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## The Lost Volume Seller in English Law

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## **The Lost Volume Seller in English Law**

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## The Lost Volume Seller In English Law

One of the mysteries in life is how different jurisdictions can be faced with the same legal problem and manage to come up with the same wrong answer. Case in point. Both English and American contract law hold that if a buyer cancels an order (breaches) and the seller resells the item at the same price, the seller's remedy need not be the contract/market differential (zero). Rather, they both say, if the seller could have sold this item and another as well, the seller could have made the profits on both items. The seller would be a "lost volume seller" and, since the breach cost it the profits on the second sale, it should be compensated for the loss of that profit.

In an earlier article on the American law, I argued that this is wrong.<sup>1</sup> When I looked at the English treatises it turned out that they made the same mistakes as the Americans.<sup>2</sup> Their problem is that they both ask the wrong question. If the question were whether the seller did lose something when the buyer breached, the answer would generally be Yes. And since courts in both places frame the legal question as one of making the seller whole, the lost profit remedy seems plausible.

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<sup>1</sup> Actually, I have made the argument a number of times, the most recent being "The Lost Volume Seller, R.I.P.," 2 *Criterion J. on Innovation* (2017). Earlier thrusts are *Framing Contract Law*, ch. 12 (2006) and *Rethinking Contract Law*, ch. 4 (2015).

<sup>2</sup> Treitel, *The Law of Contract*, 14<sup>th</sup> edition, Edwin Peel (ed.) (2015), pp.1143-44, §20-58. McGregor on Damages, 20<sup>th</sup> edition James Edelman (ed.) (2018) pp. 245-246, §9-045. Chitty on Contracts, Vol. 1, 32<sup>nd</sup> edition, H.G. Beale (ed.) (2015), p, 1861, §26-096. Adam Kramer, *The Law of Contract Damages*, 2<sup>nd</sup> edition, (2017), pp. 170-1, §5-39—5-42; 834-35, §25-118—120; pp. 840-841, §25-130—131; pp. 852-53, §26-016.

In *The Achilles*,<sup>3</sup> Lord Hoffmann said: “It seems to me logical to found liability for damages upon the intention of the parties (objectively ascertained) because all contractual liability is voluntarily undertaken. It must be in principle wrong to hold someone liable for risks for which the people entering into such a contract in their particular market, would not reasonably be considered to have undertaken.”<sup>4</sup> The same principle, I suggest, should apply to measuring damages; the lost volume seller fails that test.

A simple example should illustrate the ludicrousness of the lost volume remedy. Ajax Ltd. is putting the finishing touches on a software package and has lined up a number of customers, one of which is Bell Ltd. Bell has agreed to buy the software program for \$100,000 with delivery in one month on June 1. On June 1, the price is still \$100,000. Bell reneges on its promise (breaches). The seller would be a lost volume seller—it could have sold this package and another as well. What would be the damages? The lost volume remedy would award \$100,000 minus the but-for costs. Since the product could be delivered over the internet, the but-for costs would be close to zero,<sup>5</sup> and the lost volume damages, therefore, would be \$100,000. Would a buyer “voluntarily undertake”, to use Lord Hoffmann’s phrase, to pay the full price regardless of whether it ultimately decides to take the product? Now, there might be circumstances in which the seller would want some protection from the buyer walking away. If so, it could contract for it, by negotiating a nonrefundable deposit or liquidated damages. It is extremely

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<sup>3</sup> *Transfield Shipping Inc. v. Mercator Shipping Inc. (The Achilles)*, [2008] UKHL 48, [2009] 1 A.C. 61 (H.L.).

<sup>4</sup> At 12.

<sup>5</sup> If the product were delivered on a number of compact disks, the but-for cost would be the price of the disks, the postage, and the packaging, which might amount to a few hundred dollars.

unlikely that there would be circumstances that would have resulted in a negotiated nonrefundable deposit approaching \$100,000. That is, the lost volume remedy would result in an absurd contract which no rational buyer would enter into.

In general, after entering into a contract, the buyer has a choice. It can go forward with the purchase or it can terminate (breach). That is, it has an option and the contract determines the price of that option. If the contract did not include an explicit option price, the contract remedy would be the implicit price of the option. If there were not an explicit price, what should the implicit price (the default remedy) be? One alternative is the lost volume profit; the second is the contract/market differential.<sup>6</sup> The software hypothetical suggests that the option price determined by the lost volume measure would result in an absurd contract. I will argue in this paper that the hypothetical carries over to other contexts as well and that the lost volume remedy should be discarded. The test is a simple variant on Lord Hoffmann's question: is the resultant contract absurd? The lost volume profit remedy fails that test. As we shall see, it will typically set damages too high and, worse, it will be perverse, setting the option price high when it should be low and vice versa.

Sophisticated buyers often contract out of the lost volume remedy. It is not easy to document the extent of this, but some insight can be gained by looking at the contracts between American automobile manufacturers and their suppliers. General Motors' standard purchase order, for example, gave the buyer the "option [to] terminate all or any

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<sup>6</sup> That is the remedy embodied in the Sale of Goods Act 1979, 50(3): "Where there is an available market for the goods in question the measure of damages is prima facie to be ascertained by the difference between the contract price and the market or current price." The hypothetical does not concern goods; however, as Kramer ¶1.20 observes, the common law remedy is similar.

part of this order, at any time and for any reason.”<sup>7</sup> GM would compensate the supplier for costs that had been incurred, but there would be no recovery for lost profits. While the practices of other auto manufacturers varied, none would cover R&D and engineering expenses, a significant element of lost profits.<sup>8</sup> I suspect that the procurement contracts of large English manufacturers would also reject the lost profit remedy. The lost profit remedy is basically a trap for the unwary.

The treatises cite only a handful of cases and generally only present the conclusions without getting into the facts. Because the number is so small, a more in depth discussion of the case law is feasible. The dearth of case law is puzzling. Whether it is because defendants routinely pay the damages, sellers choose not to enforce, or because parties contract out of the remedy is not clear.

In Part I, I consider the cases involving the retail sales of consumer durables; the case law has focused almost entirely on automobiles.<sup>9</sup> In Part II, I consider the business-to-business (B2B) cases, which present somewhat different issues.

## **I. THE CAR CASES**

Treitel’s treatment is typical:

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<sup>7</sup> Quoted in my *Protecting Reliance*, 114 *Columbia Law Rev.* 1033, 1055 (2014).

<sup>8</sup> Omri Ben-Shahar & James J. White, *Boilerplate and Economic Power in Auto Manufacturer Contracts*, 104 *Mich. L. Rev.* 953, 959 (2006).

<sup>9</sup> A Scottish case concerned a dining room set; see note z, below.

The point may be illustrated by cases in which car-dealers have claimed damages for loss of profits from customers who had agreed to buy cars and then in breach of contract refused to accept them. Three situations can be distinguished. First, the sale is of a new car and the supply of cars of the contract description at the dealer's disposal exceeds the demand. Here the dealer's claim will succeed, for he would, if the original owner had not defaulted, have been able to make a sale both to him and to the second customer; hence he would have made two profits, one of which has been lost. Secondly, the sale is of a new car and the demand for cars of the contract description exceeds the supply available to the dealer. Here his claim will fail, for the number of sales he can make depends on the number of cars that he can get and not on the number of customers that he can find. Hence the default of the original customer does not reduce the number of profits that he can earn.<sup>10</sup>

That is, if the dealer could accommodate anyone who came to the dealership, and the dealer had taken orders for 20 cars in a month; if one buyer cancelled his contract there would have been only 19 sales and the dealer would have lost the profits on one sale. If, however, the dealer could only receive 20 cars in the month and one customer cancelled, the dealer would still have 20 sales and there would be no lost profits. All four treatises that were mentioned in footnote 2 make the same argument and all cite the same three cases.<sup>11</sup> (The third case involves the sale of a used car.)

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<sup>10</sup> Treitel, pp. 1143-4; §20-059. His third case, sale of a used car, will be discussed below.

<sup>11</sup> Kramer, p. 170, §5-39; McGregor, pp. 245-46; §0-045. Chitty, p. 1861, §26-096.

Automobile dealers provide retailing services to the manufacturers and their compensation is indirect. If the customer buys the car, the dealer would receive the difference between the wholesale and retail price. In England in the 1950's (when the two new car decisions cited by all the treatises occurred), cars were sold under resale price maintenance (rpm), so that the margin was fixed.<sup>12</sup> As we shall see, the fact that the dealer was not able to adjust the selling price to changing market conditions simplifies the analysis.<sup>13</sup> If the customer chose not to buy, the dealer would receive no compensation, regardless of how much time and effort the dealer spent with that customer. What if the customer signed the contract, but before the car was delivered, the customer reneged? The lost volume seller framework says that the dealer should receive the same compensation that it would have received had the customer consummated the purchase (except if supply were constrained, in which case the customer would pay nothing).

If the manufacturer had priced the car too low, the dealer could not raise the price directly. However, it could raise the price indirectly without violating its rpm commitment. One strategy would be to tie the sale to something else. Specifically, if the buyer were trading in its old car, the dealer could, in effect, alter the price of the new car by paying a below market rate for the used car. Conversely, if the manufacturer had set the retail price too high, the dealer could cut the effective price by paying an above

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<sup>12</sup> According to the dealer's counsel in the first case, "if a dealer broke that rule he was put out of business." *Thompson (W. L.) Ltd. v. Robinson (Gunmakers) Ltd* 1955] 1 Ch. 177, 179.

<sup>13</sup> The problem is a little more complicated without rpm, but the conclusion remains the same; see Goldberg *supra*, n. 1.



market price for the trade-in. The trade-in will reappear in the discussion of *Charter v Sullivan*, below.<sup>14</sup>

A second means of effectively raising the price would be for the dealer to charge a deposit.<sup>15</sup> The American natural gas market in the 1970's provides a good illustration. The prices were fixed by law at a level below the market clearing price. The sellers then responded by requiring that the buyers enter into take-or-pay contracts with a high "take". That is, the buyer agreed to pay for, say, 80% of the contract quantity regardless of whether it actually took any.<sup>16</sup> If the market were tight (in the misleading language of Treitel and the others, when demand exceeds the dealer's supply), the dealer would set a high deposit. With the deposit the customer, in effect, would be taking an option. It could walk away, forfeiting the deposit, or it could conclude the deal by paying the remainder of the contract price. The tighter the market, the higher the deposit (option price). The lost volume seller framing gets it backward. It sets the option price high when the market is slack and low (or zero) when the market is tight.

The decisions considered none of this.

*A. Thompson (W. L.) Ltd. v. Robinson (Gunmakers) Ltd.*<sup>17</sup>

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<sup>14</sup> See text at note x.

<sup>15</sup> Deposits and liquidated damages are analytically equivalent. With a deposit the dealer would not have to sue, but it would if the contract included liquidated damages. The deposit would also be a tool the dealer can deploy to decrease the likelihood that the customer would renege.

<sup>16</sup> See Glenn Hubbard and Robert J. Weiner, Efficient Contracting and Market Power: Evidence From the U.S. Natural Gas Industry, 34 J. of Law & Econ 25 (1991).

<sup>17</sup> [1955] 1 Ch. 177.

The managing director of Robinson ordered a new Vanguard car on March 4, 1954. On the following day he refused to accept the car, whereupon the dealer sued for his lost profits. The dealer's compensation was fixed at ten percent of the list price.

The decision does not provide direct evidence on the market for Vanguard cars, although the indirect evidence suggests that the market was weak.<sup>18</sup> Apparently, after Robinson cancelled, the dealer did not sell the car to a second customer. Rather, the dealer managed to rescind his contract with his supplier: "True, the motor-car in question was not sold to another purchaser, but the plaintiffs did what was reasonable, they got out of their bargain with George Thompson Ltd., but they sold one less 'Vanguard,' and lost their profit on that transaction."<sup>19</sup> The names suggest that the dealer/supplier contract was not arm's length.<sup>20</sup> Presumably, George Thompson Ltd. could have sued the dealer for its lost profits rather than granting rescission, and the manufacturer, the Standard Motor Car Company, could have sued George Thompson Ltd. for its lost profits as well, if one took the lost volume profit remedy seriously. However, there is no hint in the opinion that either had done so. Note that had the Standard Motor Company been vertically integrated into retailing, those lost profits would have been cumulative and poor Robinson would have been liable for them all. Such is the absurdity of the lost volume profit remedy.

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<sup>18</sup> The court noted that in the preceding years the car market was supply constrained: "It was, of course, notorious that dealers all over the country had long waiting lists for new motor-cars. People put their names down and had to wait five or six years, and whenever a car was spared by the manufacturer from export it was snatched at, and if any purchaser fell out there were many waiting to take his place." (At 185)

<sup>19</sup> At 184. "They took back the 'Vanguard' car which they had already supplied to the plaintiffs, free of any claim for damages, and later sold the car on May 5, 1954, to another purchaser." At 179.

<sup>20</sup> "Their supplier was a company called George Thompson Ltd., the main distributors for the East Riding, a company closely associated with the plaintiffs." At 179.

The court recognized that there were no English opinions directly on point. It cited *In Re Vic Mill*<sup>21</sup> (to be discussed in the next section) and a few cases from the Commonwealth and the United States finding that the seller would receive its lost profits.<sup>22</sup> The defense argued that the Sale of Goods Act, 1893, Section 50(3) governed: “Where there is an available market for the goods in question the measure of damages is prima facie to be ascertained by the difference between the contract price and the market or current price.”<sup>23</sup> Since the market and current price were the same, the damages under 50(3) would have been zero.

There followed a long, and rather embarrassing, discussion of whether or not there was an “available market” for Vanguard cars. Invoking *Dunkirk Colliery Co. v. Lever*,<sup>24</sup> decided in 1878, the plaintiff argued that available market meant “some place or centre at or through which a seller can reasonably expect to find a purchaser.”<sup>25</sup> The court agreed: “it was proved that there is nothing in the nature of a market like a Cotton Exchange or Baltic or Stock Exchange, or anything of the sort, for the sale of new motor-cars.”<sup>26</sup> So, since there was no available market, Section 50(3) was out.

Having rejected section 50(3), the court concluded that “the plaintiffs lost a sale in the sense that if another purchaser had come into the plaintiffs' premises there was available for that other purchaser a ‘Vanguard’ car for immediate delivery: so that the

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<sup>21</sup> [1913] 1 Ch. 465, C.A.

<sup>22</sup> The court ignored the most significant American case of that era which rejected the lost volume remedy; see *A. Lenobel, Inc. v. Senif*, 252 A.D. 533, 300 N.Y.S. 226 App. Div. 1937).

<sup>23</sup> At 177.

<sup>24</sup> (1878) 9 Ch.D. 20, 25

<sup>25</sup> At 181.

<sup>26</sup> At 185.

effect on the plaintiffs was that they had lost their profit on a sale; having sold one ‘Vanguard’ less than they would otherwise have done.”<sup>27</sup>

Although the dealer had not sold the car to another customer, the court concluded that did not matter. George Thompson (the distributor) did eventually sell the car on May 5, 1954.<sup>28</sup> “But on the assumed facts circumstances had changed in relation to ‘Vanguard’ motor-cars, and in March of this year there was not a demand in the East Riding which could readily absorb all the ‘Vanguard’ motor-cars available for sale. If a purchaser defaults, that sale is lost, and there is no means of readily disposing of the ‘Vanguard’ contracted to be sold so that there is not even on the extended definition an available market.”<sup>29</sup> Thus, even if the broader definition of available market were used and Section 50(3) did apply, the dealer would win, said the court. It would be “unjust to apply that rule . . . it seems to me plain almost beyond argument that in fact the loss to the plaintiffs is the sum of £61. Accordingly, however one interprets subsection (3), it seems to me on the facts that I have to consider one reaches the same result.”<sup>30</sup>

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<sup>27</sup> At 179.

<sup>28</sup> At 179.

<sup>29</sup> At 187.

<sup>30</sup> At 187. Shortly after *Thompson*, a Scottish court applied the reasoning in a case involving the cancellation of an order for a dining room set, *David Elder Ltd. v. Milne*, 1957 S.L.T. (Sh. Ct.) 19. (Actually, the court found that there was no contract, but, anticipating the possibility of an appeal, it ruled on damages as well). It concluded that there was not an “available market,” and therefore found that the buyer had, in effect, agreed to pay 29% of the contract price whether or not it took the dining set. “In the present case the loss suffered by the pursuers is the profit they would have got from the sale of the dining-room suite to the defender, i.e. £49 2s. It is true that both the suite in the window and the suite specially ordered and covered for the defender were sold eventually, but some six months later. One could not possibly say there was an available market for dining-room suites costing £171 in the sense that if one buyer repudiates, another could easily and readily be found. Indeed, if there is not an available market for motor cars, still less is there for dining-room suites. Consequently, if the pursuers are right in their contention that a firm order was given by the defender, it follows that they are entitled to the damages they claim.” (At 20)

Notice that the court is coy about the final disposition of the car. The wholesaler was, in fact able to resell the car, perhaps at the fixed price.<sup>31</sup> What if no one wanted the car and George Thompson Ltd had not bailed the dealer out?<sup>32</sup> The dealer would have been stuck with a car that, presumably, could only be sold for scrap. The loss in that case would not have been the 10% profit; it would have been the price of the car less the scrap value. The market price for a car that nobody wants is not the manufacturer's fixed price; it is zero.

If, however, the market had been extremely tight, as it had been in the previous years (see note 10), the court concluded that “the claim for damages must necessarily have been purely nominal.”<sup>33</sup> The fact that the retail price was fixed by the manufacturer accentuates the absurdity of the decision. With the price fixed, the dealer would set the option price accordingly. In the tight market of the previous years, the option price would have been high; in the apparently weak market for Vanguard cars in 1954, the option price would have been low. By invoking an archaic definition of available market and a naïve view of what justice would require, the court managed to get it backwards.

#### *B. Charter v. Sullivan*<sup>34</sup>

A few months after *Thompson* was decided, Ernest Sullivan placed an order for a Hillman-Minx. As in *Thompson*, the retail price was fixed by the manufacturer. The price

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<sup>31</sup> See text at footnote 12.

<sup>32</sup> This is unlikely; given that the cancellation took place one day after Robinson entered into the contract, the market could not have changed that much.

<sup>33</sup> At 185.

<sup>34</sup> [1957] 2 QB 117.

was £780 and the margin was 12.5%.<sup>35</sup> Sullivan had offered a used van as a trade-in for £350. He shopped around and, upon receiving a better offer for the van, he cancelled his contract.<sup>36</sup> A week later the dealer sold the car to a Mr. Wigley for the same price. The dealer sued for his lost profits on the second sale and the county court judge held for the dealer. A unanimous Court of Appeal reversed.

Jenkins, L.J., began by framing the problem as whether or not supply exceeded demand:

The number of sales he can effect, and consequently the amount of profit he makes, will be governed, according to the state of trade, either by the number of cars he is able to obtain from the manufacturers, or by the number of purchasers he is able to find. In the former case demand exceeds supply, so that the default of one purchaser involves him in no loss, for he sells the same number of cars as he would have sold if that purchaser had not defaulted. In the latter case supply exceeds demand, so that the default of one purchaser may be said to have lost him one sale.<sup>37</sup>

He then turned to whether there was an available market, concluding that there wasn't one. "If the only price at which a car can be sold is the fixed retail price and no

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<sup>35</sup> The price was £773 17s and the damage claim was for £97 15s.

<sup>36</sup> "No point was made on either side of the fact that the defendant was to give another vehicle in part-exchange." At 119. Nevertheless, the facts were clear: "[T]he defendant repudiated the agreement and refused to take delivery because he had found that he could get a better bargain elsewhere for his 'Commer' van which was to be taken in part payment of the price." At 132.

<sup>37</sup> At 124-5.

purchaser can be found at that price, I do not think it can reasonably be said that there is a market or current price or that there is an available market.”<sup>38</sup> Even if that were so, however, he concluded that section 50(2) should apply not section 50(3), so the available market issue was moot.<sup>39</sup>

He next argued that the dealer would not have been able to sell a second car because he could not get a second car. The only evidence for this was a statement by the dealer: “Can sell all ‘Hillman Minx’ we can get.”<sup>40</sup> This was dispositive for Jenkins, LJ:

[M]y opinion as to the meaning of this statement . . . comes, I think, to this, that according to the plaintiff's own sales manager the state of trade was such that the plaintiff could always find a purchaser for every “Hillman Minx” car he could get from the manufacturers; and if that is right it inevitably follows that he sold the same number of cars and made the same number of fixed profits as he would have sold and made if the defendant had duly carried out his bargain.<sup>41</sup>

So the decision was reversed and the plaintiff received nothing.

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<sup>38</sup> At 125. Why he said that no purchaser could be found at that price is a mystery. His argument was that there are lots of buyers, but that the seller couldn't get more cars.

<sup>39</sup> To be clear, the “available market” argument was preposterous. There clearly was a market for the Hillman-Minx with the price set by the manufacturer.

<sup>40</sup> He ignored the county judge's finding because “he made no reference to what appears to me to be the vital passage in Winter's evidence: ‘Can sell all the ‘Hillman Minx’ we can get.’” At 129

<sup>41</sup> At 130. He continued: “I think the meaning of Winter's statement is plain. It is the evidence of the plaintiff's own sales manager as to the state of the trade, and if accepted as accurate, as I think it should be accepted, it seems to me completely destructive of the plaintiff's case on damages.” At 131-2.

Jenkins's attempted to distinguish this case from *In Re Vic Mill*,<sup>42</sup> (which will be discussed in the next Section), but the attempt failed. "*In re Vic Mill Ltd.* does not really assist; it concerned a special order where there was an element of work and labour involved and the specially ordered goods were altered for resale." As we shall see, the so-called special order was irrelevant—the cost of modification was about 1% of the contract price.

The decision comes down to a literal interpretation of the casual language of a car salesman. Were the Hillman Minx cars on allocation? Surely, there would be better evidence than this. The fact that a competing dealer effectively cut the price (by increasing the price paid for the trade-in) and that the trade-in price was about half the contract price is a lot better evidence. It is not dispositive, but it does suggest that the market was not quite so tight as the judge had concluded. More significantly, the court's framing of the problem was wrong. The question should have been one of pricing the option to terminate. The tighter the market, the greater would be the price of the option. The dealer could have made that price explicit to the customer by offering a nonrefundable deposit. By framing the question as it did, the court here and in *Thompson*, did not even ask whether the buyer had made a deposit.

### C. *Lazenby Garages v. Wright*<sup>43</sup>

Wright signed a contract to buy a used BMW for £1,670. He told his wife who urged him not to buy it, so the next day he went to the dealer to cancel the order. Two months later the dealer sold the car for £1,770. The dealer said that he had bought the car

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<sup>42</sup> [1913] 1 Ch. 465, C.A.

<sup>43</sup> 22 Jan 1976 [1976] 1 WLR 459, CA.



five days prior to Mr. Wright coming to the showroom for £1,325; he sued for his lost profits, £345. The trial judge held that there was a roughly 50-50 chance of the dealer selling a similar car and awarded £172.50.

The Court of Appeal reversed. Lord Denning began by citing *Thompson*: “The cases show that if there are a number of new cars, all exactly of the same kind, available for sale, and the dealers can prove that they sold one car less than they otherwise would have done, they would be entitled to damages amounting to their loss of profit on the one car.”<sup>44</sup> The notion that the cars were exactly the same was both wrong and irrelevant. The cars could differ by color, accessories, and other features. That would not affect the reasoning in *Thompson*. Having distinguished *Thompson*, Lord Denning then argued that second hand cars are different. There was a bit of nonsense about there being no available market, but his conclusion was straight-forward: the car was resold at a profit and the dealer had suffered no damages.

#### *D. Summary*

The rote citation of these cases in the treatises perpetuates some of the dubious reasoning in the cases. The “available market” argument was wrong when it first appeared in 1878, archaic when it resurfaced in the 1950’s, and an embarrassment today. The supply and demand language is a sloppy, misleading way to characterize the market. Car dealers will on occasion find that a particular model is “hot” and the manufacturer will have it on allocation. The dealer would find that it could only sell a fixed maximum

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<sup>44</sup> At 462.

in any given month. In the 1950's world in which cars were sold under resale price maintenance, the dealer who was so constrained could not directly raise the price, but it could raise the price indirectly and one way of doing so would be to set a high nonrefundable deposit (an option price). Today the constraints on the dealer's pricing are not so tight. Still, the deposits are likely to be greater the tighter the market. In the absence of an explicit option price, contract law provides a default rule. The lost volume remedy for the car dealer sets an option price that is unknown to the buyer, that is almost certainly too high, and that is perverse, setting the price high when the market is slack and low (or zero) when the market is tight. By sticking to the contract/market differential, (likely zero), the law would force the dealer to make the option price explicit with a non-refundable deposit.<sup>45</sup>

## II. THE B2B CASES

For a retailer the lost profit was simply the difference between the wholesale and retail price; for new automobiles sold under resale price maintenance, it was a fixed markup (10% in the first case and 12.5% in the second). For business-to-business cases the lost profits are less clear-cut; they are the difference between the contract price and the but-for costs. If the seller had a substantial investment in physical plant or was in a research-intensive business, the lost profits could easily exceed 50% of the contract price. That would mean, in effect, that when the parties entered into the contract, the buyer had agreed to pay over 50% of the contract price for the option to buy the product for the

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<sup>45</sup> For an argument in favor of "forcing defaults," see Ian Ayres and Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules (with), 99 *Yale Law Journal* 87 (1989).

difference. Recall the software hypothetical in the Introduction where virtually all the seller's costs would be incurred independently of this particular sale.

Again, only a handful of cases show up in the treatises. The core cases are almost a century old.

#### A. *In Re Vic Mill*

The case generally recognized as the fount of the lost volume profit remedy is *In Re Vic Mill*.<sup>46</sup> Vic Mill, which was in voluntary liquidation, had ordered a number of machines from the seller, but had cancelled before delivery. One group of machines had already been produced. These were resold, with minor alterations and at a loss. The alterations cost £5 and the loss on resale was £23. Since the sale price for this group of machines was £465, the alteration costs were trivial.<sup>47</sup> The registrar held that the seller's loss was the alteration cost plus the loss on resale, £28. He was reversed by the trial judge, and the reversal was upheld on appeal. Instead, the court awarded lost profits—35% of the contract price (£163).

For those machines on which production had not yet begun, “the registrar was of opinion that the claimants were entitled to have the prospective profits taken into account, but having regard to the circumstances he did not think that the loss directly and naturally resulting from the breach of contract amounted to anything approaching the whole of such prospective profit, and he assessed the damages for

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<sup>46</sup> [1913] 1 Ch. 465, C.A.

<sup>47</sup> Recall Jenkins, LJ's, invocation of the alteration costs in distinguishing *Charter*.

these items at 250*l.*”<sup>48</sup> The trial judge reversed this as well and, again, his opinion was upheld on appeal. The total lost profits on the units not yet produced, according to the court, were £1002, roughly 17% of the contract price. The profits on the different items varied from about 3% to 55%; the claimed lost profit on the major items, ring frames, (90% of the total dollar value) was about 15%.

The court found that the sellers had sufficient capacity to produce goods for this contract and for others.<sup>49</sup> Rejecting the registrar’s conclusion that the remedy should take account of Vic Mill’s mitigation, the court articulated the lost volume argument:

The fallacy of that is in supposing that the second customer was a substituted customer, that, had all gone well, the makers would not have had both customers, both orders, and both profits. In fact, what they did, acting reasonably, and I think very likely more than reasonably in the interests of the Vic Mill, was to content themselves with earning the profit on the second contract at the cost of adapting the machines, which has been taken at 5*l.*; but they are still losers of the profit which they would have made on the Vic Mill contract, because they could, if they had been minded, have performed both the contracts, and have made the profit on

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<sup>48</sup> At 467.

<sup>49</sup> “The evidence on the affidavits fairly taken is evidence that the claimants’ works were sufficiently large and their equipment sufficiently ample to have enabled them to perform this contract in addition to all the others that they did perform.” (At 472).

both the contracts but for the breach by the Vic Mill Company of their contract.<sup>50</sup>

*B. Hill & Sons v. Edwin Showell & Sons, Lim.*<sup>51</sup>

Shortly after *Vic Mill*, the House of Lords faced a similar problem. In *Hill*, the buyer refused delivery of steel cartridge clips. There was no question about liability, the only issue being damages. At trial the buyer's counsel attempted to cross-examine the seller "for the purpose of diminishing the damages by showing that the mills and machinery of the appellants had been fully employed on other work as profitable as the contract sued on would have been, and that the appellants could not have undertaken this other work if they had been engaged in carrying out the contract with the respondents."<sup>52</sup> The trial judge refused to allow the testimony, holding that it was "inadmissible and irrelevant."<sup>53</sup> He awarded the difference between the price and the but-for cost, £474.

The Court of Appeal reversed and remanded; the majority accepted as obvious that if the seller had the capacity to produce the contract goods and additional goods as well, then the outcome was correct. However, it held out the possibility that the seller did not have sufficient capacity. Lord Findlay said, that the result "can be supported only if *under no circumstances* could the fact that the appellants had made other profits by the use of their mill be admissible in reduction of damages."<sup>54</sup> Viscount Haldane concurred: "it is *at least conceivable* that they may have been enabled to take on new work, which

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<sup>50</sup> At 473-4.

<sup>51</sup> 87 KB 1106 [1918].

<sup>52</sup> At 1106.

<sup>53</sup> At 1107.

<sup>54</sup> At 1107. (emphasis added)

they could not have taken on otherwise, and to make a profit out of it. I do not think that any Judge was entitled to assume that this was impossible without enquiry into the facts and the circumstances of the appellants' business, and such enquiry was wholly denied to the respondents.”<sup>55</sup>

In a lengthy dissent Lord Dunedin argued that the trial judge was correct to bar evidence on whether the seller could have performed this contract and another as well: “Had I presided as a Judge, I should have come unhesitatingly to the same conclusion as was reached by Mr. Justice Bailhache.”<sup>56</sup> He made two arguments against the notion that the seller might have been capacity constrained:

[T]he logic of this entirely depends on the accuracy of the proposition that the new work could not have been done unless the factory had been pro tanto free. It is treating the factory and its capacity of production as if the question were: How much water can a pint pot hold? Do what you will, it can never be made to hold more than a pint. But that is not the state of the case. Factories are more or less elastic. And further, the contracts secured in lieu of this one might perhaps have been such that they could have been advantageously farmed out elsewhere.<sup>57</sup>

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<sup>55</sup> At 1108. (emphasis added) Lord Parmoor agreed that the defendants should have had the opportunity to prove their mitigation of damages defense.

<sup>56</sup> At 1114.

<sup>57</sup> At 1110.

True, as he observed, the work “might have been done in the factory itself either by extension of premises or by extra shifts of workmen,”<sup>58</sup> but that would have meant a greater unit cost and, therefore, smaller profit.<sup>59</sup> So, even if his argument were accepted, the loss would have been less on that front. Could the work have been farmed out “advantageously”? There is no reason to believe that the new manufacturer would charge the plaintiff a price equal to (or better than) the plaintiff’s but-for manufacturing costs.

Lord Dunedin discussed *Vic Mill*, and mischaracterized it. “[S]ome of the articles had been made. As to them there was no difficulty. The damage was the difference between the price which would have been received under the contract and the sum realised for the articles as they stood.”<sup>60</sup> As noted above, the court reversed the registrar, awarding damages for the lost profits--£163 rather than £28. In *Vic Mill*, Lord Dunedin noted, the court had concluded that the seller had ample capacity and, therefore, could award lost profits on the goods not yet produced. However, he claimed, this did not imply the converse. “It is said that, in so deciding, these learned Judges inferentially decided that if the works had been shown to be fully occupied with other orders then the damage as sued for could not have been recovered. I respectfully decline to draw any such inference.”<sup>61</sup>

### C. *Summing Up*

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<sup>58</sup> At 1110.

<sup>59</sup> For the American take on the notion that there might be an upward sloping supply curve and, therefore, lower profits, see Charles Goetz and Robert Scott, *Measuring Seller’s Damages: The Lost-Profits Puzzle*, 31 *Stanford Law Rev.* 323, 1979; see also, *Davis v Disonics* 826 F. 2d 678 (7<sup>th</sup> Cir 1987).

<sup>60</sup> At 1111.

<sup>61</sup> At 1112.

In both cases the courts framed the question as whether the seller had adequate capacity to sell additional units; if it did, then it could receive the profit (price less but-for cost) on the sale that was lost. *Hill*'s majority held that whether it had adequate capacity was a fact question, although it is not entirely clear which party bore the burden of proof. The fact question in both cases was a red herring: did the seller have the capacity to produce the cancelled order and another order of equal magnitude at the same time? By arguing that the court should not ask that question Lord Dunedin was right, albeit for the wrong reason. Because of the way they framed the legal issue, neither court stepped back to ask whether the contract that they had constructed made any sense.

#### *D. B2B Rentals*

Two other cases, both concerning the repudiation of an equipment rental agreement, are recognized in the treatises, *Interoffice Telephone Ltd. v. Robert Freeman Co. Ltd.*<sup>62</sup> and *Robophone Facilities Ltd. v. Blank.*<sup>63</sup> Each agreement had a clause specifying damages in the event that the lessee terminated prematurely. In one case, the court rejected the termination price as an unenforceable penalty, but not in the other.

The Interoffice agreement, entered into in 1950, was for twelve years. Interoffice would install and maintain a telephone system. In 1956 the lessee was required to abandon its office and, since its new office already had an installed telephone system, it

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<sup>62</sup> [1958] 1 Q.B. 190.

<sup>63</sup> [1966] 1 W.L.R.1428.



repudiated the remainder of the contract. Interoffice sued, invoking clause 8 of the contract:

In case of default by the subscriber in payment or observance of any of the terms of the contract or if the contract shall be terminated prematurely at the wish of the subscriber the company shall be at liberty to remove the installation forthwith. The subscriber shall then pay to the company in settlement of all claims including liquidated damages a sum the equivalent of the rentals still payable or which would have become payable for the remaining term of the contract less an allowance of 10 per cent. for maintenance and less a further allowance of 5 per cent. for each unexpired year of such term.<sup>64</sup>

Application of that formula would have resulted in damages of £1,443, consisting of the rental for the rest of the term, £1,698 less the 15% allowance, £255.

The trial judge concluded that this was a penalty. He held that the plaintiff had a duty to mitigate by hiring out the equipment to someone else, so it restricted the period for recovery to six months. The lost rent, he concluded, was £130. Adding in the cost of removing the installation and other expenses resulted in an award of £338.

The Court of Appeal agreed that it was a penalty, but disagreed on the damage measure, citing *Vic Mill* and *Thompson*. While those cases involved the sale of goods, the court concluded that they applied to the rental as well. “Whether it be a hiring agreement

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<sup>64</sup> At 193-4.

or a contract for the sale of goods, where the purchaser has failed to take delivery, the defaulting party must contemplate that damages will vary according to the state of the market, including questions of supply and demand.”<sup>65</sup> The court rejected an earlier case, *British Stamp and Ticket Automatic Delivery Co. Ltd. v. Haynes*,<sup>66</sup> that awarded rent for a reasonable time after the termination. Since the evidence indicated that Interoffice had enough telephone units to complete this contract and still rent units to another client,<sup>67</sup> the court concluded that it had lost profits. To calculate those profits the court began with the damages defined by clause 8 (future rental stream less 15%) and subtracted “the depreciated value the sum of £700, which was given in evidence as the cost to the plaintiffs of a similar installation, less the sum of £200 representing, not as a matter of strict calculation but as a matter of round figure, the cost of reconditioning the installation.”<sup>68</sup> Subtracting this from the “penalty” yielded lost profits of £543.

*Robophone* involved an agreement to install a telephone answering system. The hirer, Mr. Blank, was an accountant who, it appears, was a one-man firm with little legal knowledge. Lord Denning, in dissent, summarized the problem:

The facts of this case are startling. The plaintiffs say that the machine cost them £105 to manufacture. A salesman called on a customer and got him to sign a printed form agreeing to hire it for seven years. Eleven days later, before the machine was delivered or installed, the customer repented and cancelled it. They accepted the cancellation and did not deliver it. Yet he has been ordered to pay damages of £245 14s. in respect of a machine he

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<sup>65</sup> At 2022.

<sup>66</sup> [1921] 1 K.B. 377

<sup>67</sup> “[T]here was always a supply to meet any demand.” At 196.

<sup>68</sup> At 196.

has never seen and which the plaintiffs can relet to anyone else. Some profit! I confess that I should be sorry if the law allows them to recover it.<sup>69</sup>

The contract set a rental fee of £17 11s. per quarter. On the back of the form were 15 printed terms, one of which, clause 11, was a liquidated damage clause. The hirer would be liable for all rentals up to the date of actual termination; that was not at controversy. If the hirer terminated, then it would pay “by way of liquidated or agreed damages a sum equal to 50 per cent. of the total of the rentals which would thereafter have become payable.”<sup>70</sup> Mr. Blank signed the form but cancelled his order before anything had been installed. Robophone sued to enforce clause 11.

Lord Denning argued that no contract had been formed, but even if there had been, clause 11 was an unenforceable penalty. He lost on both questions. There was also an issue of whether the defendant accepted the contract term; Harman, J, stated that such a plea “is not open to an educated man like the defendant. Moreover, there was evidence which the judge accepted that the defendant knew of and accepted the indorsed conditions.”<sup>71</sup>

Lord Denning argued that there were three possible states of the market. First, the machines were a great success and there was a waiting list of customers; then the plaintiff would suffer only nominal damages. Second, the machines were a drug on the market and

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<sup>69</sup> At 1431. Lord Diplock was sympathetic to the defendant: “I must confess that at the conclusion of the hearing I, like the Master of the Rolls, thought that the justice of the case required and the law permitted that this appeal should be allowed. But cool reflection and arithmetical exercises have convinced me otherwise.” (At 1443)

<sup>70</sup> At 1428.

<sup>71</sup> At 1439. The defendant did not have counsel. “The difficulty of this case has been greatly enhanced by reason of the fact that the defendant did not choose to enlist professional help.” (At 1438, Harman, J); see also Diplock at 1443.

the plaintiff had an unlimited stock; they would not be able to relet to anyone else and therefore would be entitled to the lost profits with no mitigation. Third, “If the machines were a sound commercial venture, and the plaintiffs, as good traders, carried sufficient stock to meet current demands, and no more (adjusting their orders to their manufacturers accordingly), then the plaintiffs would not suffer much damage from Mr. Blank's repudiation. They could take this machine back into stock, and relet it in a few weeks to one of their customers at the same rental. . . . Their damage would be the loss of rental for the few weeks pending the reletting to another customer.”<sup>72</sup>

He then invoked *Hadley v. Baxendale*, arguing that those damages “arising naturally, i.e., according to the usual course of things, from the breach”<sup>73</sup> fell in the third category. The other two were “special circumstances which cannot reasonably be supposed to be within the contemplation of the parties unless they were known to both.”<sup>74</sup> He distinguished *Interoffice*, claiming that in this case there was evidence that the plaintiff held sufficient stock to meet any demand.<sup>75</sup>

Lord Diplock also framed the question as one of whether the plaintiff lost an additional rental:

The judge, I think we must accept, was satisfied on the evidence that their facilities for manufacture exceeded, and were likely to continue to exceed, the demand from potential hirers. They were in effect in the position of a riding-stable proprietor who has in his stable, or in his adjacent paddock,

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<sup>72</sup> At 1436.

<sup>73</sup> At 1437.

<sup>74</sup> At 1437.

<sup>75</sup> At 1437.

more horses than he has potential customers to ride them. What the plaintiffs gained in money's worth by not having to deliver the machine to the defendant was the value to them of having available a machine to deliver to their next customer instead of having to manufacture a new machine for that purpose.<sup>76</sup>

Lord Diplock conceded that the plaintiff would not succeed under the first rule of *Hadley*. However, he dealt with Lord Denning's *Hadley* concerns by arguing that the risk of the special circumstances occurring were assigned to the defendant when it agreed to the liquidated damages formula.

[T]he defendant's conduct in entering into the contract without disclaiming liability for the enhanced loss which he can foresee gives rise to the implication that he undertakes to bear it. . . . And so if at the time of the contract the plaintiff informs the defendant that his loss in the event of a particular breach is likely to be £X by describing this sum as liquidated damages in the terms of his offer to contract, and the defendant expressly undertakes to pay £X to the plaintiff in the event of such breach, the clause which contains the stipulation is not a "penalty clause" unless £X is not a genuine and reasonable estimate by the plaintiff of the loss which he will in fact be likely to obtain. Such a clause is in my view enforceable whether or not the defendant knows what are the special circumstances

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<sup>76</sup> At 1443-44. Note that Lord Diplock assumed the plaintiffs manufactured the units, while Lord Denning assumed that it bought them from the manufacturer.

which make the loss likely to be £X rather than some lesser sum which it would be likely to be in the ordinary course of things.<sup>77</sup>

The majority asked whether the liquidated damages clause was a genuine and reasonable estimate of the loss. It did not consider the possibility of mitigation, assuming instead that Robophone had lost profits. It reckoned those profits as being between 47% and 58% of the future rental stream.<sup>78</sup> Since the liquidated damage clause set damages at 50% of the future revenue stream, the majority concluded that it was a reasonable estimate.

Unlike the sale of goods cases, both these decisions recognized that the contracts explicitly priced the buyer's termination. *Interoffice* implied that this was a negotiated term and that the defendant was at least capable of understanding such a clause. That is not the case in *Robophone*. Mr. Blank seemed to have no knowledge of the terms on the back of the form, notwithstanding Harman, J's assertion to the contrary. Neither contract, it appears, considered the possibility that they might have set different termination prices for different circumstances. But they didn't. While I believe that the *Interoffice* clause would overcompensate, I would have argued for enforcement—it appears to be a negotiated termination price. I believe Lord Denning was right in arguing against enforcement of the *Robophone* term. I would have accepted an argument that in a contract with an unsophisticated buyer, a penalty in a clause on the back of a form should be carefully scrutinized, and the clause should have failed on that ground.

*E. Sony Computer Entertainment UK Ltd v Cinram Logistics, UK Ltd*

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<sup>77</sup> At 1448.

<sup>78</sup> At 1446.

In *Sony Computer Entertainment UK Ltd v Cinram Logistics, UK Ltd*.<sup>79</sup> the problem confronting the court was the valuation of stolen goods. The parties and the court chose to frame the issue in terms of whether the non-breaching party had sold additional goods. Rix LJ devoted over four pages of his sixteen-page opinion to summarizing the lost volume decisions: *Charter*, *Vic Mill*, and *Hill*.<sup>80</sup> Properly framed, those decisions should have been irrelevant. The situation was very different. In the lost volume cases the breach was the buyer's cancellation of an order. In *Sony*, the distributor was responsible for the warehousing and distribution of Sony's product (memory cards for Sony's Playstation) and because of its failure, thousands of memory cards "were stolen by being diverted into the possession of fraudsters."<sup>81</sup> It conceded liability so the only question was damages.

The cost to Sony of the lost cards was £56,246; the market price was £289,170; and the contract price, which had been heavily discounted to a large buyer, Game, was £187,989. The parties framed the damage issue as a choice between the first and third. In the cited lost volume cases the argument was, as described above, that if the seller had the capacity to fill the additional orders, then it would be entitled to the profits it would have received on both the additional sale and on the lost sale. In this case, the argument flipped. If Sony did not replace the lost cards, then it lost the profit on them. Cinram's counsel claimed that the evidence was that Sony's sales had been replaced and "thus had not been lost, it must follow that Sony had earned its profit and so was entitled only to the

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<sup>79</sup> [2008] 2 CLC 441.

<sup>80</sup> He referred to *Thompson* as well.

<sup>81</sup> At ¶ 7.

cost price of the lost goods.”<sup>82</sup> Sony argued, and the trial judge agreed, “that on the balance of probabilities these sales were not replaced. There is no suggestion that in the circumstances Sony were able or minded to divert orders placed by other customers to satisfy the loss of these cards to Game.”<sup>83</sup> Rix, LJ, placed the burden of proof on the defendant:

[I]f the defendant wishes to say that the loss is less because the profit could have been earned in any event by a substitute or replacement sale, at the cost only of the expenditure of a lesser sum for the purpose of manufacturing or buying in further goods, then the defendant bears the burden of proving that case. It is not for the claimant to prove a negative, that he has not recouped the profit by a substitute sale, but for the defendant to prove a positive, that the profit has been recouped and thus the loss of profit not suffered after all.<sup>84</sup>

He concluded that “the burden of proof, for the purpose of proving that there had in fact been substitute replacement sales on which Sony had recouped its lost profit, rested on Game rather than on Sony. . . . I would have considered it impossible to think that Game would have come close to meeting that burden.”<sup>85</sup>

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<sup>82</sup> At ¶ 8

<sup>83</sup> At ¶ 12

<sup>84</sup> At ¶ 49

<sup>85</sup> At ¶ 51. It is unclear why Rix would put the burden on Game; it was an innocent third party.



This was a very convoluted way to resolve a simple issue. But before turning to that, I want to explore what would have happened if this were a case in which the buyer had breached. So, instead of this being a case in which the distributor lost the goods, assume that the buyer had cancelled the contract. Sony would then have argued that it had the capacity to fill additional contracts and the buyer would have argued the opposite. If Sony had proved its case, then it would have been awarded lost profits. That would have resulted in an absurd contract, setting an implausible option price. If the defaulting buyer were Game, which had received a substantial discount, the option price would have been 70% of the contract price.<sup>86</sup> For a buyer that had agreed to pay the full price, the option price would have been substantially higher, 80%.<sup>87</sup> It would make no sense for a buyer to agree to pay an option price of 70-80% for the right to buy the goods for the remaining 20-30% of the price, especially since the remedy presumes that an adequate supply of the goods was available.

If the lost volume framing yields an absurd result in its natural habitat, why should it do any better in this context? It shouldn't. The question of whether Sony could have, or did, replace the goods should have been irrelevant. The problem arises in any contract between two parties in a distribution chain. Consider, for example, the simple case in which a car dealer enters into a contract to sell a car, but before the risk of ownership shifts to the buyer, the car is stolen. Putting the problem in the retail versus wholesale price highlights the problem; the argument goes through in a case like the present one in which the difference is between the seller's but-for costs and the price

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<sup>86</sup>  $(187,989 - 56,246) / 187,989 = .70$

<sup>87</sup>  $(289,170 - 56,246) / 289,170 = .80$

charged to the intermediary (in this case a retailer). The dealer files a claim with its insurer. In the absence of an explicit rule, will the insurer be responsible for the wholesale or retail price of the car? That is a simple question, one that I am sure insurers have faced and have figured out how to resolve. My expectation is that if the theft (or destruction) occurred before the risk shifted, the award to the seller would be the wholesale price and if the risk had shifted to the buyer, the award would be the retail price in a claim by the buyer. The answer has nothing to do with the dealer's ability to sell more cars. Since Sony still bore the risk of theft or destruction, the remedy would have been Sony's but-for costs, £56,246.

### III. CONCLUSION

Over 70 years ago, Viscount Simon L.C said: "If the view which has hitherto prevailed in this matter is found to be based on a misapprehension of legal principles, it is of great importance that these principles should be correctly defined, for, if not, there is a danger that the error may spread in other directions, and a portion of our law be erected on a false foundation."<sup>88</sup> It is time to put to rest the notion that a seller should be compensated for its lost volume profits. This would not entail a dramatic doctrinal change. It would simply mean restoring the Section 50(3) remedy—the contract/market differential—to its proper place.

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<sup>88</sup> *Fibrosa Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd*, [1942] 1 K.B. 12. He said this in the context of overturning *Chandler v. Webster*, [1904] 1 K.B. 493. For an argument on why *Chandler* was correctly decided, see my *After Frustration: Three Cheers for Chandler v. Webster*, 68 *Wash. & Lee L. Rev.*, 1133 (2011). In another instance of the courts eventually rejecting a long-standing remedy doctrine, see Moore-Bick's decisions regarding consequential damages and exclusion clauses in *Tradigrain SA v Intertek Testing Services (ITS) Canada Ltd*, [2007] 1 C.L.C. 188, 206 (2007) and *Transocean Drilling UK Ltd v Providence Resources Plc*, [2016] 1 C.L.C. 585 (2016).

It would, however, entail a significant analytical change. Why does the lost volume remedy sound so plausible that both the English and American law have adopted it? The answer, I believe, is that the buyer's breach is being viewed as a wrong that should be punished. If, however, the question is reframed as what remedy would the buyer have "voluntarily undertaken," which in English law is available through the rule of remoteness as reformulated in *The Achilleas*, the question becomes one of pricing the buyer's option to terminate; the remedy is simply the default price of the termination option. Parties can, and often do, price the option explicitly either with deposits or liquidated damages. The failure of the courts to even mention whether there had been deposits in the two new car decisions (*Thompson (W. L.) Ltd. v. Robinson (Gunmakers) Ltd.* and *Charter v Sullivan*) is indicative of the judicial indifference to function.<sup>89</sup> The lost volume remedy sets an option price that would usually be too high; sophisticated buyers would most likely contract out of it. Moreover, it is perverse. Buyers would choose to pay higher deposits the tighter the market. But the tighter the market, the lower would be the lost volume profit remedy.

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<sup>89</sup> Both of the equipment rental cases (Section II. D) did include liquidated damages. A clause buried in the fine print, as in *Robophone*, should not be sufficient.