Court of Appeals reversed, holding that AEP's "lost profits" was indeed the appropriate damage remedy.[116] It concluded that while the projection of lost profits would be difficult it was not "speculative;" it is, in effect, the same exercise the parties engaged in when negotiating the twenty-year contract in the first place. I want to make two points. First, neither "speculative" nor "certainty" is helpful in determining whether there should be compensation. Is it easier to assess damages in this contract, with a twenty-year horizon and with both quantity and price variable, than in any of the ones discussed above in which the court first said the new business rule no longer precluded recovery, but then denied recovery because the measurement was too uncertain? Courts have been content to fall back on "certainty," using it as a wild card to reward some claimants and not others.

Second, in most of the cases discussed above the lost profit claim was for c*onsequential* damages. In *Tractebel*, the lost profits claim should be viewed as being for *direct* damages. That is, the contract was an asset for the seller and when the market collapsed the value of that asset went up. How much? That is the measure of what the seller lost at the time of repudiation. It would be the difference between the expected net revenues had the market conditions not changed and the net revenues given that there had been a change. That difference is precisely what the experts were attempting to ascertain under the lost profit rubric—the net present value of the difference between two projected revenue streams.[117]

V. Concluding Remarks

In *MindGames*, Judge Posner rejected the new business rule:

114 Trial court, 2005, p. 11-12.
115 At 8.
116 Tractebel Energy Marketing, Inc. v. AEP Power Marketing, Inc., 487 F.3d 89 (2007).
117 I have elaborated on this in "Reckoning Contract Damages: Valuation of the Contract as an Asset."

> The rule doesn't work because it manages to be at once vague and arbitrary. One reason is that the facts that it makes determinative, "new," "business," and "profits," are not facts, but rather are the conclusions of a reasoning process that is based on the rationale for the rule and that as a result turns the rule into an implicit standard. What, for example, is a "new" business? What, for that matter, is a "business"? And are royalties what the rule means by "profits"?[118]

Courts have fiddled with all these questions to determine whether or not a particular claimant should be allowed to recover. Sometimes they will uphold the per se rule but then decide that the business is not new.[119] As we have seen in a number of instances, they will find that there is no per se rule, but they will decline to award lost profits for various reasons, often invoking certainty. In other cases, courts will claim that certainty is needed only to show the existence of lost profits and that there is a lower standard to show the magnitude of the loss. Some courts have judged the lost profits measure by an even lower standard; recall Judge Peters criterion: does "the size of the verdict so shock the sense of justice as to compel the conclusion that the [trier of fact] was influenced by partiality, prejudice, mistake or corruption."[120]

Judge Posner elaborated on his dismissal of the new business rule: "The rule could be made sensible by appropriate definition of its terms, but we find it hard to see what would be gained, given the existence of the serviceable and familiar standard of excessive speculativeness."[121] However, I have argued here that speculativeness, or reasonable certainty, is the wrong way to go. The problem is not difficulties in measurement. Rather, it is that the courts have often been measuring the wrong thing. In cases in which the claim is for a future stream of profits on a project that never got off the ground, the presumption should be that there were no lost profits. Any recovery should be based on the plaintiff having some assets (either preexisting or acquired in reliance) the value of which was contingent on performance of the project. For other cases (royalty streams, delay, defect) claimants have suffered a real loss. Whether they should recover does not depend on whether they are a new business or the certainty of proof. The *Hadley* rule provides one constraint. Ex ante contract language (liquidated damages, warranty disclaimers, remedy limitations) provides another.

118 At 657.

119 *RSB Lab. Servs., Inc. v. BSI, Corp.*, 368 N.J. Super. 540, 847 A.2d 599, (App. Div. 2004).

120 See text at __.

121 At 658.