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The Lost Volume Seller, R.I.P.

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Victor P. Goldberg

I have already written on the lost volume seller problem a number of times.[1] So why am I doing it yet again? Three reasons. First, I noticed, much to my surprise, that in the White and Summers treatise I am characterized as a defender of §2-708(2)—the Code Section that gives rise to the lost volume remedy;[2] I should like to put that misconception to rest. Second, since the number of reported cases is fairly modest, I had thought that the problem, while interesting analytically, was not of much practical import. A Westlaw search for "lost volume seller" only yielded 147 cases.[3] However, if lost volume profits are being included in damage estimates without objection, the real incidence could be much greater.

I had my first inkling that this might be so when I was digging into the record of a casebook staple, *Empire Gas v. American Bakeries*.[4] The decision simply acknowledged the jury's damage determination; there was no discussion of why. The amount troubled me. There were two components of damages: the loss on the sale of conversion units and the loss on the sale of propane. Why, I thought, would there be any damages at all when Empire bought conversion units in a competitive market and resold them as an accommodation and when there was a meeting competition clause for the propane sales? Could it be, I wondered, that the lost volume formulation was taken for granted? (Turns out I was right.)

Third, as I have reengaged with the lost volume literature, I learned that a number of scholars have argued that the lost volume remedy should be the *primary remedy* for a buyer's breach. Professor Anderson, for example, asserts: "Under the Code's scheme the profit formula of section 2-708(2) is truly the dominant damage remedy for aggrieved sellers who suffer a breach prior to the time that the buyer accepts the goods. The formula applies to most commercial sellers because such sellers are usually left in a lost volume situation by a buyer's breach."[5] Earlier, Childres and Burgess presented a similar argument: "T]he lost-profit rule of 2-708(2) is no rule of last resort for the few cases that fail to fit the specific rules. It is the dominant damages rule or principle. . . . We think it probable that in the American economy of today and the foreseeable future, the

[1] Victor P. Goldberg, *An Economic Analysis of the Lost-Volume Retail Seller*, 57 S. CAL. L. REV. 283 (1984). See also Victor P. Goldberg, FRAMING CONTRACT LAW ch. 13 (2012); Victor P. Goldberg, RETHINKING CONTRACT LAW AND CONTRACT DESIGN ch. 4 (2016).

[2] James J. White & Robert S. Summers, THE UNIFORM COMMERCIAL CODE, §8-14 at 385 n.1 (6th ed. 2010).

[3] A search for §2-708(2) yielded even fewer.

[4] 840 F.2d 1333 (7th Cir. 1988).

[5] Roy Ryden Anderson, *Damages For Sellers Under The Code's Profit Formula*, 40 Sw. L.J. 1021, 1063.

overwhelming proportion of sales contracts should produce the 2-708(2) situation if repudiated by the buyer." [6]

The basic issue in the lost volume cases is that if the buyer cancels an order (breaches), and the seller "mitigates" by selling the unit at the same price to another buyer, an award of the contract market differential would result in zero damages. However, it is argued, if the second buyer would have bought a unit from the seller anyway, the seller would have had two sales, not one. The seller would have lost the "profit" on the sale that got away. Making the seller whole would require that it be compensated for the profit it would have made, but for the breach. That seems plausible. For White and Summers that remedy is "the recovery which all right-minded people would agree the lost volume seller should have."[7]

Nonetheless, I have argued, and will argue here, that all those right-minded people were wrong. It treats the remedy question as tort-like—the buyer has wronged the seller. But this is a matter of contract. By cancelling the order the buyer, in effect, would be invoking an implied termination clause. The remedy would be the price the buyer would have to pay for termination (cancellation).[8] When framed this way, it becomes clear that the lost profits remedy makes no sense. I am not proposing a test in which we compare the proposed remedy to some idealized alternative (like efficiency). The standard I am applying is more forgiving—is the contract imposed by the court absurd? The lost profit remedy, I will argue, fails that test. When the parties have not set an explicit option price (perhaps as a nonrefundable deposit) and market conditions have not changed, the appropriate default rule should be zero damages.[9] In some transactions the contract calls for progress payments when certain milestones are reached; if not refundable, these, in effect, are a series of nested options; a few illustrations of these will be discussed in Section II. B.

Two digressions. First, the jurisprudence has been sufficiently muddled so that courts on occasion will label the seller a lost volume seller even when it would have been impossible for it to have made both sales. I will just note two such cases. First, in an

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[6] Robert Childres & Robert K. Burgess, *Seller's Remedies: The Primacy of UCC 2-708(2)*, 48 N.Y.U. L. Rev. 833 (1973). See also John A. Sebert, Jr., *Remedies Under Article Two of the Uniform Commercial Code: An Agenda for Review*, 130 U. Pa. L. Rev. 360, 366 (1981) ("Although this profit plus overhead recovery may have been seen by the Code's drafters as a provision that would apply only infrequently, it is now recognized that, at least in theory, this will be the appropriate measure of damages in a substantial majority of cases involving merchant sellers.")

[7] White & Summers, *supra* note 2, §8-13 at 381.

[8] For a similar argument, see Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 COLUM. L. REV. 1428 (2004).

[9] Ayres & Gertner refer to this as a forcing default. See Ian Ayres and Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 87 (1989).

opinion written by then Circuit Judge Alito, with Ed Becker also on the panel, *Tigg v. Dow Corning*,[10] the court found that the parties had entered into an exclusive contract and that Dow Corning had breached its best efforts obligation. The court held that whether Tigg was a lost volume seller was a fact question for the jury.[11] But, so long as the contract was in force, Tigg could not have sold to anyone else—there could not have been an additional sale. That is what exclusive means. There could not, therefore, have been lost volume profits. In *Scientific Components Corp. v. Isis Surface Mounting, Inc*.,[12] the court did finally hold that the seller was not a lost volume seller. However, it ignored the main reason. After the buyer's cancellation the seller asserted that it could not sell all the contracted-for units and asked for damages under 2-709 for the full price of the unsold goods. Obviously, if the seller could not sell all of the units it could not have made the additional sale posited in the lost volume seller framework.

A second digression. On rereading the lost volume material I was struck by a bit of nonsense recurring in the treatises, journal articles, and case law: in lost volume cases supply exceeds demand. Examples abound. "The problem of the supplier's damages becomes more complex, however, if it is assumed that the supplier's own supply exceeds demand." (treatise)[13] "Thus, it is plain that in cases of sellers (including manufacturers) whose buyers are fewer than could be supplied at the prevailing price, the 2-708(1) formula is not merely inadequate, it must be held irrelevant." (journal article)[14] "A lost volume seller is one whose supply of goods exceeds the demand." (decision)[15] Even if my readers are not convinced by my main themes, I hope that they will at least stop speaking economic gibberish.[16]

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[10] 962 F.2d 1119 (1992).

[11] The District Court had held that Tigg was a lost volume seller. (*Id. at* 1129) The Court of Appeals reversed, holding that this was a fact question. "[T]he district court could not find as a matter of law that Tigg was a lost-volume seller. At the very least, the court was obligated to submit this factual question to the jury." (*Id. at* 1130). I cannot understand why so distinguished a panel would believe that a random group of laypersons would do this better than they could.

[12] 539 F.Supp.2d 653 (2008).

[13] 3 E. Allen Farnsworth, FARNSWORTH ON CONTRACTS, §12.10 at 218 (3rd ed. 1998). See also 4A Part I Anderson U.C.C. § 2-708:27 (3d. ed.)

[14] Childres & Burgess, *supra* note 6, 875. See also *Lost Profits As Contract Damages: Problems Of Proof and Limitations On Recovery*, 65 Yale L. J. 992 (1956).

[15] *Great W. Sugar Co. v. Mrs. Allison's Cookie Co.*, 563 F. Supp. 430, 433 (E.D. Mo. 1983); see also, *Lam Research Corp. v. Dallas Semiconductor Corp*., No. H027073, 2006 WL 1000573, at *20 (Cal. Ct. App. Apr. 17, 2006) and *Trienco, Inc. v. Applied Theory, Inc.*, 102 Or. App. 362, 365, 794 P.2d 1239, 1241 (1990) ("plaintiff is a 'lost volume seller'—that is, a seller whose ability to supply its goods exceeds the demand")

[16] A number of readers of an earlier draft asked that I elaborate on this. The simplest counter-example is a supplier with one good with no buyers. There could be no lost volume. More generally, the lost volume argument only requires that the supplier be capable of producing enough sales to warrant application and that there is sufficient demand so that the seller could have sold both units; that is the only limitation on the

The statute, it is fair to say, is not well written. It took some creative lawyering to read out the last clause (italicized).

> 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.*

That last clause has been interpreted to only apply when the seller has begun production, but after the buyer's cancellation the seller is stuck with partially completed goods.[17] In the concluding section I will suggest that one possible path to undoing the lost volume remedy is to read that clause back in.

I must emphasize that I am only proposing a default rule. The seller should be able to supplement the remedy with additional remedies—nonrefundable deposits or liquidated damages. Unfortunately, both the UCC (2-718(2)) and the common law skepticism regarding liquidated damages create unnecessary roadblocks to this. Ironically, courts and commentators that would routinely apply a lost profit remedy are troubled by the possible punitive aspects of a liquidated damages clause, notwithstanding the fact that the lost profits remedy is often more punitive. In the following sections I will provide a number of examples.

The central theme of this paper is that buyers would often be willing to pay a price for the option to terminate (or cancel), but that price bears no resemblance to the lost profit remedy. By framing the problem in terms of making the nonbreacher whole (or some variant on that phrase) courts and many commentators have lost sight of that simple point and have created contracts for parties that make no sense. The first two Sections of this paper illustrate this point by examining in some detail a number of cases in which courts adopted the lost volume theory. The first Section concerns the lost volume retailer; I will begin that Section by examining one pre-Code case in which the court got it right (i.e., declined to label the seller a lost volume seller), much to the consternation of the drafters of the UCC; the second Section concerns the lost volume manufacturer. Section III explores the *Empire Gas* puzzle and shows that the court did, in fact, treat it as a lost volume case.

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demand side. If we take the language literally—when supply exceeds demand—the Econ 1 text will tell you, that the price will have to fall so that the market would clear; that surely is not what the authors or the courts could have meant.

[17] Credit (or blame) for this interpretation usually goes to Robert J. Harris, *A Radical Restatement of the Law of Seller's Damages: Sales Act and Commercial Code Results Compared*, 18 Stan. L. Rev. 66 (1965).

I. The Lost Volume Retailer

The concern with the lost volume seller initially arose in the context of a buyer of an expensive consumer durable—for example, a car—who cancels (breaches) the sale. The dealer subsequently resells the car to a second customer at the same price. The standard remedy, the contract price-market price differential, would be zero. However, the dealer claims that he would have had that second sale as well and that he has lost the "profit" on the initial sale. Comment 2 of §2-708(2) provides the purpose and the intended remedy:

> 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 [the gross margin] or list price less manufacturing cost to the manufacturer.

Manufacturers do not pay for retailing services directly; the dealer's compensation is the list price less cost to the dealer (the gross margin). The gross margin is, in effect, the market price of retailing services. It is what the courts have labelled "lost profits." The cost of providing the retail services includes a broad mix of activities, some of which are specific to the particular transaction and some of which are spread over the entire customer base: 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. All those costs, whether incurred on behalf of a particular customer or not, must be covered if the dealership is to survive. The dealership makes decisions on these factors with the expectation of selling a target number of cars in any given month. Unless the cars are on allocation by the manufacturer, it can expect to sell to anyone who orders a car. If a buyer were to order a car and then renege, the dealer would sell one less car than it would have had the buyer not cancelled. In that sense, the seller does indeed lose the profit (gross margin) on the sale.

But that asks the wrong question. A customer ordering a car, in effect, takes an option. So, if the contract price were $15,000 and the price to the dealer were $14,000, the lost volume remedy would, in effect, say that the buyer had bought an option for $1,000 for the right to buy the car for the remaining $14,000. The price of that option could be made explicit either with a liquidated damages clause (buyer pays after the fact) or a nonrefundable deposit (the buyer pays prior to delivery). The gross margin sets an implicit option price, one that is unrelated to any plausible function.

Consider a pre-Code case, *Lenobel v. Senif*,[18] which figured prominently in the design of 2-708(2). The buyer cancelled his order for a car, the dealer sold the car to a subsequent buyer for the same price, and the dealer then sued for his lost profits. The selling price was fixed by the manufacturer (Plymouth) so the contract-market differential would have been zero.[19] While the gross margin (implied option price) was 28%,[20] the buyer only had paid a $50 deposit, an explicit option price of about 7% of the sale price. The court noted that the buyer had no knowledge of the size of the dealer's margin, and held that the dealer could not recover its lost profits. It also denied the buyer's counterclaim for the return of the deposit.

The likelihood that any buyer would choose to cancel its order is not random. It can be influenced by the dealership. One obvious tool is shortening the gap between order and delivery. The option price is another tool. The higher the option price, the less likely the buyer would cancel, assuming, of course, that the buyer was made aware of the price and the price was legally enforceable. The *Lenobel* court made this explicit:

> But plaintiff had other remedies. It could have exacted a larger down payment in cash or notes to protect itself against a breach of contract by the vendee. In place of the contrary provision as to title now set out in the contract, it could have provided in its contract that title was to pass to the buyer when the sale was made, and have the common-law rule prevail by agreement. [21]

With the lost profit remedy, if the seller could have sold the second car with no difficulty, the buyer would be liable for the gross margin, a number unknown to her at the time of the decision to cancel. If, however, the dealer could not get more cars (perhaps because it was a "hot" car that the manufacturer had on allocation), then there would not be any lost volume and the seller would be restricted to the contract-market price differential—which would be zero. In effect, the lost volume profit rule sets the option price at the gross margin in normal times, but as the market gets tighter (as the dealer's chances of obtaining an additional car from the manufacturer diminish) the lost volume measure (option price) falls. There is no good economic reason for such a result. Indeed, it is perverse. Other things equal, the tighter the market, the greater should be the option price. The lost volume remedy sets the option price high when the market is slack and low when it is tight, the opposite of what a rational dealer would do.

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[18] *A. Lenobel, Inc. v. Senif*, 252 A.D. 533, 300 N.Y.S. 226 App. Div. 1937), *order resettled sub nom. Lenobel v. Senif*, 253 A.D. 813, 1 N.Y.S.2d 1022 (App. Div. 1938) [hereinafter *Lenobel v. Senif*]. The decision was strongly disapproved by Professor Edwin Patterson, whose commentary arguably led to adoption of the lost volume theory; see John M. Breen, *The Lost Volume Seller and Lost Profits Under U.C.C. S 2-708(2): A Conceptual and Linguistic Critique*, 50 U. MIAMI. L. REV. 779, 888-894 (1996).
[19] The reference to "fixed price articles" in the Comment reflects the notion that years ago many articles were sold under resale price maintenance agreements.
[20] Nowadays it is typically around 10%.
[21] Lenobel v. Senif, *supra* note 17, at 230.

For an egregious consumer case awarding lost profits, consider *Kenco Homes, Inc. v. Williams*.[22] Williams entered into a contract to buy a mobile home for a price of $39,400, with $500 down. Before Kenco had ordered the home from the factory, Williams repudiated because he "had found a better deal elsewhere."[23] The trial court found that lost profits were over $11,000, but that Kenco was adequately compensated by retaining the $500 deposit.[24] The Court of Appeals ignored the deposit[25] and held that Kenco was a lost volume seller:

> In this case, Kenco did not order the breached goods before Williams repudiated. After Williams repudiated, Kenco was not required to order the breached goods from the factory; it rightfully elected not to do so; and it could not resell the breached goods on the open market. Here, then, "the measure of damages provided in subsection (1) is inadequate to put [Kenco] in as good a position as [Williams'] performance would have done"; subsection (2) states the applicable measure of damages; and Kenco is entitled to its lost profit of $11,133.[26]

In other lost volume cases the court at least indicated that there was a subsequent sale. Here, the court doesn't even require that. The court obviously gave no thought to why an explicit option price of 1% (the deposit) should be displaced by an implicit option price of nearly 30%.

II. The Lost Volume Manufacturer

The intuitive appeal of the lost volume remedy in the retail context is that the gross margin is a rough approximation of the market price of retailing services. That intuition does not carry over to the manufacturer context. There, the loss would be the difference between the contract price and the seller's "but-for" costs. So, if, for example, a seller was in an R&D intensive industry, the "lost profits" could be a very large fraction of the contract price.

Note one peculiar feature of the lost profit remedy: if the seller were vertically integrated, the lost profits would be greater than if it had bought its input from a third

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[22] 94 Wash.App. 219, 972 P.2d 125 (1999).
[23] *id.* at 228, 972 P.2d at 130.
[24] The contract awarded reasonable attorney fees to the prevailing party. The trial court held that Williams was the prevailing party. After the trial court opinion was reversed, Kenco was deemed the prevailing party, adding insult to injury.
[25] The contract included the following language: "I [Williams] understand that you [Kenco] shall have all the rights of a seller upon breach of contract under the Uniform Commercial Code, except the right to seek and collect 'liquidated damages' under Section 2–718." (*Id.* at 221) The Court did not attempt to interpret this, but I do not think it would preclude recognizing the $500 deposit.
[26] *Id.* at 227-228. The court gave no indication as to why the goods could not be sold on the open market.

party. A simple illustration will make this clear. Suppose that the Manufacturer A bought its only variable input from an independent firm (B) with a single factory. A enters into a contract with C for $100 and C then breaches; A's fixed costs were $30 and it pays $70 for B's input. The lost volume remedy: $30. Now, suppose that the manufacturer bought B's factory, which has fixed costs of $25 and variable costs of $45. The combined firm would then have had fixed costs of $55 ($30+$25) and variable costs of $45. Lost profits would go from $30 to $55 even though the technology would have remained the same. So, in the retail cases discussed above, if, instead of selling cars through a franchised dealer, the car manufacturer owned its retail outlets, the lost profits would have to take into account the variable costs of the manufacturer. It is hard to rationalize such a nonsensical result; yet that is inherent in the lost profits remedy.

In this Section, I will make three observations about the lost volume seller cases. First, the remedy often sets an excessive implicit option price; second, courts sometimes give inadequate weight to the explicit option price; and third, courts will sometimes leap to the lost profit remedy when an adequate remedy already exists. I will develop these points through a close examination of the remedies in a number of decisions.

A. Excessive Implicit Options

1. Teradyne, Inc. v. Teledyne Industries, Inc.[27]

Teradyne contracted to sell a transistor test system to Teledyne for the list price, $98,400, less a 1% discount. Two days later the buyer canceled the contract; Teradyne incurred $614 testing and reassembling the unit and sold it to another purchaser for $98,400. The applicability of §2-708(2) was taken for granted and Teledyne conceded as such in its brief.[28] The only dispute regarded one component of damages. There was agreement that lost profits would be the contract price less variable costs, but there was disagreement over whether the special master had identified all the variable costs.

The special master found the variable costs to be about $22,000, so he concluded that the lost profits were about $76,000. The bulk of the fixed costs, 64%, was for "costs of sales and engineering" (primarily R&D). Teledyne did not contest the conclusion that damages were the lost profits—price less but-for costs. The only issue on appeal was Teledyne's argument that the wages and fringe benefits paid to testers, shippers, and installers should also have been included as variable costs, even though their employment would not have been affected by production of an additional unit. The court agreed and remanded to include these costs as direct costs. These costs might have added a couple of percent to the variable costs, but the lost profit damages still would have exceeded 70% of the contract price.[29]

[27] 676 F.2d 865 (1982).
[28] *Id.* at 869.
[29] I find it hard to believe that the possibility of this small reduction in the damage remedy justified the additional litigation costs.

The contract the court created was this: Teledyne agreed to pay about $76,000 for the option to buy the test system for an additional $22,000. No one asked the simple question: why on earth would it do something that stupid? Are there any circumstances in which a buyer would be willing to enter into such an arrangement? Yes, some. But none of relevance here. For example, in a take-or-pay contract the "take" is the buyer's option price. It would reflect the seller's reliance on this particular buyer; the greater the reliance, the higher the take percentage. Or if the item were highly customized with little market value were the buyer to cancel, a high cancellation fee (option price) would be likely. Of course, in neither of these cases would the seller expect to be able to sell to this buyer and another. The seller would not be a lost volume seller.

If the product were in short supply the seller could require a substantial deposit. Other things equal, the tighter the market, the greater the deposit (termination fee). But the court did not find that there was a tight market—it presumed that Teradyne could have easily filled this order and another. The lost volume remedy got it backwards. It would award the lost volume profits when the seller had ample capacity and deny them when the seller does not. Once we make the contract structure explicit—an option price that was over 70% of the contract price—it is clear that no "right-minded person" would have voluntarily entered into such a contract.

2. Trienco, Inc. v. Applied Theory, Inc.[30]

Trienco designed and manufactured an optical scanning device, known as an Edger, for use in the forest products industry. It agreed to sell a device to Applied Theory (AT) which sold and installed automated lumber handling systems that use such optical scanning devices. While the device was under construction, AT was purchased by a firm that produced a competing scanner. It sent a stop work notice and offered to pay an appropriate cancelation fee. When the parties could not reach agreement, Trienco sued for damages. The scanner had not been completed and was being built to the buyer's specifications.

The court claimed that the buyer "acknowledges that plaintiff is a lost volume seller and that lost profits under [2-708(2)] is the appropriate measure of damages."[31] There is no indication as to why the buyer would have made such a concession. It did argue that because the seller had sold some of the parts and incorporated others into scanners sold to other buyers that there should be an offset under the "due credit" clause. However, the court held that the seller had "incorporated the parts of the incomplete scanner into other systems that it sold as completed units, which it would have produced and sold regardless of defendant's breach."[32] It did not, the court concluded, "act as a 'components' seller and 'realize junk value' by selling those component parts as scrap. Under [2-708(2)] therefore, no credit was due defendant."[33]

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[30] 102 Or.App. 362, 794 P.2d 1239 (1990)
[31] *Id.* at 366.
[32] *Id.* at 367.
[33] *Id.* at 367.

The contract price was $130,000 and the court found that the but-for costs were 40% and profits plus overhead were 60%, or $78,000. The award was reduced by an amount necessary to complete the system ($6,000 plus $9,000 overhead and profit on that expenditure) so the final award was $63,000, almost 50% of the contract price.[34] The court was a bit vague about the role of the $6,000. I interpret it to mean that with an extra $6,000 the seller could have repurposed the partially completed scanner and resold it.

In their previous dealings the seller had required a deposit of 20% before scheduling production;[35] in this deal, the deposit was only 10%. By simply adopting the lost volume framing, the court converted a plausible option price (10-20%) to nearly 50% without any acknowledgement of what it had done.

B. Implicit versus Explicit Options

The explicit option price sometimes runs afoul of the liquidated damages/penalty doctrine and its UCC manifestation embodied in 2-718:

> (1) Damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in the light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.
>
> 2) Where the seller justifiably withholds delivery of goods because of the buyer's breach, the buyer is entitled to restitution of any amount by which the sum of his payments exceeds
>
> (a) the amount to which the seller is entitled by virtue of terms liquidating the seller's damages in accordance with subsection (1), or
>
> (b) in the absence of such terms, twenty per cent of the value of the total performance for which the buyer is obligated under the contract or $500, whichever is smaller.[36]

Ironically, under the doctrine, in cases in which an explicit option price would be unenforceable, or at least questionable, courts have had no difficulty with awarding lost profits, even when that remedy exceeded the explicit option price.

[34] The court gave no reason for adding on a proportion of the fixed costs to the additional cost the seller would have had to incur to make the first system saleable.
[35] *Trienco, Inc. v. Applied Theory, Inc.*, 91 Or.App. 588, 591, 756 P.2d 66, 66 (1988).
[36] There must be some rationale for 2-718(2b)'s limitation to $500, but I can't think of one.

1. R.E. Davis Chemical Corp. v. Diasonics, Inc.,[37]

Davis ordered an MRI machine from Diasonics. The contract price was $1.5 million. There was an initial non-refundable deposit of $300,000. (The opinion ignored the fact that the deposit was non-refundable)[38] Payment was conditioned on meeting certain milestones: $700,000 was due upon delivery of the equipment, $275,000 upon completion of installation, and the final $225,000 thirty days after the first clinical use. When Davis's customers cancelled their order, Davis cancelled its order with Diasonics. Diasonics subsequently sold the machine to another buyer for the same (or greater) price. Davis, invoking §2-718(2), asked for restitution of its $300,000 down payment. According to the court, Diasonics did not deny that §2-718(2) applied; however, it did not return the money and counterclaimed under §2-718(3) for its lost profits.[39] The trial court rejected Diasonics claim and awarded Davis his down payment plus interest. On appeal, the decision was reversed. The court held that Diasonics could be a lost volume seller. However, it added an additional burden for Diasonics to prove that it was a lost volume seller:

> [W]e disagree with the definition of "lost volume seller" adopted by other courts. Courts awarding lost profits to a lost volume seller have focused on whether the seller had the capacity to supply the breached units in addition to what it actually sold. In reality, however, the relevant questions include, not only whether the seller could have produced the breached units in addition to its actual volume, but also whether it would have been profitable for the seller to produce both units.[40]

On remand the trial court concluded that Diasonics could have produced the additional unit profitably so it was a lost volume seller. The lost profits, it found, were $453,050; by contesting the "penalty," Davis managed to impose an additional 50% cost on itself (not to mention substantial legal fees). Davis was not done. On appeal it raised two objections. First, the contract included a "research grant" from Diasonics of $225,000; if that masked a rebate, it should have been deducted from the contract price. Second, the contract gave Davis an option to upgrade for $700,000; the value of that option had not been taken into account. The Court of Appeals remanded yet again so that these two factors might then be included in the lost profit determination.[41] The parties appear to have settled before another round of litigation commenced. For my purposes, the significant point is that the court was comfortable with the notion that the $300,000

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[37] 826 F.2d 678 (1987).

[38] The full payment terms are in the contract, a copy of which is available from the author.

[39] 2-718(3), "The buyer's right to restitution under subsection (2) is subject to offset to the extent that the seller establishes (a) a right to recover damages under the provisions of this Article other than subsection (1).

[40] *Id.* at 684.

[41] *R.E. Davis Chemical Corp. v. Diasonics, Inc.*, 924 F.2d 709 (1991).

down payment would be an unenforceable penalty, but a $450,000 lost profits award would not be.

2. Rodriguez v. Learjet[42]

Lear sold an airplane for future delivery with the contract also calling for a series of progress payments when certain milestones were reached. The buyer made the first payment of $250,000, canceled the order shortly thereafter, and then asked for the return of the payment. Unlike Davis, it did not invoke 2-718(2)(b) (at least the court doesn't mention it). Instead, the buyer invoked 2-718(1) claiming that the liquidated damages were unreasonably large and therefore acted as a penalty. The clause in question read as follows:

> Learjet may terminate this Agreement as a result of the Buyer's . . . failure to make any progress payment when due . . . . If this Agreement is terminated by Learjet for any reason stipulated in the previous sentence Learjet shall retain all payments theretofore made by the Buyer as liquidated damages and not as a penalty and the parties shall thenceforth be released from all further obligations hereunder. Such damages include, but are not limited to, loss of profit on this sale, direct and indirect costs incurred as a result of disruption in production, training expense advance and selling expenses in effecting resale of the Airplane.[43]

Lear sold the jet to another customer for a "profit" of $1,887,464. Here is where it gets weird. To show that the liquidated damages were not unreasonable the court considered Lear's argument that it was a lost volume seller. It found that Lear was and that the lost volume profits were the $1.8+ million profit that it received in the subsequent sale. The court went through the *Diasonics* exercise, finding that Lear had the capacity to produce an additional airplane and that it would have been profitable to do so. Had Lear been greedy (at least in the short term) it could have accepted Rodriguez's claim that the clause was unenforceable, and taken the $1.8 million instead, something the court chose not to mention. To its credit, Learjet was more concerned with establishing the legality of its standard system of progress payments than in making a one-time killing. Rather than simply recognizing that the progress payments established a series of options for the buyer, the court was forced to ask a bunch of foolish questions. The court did not address the obvious disconnect. To prove that $250,000 was not punitive, the seller showed that it would have been entitled to an award seven times that which would not have been punitive.

3. *Invest Air, Inc. v. Swearingen Aviation Corporation*[44]

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[42] 24 Kan. App. 2d 461, 946 P.2d 1010 (1997).

[43] I*d.* at 463.

[44] C77-1841A, 1979 U.S. Dist. LEXIS 13101 (N.D. Ga. Apr. 11, 1979).

This case also involved a deposit for the purchase of an airplane—a much smaller plane. One piece of the litigation concerned Invest's breach of an Aircraft Purchase Agreement to buy a Marlin IIIA aircraft. The contract required a down payment of $50,000. It included the following language:

> In the event Purchaser does not accept said Aircraft within ten (10) days of tender, Seller may terminate this Agreement, retain the aforementioned deposit, and dispose of the Aircraft with no further liability to Purchaser. The deposit made with this order shall be retained by Seller, not as a forfeiture but as consideration for Seller's expenditures and costs of resale of the Aircraft.[45]

The plaintiff sued to recover the $50,000 invoking 2-718(2) and arguing that the clause was void as a penalty. The defendant resold the plane in "a matter of days" at a price greater than the contract price.[46] It argued that it could both retain the deposit as liquidated damages and also recover lost profits as a lost volume seller. The court accepted the notion that the seller could be a lost volume seller; whether it would have been able to sell both planes was a fact question that could not be resolved on a summary judgment motion.

The court characterized the seller's argument as having two components: the deposit only covered the expected costs of resale and those would be in addition to the lost profits. It suggested that the $50,000 for resale expenses was probably excessive. Why? Because the seller "fashions itself as a lost volume seller which has little problem selling as many aircraft as it can make available."[47] That is, a lost volume seller should be able to resell easily and therefore the costs of reselling must be low, a non sequitur. The seller opened itself up to this by characterizing the deposit "as consideration for Seller's expenditures and costs of resale of the Aircraft." Perhaps it felt it had to provide this rationalization in order to avoid having the clause labeled a penalty. The court could not resolve the matter at summary judgment: "Despite these troubling aspects of the defendant's position, the Court, . . . is unable to conclude as a legal certainty that the forfeited amount constitutes a penalty."[48] Lear had invoked lost profits in order to enforce the liquidated damages; here, the seller took the aggressive (and foolish) position that the deposit was independent of the lost profits and that it could recover both. In the end, it might well end up recovering neither.

4. Summing Up

What is remarkable in all these cases is the court's absolute indifference to function. The lost profits remedy prices the buyer's termination option without regard for

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[45] *Id.* at 28-29.
[46] *Id.* at 25.
[47] *Id.* at 31-32.
[48] *Id.* at 32.

the value of the option. And where sophisticated parties explicitly priced the option, the courts ignored them. The notion that explicit options could be nonenforceable penalties while the lost-profit implicit option would not be a penalty (even if it were much greater) is truly bizarre.

C. Adequate Remedies Were Available

If an adequate remedy were available, then invocation of 2-708(2) would be unnecessary. The statute says that 2-708(2) will apply 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." If the market had changed and the price had fallen before the buyer breached, the contract/market differential (2-708(1)) would be adequate. Or if the seller completed production but could not sell the product, then 2-709 (an action for the price) would provide an adequate remedy.[49] In a number of cases when these adequate remedies were available the courts instead opted for the lost volume remedy.

1. Lam v Dallas[50]

This case adds new complications to the picture. The contract was for six customized machine tools.[51] As in *Trienco,* the buyer cancelled the contract after a change in control, not a change in market conditions. When the buyer cancelled, two of the tools had been completed; after the rejection, they were disassembled and some of the components were used in other tools. For one tool, there had been partial performance (about 30%) and for the remaining three, nothing had yet been done. The court found that Lam was a lost volume seller for all six tools. So, there were potentially three different types of damage claims.

For some reason, this decision was deemed nonpublished and is, per California rules, noncitable. One might have thought that the decision not to publish was reserved for routine cases with little at stake. Quite the opposite. This was a bitterly contested case involving a $20 million contract ($27 million in 2017 prices), a damage award of $11

[49] 2-719 (Action for the Price
(1) When the buyer fails to pay the price as it becomes due the seller may recover, together with any incidental damages under the next section, the price . . .

> (b) of goods identified to the contract if the seller is unable after reasonable effort to resell them at a reasonable price or the circumstances reasonably indicate that such effort will be unavailing.

(2) Where the <u>seller</u> sues for the price . . . if resale becomes possible he may resell them at any time prior to the collection of the judgment. The net proceeds of any such resale must be credited to the buyer and payment of the judgment entitles him to any goods not resold.

[50] *Lam Research Corp. v. Dallas Semiconductor Corp.*, No. H027073, 2006 WL 1000573 (Cal. Ct. App. Apr. 17, 2006). California Rules of Court, rule 8.1115, restricts citation of unpublished opinions in California courts.

[51] There was a dispute over whether there was one contract, six contracts, or no contract. That issue need not concern us.

million ($15 million in 2017 prices), and a 14,000 word (24 page) opinion. Even if you can't cite it, it is worth contemplating.

One more quirk. Despite the fact that the deal was for a substantial amount of money, there was no negotiated contract, only competing forms. Dallas, the buyer, argued unsuccessfully that because the parties' forms differed, there was no contract at all. The trial court left the question of contract formation to the jury, which concluded that a contract had been formed. [52] In its decision upholding the jury's conclusion the Court of Appeals devoted about 30% of its opinion to the question of whether a contract existed, but zero percent to the content of either of the forms.[53] I find it surprising and disappointing that parties would enter a deal of this magnitude without a formal contract; cases like this underscore the need for sensible default rules.

Dallas Semiconductor Corporation manufactured and sold semiconductor chips. Lam Research Corporation supplied wafer fabrication equipment to the semiconductor industry; it manufactured complex etching machines, known as tools, that are used in the process of making semiconductor chips on silicon wafers. The tools are customized for the particular users. Dallas agreed to purchase six tools. Before any tools were delivered Dallas was purchased by Maxim, which refused to perform. Lam sued for damages. At the time of the breach the first two tools (total price about $8 million) had been completed; a third (price about $4 million) was partially completed, and nothing had been done yet on the last three (price about $8 million). The first two tools could not be resold as is; the parts were cannibalized and around $3.6 million were incorporated into tools sold to other customers.[54]

The trial judge held that, as a matter of law, Lam was a lost volume seller. Because Lam was a lost volume seller, he held, evidence about any offset (the $3.6 million) would be excluded. Lam's expert determined that damages were $13,860,847, representing lost profits on all six tools, plus lost profits on the extended warranties and

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[52] "In discussions prior to trial, the parties stipulated that the pre-printed forms sent back and forth, such as quotes, purchase orders and acknowledgments, contained differing terms and conditions and did not in themselves constitute contracts. The court read this stipulation to the jury just before opening arguments: 'The parties involved in this case are merchants. They have exchanged documents that have different terms and conditions, and I am instructing you that the exchange of the documents alone does not constitute a contract. However, there is a contract or contracts if the conduct by both parties recognizes the existence of a contract.'" (*Id*. at *7)

[53] Dallas' form provided that it could cancel or terminate the purchase order in whole or in part at any time on notice. Lam's form required payment for completed goods, payment of actual costs for work in progress and raw materials, and a reasonable profit. (Dallas Semiconductor Corporation's Appellant's Opening Brief, at 11-12, Lam Research Corp. v. Dallas Semiconductor Corp., No. H027073 (Cal. Ct. App. Apr. 17, 2006) (No. CV805045), 2004 WL 3256077 at *11.

[54] The opinion is unclear as to whether any of the $3.6 million was for resale from the third, partially completed, tool. I am assuming none was.

training packages for the tools. The jury awarded Lam damages of $11,419,545, about 55% of the contract price.

Dallas argued that for Lam to be a lost volume seller it would have to have sold the exact contract goods to a third party following the breach. Since the seller had disassembled the tools and used the components in new tools for third party customers, it could not be a lost volume seller. Instead it should have been considered a component seller, in which case the "due credit" language in section 2-708(2) would have applied. Dallas argued that the UCC required "in a component seller situation, that *proceeds of resale* be deducted from *profits* plus extra expense . . . . Lam received as 'proceeds of resale' $3.6 million for the parts of A and B alone, and it is *this crucial mitigation evidence* that is *to be deducted from the 'lost profits'* under the section 2708 (2) formula."[55] That is, the court should first determine lost profits on the two completed machines (roughly 55% of the contract price) and then subtract from that the $3.6 million.

Dallas had attempted to put forth an alternative theory of damages but was denied. The expert reports are not available, but the basic contours can be inferred from the decision, briefs, and some motions.[56] The Dallas expert produced a report that accepted the lost profit measure for the two completed tools, but rejected it for the others: "Mr. Yerman [the Dallas expert] has also apparently assumed that Lam would not be entitled to lost profits on the sale of System C and that Lam would not be entitled to any damages on Systems D, E, and F."[57] There is some ambiguity regarding his report. In arguing (successfully) against admitting Yerman's report, Lam's counsel complained: "Mr. Yerman's analysis is clearly a calculation based on Commercial Code §2706. Lam is not proceeding under §2706 and Mr. Yerman's analysis is accordingly irrelevant and likely to confuse the jury."[58]

Dallas anticipatorily repudiated the obligation for the three tools on which production had not begun. If there were no changes in market conditions, the contract/market difference would have been zero. The court's lost profit remedy in effect implied that Dallas would have paid 55% of the contract price for the option to buy the tools for 45% of the price. The fact that the tools were customized suggests that some

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55 Dallas Semiconductor Corporation's Appellant's Reply Brief, at 17. (emphasis in original)

56 Most decisions in Westlaw do not include other filings. Here, despite the fact that the opinion was unpublishable, 45 filings were available.

57 Westerman Aff., Lam Research Corp. v. Dallas Semiconductor Corp., No. H027073 (Cal. Ct. App. Apr. 17, 2006) (No. 1-02-CV805045), 2003 WL 25788061 (Lam's expert witness).

58 Plaintiff's Motion in Limine 5: Renewed Motion to Restrict Testimony of Robert N. Yerman; Supplemental Declaration of Marc G. Van Niekerk at n.1, Lam Research Corp. v. Dallas Semiconductor Corp., No. H027073 (Cal. Ct. App. Apr. 17, 2006) No. 1-02-CV805045, 2003 WL 25786764.

protection for the seller would be important *after* production had begun; but prior to that, the seller's reliance would have been modest. The implied option price would substantially overstate any plausible option price.

There is not much information in the opinion regarding the partially completed machine. From what is available, it appears that the last clause of 2-708(2) would be apposite: "due allowance for costs reasonably incurred and due credit for payments or proceeds of resale." Lam incurred a bit over $1 million in costs and, apparently either sold the parts or incorporated them in other units. I would presume that "proceeds" was broad enough to encompass the market value of parts that were incorporated into other tools.

For the two completed machines, the court held that because the contract/market difference was inadequate it had to go directly to 2-708(2). However, 2-709 provided a perfectly adequate remedy. Lam could not resell the goods—they were customized for Dallas. Lam should have sued for the price (under 2-709(1)(b)) less the net proceeds from using the cannibalized parts (under (2)). That, by chance, would result in the same measure of damages for these tools as the 2-708(2) measure (assuming that the numbers bandied about in the opinion were correct). The price of $8 million would have been offset by the resale of $3.6 million resulting in measured damages of $4.4 million—55% of the price. Dallas' argument went further. It argued that the $3.6 million should have been an offset against the *lost profits,* not the *price*. Had it succeeded in that spurious argument the measured damages for those tools would have been around $.8 million ($4.4-$3.6 million). But, as should be clear, combining the alleged lost profits with the offset would have made no sense.

b. Nederlandse Draadindustrie NDI B.V. v. Grand Pre-Stressed Corp.[59]

This is a much simpler case. The contract called for delivery in installments of 1180 metric tons of steel strand during 1975. After five shipments of about 220 tons, the buyer repudiated for the remaining 960 tons. The court held that the seller was a lost volume seller, awarding it the lost profits on the remaining 960 tons. It found that the variable costs were $394, the contract price was $608, and, therefore, the lost profits were $214 (around 35% of the price).

The court noted that in 1975 the seller had the capacity to produce 13,000 metric tons and that actual sales were 8,788 metric tons in 1974 and 6,923 metric tons in 1975. From this it concluded that the seller had ample capacity to fill this order and others so it would be a lost volume seller.

The buyer cancelled the contract for a simple reason. Market conditions had changed and strand was now available from other sources at a lower price. The contract

[59] 466 F.Supp. 846 (1979).

price was $159 per 1,000 linear feet but the market price had fallen below $149.[60] The extraordinary feature of the decision is that the court did not even consider the possibility that the standard contract/market differential remedy would have been adequate. The difference was the magnitude. Damages so measured would have been only around 6-10% of the contract price, not the 35% the court found. By framing the question as one of lost volume the court simply bypassed the normal remedy and rewrote the contract by creating an unrealistic implicit option price.

c. Jewish Federation of Greater Des Moines v. Cedar Forest Products Co.[61]

In this case, the court purported to award lost profits to a lost volume seller. It provides yet another illustration of the confusion engendered by the concept. Cedar Forest Products (CFP) manufactured pre-cut building packages. The Federation contracted with CFP for a 3,500 square foot building for about $214,000, putting down a deposit of about $53,000. After the Federation rescinded its order it asked for the return of its deposit. CFP refused and counterclaimed arguing that it was a lost volume seller. The trial court held that it was indeed a lost volume seller, but it "fashioned an equitable remedy,"[62] awarding only $13,000 for incidental damages. The trial court concluded: "[I]t would be *unjust* to allow [CFP] to recoup lost profits in a situation here where it has not even begun to partially assemble component parts into a specialty item. . . . [T]his Court does not believe that the lost volume seller theory was intended to apply to sellers who were in the process of preparing to assemble a specialty item."[63] The Court of Appeals noted that CFP had purchased a number of items in anticipation of the project (cedar paneling, insulation, cedar timber, etc.) but had not yet begun assembly. After the breach it resold those items to other customer for the same price as called for in the contract.

In concluding that CFP was a lost volume seller, the Court of Appeals rejected the Federation's contention that since it had not yet begun assembly incidental damages were sufficient. "However," said the court, "this position is not supported by case law. Lost profits may be awarded on items *yet to be manufactured*."[64] The Court of Appeals held that the trial court had erred in its application and that it should have awarded lost profits. What were they? Not, it appears, anything to do with but-for costs. According to the court they were the original down payment—the $53,000! So, in a very roundabout way we end up right where we began—the seller got to keep the deposit. The Federation's reward for its failed attempt to get it back was that it paid its legal fees and, by contract, the reasonable legal fees of the seller.

[60] "In consideration of the falling market price of strand . . . [the seller] offered to modify the agreement in two respects: first, by permitting deferred payment by letter of credit at 60 days, and second, by reducing the price per thousand feet from $159 to $149." *Id.* at 848.
[61] 796 N.W.2d 456 (2003).
[62] *Id.* at 1.
[63] *Id.* at 2.
[64] *Id.* at 2. (emphasis in the original)

d. Bitterroot Intern. Systems, Ltd. v. Western Star Trucks, Inc.[65]

Bitterroot, a provider of freight hauling and transportation logistics services, and Western, a manufacturer of custom-built trucks, negotiated a five-year deal in which Bitterroot would provide services. However, before it went into effect Western signed with a competitor. Bitterroot sued alleging breach of contract and breach of the covenant of good faith and fair dealing. Western argued that no contract had been formed, but the court found to the contrary. While the *Lam* contract was concluded on the basis of inconsistent forms, here the existence question was less clear. Bitterroot presented a "Transportation Logistics Proposal" and Western responded with a letter: "I can confidently say that I see no reason why we would not be able to finalize the details of this proposal. Should this not be the case, a 120 day notice in writing is required by either party to terminate this agreement."[66] The court concluded that Bitterroot's subsequent actions in reliance acted as an acceptance. Those actions included "hiring, training, and placing a logistics employee at Western Star's facility . . . and also installing computer equipment, telephone lines and a 'data line,' in order to provide Western with logistics services."[67] I am not interested in the question of whether a contract existed. I only describe the process for two reasons. First, this is another example of a multi-million dollar contract in which the contract formation process made it difficult to include an explicit termination clause. Second, the court does not say whether the 120-day notice proposed in the letter was part of the contract and whether it was relevant for its determination of damages.

Having found that a contract existed and that Western had breached it, the court turned to the damages question. Since Bitterroot was a provider of services 2-708(2) did not apply. However, the principle, as stated in the Restatement (350), could apply. Western argued that Bitterroot's mitigation should be taken into account; Bitterroot argued that it was a lost volume seller. The trial judge instructed the jury on *both* theories:[68]

> The District Court agreed [with Western] and first instructed the jury on the duty to mitigate: "[t]he Plaintiff has a duty to minimize their damages. However, that duty does not require them to do what is unreasonable or impracticable." The Court also instructed the jury on lost volume seller theory:
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> > As to damages claims after February 24, 1998 if you find: (1) the seller of services possessed the capability to perform additional contracts simultaneously, (2) the additional contracts would have been profitable, and (3) the seller of services probably would have entered into the additional contracts even if the first contract had not terminated [, all] to be established by a preponderance of

[65] 336 Mont. 145 (2007).
[66] *Id.* at 153.
[67] *Id.* at 148.
[68] *Id.* at 158-159.

> the evidence, then the gains, which were or could have been received by the non defaulting party by entering into another contract or transaction (mitigation) should not be used in reducing damages caused by a breach of contract.

The trial court took no position. It simply "left it to the jury to decide whether Bitterroot's duty to mitigate its losses reduced its damages, or whether, in the alternative, Bitterroot qualified as a lost volume seller, thereby making Bitterroot eligible for an award of lost volume sales."[69] Western argued that this ought to be a matter of law, but the Montana Supreme Court disagreed: "Western appears to argue that the District Court first should have resolved whether Bitterroot was a lost volume seller before the court permitted the jury to consider lost volume seller damages. The question of whether an injured party violated its duty to mitigate damages presents a question for the trier of fact."[70] And so a jury verdict of over $2 million for the repudiation of a five-year contract was upheld. Leaving the mitigation versus lost volume question to a lay jury without any guidance was an abdication of responsibility by the courts.

The decision does not provide much insight on how the lost volume sales damages were determined. This is all the court says:

> The question arises whether the jury properly found Bitterroot to be a lost volume seller. We review a jury's findings of fact to determine whether substantial credible evidence supports those findings . . . . Bitterroot presented evidence that it expected its business to grow at a rate of thirteen to fourteen percent per year, buttressed by the introduction into evidence of its tax returns and consolidated financial statements. Bitterroot also presented evidence that it had a brokerage division that could contract with other carriers to handle excess freight volume. Thus, Bitterroot argued, it profitably could have serviced the Western contract and other contracts that it entered after Western's breach. Substantial credible evidence supports the jury's determination that Bitterroot qualified as a lost volume seller.[71]

In *Lam* the court extended the lost volume concept to the anticipatory repudiation of the agreement to build the last three tools. Here, the repudiation was of a long-term (five-year) contract. There is no hint in the opinion as to why Western would have paid a $2 million price for the option to use Bitterroot's services for five years (with a possible 120-day termination option). For the sale of a single good, the implicit termination price could be compared to the contract price. Teledyne, for example, was characterized as paying about 75% of the contract price for the option. For an anticipatory repudiation that price would be harder to compute. That, however, did not stop the court from doing so in *Empire Gas* to which I now turn.

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[69] *Id.* at 161.
[70] *Id.* at 162.
[71] *Id.* at 163

III. *Empire Gas v. American Bakeries*[72]

In 1980, at the height of the gasoline crisis, American Bakeries (ABC) contemplated converting some of its truck fleet so that it might be able to switch between propane and gasoline. It entered into a four-year contract in which it agreed to take all of its propane from Empire and to buy conversion units (which, at a flip of a switch, would enable them to use either propane or gasoline). The contract was "for approximately three thousand (3,000) [conversion] units, more or less depending upon requirements of Buyer." The price per unit was $750. The contract included a variation on a meeting competition clause: "American Bakeries agrees to purchase propane motor fuel solely from EMPIRE GAS CORPORATION at all locations where EMPIRE GAS has supplied carburetion and dispensing equipment as long as EMPIRE GAS CORPORATION remains in a reasonably competitive price posture with other major suppliers."[73]

American Bakeries changed its mind, repudiated the contract, and took nothing. Judge Posner ruled that this was a requirements contract and that a buyer could take nothing under a requirements contract as long as it had a good faith justification. Since ABC offered no justification, however, he held that it had breached and was liable for damages. There was "a jury verdict for $3,254,963, representing lost profits on 2,242 conversion units (the jury's estimate of American Bakeries' requirements) and on the propane fuel that the converted vehicles would have consumed during the contract period."[74] The breakdown of damages, not cited in that opinion, was $642,062 for the conversion units and $2,612,901 for the propane.[75] There was little discussion in the opinion of the measure of damages. It was limited to ABC's objection to the expert witness's assumption that, because propane was so much cheaper, after the units were installed ABC would use only propane.[76]

Empire's primary business was selling propane and it supplied conversion units as an accommodation to its customers. Empire did not produce conversion units; it bought

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[72] 840 F.2d 1333, (7th Cir. 1988).

[73] *Id.* at 1335. I doubt that the contract would have been enforceable under the common law rules. Given the more liberal UCC rule (2-305), the issue did not arise.

[74] *Id.* at 1335.

[75] Brief and Short Appendix American Bakeries Company Defendant-Appellant, at 39, Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333 (7th Cir. 1988) (No. 82 C 815).

[76] Judge Posner dismissed ABC's other concerns: "A great weakness of American Bakeries' case was its failure to present its own estimate of damages, in the absence of which the jury could have no idea of what adjustments to make in order to take account of American Bakeries' arguments. American Bakeries may have feared that if it put in its own estimate of damages the jury would be irresistibly attracted to that figure as a compromise. But if so, American Bakeries gambled double or nothing, as it were; and we will not relieve it of the consequences of its risky strategy." *Empire Gas Corp. v. Am. Bakeries Co.*, 840 F.2d 1333, 1342 (7th Cir. 1988).

them in a competitive market.[77] Why would there be any damages at all? If market conditions for conversion units hadn't changed there should be no damages on that score. And the meeting competition clause would suggest that the market/contract price differential for propane should be zero.

Let me qualify that. It is possible, albeit unlikely, that there had been a change in the market price of conversion units. In the opening sentence of its Brief, ABC hinted at this: "During 1980 and for part of 1981, the gasoline crisis led to a shortage of propane carburetion equipment for cars and trucks."[78] It is at least possible that the market price of converters had fallen in the interim and that there was a contract-market differential that should have been awarded. But there is no hint of such a claim in the Briefs, and even if it were so, the differential would have been far smaller than the lost profits awarded by the court. Measurable damages in the propane market would have been more plausible.[79] Because Empire sold propane at multiple locations, and because the costs of Empire and its competitors varied between locations, the "reasonably competitive" standard could be problematic. If, for example, ABC's facility in one locality were adjacent to Empire's, but not close to a competitor, the meeting competition clause could give Empire ample pricing leeway. The "contract price" could include "locational rents." I do not mean to suggest that damages measured in this way would have been significant or that it would have been a good idea to award damages on this basis.

The decision did not mention 2-708(2). Moreover, the Briefs to the Court of Appeals also fail to mention it. This I found puzzling. The puzzle was resolved when I found the trial judge's decision on ABC's motion for a JNOV; he rejected ABC's argument that the contract-market formula was adequate:

> ABC urges that, as a matter for law, Empire failed to prove damages as a result of the alleged breach of contract, thereby mandating judgment for ABC. With regard to the damage award for lost profits on the sale of the conversion units, it takes the position that Empire was not entitled to lost

[77] In its Brief, Empire listed five brands that it had in inventory in 1980. Brief of Empire Gas Corporation Plaintiff-Appellee, at 6, Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333 (7th Cir. 1988) (No. 82 C 815). ABC argued that it had been shown only one and that the contract called for delivery of that brand; since that brand turned out to be defective, it argued, Empire was not ready, willing, and able to perform, and therefore it had breached. However, the contract language did not require a specific brand and the court held that any of the other brands carried by Empire would have satisfied the contract language.

[78] Brief and Short Appendix American Bakeries Company Defendant-Appellant, at 3, Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333 (7th Cir. 1988) (No. 82 C 815).

[79] Since propane had been subject to price controls around this period, I thought that it might be possible that the tie-in with converter sales might have been a way of circumventing the price controls. There is no hint of this in the Briefs and the two people who I spoke with who were involved in the case had no recollection of this.

> profit damages because it failed to prove first that a contract-market formula of damages was inadequate.
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> * * *
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> Any plaintiff who seeks to prove that damages recoverable under § 2-708(1) will not put him in the same position as performance, should be permitted to prove lost profits under § 2-708(2). J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code, §7-11 at 279 (2d ed. 1980). In this case, Empire chose to undertake the burden of proving lost profits, Tr. 2472, and the jury concluded that it sustained its burden and accordingly made an award for lost profits on the sale of the conversion units; the conclusion was reasonable in light of the evidence.[80]

So, it turns out, 2-708(2) was deemed relevant in at least one phase of the litigation; why ABC did not continue to question it further remains unexplained. In its Brief to the Seventh Circuit ABC did not contest the claim for lost conversion unit sales at all. Damages for that component worked out to $286 per unit, about 38% of the contract price. I presume that this was the difference between the retail and wholesale price. In effect, the court found that ABC agreed to pay an option price of 38% for the privilege of buying conversion units, for $464, units that were available in a competitive market.[81] Why, on earth, would ABC have needed to pay any option price, let alone the implied option price of 38%? The question was never put before the Court of Appeals; the trial court's framing of the remedy matter precluded its asking the question.

ABC did challenge vigorously the expert's determination of lost profits on the propane claim, but without success. The expert calculated how much more propane Empire would have sold, but for the breach. ABC questioned a number of the expert's assumptions: the rate at which conversion units would be installed; propane's share of the fuel consumption (100%); the propane price; and the costs of adding new equipment in areas that Empire had not previously served.[82] I have not been able to find the expert's report and the briefs do not provide sufficient information to ascertain the ratio of the damage claim to total projected propane sales, but it was probably in the 5-10% range.[83] ABC did not contest the notion that damages on the propane business should be Empire's lost profits.

IV. Concluding Remarks

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[80] *Id.* at S.A. 9-11 Motion for JNOV, pp. 9-11. Reprinted as Appendix to ABC Brief.

[81] $750-$286=$464.

[82] ABC Brief, at 39-47.

[83] Empire's annual sales were about $350 million and the projected sales under this contract were for 2-3% of that amount. Brief of Empire Gas Corporation Plaintiff-Appellee, at 2, 7, Empire Gas Corp. v. Am. Bakeries Co., 840 F.2d 1333 (7th Cir. 1988) (No. 82 C 815). Over the four-year life of the contract the total projected sales would have been in the $25-$40 million range; since the damage claim was $2,612,901, that would be 6-9%. Given the roughness of this calculation, I expanded the range to 5-10%.

Okay, so the doctrine is bogus. What can we do about it? There are, after all, decades of interpretation of the statute to overcome. I am content to leave the statutory interpretation task to others—a bit of a copout, I confess. But I can at least suggest a few possible paths. One line that was suggested by Shanker and Breen decades ago is to take seriously the last clause of 2-708(2) and allow for mitigation.[84] Since 2-708(2) is the exception to the remedy in 2-706 and 2-708(1), an interpretation in which the exception swallows up the rule should be suspect. Relatedly, one canon of interpretation of contracts and statutes is that the language should not result in an absurd result.[85] Since 2-708(2) as currently interpreted systematically produces absurd results, an alternate interpretation (mine) should be adopted.[86]

Since a precondition for applying the 2-708(2) remedy is the adequacy of the other remedies, a simple solution would be to define "adequate" liberally. For example, holding that when the buyer cancels a contract to buy a car, the deposit is adequate, or recognizing that when the buyer anticipatorily repudiates a long-term contract, adequacy requires that the seller mitigate. The law's hostility to penalty clauses could be turned on its head; if, as I suggested above, the lost volume measure typically results in an excessive measure of damages, then it could be rejected as punitive. Finally, even if we concede (reluctantly) the plausibility of the lost volume story for the one-off deals, we could at least raise the proof standards in the anticipatory repudiation context.

Along with eliminating the lost volume, lost profit remedy, courts should rethink the hostility to so-called penalty clauses. Commercial parties have lots of good reasons for imposing an explicit termination option price and courts should not get in the way. Of course, as some of the cases indicated, the contract formation process might prevent such terms from becoming part of the contract. Both the Dallas-Lam and the Bitterroot-Western contracts are illustrative of multi-million dollar deals without a written contract. Deals of that sort reinforce my concern about the substance of the default rules.

Why is it that so many "right-thinking people" have been thinking about it the wrong way for so long? This relates to a more general point. The notion of "making the victim whole," while superficially appealing, is not a particularly helpful guide for analyzing contract remedies. For the problem at hand, the buyer's exercise of its termination option, it does not work. But that is only one way in which a contract can be breached. Others might call for very different remedy regimes; they might even entail compensation for lost profits. Recognizing that breach can be characterized as exercising an option does not mean that all such breaches should be viewed as such. It would not be particularly

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[84] Morris G. Shanker, *The Case for a Literal Reading of UCC Section 2-708(2) (One Profit for the Reseller)*, 24 Case. W. Res. L. Rev. 697 (1973); and Breen, *supra* note 18.

[85] "As between two interpretations, the court will not adopt an interpretation that produces an absurd result." Vincent R. Martorana, *A Guide to Contract Interpretation*, 14, Reed Smith LLP, http://webcasts.acc.com/handouts/Article_478_26B1_A_Guide_to_Contract_Interpretation__July_2014_Reed_Smith-2.pdf.

[86] And for heaven's sake, don't leave the mitigation versus lost profit question as a fact question for a lay jury.

helpful, for example, to refer to the seller's option to transport goods to the wrong location or to provide goods that breach an express warranty.