

## When Lightning Strikes: *Hadley v. Baxendale*'s Probability Standard Applied to Long-Shot Contracts

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*There is a type of contract that could go virtually unenforced as a result of the rule of Hadley v. Baxendale. When a contract's principal purpose is to enable the plaintiff to obtain an opportunity for an unlikely profit or to avoid an unlikely loss (a "long-shot contract"), and the defendant's breach causes the plaintiff to lose the profit or suffer the loss, Hadley's requirement that a loss be reasonably foreseeable at the time of contract formation would preclude recovery. This is demonstrated by Offenberger v. Beulah Park Jockey Club, Inc., where the Hadley rule precluded the recovery of lost winnings when the defendant failed to issue the plaintiff what turned out to be a winning ticket at a horse race because the plaintiff's odds of winning were too small. Applying the Hadley rule to such a long-shot contract is not supported by any of the rationales for the rule and renders the contract virtually unenforceable. Accordingly, this Article proposes that the Hadley rule not apply to contracts whose principal purpose is to enable the plaintiff to obtain an opportunity for an unlikely profit or to avoid an unlikely loss, which would include not only gambling contracts, but contracts such as security-alarm contracts, contracts to prevent home damage, contracts for inspections, and promises to obtain insurance, to name just a few. In other words, when a contract's principal purpose is to provide a chance at lightning striking, or to prevent lightning from striking, the Hadley rule should not prevent the injured party from obtaining full compensation.*

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## INTRODUCTION

On April 27, 1978, Martin Offenberger went to Beulah Park, a thoroughbred racetrack owned and operated by Beulah Park Jockey Club, Inc. (Jockey Club).<sup>1</sup> For the ninth race, he placed a trifecta bet, which requires selecting the horses that will finish first, second, and

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1. Offenberger v. Beulah Park Jockey Club, Inc., No. 79AP-471, 1979 WL 209570, at \*1 (Ohio Ct. App. Dec. 28, 1979).

third (win, place, and show) in the correct order of finish.<sup>2</sup> If the bettor wins, the payout can be substantial.<sup>3</sup>

There were eleven horses in the ninth race,<sup>4</sup> so the odds of correctly selecting the horses that would win, place, and show, in the correct order, were long.<sup>5</sup> Offenberger requested 135 tickets from the pari-mutuel clerk, combining the 10 and 8 horses (in the win and place positions, respectively) with every other horse in the race (in the show position) fifteen times each.<sup>6</sup> Purchasing tickets with every horse other than the 10 and 8 horses in the show position increased his odds of winning, but having a winning ticket remained a long shot.<sup>7</sup> By purchasing fifteen tickets for each combination requested, he would increase his winnings by fifteen, if he won, though he would also increase the amount of loss if he did not win. He paid \$405 for the tickets (\$3 per ticket).<sup>8</sup>

The Jockey Club did not participate in the payout of winning tickets; it simply sold the tickets.<sup>9</sup> Accordingly, the Jockey Club was not under a duty to pay out any winnings, but it was under a contractual duty to provide any tickets that were purchased.<sup>10</sup> The payout for a winning ticket would have been according to the pari-mutuel betting system, under which all bets are placed together and the payout is based on all winning bets after removing a portion for the house (the remaining portion is known as the winning pool).<sup>11</sup> It took the clerk three to four

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2. *Id.*

3. *Id.*

4. *Id.*

5. The odds of correctly selecting the horses that would win, place, and show, in the correct order (assuming no difference in ability between each horse or no awareness of any differences in ability), were 1 out of 990. The odds of correctly selecting the horse that would finish first would be 1 out of 11. The odds of then correctly selecting the horse that would finish second would be 1 out of 10. The odds of then correctly selecting the horse that would finish third would be 1 out of 9. Accordingly, the odds of correctly selecting the three horses that would win, place, and show, in the correct order, would be 1 out of 11 x 10 x 9, or 1 out of 990.

6. *Offenberger*, 1979 WL 209570, at \*1. Thus, he ordered fifteen tickets with the 10–8–1 combination, fifteen with the 10–8–2 combination, and so on.

7. Purchasing tickets with every horse other than the 10 and 8 in the show position increased his odds of winning to 1 out of 110 (again assuming no difference in ability between each horse) because as long as he correctly selected the horses finishing first and second he would have a winning ticket. Because Offenberger was assured of selecting the third horse correctly if he selected the first two horses correctly, the odds of having a winning ticket were reduced to correctly selecting the horse that would finish first (1 out of 11) and correctly selecting the horse that would finish second (1 out of 10). Thus, the odds of winning were 1 out of 11 x 10, or 1 out of 110.

8. *Offenberger*, 1979 WL 209570, at \*1.

9. *Id.* at \*2.

10. *Id.*

11. *Pari-mutuel*, MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 901 (11th ed. 2003).

minutes to issue Offenberger the tickets, but she issued only 120 tickets, failing to issue the fifteen tickets for the 10-8-9 combination.<sup>12</sup>

After receiving the tickets, Offenberger did not check to determine whether he had received all that he ordered.<sup>13</sup> The race began about one minute later, and lightning struck for Offenberger, with the 10 horse winning, the 8 horse placing, and the 9 horse showing.<sup>14</sup> When Offenberger went to collect his winnings for his fifteen 10-8-9 combination tickets, he discovered that the clerk had not issued them.<sup>15</sup> He was therefore unable to participate in the winning pool because under the rules of pari-mutuel betting, a person is only entitled to a share by presenting a winning ticket.<sup>16</sup>

Offenberger then sued the Jockey Club for breach of contract, seeking damages in the amount of his lost winnings.<sup>17</sup> The Jockey Club admitted that Offenberger had ordered and paid for the fifteen 10-8-9 tickets and had not received them, and the trial court therefore entered judgment in Offenberger's favor.<sup>18</sup> The trial court, however, only awarded him \$45, the amount paid for the unissued tickets.<sup>19</sup> Offenberger appealed.<sup>20</sup>

The appellate court affirmed, holding that Offenberger was not entitled to more than \$45 in damages because of the rule of *Hadley v. Baxendale*.<sup>21</sup> Under the *Hadley* rule, a particular loss can only be recovered in a breach-of-contract action if it arises "naturally according to the usual course of things from the breach of contract or [was] in the contemplation of both parties at the time they made the contract as the probable result of the breach."<sup>22</sup> The court found that the likelihood that a breach would cause Offenberger to lose a share of the winning pool was too small to permit recovery:

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Thus, the house always wins.

12. *Offenberger*, 1979 WL 209570, at \*1. Presumably, the 10-8 combination for the first two horses led the clerk to jump from 7 to 11 for the third horse, inadvertently skipping over the 9 horse because the number was between the first two horses.

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.* Accordingly, Offenberger presumably would have no claim against the third party who pays out the winnings, and there is no indication he sued the third party.

17. *Id.* The court's opinion does not indicate the amount of lost winnings.

18. *Id.*

19. *Id.* The trial court held that Offenberger was seeking to participate in the winning pool, a point rejected by the appellate court. *Id.* at \*2.

20. *Id.* at \*1.

21. *Id.* at \*4.

22. *Id.*

At the time that the contract was entered into, that is at the time of the ordering and issuance of the pari-mutuel tickets, the loss of profits that plaintiff has suffered was purely speculative and could not have been considered the *probable* result of the breach by defendants. It was just as likely that one of the series of tickets actually issued would be the winner, and even more likely that none of the tickets, including those not issued, would be the winning tickets. Thus, defendants could foresee the *possibility but not the probability* that the breach would result in the loss of profits to plaintiff. . . .

Failure to deliver a parimutuel ticket on a race would give rise to no loss of profits in the usual course of things, inasmuch as it is rare, rather than common, that one purchases the winning ticket. Even considering the 135 tickets that plaintiff contracted to purchase, there was at most one chance in nine that the tickets which defendants failed to deliver would constitute winning tickets. The odds that the tickets would be winning tickets are much greater when the other two positions in the trifecta are considered. At the time the parties made the contract, the probable result of defendants' breach would have been that defendants failed to deliver a series of losing tickets to plaintiff. In the usual course of things, plaintiff would have sustained no loss of profits, and his loss of profits cannot be considered the probable result of the breach of contract either at the time the contract was consummated or at the time of breach thereof, which were virtually contemporaneous.<sup>23</sup>

The appellate court therefore held that Offenberger was not entitled to the lost winnings and affirmed the judgment for just \$45.<sup>24</sup>

The appellate court's application of the *Hadley* rule to the facts was sound. The *Hadley* rule is all about how foreseeable a particular loss is, as determined at the time of contract formation—and at the time of formation, the chance Offenberger would suffer consequential losses from not being issued the 10-8-9 tickets was extremely small. The foreseeable probability of loss was far below that required for a recovery under the *Hadley* rule.

But the result appears unjust. It was undisputed that the Jockey Club

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23. *Id.* at \*3–4.

24. *Id.* at \*5. The \$45 recovery was presumably a recovery of reliance damages or restitution, as an alternative to an award of expectation damages. See RESTATEMENT (SECOND) OF CONTRACTS § 349 (AM. LAW INST. 1981) (“As an alternative to [expectation damages], the injured party has a right to damages based on his reliance interest, including expenditures made in preparation for performance or in performance . . . .”); *id.* § 373(1) (“[O]n a breach by non-performance that gives rise to a claim for damages for total breach or on a repudiation, the injured party is entitled to restitution for any benefit that he has conferred on the other party by way of part performance or reliance.”).

breached the contract; it was undisputed that the Jockey Club's breach caused Offenberger to be unable to participate in the winning pool; and the amount of the loss could be determined to a certainty. Most importantly, however, the chance of participating in the winning pool was the contract's sole purpose. Thus, without a recovery based on the lost winnings, Offenberger was left with a recovery that simply returned the purchase price to him, essentially undoing the contract, as opposed to enforcing it. In a situation such as this, the *Hadley* rule would permit the defendant to breach with impunity.

This Article proposes an exception to the *Hadley* rule that would avoid the unjust result in the long-shot contract situation. By a "long-shot contract situation," this Article is referring to a case in which the contract's principal purpose is for the plaintiff to obtain an opportunity for an unlikely profit (as opposed to obtaining a profit directly from the performance itself) or to avoid a particular unlikely loss. The proposed exception is as follows:

When both parties had reason to know that the principal purpose of the contract was to enable the injured party to obtain an opportunity for a profit or to avoid a particular loss, and the breach caused the injured party to lose the profit or suffer the loss, the requirement that a loss be reasonably foreseeable at the time of contract formation does not prevent the recovery of damages to compensate for the loss, provided the loss was not due in part to the injured party's undisclosed failure to take reasonable precautions prior to contract formation or to take reasonable precautions after formation but before breach or repudiation.

This exception would apply not only to gambling contracts, but would include contracts in which the defendant provides protection from a loss, such as security-alarm contracts, contracts to prevent home damage, contracts for inspections, and promises to secure insurance, to name just a few. The rule applicable to long-shot contracts should be a reversion to the general rule of fully protecting the injured party's expectation interest, which includes a recovery of consequential losses.

Part I of this Article discusses *Hadley v. Baxendale*. Part II discusses the contours of the *Hadley* rule. Part III discusses the various rationales suggested for the rule of *Hadley v. Baxendale* and identifies those rationales that are the likely bases for the rule. Part IV examines the scope of the long-shot contract problem; whether there are any existing doctrines to avoid the problem; and whether the bases for the *Hadley* rule support the rule's application to long-shot contracts and whether

this Article's proposed exception undermines them. Part V is a brief conclusion.

### I. *HADLEY V. BAXENDALE*: FOR WANT OF A CRANKSHAFT

*Hadley v. Baxendale*, perhaps contract law's most famous case,<sup>25</sup> was decided in 1854 by England's Court of Exchequer.<sup>26</sup> The plaintiffs (Joseph and Jonah Hadley) were millers in Gloucester, England.<sup>27</sup> On May 11, 1853, their grist mill stopped operating when the crankshaft on the mill's steam engine broke.<sup>28</sup> The fracture was discovered on May 12, and the plaintiffs needed to send it to W. Joyce & Co. in Greenwich, the engineers who originally manufactured the mill's steam engine, so that it could be used as a model to make a replacement.<sup>29</sup>

On May 13 the plaintiffs sent one of their employees to Pickford & Co., a well-known carrier.<sup>30</sup> The carrier's clerk told the employee that if the crankshaft was provided by noon on any day, it would be delivered to Greenwich by the following day.<sup>31</sup> On May 14, before noon, the crankshaft was provided to the carrier and two pounds and four shillings were paid for its delivery.<sup>32</sup> The delivery, however, was delayed several days due to the carrier's negligence.<sup>33</sup> The carrier routed it through London, and rather than immediately forwarding it by rail to Greenwich, the carrier kept it in London for several days and then sent it by canal along with other items destined for W. Joyce & Co.<sup>34</sup>

25. See ROBERT A. HILLMAN, *PRINCIPLES OF CONTRACT LAW* 159 (2d ed. 2009) (“*Hadley v. Baxendale* may be the most famous contracts case. Perhaps it is one of the most famous cases in any field of Anglo-American jurisprudence.”).

26. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 9 Ex. 341. The decision is sometimes incorrectly attributed to the Exchequer Chamber, a different court. See J.H. BAKER, *AN INTRODUCTION TO ENGLISH LEGAL HISTORY* 138 (4th ed. 2002) (discussing the creation in 1830 of a new Exchequer Chamber).

27. *Hadley*, 156 Eng. Rep. at 147, 9 Ex. at 344.

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.* The Hadleys' declaration asserted that it was “to be delivered for the plaintiffs on the second day after the day of such delivery,” *id.* at 146, leading to confusion as to whether the carrier represented delivery would be made within one day or two days. Compare Florian Faust, *Hadley v. Baxendale—an Understandable Miscarriage of Justice*, 15 J. LEGAL HIST. 41, 44 (1994) (“The plaintiffs were told that the shaft would be delivered at Greenwich on the following day.”), with Richard Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J.L. STUD. 249, 251 (1975) (“A Pickfords employee, Mr. Perrett, represented that it would be delivered ‘on the second day after the day of . . . delivery’ to Pickfords.”).

32. *Hadley*, 156 Eng. Rep. at 147, 9 Ex. at 344.

33. *Id.*

34. Danzig, *supra* note 31, at 251 & n.5. The crankshaft arrived at W. Joyce & Co. on May 21. *Id.* at 251.

As a result, the replacement crankshaft arrived at the plaintiffs' mill five days later than it should have, causing the mill to remain shut down five days longer than if delivery had been timely.<sup>35</sup>

The plaintiffs sued Pickford & Co. and its managing director, Joseph Baxendale, and sought damages in the amount of £300, representing their lost profits during the period of delay.<sup>36</sup> At the time, there were almost no rules regarding contract damages<sup>37</sup> and no significant restrictions on the recovery of losses.<sup>38</sup> Losses were recoverable as long as they were the "natural consequence" of the breach, which meant simply that they must be caused by the breach and not exacerbated by the plaintiff.<sup>39</sup> Accordingly, juries had been permitted to award damages for consequential losses,<sup>40</sup> and trial judges generally left the matter to the jury's discretion.<sup>41</sup>

The defendants argued that the plaintiffs' lost profits were "too remote,"<sup>42</sup> but the trial judge instructed the jury that

[t]hey should give their damages for the natural consequences of the defendant's breach of contract, and with that view they would have to consider whether the stoppage of the plaintiffs' works was one of the probable and natural consequences of that breach of contract, and then, looking to all the circumstances of the case and the position of the parties, to say what was the amount of the damages occasioned by the stoppage of the works.<sup>43</sup>

The jury awarded the plaintiffs £50,<sup>44</sup> a compromise verdict that included a portion of the plaintiffs' lost profits.<sup>45</sup> Believing that the jury

35. *Id.*

36. *Id.*

37. JOSEPH M. PERILLO, CALAMARI AND PERILLO ON CONTRACTS 492 (6th ed. 2009).

38. Thomas A. Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to Hadley v. Baxendale*, 63 *FORDHAM L. REV.* 665, 667 (1994).

39. Danzig, *supra* note 31, at 253.

40. *Id.* at 255.

41. See E. ALLAN FARNSWORTH, *CONTRACTS* 792 (4th ed. 2004) ("[U]ntil the nineteenth century judges left the assessment of damages for breach of contract largely to the discretion of the jury."); Danzig, *supra* note 31, at 255 ("[T]he calculation of damages in contracts suits . . . had previously been left to almost entirely unstructured decision by English juries."); Diamond & Foss, *supra* note 38, at 667 n.11 ("Prior to *Hadley*, the law was that 'it is, in general, entirely the province of the jury to assess the amount, with reference to all the circumstances of the case.'" (quoting JOSEPH CHITTY, *A PRACTICAL TREATISE ON THE LAW OF CONTRACTS* 768 (4th ed. 1851))). In fact, just seven years earlier in *Black v. Baxendale*, a case involving the same carrier, the Court of Exchequer had held that whether consequential losses were recoverable was not a question for the court, but for the jury. *Black v. Baxendale* (1847) 154 Eng. Rep. 174, 1 Ex. 410.

42. Danzig, *supra* note 31, at 252.

43. *Id.* (quoting *J. and J. Hadley v. Baxendale and Others*, GLOUCESTER J. (Supplement) (Eng.), Aug. 13, 1853, at 1, col. 4).

44. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 147, 9 Ex. 341, 344–45.

45. PERILLO, *supra* note 37, at 493; Danzig, *supra* note 31, at 252. At trial the plaintiffs



should not have awarded the lost profits, the defendants appealed.<sup>46</sup>

On appeal at the Court of Exchequer, Baron Parke stated during oral argument that the sensible rule would be the rule adopted in the French Civil Code, which provided that “[t]he debtor is only liable for the damages foreseen, or which might have been foreseen, at the time of the execution of the contract, when it is not owing to his fraud that the agreement has been violated.”<sup>47</sup> This French rule, based on foreseeability, was well known to English lawyers. It was first proposed by Robert J. Pothier, a French jurist, in his two-volume treatise *Law of Obligations*, which was published in the 1760s.<sup>48</sup> In this treatise the rule was articulated as follows: “[T]he debtor is only liable for the damages and interest which might have been contemplated at the time of the contract; for to such alone the debtor can be considered as having intended to submit.”<sup>49</sup> Pothier’s treatise had been translated into English in 1806 and was widely disseminated.<sup>50</sup>

When the Court of Exchequer issued its opinion in *Hadley*, the court essentially adopted the French rule, though it did not reference it.<sup>51</sup> The opinion, written by Baron Alderson, adopted the following rule:

Where two parties have made a contract, which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either [1] arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or [2] such as may reasonably be supposed to have been in the contemplation of both

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reduced their claimed damages to “near £200,” and their witnesses testified to only £120 in damages. Danzig, *supra* note 31, at 251.

46. *Id.* at 253.

47. *Hadley*, 156 Eng. Rep. at 147–48, 9 Ex. at 346; see also Wayne Barnes, *Hadley v. Baxendale and Other Common Law Borrowings from the Civil Law*, 11 TEX. WESLEYAN L. REV. 627, 632 (2005) (discussing Baron Parke’s comment). Baron Parke’s comment led A.W.B. Simpson to conclude that Parke was primarily responsible for the *Hadley* rule. See Danzig, *supra* note 31, at 257.

48. P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 399 (1979).

49. 1 ROBERT JOSEPH POTHIER, A TREATISE ON OBLIGATIONS, CONSIDERED IN A MORAL AND LEGAL VIEW 91 (William David Evans trans., 1806) (1802).

50. Danzig, *supra* note 31, at 257; ATIYAH, *supra* note 48, at 399; Joseph M. Perillo, *Robert J. Pothier’s Influence on the Common Law of Contract*, 11 TEX. WESLEYAN L. REV. 267, 270 (2005). An earlier English translation was published in the United States in 1802 but was not well known. *Id.*; see also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 66 (3d ed. 2005) (“A few civil-law books were translated into English during this period; ‘*A Treatise on Obligations, Considered in a Moral and Legal View*, translated from the French of [Robert] Pothier,’ appeared in New Bern, North Carolina, in 1802.”).

51. See ATIYAH, *supra* note 48, at 432 (“[A] comparison between [Pothier’s] language and that used by the Court in *Hadley v. Baxendale*, suggests the possibility of borrowing.”).

parties at the time they made the contract, as the probable result of the breach of it.<sup>52</sup>

The court's discussion focused on a situation like the one before it where the plaintiff's loss was due to the plaintiff's special circumstances:

Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract.<sup>53</sup>

The court's rationale for excluding recovery for consequential losses that were not sufficiently foreseeable due to a special circumstance of the plaintiff was that a failure by the plaintiff to disclose the special circumstance deprived the parties of the opportunity to agree upon whether, and in what amount, they would be recoverable.<sup>54</sup> As stated by the court: "For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them."<sup>55</sup>

The court stated that the new rule should be applied in determining damages arising out of any breach of contract.<sup>56</sup> Unlike the French rule, the newly announced rule did not differentiate based on the reason for breach.<sup>57</sup> Also, it substituted "foreseeable" with a requirement that the loss be "probable."<sup>58</sup>

The court then, and perhaps surprisingly, applied the rule to the facts, instead of simply returning the case to the trial court for application of the new rule by the jury.<sup>59</sup> The court found "that the only circumstances here communicated by the plaintiffs to the defendants at

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52. *Hadley* 156 Eng. Rep. at 151, 9 Ex. at 354.

53. *Id.* at 151, 9 Ex. at 354-55.

54. *Id.* at 151, 9 Ex. at 355.

55. *Id.*

56. *Id.* at 151, 9 Ex. at 354.

57. *Id.*

58. *Id.*

59. *Id.* at 151, 9 Ex. at 355-56.

the time the contract was made, were, that the article to be carried was the broken shaft of a mill, and that the plaintiffs were the millers of that mill.”<sup>60</sup> As a result, the court believed that the loss was not sufficiently foreseeable because for all the defendants knew, the plaintiffs might have had a spare crankshaft or the mill might have been shut down for additional reasons.<sup>61</sup> According to the court, “in the great multitude of cases of millers sending off broken shafts to third persons by a carrier under ordinary circumstances, such consequences would not, in all probability, have occurred.”<sup>62</sup> Importantly, it then found that “these special circumstances were here never communicated by the plaintiffs to the defendants.”<sup>63</sup> The court therefore held that

such loss would neither have flowed naturally from the breach of this contract in the great multitude of such cases occurring under ordinary circumstances, nor were the special circumstances, which, perhaps, would have made it a reasonable and natural consequence of such breach of contract, communicated to or known by the defendants.<sup>64</sup>

Accordingly, a new trial was necessary and the trial judge should instruct the jury that upon the facts before them they should not permit a

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60. *Id.* at 151, 9 Ex. at 355. Whether the plaintiffs’ employee told Pickford & Co.’s clerk that the mill was shut down is a matter of contention. The case’s headnote and statement of facts, written by a reporter, indicate that the employee told the clerk the mill was shut down. *See id.* at 145, 9 Ex. at 341 (“[T]he defendants’ clerk, who attended at the office, was told that the mill was stopped, that the shaft must be delivered immediately, and that a special entry, if necessary, must be made to hasten its delivery . . .”) (headnote); *id.* at 147, 9 Ex. at 344 (stating that on May 13 “[t]he plaintiffs’ servant told the clerk that the mill was stopped, and that the shaft must be sent immediately” and on May 14 told the clerk “that a special entry, if required, should be made to hasten its delivery”). But Baron Alderson’s opinion states otherwise. *See id.* at 151, 9 Ex. at 355 (“[W]e find that the only circumstances here communicated by the plaintiffs to the defendants at the time the contract was made, were, that the article to be carried was the broken shaft of a mill, and that the plaintiffs were the millers of that mill.”). Some believe the reporter’s headnote and statement of facts are correct and others believe the court’s opinion is correct. In *Victoria Laundry (Windsor) Ltd. v. Newman Industries Ltd.* (1949) 2 K.B. 528 (appeal taken from Eng.), Lord Justice Asquith stated that the reporter’s headnote and statement of facts must have been incorrect. *Id.* at 537. Professor Melvin Eisenberg, however, believes the plaintiffs’ employee told the clerk, and the court intentionally misstated the facts to arrive at its holding. Melvin Aron Eisenberg, *The Principle of Hadley v. Baxendale*, 80 CALIF. L. REV. 563, 570 (1992). It has also been suggested that there is no inconsistency between the reporter’s headnote and statement of facts and the court’s opinion inasmuch as different clerks might have been working on May 13 and 14, with the disclosure of the mill being stopped being made on May 13 and not repeated to the different clerk on May 14. David Pugsley, *The Facts of Hadley v. Baxendale*, 126 NEW L.J. 420 (1976). Along this line, Professor Eric Posner has suggested that the court attached no importance to the disclosure, “perhaps because the disclosure may have seemed too casual or otherwise not adequate.” ERIC A. POSNER, CONTRACT LAW AND THEORY 195 n.33 (2011).

61. *Hadley*, 156 Eng. Rep. at 151, 9 Ex. at 355–56.

62. *Id.* at 151, 9 Ex. at 355.

63. *Id.* at 151, 9 Ex. at 356.

64. *Id.*

recovery of the lost profits.<sup>65</sup> No further appeal was taken.<sup>66</sup> The *Hadley* rule was thus established.

Although the *Hadley* rule provided for the recovery of consequential losses if they were sufficiently foreseeable (its so-called affirmative aspect),<sup>67</sup> it is primarily known for the limit it placed on the recovery of consequential losses (its so-called negative aspect).<sup>68</sup> This negative aspect was more significant because it imposed “an important new limitation on the scope of recovery that juries could allow for breach of contract.”<sup>69</sup> It effected “a subtle but significant change in the contemporary understanding of the rule that damages be awarded only for the ‘natural consequences’ of a breach.”<sup>70</sup>

The *Hadley* opinion was immediately celebrated in the United States<sup>71</sup> and “was eagerly adopted in the states.”<sup>72</sup> A court in 1883 noted that the *Hadley* rule had been “repeated and re-repeated in many judicial opinions [and had] come to be almost a stereotyped phrase; so general, that it may appear to be temerity . . . to question its

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65. *Id.* at 151–52, 9 Ex. 356; *see also* Faust, *supra* note 31, at 51 (“The purpose of the new trial, which the court granted, seems to be the mere compliance with the rules of procedure. The court explicitly ordered the trial judge to tell the jury that they must not take into consideration the damages resulting from the stoppage of the mill, and other damages were not claimed. Therefore the new trial necessarily was to be a sheer farce.”).

66. Danzig, *supra* note 31, at 253.

67. *See* GRANT GILMORE, *THE DEATH OF CONTRACT* 52 (1974) (“[T]he essential novelty of the *Hadley* formula, it may be suggested, was its affirmative statement that, subject to the limitation of foreseeability and provided only that all the ‘special circumstances’ were communicated, lost profits and other consequential damages caused by breach of a contractual duty were recoverable.”).

68. *See* ATIYAH, *supra* note 48, at 431 (“The importance of the decision may well have lain primarily in the *limits* that [the rule] placed on the liability of a contract-breaker . . .”); RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 127 (6th ed. 2003) (“The common law’s traditional hostility to consequential damages in contract cases is epitomized by the famous case of *Hadley v. Baxendale*.”).

69. FARNSWORTH, *supra* note 41, at 794.

70. Danzig, *supra* note 31, at 253.

71. GILMORE, *supra* note 67, at 49.

72. FRIEDMAN, *supra* note 50, at 406; *see also* Marsha Huie, *Hadley’s Liability-Limiting and Commerce-Enhancing Principles Applied in the British Commonwealth and the U.S.A.*, 11 *TEX. WESLEYAN L. REV.* 649, 651 (2005) (“U.S. state courts quickly accepted from England the rationale of *Hadley v. Baxendale* as a principle of law.”); Mara Kent, *The Common-Law History of Non-Economic Damages in Breach of Contract Actions Versus Willful Breach of Contract Actions*, 11 *TEX. WESLEYAN L. REV.* 481, 491 (2005) (“Not long after the *Hadley* decision was announced in England, news of the decision swept to the United States. . . . [A]doption of the rule was nearly universal . . . .”); JOHN EDWARD MURRAY, JR., *MURRAY ON CONTRACTS* 764 (5th ed. 2011) (“It has been universally accepted by our courts as a correct statement of the principle in accordance with which the extent of the recovery is to be determined in an action for breach of contract.”).

propriety.”<sup>73</sup> The *Hadley* rule was ultimately adopted in all U.S. jurisdictions<sup>74</sup> and was later codified in Article 2 of the Uniform Commercial Code (“U.C.C.”).<sup>75</sup> It is now hailed as “the definitive source for determining when consequential damages may be recovered for breach of contract.”<sup>76</sup> The rule’s adoption means, however, that it is more difficult to recover consequential losses in a breach-of-contract action than a tort action, the latter being subject solely to the limit of proximate cause.<sup>77</sup>

## II. THE *HADLEY* RULE’S CONTOURS

The rule announced in *Hadley v. Baxendale* was actually stated as two separate rules.<sup>78</sup> The first rule is that the injured party is entitled to recover for a loss if it “may fairly and reasonably be considered either

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73. *Daugherty v. Am. Union Tel. Co.*, 75 Ala. 168, 177 (1883), *overruled in part by* *Manker v. W. Union Tel. Co.*, 34 So. 839 (Ala. 1902).

74. Steven W. Feldman, *Autonomy and Accountability in the Law of Contracts: A Response to Professor Shiffrin*, 58 *DRAKE L. REV.* 177, 215 (2009); see HILLMAN, *supra* note 25, at 163–68 (“Whatever the reasons for the rule of *Hadley v. Baxendale*, it has met with wide approval and adoption.”); see also PERILLO, *supra* note 37, at 492 (“It has won universal acceptance in the common law world . . .”); Diamond & Foss, *supra* note 38, at 665 (“[T]he English case of *Hadley v. Baxendale* has been recognized in American jurisprudence as the definitive source for determining when consequential damages may be recovered for breach of contract.” (citation omitted)).

75. See U.C.C. § 2-715(2)(a) (2002) (“Consequential damages resulting from the seller’s breach include (a) any loss resulting from general or particular requirements and needs of which the seller at the time of contracting had reason to know and which could not reasonably be prevented by cover or otherwise . . .”); MURRAY, *supra* note 72, at 765 (noting that the rule has been codified in the U.C.C.). Although the U.C.C. language is different from the language in *Hadley*, “the Official Comments to the Code state that it was intended to incorporate the common law rule. The courts have agreed.” Diamond & Foss, *supra* note 38, at 670. The U.C.C., however, permits recovery for all personal injury and property damage “proximately resulting” from the breach of a warranty. U.C.C. § 2-715(2)(b). A seller is not entitled to recover consequential losses under the U.C.C. *Commonwealth Edison Co. v. Allied Chem. Nuclear Prod., Inc.*, 684 F. Supp. 1429, 1433 (N.D. Ill. 1988). This is presumably because “[t]he buyer’s breach ordinarily involves the late payment or nonpayment of money, seldom resulting in consequential economic damages.” Diamond & Foss, *supra* note 38, at 673; see also Eisenberg, *supra* note 60, at 565 (“The two rules of *Hadley v. Baxendale* are normally applied only to cases involving a breach by the seller of a commodity, because usually a buyer’s major obligation is to pay money, and the nonpayment of a money price rarely implicates those two rules.”).

76. Diamond & Foss, *supra* note 38, at 665.

77. FARNSWORTH, *supra* note 41, at 794; see also Eisenberg, *supra* note 60, at 577 (“Outside of the law of contract . . . once it has been established that *A* has violated a duty to *B*, *B* is normally entitled to compensation for all damages proximately caused by *A*’s wrongful act.”); RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (AM. LAW INST. 1981) (“[T]he requirement of foreseeability is a more severe limitation of liability than is the requirement of substantial or ‘proximate’ cause in the case of an action in tort or for breach of warranty.”).

78. FARNSWORTH, *supra* note 41, at 793; Diamond & Foss, *supra* note 38, at 667–68; Eisenberg, *supra* note 60, at 564.

arising naturally, i.e., according to the usual course of things, from such breach of contract itself.”<sup>79</sup> This is known as the “usual course of things” branch.<sup>80</sup> The injured party can recover such losses even if they were not in fact expected by the defendant,<sup>81</sup> but they must “arise generally, and in the great multitude of cases not affected by any special circumstances.”<sup>82</sup> These losses are often referred to as general damages,<sup>83</sup> and their recovery is not controversial.<sup>84</sup>

The second rule is that for a loss that does not arise naturally from the breach, the injured party is only entitled to recover for the loss if the loss was “such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.”<sup>85</sup> This is known as the “contemplation” branch.<sup>86</sup> Such losses are usually referred to as consequential losses or special damages.<sup>87</sup> The contemplation rule means that not only must special circumstances be made known to the defendant at the time of contract formation, but also that any special circumstances that arise after formation that cause the injured party to suffer additional losses cannot be recovered.<sup>88</sup>

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79. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 151, 9 Ex. 341, 354.

80. Danzig, *supra* note 31, at 254.

81. *Diamond & Foss*, *supra* note 38, at 668.

82. *Hadley*, 156 Eng. Rep. at 151, 9 Ex. at 355.

83. PERILLO, *supra* note 37, at 493. General damages have been defined as the loss of the “value of the performance itself, independent of the [injured party’s] special circumstances . . . .” *Diamond & Foss*, *supra* note 38, at 668; *see Eisenberg*, *supra* note 60, at 565 (“General or direct damages are the damages that flow from a given type of breach without regard to the buyer’s particular circumstances.”); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b (AM. LAW INST. 1981) (“The damages recoverable for such loss that results in the ordinary course of events are sometimes called ‘general’ damages.”).

84. FARNSWORTH, *supra* note 41, at 793.

85. *Id.* (internal quotation marks omitted).

86. Danzig, *supra* note 31, at 253.

87. PERILLO, *supra* note 37, at 493. Consequential damages have been defined as losses arising “as a secondary consequence of nonperformance resulting from the injured party’s special circumstances . . . .” *Diamond & Foss*, *supra* note 38, at 668; *see also Eisenberg*, *supra* note 60, at 565 (“Special or consequential damages are the damages above and beyond general damages that flow from a breach as a result of the buyer’s particular circumstances.”). Examples include “lost profits from lost resale contracts, losses and expenses caused by defective or undelivered goods purchased for production, lost goodwill, third-party claims brought against the buyer of defective goods, loss of use of defective property (including the rental value of substitute goods), interest, attorney’s fees, personal injury or property damage.” *Diamond & Foss*, *supra* note 38, at 668 n.17.

88. *See Diamond & Foss*, *supra* note 38, at 688 (“[E]vents after the formation of the contract may cause the [injured party] to suffer losses that were, at the time of formation, not within the parties’ expectations.”). Under the contemplation branch, even if the miller in *Hadley* had told the carrier that the crankshaft was part of the milling machine and that it must be sent immediately, the resulting lost profits would not be recoverable because the carrier would not

Although the *Hadley* rule was set forth as two rules, it is in essence a single rule based on the foreseeable probability of the loss.<sup>89</sup> For example, the Restatement (Second) of Contracts simply provides that “[d]amages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.”<sup>90</sup> Professor Melvin Eisenberg has explained that

the first rule is simply a special case of the second: if a given type of damages arises “naturally, i.e., according to the usual course of things” from the breach of a given contract (the first rule), then a seller will always have reason to foresee that the given type of damages are the probable result of the breach (the second rule).<sup>91</sup>

Under the *Hadley* rule, foreseeable probability of the loss is determined at the time of the contract formation and does not take into account knowledge gained by the defendant after contract formation and before the breach.<sup>92</sup> All that must be sufficiently foreseeable, however, is the loss, and not the type of breach or the way in which the loss came about.<sup>93</sup> The court assesses whether the loss was sufficiently foreseeable at the time of contract formation by considering the breach that in fact occurred.<sup>94</sup> Also, under the modern rule, the loss need only be sufficiently foreseeable to the defendant, not the plaintiff, despite Baron Alderson’s reference in *Hadley* to the loss having to be within the contemplation “of both parties.”<sup>95</sup> Whether the loss is sufficiently

know or have reason to know that the broken crankshaft was necessary for the mills’ operation. RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a, illus. 1.

89. See *Koufos v. C. Czarnikow, Ltd.* (1967) 3 All ER 686 (HL) (Asquith, L.J.) (“[T]here are not two rules formulated in *Hadley v. Baxendale* but two different instances of the application of a single rule.”).

90. RESTATEMENT (SECOND) OF CONTRACTS § 351(1). The Restatement retains the two branches as examples of when the loss may be foreseeable as a probable result of the breach. See *id.* § 352(2) (“Loss may be foreseeable as a probable result of a breach because it follows from the breach (a) in the ordinary course of events, or (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.”).

91. Eisenberg, *supra* note 60, at 566; see also RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b (“Loss that results from a breach in the ordinary course of events is foreseeable as the probable result of the breach.”).

92. FARNSWORTH, *supra* note 41, at 795; see also Eisenberg, *supra* note 60, at 571–72 (“Under *Hadley*, the seller’s liability was determined by what he knew or should have known at the time of contract formation, so that he could shut his eyes to circumstances that developed in the course of time and performance and to information communicated after the contract was made. The principle therefore conceived of contracts as lacking, for liability purposes, any capacity for dynamic change with respect to circumstances unfolding after contract formation.”).

93. FARNSWORTH, *supra* note 41, at 795.

94. See RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (noting that a party is not “liable in the event of breach for loss that he did not at the time of contracting have reason to foresee as a probable result of *such a breach*” (emphasis added)).

95. FARNSWORTH, *supra* note 41, at 795; see also RESTATEMENT (SECOND) OF CONTRACTS

foreseeable is based on an objective standard, that is, what would the foreseeable probability have been to a reasonable person?<sup>96</sup>

But a key issue that remains unresolved is the level of foreseeable probability necessary to sustain a recovery. As noted by Judge Richard Posner, foreseeability is a “maddeningly vague” term.<sup>97</sup> The loss need not have been a necessary or certain result of the breach,<sup>98</sup> but the mere fact that the loss was foreseeable is insufficient because any loss is foreseeable.<sup>99</sup> The *Hadley* opinion stated that the loss must be foreseeable as the *probable* result of the breach,<sup>100</sup> a high standard adopted by the Restatement.<sup>101</sup> This standard presumably means that the loss must be more likely than not.<sup>102</sup> Another possibility, however, is that the loss simply be “reasonably foreseeable,” meaning “more than marginal, or not insignificant.”<sup>103</sup>

Unfortunately, U.S. courts freely interchange the expressions “probable” and “foreseeable,” thereby keeping “shrouded in ambiguity

§ 351 cmt. a (“There is no requirement of foreseeability with respect to the injured party.”).

96. FARNSWORTH, *supra* note 41, at 795; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (“[T]he test is an objective one based on what he had reason to foresee.”).

97. POSNER, *supra* note 68, at 127; *see also* PERILLO, *supra* note 37, at 494 n.8 (“Foreseeability is an ambiguous term.”).

98. FARNSWORTH, *supra* note 41, at 795; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (“[I]t is enough . . . that the loss was foreseeable as a probable, as distinguished from a necessary, result of his breach.”).

99. Eisenberg, *supra* note 60, at 566.

100. *See Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 151, 9 Ex. 341, 354 (“Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either [1] arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or [2] such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the *probable* result of the breach of it.” (emphasis added)).

101. RESTATEMENT (SECOND) OF CONTRACTS § 351(1); *see* Eisenberg, *supra* note 60, at 611 (“Restatement (Second) of Contracts section 351(1) states the principle of *Hadley v. Baxendale* in traditional terms . . . .” (emphasis omitted)).

102. *See Diamond & Foss*, *supra* note 38, at 669 (“[T]he term ‘probable’ would appear to mean statistically probable, that is, more likely than not . . . .”). Professor Eisenberg has suggested that the court in *Hadley* might have applied an even stricter standard: “Another interpretation of *Hadley v. Baxendale* is that relief was denied because the court effectively required that damages be not only probable but highly probable.” Eisenberg, *supra* note 60, at 570 n.26. The Restatement as well arguably has some ambiguity on the required degree of certainty. As noted by Professor Eisenberg, under section 351(2)(b):

Loss may be foreseeable as a probable result of a breach because it follows from the breach . . . as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know. . . . [Section 351] can [thus] be interpreted to mean that satisfaction of a test of reasonable foreseeability under § 351(2)(b) is sufficient to satisfy the “probable result of a breach” test under § 351(1).

*Id.* at 611 n.121.

103. Eisenberg, *supra* note 60, at 566–67.



the degree to which loss must be predictable in order to be recovered [and] [m]ost courts have avoided the interpretational dilemma of reconciling these terms by leaving them undefined.”<sup>104</sup> A notable exception is the Fifth Circuit’s opinion in *Hector Martinez & Co. v. Southern Pacific Transportation Co.*, a case involving a delay in delivering a machine, and also delivering it in a damaged condition.<sup>105</sup> The court, in discussing the required level of foreseeability to recover losses caused by the delay, stated:

Southern Pacific [the carrier] replies that it was as foreseeable that the goods were to be sold as that they were to be used. This contention proves too much because *Hadley* allows recovery for harms that should have been foreseen. The general rule does not require the plaintiff to show that the actual harm suffered was the most foreseeable of possible harms. He need only demonstrate that his harm was not so remote as to make it unforeseeable to a reasonable man at the time of contracting.<sup>106</sup>

Although the matter remains “shrouded in ambiguity,” the *Hector Martinez* decision is part of a trend in the United States to relax the standard of foreseeability required under the *Hadley* rule.<sup>107</sup> “The term used nowadays is reasonable foreseeability,”<sup>108</sup> and “[t]he recurring problem in *Hadley* cases is determining what is reasonably foreseeable.”<sup>109</sup>

In any event, irrespective of the required degree of foreseeability, the test can be easily manipulated by the court to achieve a desired outcome.<sup>110</sup> As noted by Professor Lawrence Friedman, although the *Hadley* rule was aimed at objectivity, the way it was phrased made it a tent rather than a cage.<sup>111</sup> He explains: “Application was all. *Hadley v. Baxendale* . . . spoke of ‘natural consequences.’ Only the courts could say what was natural and what was not.”<sup>112</sup>

Another difficult issue with *Hadley* is determining what is meant by the “loss.” For example, the Restatement comments provide that “[t]he

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104. Diamond & Foss, *supra* note 38, at 669–70.

105. *Martinez v. S. Pac. Transp. Co.*, 606 F.2d 106, 107 (5th Cir. 1979).

106. *Id.* at 110.

107. Eisenberg, *supra* note 60, at 610; see FARNSWORTH, *supra* note 41, at 794 (“The modern trend is . . . toward narrowing the limitation imposed by *Hadley v. Baxendale* . . .”).

108. POSNER, *supra* note 60, at 194.

109. *Id.* at 195.

110. GILMORE, *supra* note 67, at 83.

111. FRIEDMAN, *supra* note 50, at 407.

112. *Id.*; see Anselmo Reyes, *On Two Suggested Alternatives to the Rule in Hadley v Baxendale*, 38 HONG KONG L.J. 347, 358 (2008) (noting that the rule gives rise to uncertainty regarding “where to draw the line between what is likely to occur in the general majority of cases and what is a more remote or exceptional occurrence”).

mere circumstance that some loss was foreseeable . . . will not suffice if the loss that actually occurred was not foreseeable.”<sup>113</sup> Accordingly, the *Hadley* rule can be applied broadly or narrowly based on how the court characterizes the type of loss. A broad description of the type of loss will increase its foreseeable probability, and a narrow description will decrease it.<sup>114</sup>

Further complicating the *Hadley* analysis is whether, in addition to the *type* of loss having to be reasonably foreseeable, the *amount* of the loss must be reasonably foreseeable. Most courts hold that only the type of loss must be sufficiently foreseeable,<sup>115</sup> but some courts and the Restatement implicitly require that the amount of the loss be sufficiently foreseeable.<sup>116</sup> Also, some courts have adopted the Restatement rule that provides courts with discretion to preclude the recovery of consequential losses, even when sufficiently foreseeable, if the amount is disproportionate to the contract price.<sup>117</sup>

The *Hadley* rule is, however, just a default rule,<sup>118</sup> meaning that the rule “takes effect only when a contract is silent on the issue of consequential damages.”<sup>119</sup> Accordingly, parties are permitted to contract around the rule if they wish,<sup>120</sup> and a common situation in

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113. RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (AM. LAW INST. 1981).

114. For example, assume that a security company breaches a contract, resulting in a Picasso painting being stolen. The loss could be described narrowly—a Picasso painting being stolen—or broadly—property being stolen.

115. See FARNSWORTH, *supra* note 41, at 796 (“The magnitude of the loss need not have been foreseeable . . .”); see also Diamond & Foss, *supra* note 38, at 708 n.193 (“Most authority addressing the issue has held that it is not a defense that the seller could not foresee the *amount* of the loss.”).

116. Diamond & Foss, *supra* note 38, at 708 n.193. The Restatement (Second) of Contracts states that “a seller who fails to deliver a commodity to a wholesaler is not liable for the wholesaler’s loss of profits to the extent that it is extraordinary,” RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. b, and then includes a series of illustrations permitting recovery for a *reasonable* resale profit but not an *extraordinarily or unusually large* resale profit. *Id.* § 351 cmt. b, illus. 3–7. *But see* Fla. Power & Light Co. v. Westinghouse Elec. Corp., 597 F. Supp. 1456, 1474–75 (E.D. Va. 1984) (“The language of the Restatement—focusing as it does on the foreseeability of the loss rather than the foreseeability of the damages—supports the Court’s interpretation that the *Hadley* foreseeability test is to be applied to the kind, not the amount, of damage.” (emphasis omitted)), *aff’d in part, rev’d in part*, 826 F.2d 239, 240 (4th Cir. 1987).

117. RESTATEMENT (SECOND) OF CONTRACTS § 351(3); see also Larry T. Garvin, *Disproportionality and the Law of Consequential Damages: Default Theory and Cognitive Reality*, 59 OHIO ST. L.J. 339, 345–60 (1998) (discussing the disproportionality doctrine in the courts).

118. Eisenberg, *supra* note 60, at 566.

119. Gregory S. Geis, *Empirically Assessing Hadley v. Baxendale*, 32 FLA. ST. L. REV. 897, 905 (2005).

120. *Id.*; see POSNER, *supra* note 60, at 194 (“The *Hadley* rule is a default rule: it comes into play only when the parties do not say what happens if the loss is above average.”).

which parties opt out of the *Hadley* rule is when their agreement expressly precludes a recovery of consequential losses.<sup>121</sup> Whether such a limitation is enforceable is determined by the doctrine of unconscionability.<sup>122</sup> And, of course, courts will likely only address the *Hadley* rule if one of the parties raises it as an issue.<sup>123</sup>

### III. THE BASES FOR THE *HADLEY* RULE

To determine whether an exception to a legal doctrine is warranted, the bases for the legal doctrine must be determined.<sup>124</sup> Accordingly, this Part addresses the possible bases for the *Hadley* rule.

To appreciate the bases supporting the *Hadley* rule, one must first recognize that the *Hadley* rule is set against the backdrop of the general rule that contract damages are designed to protect the injured party's expectation interest.<sup>125</sup> The expectation interest is the injured party's "interest in having his benefit of the bargain by being put in as good a position as he would have been in had the contract been performed."<sup>126</sup> Full protection of the injured party's expectation interest includes compensation for consequential losses,<sup>127</sup> no matter how unlikely such losses were. The award of expectation damages has been defended on the grounds of efficiency<sup>128</sup> as well as morality,<sup>129</sup> thereby providing an area of agreement between two groups that do not always agree.<sup>130</sup>

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121. See Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 411 (1993) ("[C]ommercial contracts routinely exclude liability for consequential damages when these are expected to be substantial.").

122. See RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a ("A term that fixes an unreasonably small amount as damages may be unenforceable as unconscionable.").

123. See Michael T. Morley, *Avoiding Adversarial Adjudication*, 41 FLA. ST. U. L. REV. 291, 293 (2014) (discussing "the extent to which litigants may, expressly or implicitly, through their acts or omissions, induce courts to enter substantive rulings and judgments that declare or change their legal rights and obligations, while failing to consider fully the merits of one or more of the legal issues involved.").

124. See MELVIN ARON EISENBERG, *THE NATURE OF THE COMMON LAW* 66 (1988) ("[I]f . . . a case arises that falls within the stated ambit of the rule but that requires different treatment given the social propositions that support the rule, the announced rule should be reformulated.").

125. RESTATEMENT (SECOND) OF CONTRACTS § 347; see also *Hawkins v. McGee*, 146 A. 641, 644 (N.H. 1929) (holding that the proper measure of damages in a case involving a doctor's breach of a promise to give a patient a 100% perfect or good hand was an amount designed to put the patient in the position he would have been in had the doctor kept his promise).

126. RESTATEMENT (SECOND) OF CONTRACTS § 344(a).

127. *Id.* § 344 cmt. b, illus. 3.

128. See A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 33–36 (3d ed. 2003) (discussing why expectation damages are efficient).

129. See CHARLES FRIED, *CONTRACT AS PROMISE* 17–21 (1981) (arguing that expectation damages are supported by the moral obligation to keep a promise).

130. See Charles Fried, *Contract as Promise Thirty Years on*, 45 SUFFOLK U. L. REV. 961, 965 (2012) ("Given the similarity of the premises of the law and economics school and of

Accordingly, any rule that would preclude full protection of the injured party's expectation interest requires justification.<sup>131</sup> The strength of the justification, however, presumably need not be particularly great because a breach of contract is not necessarily considered as reprehensible as a tort, and the bargained-for aspect of contracts (as opposed to torts) also permits a greater role for taking into account the parties' intentions.<sup>132</sup>

Against this backdrop, each of the possible bases for the *Hadley* rule is discussed below. The discussion is divided between the legal form in which the *Hadley* rule is cast and the possible substantive bases for the rule. A final section, Part III.C, discusses how the *Hadley* rule's form and substantive bases have contributed to its success.

### A. The *Hadley* Rule's Legal Form

A doctrine's legal form is the way in which the doctrine is cast, as opposed to the substantive reasons for creating the doctrine.<sup>133</sup> For this Article's purposes, the most important aspect of legal form is the degree

*Contract as Promise*, it is not surprising that the two should arrive at similar conclusions on many of the main points of contract doctrine. The former is utilitarian and proceeds from a premise of consumer sovereignty or subjective measure of welfare; the latter is avowedly Kantian and more or less takes its cue from Kant's *The Metaphysical Elements of Justice*. In their deepest premises, the two analyses are quite dissimilar, differences that come to the fore when the issue is the effect of social arrangements on the overall welfare of groups, as opposed to the joint welfare of two contracting parties."'). Whether protecting the injured party's expectation interest is the proper measure of damages is an issue beyond the scope of this Article. See generally L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52, 53 (1936) (discussing whether expectation damages should be the measure of damages).

131. See Eisenberg, *supra* note 60, at 572 ("The general principle of expectation damages is that the victim of a breach of contract is to be put in the position he would have been in had the contract been performed. In contrast, the special principle of *Hadley v. Baxendale* often leaves the victim far short of the position he would have been in if the contract had been performed."); *id.* at 581 ("[T]he special principle of *Hadley v. Baxendale*, as traditionally formulated and applied, diverges from both the general principle of expectation damages and the general principles of damages outside the law of contract. If those general principles are desirable, the special principle of *Hadley v. Baxendale* must then be undesirable unless it can be supported by some special justifications."); Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 724 (2007) ("[U]nder the *Hadley* rule, promisors are liable only for those consequential damages that could reasonably have been foreseen at the time of the contract's formation. From a moral perspective, this is quite strange. If one is bound to perform but without excuse voluntarily elects to breach one's duty, a case could be made that the promisor should be liable for all consequential damages." (citations omitted)).

132. Diamond & Foss, *supra* note 38, at 675-76; see Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else.").

133. Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687 (1976).

to which the doctrine has the characteristics of a rule or a standard.<sup>134</sup> Often, a legal doctrine has characteristics of both a rule and a standard, and the degree to which it has the characteristics of a rule can be referred to as its “ruleness,”<sup>135</sup> and the degree to which it has the characteristics of a standard can be referred to as its “standardness.”

A rule is a doctrine whose application is based on one or a few easily determinable facts.<sup>136</sup> For example, contract law’s infancy doctrine is a rule because it is based solely on whether the contracting party was an infant, a single fact that is easily determined by the party’s age at the time of contract formation.<sup>137</sup> The benefits of a rule are that it restrains official arbitrariness and promotes certainty.<sup>138</sup> Its detriment is that its inflexibility might result in an outcome in a particular case at odds with the rule’s purpose.<sup>139</sup> For example, a mature infant does not have full capacity to contract while an immature adult does.<sup>140</sup>

A standard is a legal doctrine that is cast in terms of its objective and whose application takes into account all relevant circumstances.<sup>141</sup> For example, the doctrine of unconscionability and the implied covenant of good faith and fair dealing are standards.<sup>142</sup> The benefit of a standard is that it can be applied to achieve an outcome in a particular case that is consistent with the doctrine’s purpose.<sup>143</sup> Its detriments are that it is more difficult to apply (all relevant facts are considered), it does a poor job of restraining official arbitrariness, and its lack of precision makes it

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134. *Id.* at 1687–89.

135. *Id.* at 1687.

136. *Id.* at 1687–88.

137. *Id.* at 1689; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 14 (AM. LAW INST. 1981) (“Unless a statute provides otherwise, a natural person has the capacity to incur only voidable contractual duties until the beginning of the day before the person’s eighteenth birthday.”).

138. Kennedy, *supra* note 133, at 1688.

139. *Id.* at 1689.

140. *See* Cheryl B. Preston & Brandon T. Crowther, *Infancy Doctrine Inquiries*, 52 SANTA CLARA L. REV. 47, 50 (2012) (“For ease of administration and clarity in application, the rule was settled with a categorical age cutoff line without regard to whether any particular individual is mature or infantile.”).

141. Kennedy, *supra* note 133, at 1688.

142. *Id.*; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 208 (“If a contract or term thereof is unconscionable at the time the contract is made a court may refuse to enforce the contract, or may enforce the remainder of the contract without the unconscionable term, or may so limit the application of any unconscionable term as to avoid any unconscionable result.”); *id.* § 205 (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”).

143. Kathleen M. Sullivan, *The Justices of Rules and Standards*, 106 HARV. L. REV. 22, 58–59 (1992).

difficult to predict the outcome in particular cases.<sup>144</sup>

In terms of the “ruleness” or “standardness” of the *Hadley* rule, it falls somewhere between a rule and a standard. It has some of the characteristics of a rule in that it is based on a single fact—the foreseeable probability of the loss—and thereby promotes predictability.<sup>145</sup> In fact, it has been argued that the cases applying the *Hadley* rule, at least on the appellate level, are fairly predictable.<sup>146</sup> Also, one of the most important aspects of the *Hadley* rule is that, irrespective of the rule’s substance, it constrains jury discretion with respect to awarding damages.<sup>147</sup> The *Hadley* court’s holding that the judge ought to have told the jury that lost profits not be taken into consideration meant that the opinion directed judges, in certain situations, to keep the issue from the jury.<sup>148</sup>

Indeed the *Hadley* rule was likely designed to promote predictability, particularly for businesses. The court’s desire to set forth a predictable rule to replace the jury’s discretion under the “natural consequences” test is supported by the following passage from the court:

[W]e deem it to be expedient and necessary to state explicitly the rule which the Judge, at the next trial, ought, in our opinion, to direct the jury to be governed by when they estimate the damages. It is, indeed, of the last importance that we should do this; for, if the jury are left without any definite rule to guide them, it will, in such cases as these, manifestly lead to the greatest injustice.<sup>149</sup>

In the nineteenth century, “[c]ontractors planning for the future needed clear rules for when damages were recoverable and for the extent of any recovery.”<sup>150</sup> The new doctrine’s “ruleness” was also consistent with classical contract law’s preference for standardized doctrines that did not take into account a party’s special circumstances,<sup>151</sup> thereby limiting the number of relevant facts to be considered. The *Hadley* rule’s favorable reception in both England and

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144. *Id.* at 59.

145. See Diamond & Foss, *supra* note 38, at 672 (noting that the *Hadley* rule promotes predictability).

146. Symposium, *Hadley v. Baxendale: Still Crazy After All These Years?*, 11 TEX. WESLEYAN L. REV. 707, 719 (2005) (remark by Joseph M. Perillo).

147. ATIYAH, *supra* note 48, at 432; see also Symposium, *supra* note 146, at 716 (“*Hadley v. Baxendale* was primarily about controlling jury discretion.”) (remark by Roy Ryden Anderson).

148. Danzig, *supra* note 31, at 254.

149. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 150, 9 Ex. 341, 353–54.

150. KEVIN M. TEEVEN, A HISTORY OF THE ANGLO-AMERICAN COMMON LAW OF CONTRACT 190 (1990); see *id.* at 194 (“Before taking business risks, entrepreneurs wanted clearer limitations on the extent of liability than was in place in the first half of the nineteenth century.”).

151. Eisenberg, *supra* note 60, at 571.

the United States was likely based on the desire to remove the confusion surrounding the law of damages and adopt a general rule that applied irrespective of the type of contract or other circumstances.<sup>152</sup> In fact, the *Hadley* rule might have been an attempt by the courts to reverse a trend of merchants resorting to arbitration because of unpredictable damages awards.<sup>153</sup>

The *Hadley* rule is like a standard, however, for a variety of reasons: courts have not clearly set forth the required degree of foreseeability;<sup>154</sup> often the foreseeable probability will have to be estimated;<sup>155</sup> the court must decide whether the circumstances that caused the loss were “special circumstances”; the court will have to decide whether any disclosure of special circumstances was sufficiently specific;<sup>156</sup> and the test is vague enough that it can be easily manipulated to reach a desired result.<sup>157</sup> For example, it has been argued that one of the benefits of the *Hadley* rule is that its very ambiguity enables judges to do justice in particular cases.<sup>158</sup>

What then is to be made of the legal form chosen for the *Hadley* rule? Presumably, that the *Hadley* rule was given enough “ruleness” to increase predictability regarding the recoverability of consequential losses (remember, prior to *Hadley* the matter was left to the jury’s discretion under the “natural consequences” test), but also enough “standardness” to leave a measure of discretion with the court to achieve a just outcome in particular cases.

### *B. The Substantive Bases for the Hadley Rule*

This Section discusses the various substantive bases that have been asserted for the *Hadley* rule. As will be shown, only some of those asserted can legitimately be considered a basis for the rule.

#### 1. The Parties’ Presumed Intentions

During the era of classical contract law in the nineteenth century,<sup>159</sup>

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152. Faust, *supra* note 31, at 57.

153. *Id.* at 60.

154. Diamond & Foss, *supra* note 38, at 669–70.

155. See POSNER, *supra* note 60, at 195 (“The recurring problem in *Hadley* cases is determining what is reasonably foreseeable.”).

156. See *id.* (“A . . . problem is determining when communication gives adequate notice of the idiosyncratic loss.”).

157. FRIEDMAN, *supra* note 50, at 407; GILMORE, *supra* note 67, at 83.

158. Roy R. Anderson, *Incidental and Consequential Damages*, 7 J.L. & COM. 327, 353 (1987).

159. See Larry A. DiMatteo, *Equity’s Modification of Contract: An Analysis of the Twentieth Century’s Equitable Reformation of Contract Law*, 33 NEW ENG. L. REV. 265, 338 (1999)

the content of contractual duty was presumed to be derived strictly from the parties' intentions.<sup>160</sup> Not surprisingly, therefore, during the development of the law of contract damages in England between 1820 and 1870 "there was a tendency to treat the rules as to damages as following from the parties' own intentions."<sup>161</sup> The *Hadley* rule, with its reference to the "contemplation of the parties," can be seen as implementing the parties' presumed intentions regarding whether a particular loss is recoverable.<sup>162</sup> If a loss was sufficiently foreseeable, then it could be presumed that the risk of the loss was taken into account by the parties in fixing the contract's terms.<sup>163</sup> And classical economic theory assumed that such a risk would have been taken into account, without inquiring in each case whether it in fact had been.<sup>164</sup> If the loss was not reasonably foreseeable, it could therefore be presumed that the parties had not taken it into account when fixing the contract's terms, and had not intended it to be recoverable.<sup>165</sup>

This justification thereafter led to the brief rise of the so-called tacit-agreement test and a search for whether the defendant *in fact* intended to be liable for the loss, rather than simply presuming the defendant intended to be liable for it as a result of its degree of foreseeability.<sup>166</sup> Not surprisingly, Professor Charles Fried, the most notable modern advocate that contract law should be based on voluntarily imposed obligations, favors the tacit-agreement test.<sup>167</sup>

The tacit-agreement test, however, has generally been rejected,<sup>168</sup> and it might be tempting to conclude that presumed intent can therefore not be a basis for the modern *Hadley* rule. But this overlooks the

("Modern Anglo-American contract law can be divided into three eras: the end of the writ system, along with the separation of law and equity in the eighteenth century, the evolution of classical contract theory of the nineteenth century, and the erosion or reformation of classical contract law in the twentieth century.")

160. Kennedy, *supra* note 133, at 1729.

161. ATIYAH, *supra* note 48, at 431.

162. *Id.*

163. *Id.* at 432; *see also* RESTATEMENT (SECOND) OF CONTRACTS § 351 cmt. a (AM. LAW INST. 1981) ("A contracting party is generally expected to take account of those risks that are foreseeable at the time he makes the contract.")

164. ATIYAH, *supra* note 48, at 431.

165. *But see* Eisenberg, *supra* note 60, at 597 ("[T]he principle of *Hadley v. Baxendale* defeats reasonable expectations because a seller's commitment to perform would often be understood by a buyer as a commitment to shoulder reasonably foreseeable damages caused by the seller's breach.")

166. PERILLO, *supra* note 37, at 494-95.

167. *See* FRIED, *supra* note 129, at 139 n.25 ("Holmes's [tacit-agreement] test seems more consonant with the thesis of this work.")

168. *See* PERILLO, *supra* note 37, at 494 (explaining that state courts generally have not followed the tacit-agreement test).



“ruleness” of the *Hadley* rule. The *Hadley* rule might use foreseeable probability as a proxy for determining intent so as to avoid the added time and expense of determining actual intent. For example, as long as one believes that more than half of the parties who form a contract tacitly agree to be liable for a loss that is sufficiently foreseeable, the presumed-intent rationale is defensible.

It might be argued that parties, when forming a contract, do not typically contemplate breach, and thus do not consider liability for consequential losses.<sup>169</sup> An assumption of this proposition’s truth does not, however, mean that the presumed-intent rationale cannot be one of the bases for the *Hadley* rule. For example, assume that at the time of contract formation 10% of contracting parties consider the extent of their liability for breach and 90% do not. If most of the 10% (even just 6%) assume they are liable for any losses that are sufficiently foreseeable at the time of contract formation and are not liable for those losses that are not sufficiently foreseeable, then a default rule that tracks this belief would capture the parties’ intentions more often than the opposite rule (6% to 4%).

Although such a rationale would likely not alone be an adequate explanation for the rule because it only applies in 10% of the situations covered by the doctrine, it could still be a factor on the scales of determining what the default rule should be. In fact, all else being equal, it would determine the appropriate rule. Also, because the *Hadley* rule is simply a default rule, the parties may opt out of the rule if their actual intentions are different from the presumed intentions under the rule. Further, and perhaps most importantly, because the *Hadley* court referred to the contemplation of the parties,<sup>170</sup> the presumed-intent rationale appears to be at least one of the bases for the *Hadley* rule. In fact, Pothier’s contemplation rule expressly stated that it was based on the belief that a party could only be considered to have intended to be liable for a loss within his contemplation.<sup>171</sup>

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169. See, e.g., MURRAY, *supra* note 72, at 763 (“In the typical case, the promise is made in a time of optimism on the assumption that it will be performed.”); M.N. Kniffin, *A Newly Identified Contract Unconscionability: Unconscionability of Remedy*, 63 NOTRE DAME L. REV. 247, 255 (1988) (“[I]ndividuals at the moment of entering into a contract generally do not contemplate breach . . . .”); Comment, *Lost Profits as Contract Damages: Problems of Proof and Limitations on Recovery*, 65 YALE L.J. 992, 1021 (1956) (“Businessmen’s primary expectations are of full performance; they do not consider the possibilities of large losses that, in retrospect, might have been foreseeable for the reason that they do not normally contemplate breach.”).

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

171. See POTHIER, *supra* note 49, at 91 (“[T]he debtor is only liable for the damages and interest which might have been contemplated at the time of the contract; *for to such alone the debtor can be considered as having intended to submit.*” (emphasis added)).

## 2. Efficiency

Most of the rationales for the *Hadley* rule involve an argument that the rule promotes efficiency, though the arguments have taken several different forms. First, scholars have argued that the *Hadley* rule is based on the utilitarian moral philosophy that an action is only immoral if it causes more harm than good.<sup>172</sup> Second, scholars have argued that the *Hadley* rule is designed to discourage inefficient behavior by the injured party, either before or after contract formation.<sup>173</sup> Third, scholars have argued that the *Hadley* rule encourages the injured party to disclose special circumstances to the defendant, thereby enabling the defendant to adequately assess the risks involved.<sup>174</sup> Fourth, scholars have argued that the *Hadley* rule is designed to protect business enterprises.<sup>175</sup> Each asserted rationale is discussed below.

### a. Utilitarian Moral Philosophy's Concept of Right and Wrong Actions and the Defendant's Conduct

Professor Patrick Atiyah has argued that the *Hadley* rule is consistent with utilitarian moral philosophy's concept of right and wrong actions.<sup>176</sup> The classical utilitarians "took the fundamental basis of morality to be a requirement that happiness should be maximised: the basic principle of utility required us to weigh up the consequences, in terms of happiness and unhappiness, of various alternative actions, and choose that action which would, on balance, have the best consequences, in the sense of producing the largest net balance of happiness."<sup>177</sup> Atiyah has argued that "the notion that a man was responsible for the foreseeable consequences of his actions was an important, and perhaps an essential, part of utilitarian philosophy," and for a person to know the moral course of action, the person must know the foreseeable consequences of that action.<sup>178</sup> Similarly, Professor Joseph Perillo has argued that the rule is based on the deeply felt belief by business people that the injured party should bear the loss when it was not sufficiently foreseeable.<sup>179</sup>

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172. ATIYAH, *supra* note 48, at 432.

173. POSNER, *supra* note 68, at 127–28; *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 957 (7th Cir. 1982).

174. *See Diamond & Foss*, *supra* note 38, at 688 (discussing the rationale behind the rule in *Hadley v. Baxendale*).

175. PERILLO, *supra* note 37, at 493.

176. ATIYAH, *supra* note 48, at 432.

177. NIGEL E. SIMMONDS, *CENTRAL ISSUES IN JURISPRUDENCE* 17 (3d ed. 2008).

178. ATIYAH, *supra* note 48, at 432.

179. Symposium, *supra* note 146, at 719.

This argument is not that the *Hadley* rule is designed to increase the ability of the parties to determine the most efficient course of action. Rather, it is that a person should not be held responsible for causing a loss when the person justifiably assumed that the benefit from the action causing the loss would exceed the loss, even if it turned out the person was wrong.<sup>180</sup> It is about sanctioning a person for morally wrong actions and not sanctioning a person when his or her actions are not morally wrong.

Utilitarian moral philosophy's concept of right and wrong actions cannot, however, be a justification for the *Hadley* rule, even taking into account its "ruleness" and the resulting acceptable level of deviation from the doctrine's purpose when it is applied. Under the *Hadley* rule, the foreseeable probability of loss is determined at the time of contract formation.<sup>181</sup> Accordingly, even if the defendant learns of the plaintiff's special circumstances prior to breach, but after contract formation, the defendant will not be held responsible for the resulting consequential loss if it was not sufficiently foreseeable at the time of contract formation. Such a result is inconsistent with utilitarian moral philosophy's concept of right and wrong actions because it permits a defendant to breach a contract and avoid responsibility for the consequential loss even when the defendant knows that the consequential loss will exceed any benefit to the defendant from breach. Utilitarianism's cost-benefit analysis is based solely on the future consequences of an act without any reference to past events, unless those past events have a bearing on the future.<sup>182</sup> Thus, the fact that the plaintiff failed to disclose special circumstances to the defendant at the time of contract formation should play no role in a utilitarian's cost-benefit analysis at the time of breach.

It could be argued that utilitarian moral philosophy's concept of right and wrong actions is a basis for the *Hadley* rule but the doctrine's "ruleness" results in some cases where the rule's purpose is not achieved. In other words, this is simply an example of rule utilitarianism rather than act utilitarianism, which provides that the morally correct action should be guided by general rules, as opposed to deciding on a case-by-case basis whether a particular act will increase

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180. See D.D. RAPHAEL, *MORAL PHILOSOPHY* 34 (2d ed. 1994) (noting that according to utilitarianism, "an action is right, the action which you ought to do, if it seems to you likely to produce the greatest possible amount of happiness, i.e. if it seems likely to produce more happiness . . .").

181. FARNSWORTH, *supra* note 41, at 795.

182. SIMMONDS, *supra* note 177, at 18–19.

utility.<sup>183</sup> But the problem is not with having a general rule; the problem is with the general rule that has been adopted. The gain achieved from a court only having to focus on the time of contracting as opposed to up until the point of breach is likely minimal and the number of cases of injustice substantial, such that the test would likely have been different if its basis was, even in part, utilitarian moral philosophy's concept of right and wrong actions. Accordingly, utilitarian moral philosophy's concept of right and wrong actions can be rejected as a basis for the *Hadley* rule.

b. Encouraging Efficient Precautions by the Plaintiff to Avoid the Loss

Another efficiency-related rationale is that the *Hadley* rule is designed to encourage efficient behavior by the plaintiff, either before or after contract formation. It is similar to the prior rationale in that it argues for the sanctioning of inefficient behavior, but it is different in that it focuses on the *plaintiff's* actions. It is similar to the doctrine of avoidable losses (commonly called the "duty to mitigate"), under which a plaintiff cannot recover a loss that he could have avoided through reasonable efforts,<sup>184</sup> but the difference is that the doctrine of avoidable losses only applies to post-breach or post-repudiation actions.<sup>185</sup>

With respect to pre-contract precautions, this theory can be called the "spare crankshaft" rationale. Judge Richard Posner is the leading advocate of the spare crankshaft theory, arguing that the *Hadley* rule's animating principle is

that the costs of the untoward consequence of a course of dealings should be borne by that party who was able to avert the consequence at least cost and failed to do so. In *Hadley* the untoward consequence was the shutting down of the mill. The carrier could have avoided it by delivering the engine shaft on time. But the mill owners, as the court noted, could have avoided it simply by having a spare shaft. Prudence required that they have a spare shaft anyway, since a replacement could not be obtained at once even if there was no undue delay in carting the broken shaft to and the replacement shaft from the manufacturer. The court refused to imply a duty on the part of the carrier to guarantee the mill owners against the consequences of their

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183. *Id.* at 35.

184. See RESTATEMENT (SECOND) OF CONTRACTS § 350 (AM. LAW INST. 1981) ("[D]amages are not recoverable for loss that the injured party could have avoided without undue risk, burden or humiliation. . . . [But t]he injured party is not precluded from recovery . . . to the extent that he has made reasonable but unsuccessful efforts to avoid loss.").

185. See *id.* § 350 cmt. b (noting that a party is expected to take reasonable actions to avoid loss "[o]nce a party has reason to know that performance by the other party will not be forthcoming").

own lack of prudence, though of course if the parties had stipulated for such a guarantee the court would have enforced it. The notice requirement of *Hadley v. Baxendale* is designed to assure that such an improbable guarantee really is intended.<sup>186</sup>

Under this theory, the *Hadley* rule is designed to preclude recovery because the plaintiff's consequential losses are more the plaintiff's fault for not having taken precautions beforehand to prevent the need to contract with the defendant to rescue the plaintiff from the situation that has arisen. It is similar to tort law's comparative fault standard, precluding recovery when the plaintiff was negligent.<sup>187</sup> By not holding the defendant liable for the consequential losses, the plaintiff will be encouraged to act reasonably and take precautions to avoid the loss.

The problem with the spare crankshaft rationale is that it assumes that in most of the cases involving a consequential loss the loss was caused in part by the plaintiff's pre-contract failure to take adequate precautions. Arguably, however, most plaintiffs will have taken appropriate precautions as a matter of self-interest.<sup>188</sup> It is not even clear in *Hadley* that having a spare crankshaft was the optimal level of care.<sup>189</sup> The expense of a spare crankshaft might exceed the probable loss, taking into account not only the amount of loss but the chance the loss will occur. For example, assume the following facts: a spare crankshaft costs \$6; the loss from the mill being shut down is \$100 per day; if the crankshaft breaks it will take, on average, five days to obtain a new crankshaft (taking into account the chance of a delay); and the chance of a crankshaft breaking is 1% over the ten-year period of the machine's life expectancy. The expected loss in the future is \$5 ( $\$100 \times 1\%$ ), but the crankshaft costs \$6. Accordingly, a risk-neutral actor will not invest in a spare crankshaft, particularly when one considers the time value of money.

It could be argued, however, that in most cases, a consequential loss will be partly due to the plaintiff's failure to take reasonable precautions, and the "ruleness" of the *Hadley* rule simply results in the denial of recovery in some cases where the plaintiff was not negligent. But with the wide variety of types of transactions, such an assertion is difficult to support, particularly when one assumes that most persons

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186. *Evra Corp. v. Swiss Bank Corp.*, 673 F.2d 951, 957 (7th Cir. 1982) (citation omitted).

187. See RESTATEMENT (SECOND) OF TORTS § 467 (AM. LAW INST. 1965) ("Except where the defendant has the last clear chance, the plaintiff's contributory negligence bars recovery against a defendant whose negligent conduct would otherwise make him liable to the plaintiff for the harm sustained by him.").

188. Eisenberg, *supra* note 60, at 582.

189. *Id.*

will act reasonably to protect their self-interest.

Further, the *Hadley* court did not reference the lack of a spare crankshaft to show that the plaintiff was negligent. Rather, it referenced the spare crankshaft to reduce the degree of foreseeability of the particular loss. A reasonable person in the defendant's position will assume that the plaintiff has already taken reasonable precautions to avoid consequential losses unless told otherwise. Accordingly, the spare crankshaft discussion was about the degree of foreseeability of the loss and not about precluding recovery for negligent plaintiffs.

Of course, the *Hadley* rule does encourage a plaintiff to take reasonable precautions because the foreseeable probability of loss will be based on the assumption the plaintiff has taken such measures. Thus, if reasonable precautions could avoid the loss, then the foreseeable probability of loss is likely low because it will be assumed the plaintiff has acted reasonably.<sup>190</sup> For example, if 90% of mill owners have a spare crankshaft, then the foreseeable probability of consequential loss can be no more than 10%, unless the mill owner tells the carrier that he does not have a spare crankshaft. Accordingly, under *Hadley* any consequential loss will not be recoverable in such a situation and the plaintiff is thereby encouraged to take precautions to avoid the loss. But this is likely just an effect of the rule, and not one of its bases, for the simple reason that it cannot be said that most consequential losses are caused by the plaintiff's pre-contract failure to take reasonable precautions.

A second similar rationale, also advanced by Judge Posner, is that the *Hadley* rule encourages efficient *post-formation*, pre-breach behavior by the plaintiff. He provides the following example:

A commercial photographer purchases a roll of film to take pictures of the Himalayas for a magazine. The cost of developing the film is included in the purchase price. The photographer incurs heavy expenses (including the hire of an airplane) to complete the assignment. He mails the film to the manufacturer but it is mislaid in the developing room and never found.<sup>191</sup>

Posner argues that the *Hadley* rule, which will preclude recovery for

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190. This argument does not align completely with tort law's concept of reasonable behavior, because it would be based on what most persons do, and not what they should do. Cf. *The T.J. Hooper*, 60 F.2d 737, 740 (2d Cir. 1932) (“[I]n most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required; there are precautions so imperative that even their universal disregard will not excuse their omission.”).

191. POSNER, *supra* note 68, at 127.

the consequential losses, encourages the photographer to take adequate post-formation precautions against the loss, such as “using two rolls of film or requesting special handling when he sends the roll in to be developed.”<sup>192</sup> Posner believes this is efficient because the photographer can avoid the losses more inexpensively.<sup>193</sup> If the plaintiff cannot avoid the risk more inexpensively, the plaintiff is encouraged to disclose the special circumstances to the defendant, even if it means paying a higher price.<sup>194</sup>

The problem with this theory as an explanation of the *Hadley* rule’s basis—as opposed to a beneficial effect—is that, like the situation of pre-contract precautions, it is not clear that the plaintiff will usually be the party who can, after contract formation, avoid the consequential loss at the least expense.<sup>195</sup> For example, in *Offenberger*, the appellate court found that the plaintiff had not been negligent in failing to check whether he had received all of his tickets,<sup>196</sup> and it is not clear in *Hadley* that there was anything the plaintiff could do post-contract to avoid the loss more inexpensively than the carrier.

Of course, the *Hadley* rule has the effect of encouraging taking reasonable precautions to avoid loss after contract formation, just like it has the effect of encouraging the taking of pre-contract precautions. At the time of contract formation, a reasonable defendant will assume that the plaintiff will take such precautions, and this will thereby reduce the foreseeable probability of loss.

In sum, tying the *Hadley* rule to discouraging negligent pre-contract and post-contract behavior by the injured party is inconsistent with the rule itself, which is based solely on the foreseeable probability of loss. It is possible, of course, that the rule is in fact based on discouraging such behavior and is just a poorly designed instrument for achieving that purpose, but a rule directly implementing that purpose would have been easy to develop, leading to the belief that this could not have been

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192. *Id.*

193. *Id.*

194. *Id.*

195. See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 101 (1989) (noting that in *Hadley* “the carrier may have been the more efficient bearer of this risk”).

196. See *Offenberger v. Beulah Park Jockey Club, Inc.*, No. 79AP-471, 1979 WL 209570, at \*4 (Ohio Ct. App. Dec. 28, 1979) (“Defendants further contend that plaintiff had an obligation to check to make sure that he had all of the 135 tickets before he left the window. It is not clear that the trial court reached this issue. In any event, there is insufficient evidence to show that plaintiff breached a duty of reasonable inspection, since the stipulated facts do not indicate that he had more than approximately one minute after receiving the tickets to make such inspection before the race started and the window closed.”).

one of its bases, and is instead just one of its effects.

### c. Information Forcing

The traditional rationale for the *Hadley* rule is the information-forcing argument.<sup>197</sup> Unlike the prior discussion, this rationale is designed primarily to affect the *defendant's* actions, not the plaintiff's. By encouraging buyers to disclose special circumstances to sellers, the *Hadley* rule enables the seller to make contract decisions consistent with utilitarian goals. It is similar to the spare crankshaft rationale, however, in that disclosing such information can be considered a form of taking efficient precautions in that it might encourage added care by the other party to avoid breach. Similarly, it has been argued that the *Hadley* rule is a so-called penalty default rule that encourages disclosure by penalizing nondisclosure.<sup>198</sup>

The information-forcing rationale is the most common explanation for the *Hadley* rule. Most scholars have explained the *Hadley* rule as one "that promotes economic efficiency by encouraging the disclosure of risk-related information."<sup>199</sup> This argument provides that the rule is designed to encourage promisees to disclose their special circumstances to promisors so that promisors can use this information in a variety of ways, including deciding whether to contract; determining the price to charge; deciding whether to contractually limit liability; and determining the efficient amount of precautions to take to avoid breach.<sup>200</sup> As stated by one court:

The *Hadley* rule is designed to further a fundamental principle of contract law: parties must be able to confidently allocate risks and costs during their bargaining without fear that unanticipated liability may arise in the future, effectively negating the parties' efforts to build these cost considerations into the contract. Under *Hadley*, a party to a contract is only responsible for those damages that he should

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197. POSNER, *supra* note 60, at 194; Diamond & Foss, *supra* note 38, at 688.

198. Gertner & Ayres, *supra* note 195, at 101–03.

199. Diamond & Foss, *supra* note 38, at 672; *see also id.* at 689 n.104 (noting that it is the rationale advanced by most scholars).

200. *Id.* at 688; *see, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 113 n.45 (1985) ("The foreseeability doctrine of *Hadley v. Baxendale* denies recovery for nonforeseeable losses, which gives plaintiffs an incentive to disclose any unusual conditions and risks at the time of the transaction. Disclosure, in turn, allows the other party to take extra precautions or to charge appropriate compensation for bearing increased risk." (citation omitted)); Gertner & Ayres, *supra* note 195, at 101 ("Informing the carrier creates value because if the carrier foresees the loss, he will be able to prevent it more efficiently."). Adjusting the contract price based on risk is known as "stratifying precautions," in which the seller charges different prices based on the risk involved with the particular customer. Eisenberg, *supra* note 60, at 593.



reasonably have contemplated as the probable result of a breach at the time the contract was entered into. Because the party is aware, or should be aware, that these damages are a potential consequence of breach, he presumably will take into account the risk that these contingencies will occur while negotiating the contract. Thus, by limiting contractual liability to those damages foreseen by the parties at the time the contract was formed, *Hadley* ensures that the bargain struck reflects a mutually agreeable allocation of the risks and costs of breach. In other words, *Hadley* guarantees the fairness of a bilateral agreement by protecting the parties from unanticipated liability arising in the future.<sup>201</sup>

Absent a disclosure requirement, a seller would presumably have to charge a higher contract price, even to low-risk buyers, resulting in cross-subsidization of the high-risk buyers by the low-risk buyers. It has also been argued that by forcing disclosure, the *Hadley* rule promotes efficient breaches.<sup>202</sup> The disclosure of the information enables the party contemplating breach to determine whether the cost of breach will exceed its benefits.<sup>203</sup> Moreover, it has been argued that the information-forcing rationale not only implements a good policy, but also mimics what most parties would have agreed to had they considered the matter.<sup>204</sup> The rationale also has the strength of being supported by the following passage from the *Hadley* opinion: “For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them.”<sup>205</sup>

The information-forcing rationale is, however, subject to several objections. First, the quoted passage from *Hadley* does not reference providing the promisor with the opportunity to take adequate precautions *in performing the contract*, and such a rationale is undermined by the rule testing foreseeability at the time of contract formation. If one of the rationales for the rule was enabling the promisor to take adequate precautions in performing the contract, post-formation, pre-performance disclosure of the special circumstances would often be sufficient to enable the promisor to take the optimal precautions. This concern, however, does not undermine the information-forcing rationale entirely, but simply excludes as one of its

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201. *Vanderbeek v. Vernon Corp.*, 50 P.3d 866, 871 (Colo. 2002).

202. Eisenberg, *supra* note 60, at 584.

203. *Id.* at 584–85.

204. *Diamond & Foss*, *supra* note 38, at 691.

205. *Id.* at 689 n.103 (citing *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 151, 9 Ex. 341, 354–55).

purposes the goal of affecting the defendant's *post-formation* behavior.

Second, the *Hadley* court could have easily created a test limited to the situation in which the plaintiff's special circumstances caused the consequential loss, but rather the court's rule was limited solely to the issue of foreseeability. Although the court supported the rule's application based on the plaintiff's failure to disclose special circumstances, this appears to have been an additional justification for why the rule's application led to a just result in that particular case. But it is likely that in most situations in which an unlikely consequential loss occurs, it was due to the plaintiff's special circumstances. Accordingly, the "ruleness" of *Hadley* arguably justifies presuming that the loss was caused by undisclosed special circumstances.

Third, it has been argued that information forcing will not, in fact, lead to more efficient results. For example, it has been asserted that a rule of unlimited liability would have the same effect as compelling disclosure, in that with unlimited liability buyers without special circumstances would have an incentive to disclose that there are no special circumstances so as to obtain a lower contract price, and thus a failure to disclose would mean there were special circumstances.<sup>206</sup> It has also been asserted that the cost of the buyer assembling information regarding its special circumstances and communicating them to the seller might exceed the probable loss (amount multiplied by probability of breach), and thus disclosure might never occur.<sup>207</sup> Disclosure could also involve disclosing valuable information that the seller might take advantage of, such as knowing that a buyer has a particularly lucrative resale contract.<sup>208</sup> Additionally, a typical buyer is unlikely to believe that disclosure is necessary.<sup>209</sup> Similarly, it has been argued that with respect to efficient breach, even without the *Hadley* rule the party contemplating breach would negotiate with the injured party prior to breach, and an efficient result would still be achieved.<sup>210</sup>

But merely because a rationale is subject to criticism does not mean that it is not, in fact, a rationale for the doctrine. Some of the criticism, such as the argument that the rule will not lead to efficient breaches

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206. POSNER, *supra* note 60, at 195. *But see* Gertner & Ayres, *supra* note 195, at 103 (questioning how often low-risk buyers would disclose a lack of special circumstances).

207. Eisenberg, *supra* note 60, at 594-95.

208. *Id.* at 595. A particularly interesting example of a similar situation is *Lenox v. Triangle Auto Alarm*, 738 F. Supp. 262 (N.D. Ill. 1990), where the plaintiff bought a car-alarm system because the plaintiff kept jewelry in the car. Understandably, the plaintiff would be reluctant to disclose this information.

209. Eisenberg, *supra* note 60, at 595; *see also id.* at 596 ("It is reasonable for laymen not to know the intricacies of damage law.").

210. *Id.* at 585.

because the rule ignores post-formation disclosures of special circumstances, are stronger than others, but the idea that forcing disclosure leads to more efficient action is sufficiently plausible for it to be a basis for the *Hadley* rule.

In conclusion, the court's express reference to requiring disclosure so that the defendant can take the risk into account shows that information forcing is likely the *Hadley* rule's principal purpose. Although the rule precludes the recovery of consequential losses that were insufficiently probable even when they were not caused by undisclosed special circumstances, this is likely just an aspect of its "ruleness."

#### d. Protecting Business Enterprises

Another asserted justification based on efficiency is that the rule is designed to encourage risk-taking and protect business enterprises from "large damage verdicts by irresponsible juries."<sup>211</sup> For example, it has been argued that "[t]he decision . . . was clearly based on the policy of protecting enterprises in the then burgeoning industrial revolution."<sup>212</sup> Professor E. Allan Farnsworth has argued that "[t]he development of such a limitation was encouraged by the realization that liability for unforeseeable loss might impose upon an entrepreneur a burden greatly out of proportion to the risk that the entrepreneur originally supposed was involved and to the corresponding benefit that the entrepreneur stood to gain."<sup>213</sup>

This rationale differs from the predictability rationale (discussed with respect to the *Hadley* rule's legal form) in that it involves choosing a predictably low recovery instead of a predictably high recovery so as to protect businesses. Although the rule is not expressly limited to cases in which the plaintiff is a natural person and the defendant a business entity (in fact, in *Hadley* the plaintiffs operated a business), most businesses are probably repeat players in litigation and in many of those cases the opposing party will be a consumer. Accordingly, overall businesses will presumably benefit from the *Hadley* limitation. Also, this rationale is so widely accepted, and impossible to disprove, that it should be recognized as one of the rationales for the *Hadley* rule.

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211. GILMORE, *supra* note 67, at 126 nn.121–22.

212. PERILLO, *supra* note 37, at 493; FARNSWORTH, *supra* note 41 ("With the advent of the industrial revolution, a solicitude for burgeoning enterprise led to the development of rules to curb [the] discretion [of juries] and the 'outrageous and excessive' verdicts to which it led. The limitation of unforeseeability is an apt example."); Huie, *supra* note 72, at 650 ("The venerable decision . . . can be broadly read as necessary to aid nascent industry trying to prosper in the middle years of the Industrial Revolution.").

213. FARNSWORTH, *supra* note 41.

### 3. Conclusion Regarding Substantive Bases

In sum, there are likely a variety of substantive reasons for the *Hadley* rule. First, for those parties who did, at the time of contract formation, consider the issue of damages, they likely tacitly agreed that the defendant would be liable for any consequential losses that were sufficiently foreseeable. Second, it encourages plaintiffs who have special circumstances that would cause consequential losses to disclose them so that the defendant can take account of those risks when negotiating the contract's terms. Third, the rule encourages business activity by limiting liability. Although encouraging pre-contract and post-contract, pre-breach reasonable precautions by the plaintiff is likely not a basis for the rule, the rule has the effect of encouraging such behavior.

#### C. *Why the Hadley Rule Perseveres*

As previously discussed, the *Hadley* rule was an immediate success. And it has remained unchanged from its original formulation in 1854, except for the era of the tacit-agreement test and some courts' recent tendency to reduce the required degree of foreseeability. As was noted by Chancellor John Murray, the *Hadley* rule "has demonstrated a remarkable record of consistent application since it was first announced in 1854."<sup>214</sup>

Despite scholarly criticism, the rule remains, and it remains presumably because courts like it for the following reasons: (1) its "ruleness" promotes predictability while its "standardness" promotes justice in close cases, thereby providing a compromise for those favoring rules and those favoring standards; (2) the rule promotes the parties' intentions while also promoting efficiency, thereby providing a compromise between those favoring the will theory of contract and law-and-economic utilitarians; and (3) as a default rule, parties are able to contract out of it if they so desire. Accordingly, any effort at wholesale revision of the *Hadley* rule is likely to be futile.<sup>215</sup> But this does not

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214. MURRAY, *supra* note 72, at 764.

215. In fact, Article 74 of the United Nations Convention on Contracts for the International Sale of Goods includes a provision similar to the *Hadley* rule. See U.S. Ratification of 1980 United Nations Convention on Contracts for the International Sale of Goods: Official English Text art. 74, 52 Fed. Reg. 6262, 6264-6280 (Mar. 2, 1987) ("Damages for breach of contract by one party consist of a sum equal to the loss, including loss of profit, suffered by the other party as a consequence of the breach. Such damages may not exceed the loss which the party in breach foresaw or ought to have foreseen at the time of the conclusion of the contract, in the light of the facts and matters of which he then knew or ought to have known, as a possible consequence of the breach of contract."). See generally Arthur G. Murphey, Jr., *Consequential Damages in Contracts for the International Sale of Goods and the Legacy of Hadley*, 23 GEO. WASH. J. INT'L

mean that an exception is not in order. That matter is taken up in the next Part.

#### IV. SOLVING THE LONG-SHOT CONTRACT PROBLEM

In this Part, it will be shown that the long-shot contract problem extends beyond gambling contracts, and applies to a variety of other types of contracts. It will then be shown that there are no existing doctrines that can be used to solve the problem, thereby making an exception to existing doctrine necessary if the problem is to be solved. It will also be demonstrated that the *Hadley* rule's purposes and beneficial effects, as determined in the preceding Part, do not support the *Offenberger* result in a long-shot contract situation, and will not be undermined by this Article's proposed exception to the *Hadley* rule.

##### A. Scope of the Problem

At the outset of this Article, the court's decision in *Offenberger v. Beulah Park Jockey Club, Inc.*<sup>216</sup> was provided as an example of when an application of the *Hadley* rule results in injustice. Because the contract's principal purpose was to provide the plaintiff with an opportunity for an unlikely profit, the *Hadley* rule resulted in the plaintiff obtaining virtually no remedy for the breach.

It might be argued, however, that there really is not much of a problem because the situation in *Offenberger* is unlikely to recur. But the *Offenberger* problem extends beyond gambling contracts. For example, it extends to all sorts of security contracts, including contracts for alarm systems, to prevent home damage (such as termite or fire damage), for inspections, and to secure insurance, to name just a few. In all of these contracts, the foreseeable probability of loss from breach is likely very low, often below the probability necessary to obtain a recovery under the *Hadley* rule, even for courts applying a lower than "probable" standard.

One's initial response to such a suggestion might be an argument that it is reasonably foreseeable that if a breach of an alarm-system contract occurs there will be consequential losses in the form of stolen goods, and if there is a breach of a promise to secure insurance, it is reasonably foreseeable that there will be consequential losses in the form of expenses that are not compensated by insurance. Such an argument, however, is based on a misapplication of the *Hadley* rule, one that is

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L. & ECON. 415, 435 (1989) (discussing Article 74 and *Hadley*).

216. *Offenberger v. Beulah Park Jockey Club*, No. 79AP-471, 1979 WL 209570, at \*1 (Ohio Ct. App. Dec. 28, 1979).

even made by courts. The misapplication results in essentially applying tort's proximate-cause standard instead of contract law's *Hadley* standard.

Take, for example, *Ligon v. Charles P. Davis Hardware, Inc.*<sup>217</sup> In that case, a hardware store and an alarm-system company entered into a contract under which the alarm-system company installed an alarm system at the store and promised to maintain the system and contact the police if the alarm was triggered.<sup>218</sup> Several months after installing the system, a thief broke into the hardware store at night and stole four shotguns without the alarm sounding.<sup>219</sup> The hardware store sued the alarm-system company owners for breach of contract and sought damages in the amount of the store's loss.<sup>220</sup> The evidence introduced at trial showed that the alarm system was defective and not properly maintained.<sup>221</sup> The evidence also showed that had the system been operating properly, it would have detected the thief's presence.<sup>222</sup> One of the alarm-system company's owners testified that there was a 90% chance the thief would have been caught and the loss would have been avoided if the alarm had worked.<sup>223</sup> The appellate court then held that the consequential loss was recoverable under the *Hadley* rule:

With respect to foreseeability, there is evidence to support the view that appellants could have reasonably foreseen that, if the alarm system did not operate properly, a burglar could enter and leave appellee's store unmolested and that appellee, on that account, could suffer loss. We are of the further opinion that the evidence supports the further opinion that the loss suffered was one which was fairly and reasonably within the contemplation of the parties at the time they entered into the service agreement.<sup>224</sup>

Superficially, the court's opinion makes sense, but the court did not apply the *Hadley* rule properly. The *Hadley* rule is all about the foreseeable probability of the loss at the time of contract formation. Thus, the issue was not the percentage chance that the loss would have been avoided if the alarm system had been operating properly on the night of the break in, but the percentage chance that if the alarm system is defective or not properly maintained the hardware store will suffer a

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217. *Ligon v. Charles P. Davis Hardware*, 492 S.W.2d 374 (Tex. Ct. App. 1973).

218. *Id.* at 375.

219. *Id.*

220. *Id.* at 374.

221. *Id.* at 375.

222. *Id.*

223. *Ligon*, 492 S.W.2d at 376. The evidence showed that depending on the circumstances, the police could arrive within four to six minutes of being contacted. *Id.* at 375.

224. *Id.*

loss. The probability of this occurring must take into account the chance a thief will try to rob the store, which would require an analysis of how often commercial establishments in the area were robbed at night.<sup>225</sup> For example, assume that the service contract was for a one-year period and that over the course of a year the probability that a thief will attempt to rob a commercial establishment in the relevant area at night is 10%. The 90% chance of catching the thief if the alarm system works must be multiplied by 10% to determine the foreseeable probability that the breach will cause a loss. The foreseeable probability is actually 9%, an amount that is definitely too low if the court requires that the loss be probable, and probably too low even if the court requires a lower degree of probability.

The court's statement that the appellants "could have reasonably foreseen that, if the alarm system did not operate properly, a burglar *could* enter and leave appellee's store unmolested and that appellee, on that account, could suffer loss,"<sup>226</sup> did not take into account the percentage chance of that happening. Rather, the mere possibility seemed to be sufficient. Likewise, the court's statement that "the loss suffered was one which was fairly and reasonably within the contemplation of the parties at the time they entered into the service agreement"<sup>227</sup> again failed to take into account the percentage chance of the loss occurring, dropping the typical and critical concluding language of the *Hadley* test—"as the *probable* result of the breach of it."<sup>228</sup>

The *Ligon* court seems to have confused causation and foreseeable probability. The plaintiff must prove that the defendant's breach in fact caused the loss, but that is a separate, additional requirement to proving that at the time of contract formation, the probability of loss from the breach was sufficient.<sup>229</sup> If the court did not confuse causation and foreseeable probability, then the court manipulated the result to achieve a just outcome. Had the court properly applied the *Hadley* rule, however, the appellants would likely not have been liable for the consequential loss.<sup>230</sup>

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225. See RONALD V. CLARKE, BURGLARY OF RETAIL ESTABLISHMENTS: GUIDE NO. 15 (2002), [http://www.popcenter.org/problems/pdfs/Burglary\\_of\\_Retail\\_Establishments.pdf](http://www.popcenter.org/problems/pdfs/Burglary_of_Retail_Establishments.pdf).

226. *Ligon*, 492 S.W.2d at 376 (emphasis added).

227. *Id.*

228. *Hadley v. Baxendale* (1854) 156 Eng. Rep. 145, 151, 9 Ex. 341, 354.

229. See, e.g., *Ind. Mich. Power Co. v. United States*, 422 F.3d 1369, 1373 (Fed. Cir. 2005) ("Damages for a breach of contract are recoverable where: (1) the damages were reasonably foreseeable by the breaching party at the time of contracting; (2) the breach is a substantial causal factor in the damages; and (3) the damages are shown with reasonable certainty." (emphasis added)).

230. Interestingly, although the court applied the U.C.C., the court did not discuss whether the

A contract between an insurance agent or broker and an insured under which the agent or broker promises to secure particular coverage provides another example of how the *Hadley* rule could be used to prevent a recovery of consequential losses in an unjust manner. Assume an agent promises to secure coverage for a particular loss, but then fails to do so, breaching a contract between the agent and the insured. Thereafter, the insured suffers a loss, but then discovers that the agent failed to obtain the coverage. Assume also that the insured did not have an opportunity to discover that the policy was not issued prior to the loss. If the action is brought for breach of contract rather than in tort, the *Hadley* rule could be used to avoid liability for the consequential loss if the chance of the type of loss occurring was sufficiently unlikely. For example, if the loss for which coverage was sought was the destruction of a building by fire, the agent could argue that the foreseeable probability of the insured suffering such a loss was sufficiently small that it cannot be recovered.

Accordingly, there are a variety of contracts in which the defendant could use the *Hadley* rule to effectively avoid any liability, and the scope of the problem is not limited to gambling contracts such as the one in *Offenberger*. Although there might not be many examples of courts using the *Hadley* rule to deny recovery in an *Offenberger* situation, this is likely because defendants and courts are not sufficiently aware that the *Hadley* rule can be used in such a situation.

#### *B. Lack of Existing Doctrines to Solve the Long-Shot Contract Problem*

Currently, there is no way to argue around the *Hadley* rule in these cases, assuming the rule is applied properly. For example, unlike the result in *Ligon*, the result in *Offenberger* was correct under *Hadley*. The result in *Offenberger* was dictated by *Hadley*'s "ruleness" and its limited focus on foreseeable probability. With the foreseeable probability of loss so small the court was unable to consider the rule's substantive purposes to achieve a just result. No reasonable person would construe the chance of winning in *Offenberger* as sufficiently probable under *Hadley*.

Furthermore, contract law's loss-of-chance doctrine would not provide an adequate remedy. That doctrine provides that "[i]f a breach is of a promise conditioned on a fortuitous event and it is uncertain whether the event would have occurred had there been no breach, the

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*Hadley* rule was inapplicable under the U.C.C. rule that consequential losses in the form of property damage are recoverable as long as they were proximately caused by a breach of warranty. See U.C.C. § 2-715(2)(b) & official cmt. 5 (2015).



injured party may recover damages based on the value of the conditional right at the time of breach.”<sup>231</sup> Under this doctrine, the plaintiff is awarded the value of his “chance of winning.”<sup>232</sup> The value of the loss of chance is recoverable despite the *Hadley* rule because it is sufficiently foreseeable that a breach will deprive the plaintiff of that value.

The amount recovered under the loss-of-chance doctrine will not, however, be adequate compensation in a long-shot contract situation for a variety of reasons. First, because the consequential loss is multiplied by the chance of the event occurring, the award would typically be quite low. Take, for example, the illustration provided by the Restatement (Second) of Contracts, which is reminiscent of *Offenberger*:

A offers a \$100,000 prize to the owner whose horse wins a race at A’s track. B accepts by entering his horse and paying the registration fee. When the race is run, A wrongfully prevents B’s horse from taking part. Although B cannot prove that his horse would have won the race, he can prove that it was considered to have one chance in four of winning because one fourth of the money bet on the race was bet on his horse. B has a right to damages of \$25,000 based on the value of the conditional right to the prize.<sup>233</sup>

The loss-of-chance doctrine would provide a recovery of only \$25,000, even if A could prove that his horse would have won. A recovery of \$25,000 is not low, of course, but in most long-shot contract situations the recovery would be much smaller. A long-shot contract problem arises because the plaintiff’s chance of making a profit or suffering a loss was so low that it is not recoverable under the *Hadley* rule. For example, in *Offenberger*, the value of the plaintiff’s chance of winning was less than the \$3 ticket price because the house always took a share from the winning pool.

Second, in many cases the value of the chance of winning (or avoiding the loss) could not be proven to a reasonable certainty, which precludes use of the doctrine.<sup>234</sup> Third, it is not clear that the loss-of-chance doctrine would apply when the contract was to prevent a loss as opposed to providing an opportunity for a gain. Fourth, the loss-of-

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231. RESTATEMENT (SECOND) OF CONTRACTS § 348(3) (AM. LAW INST. 1981).

232. *Id.* § 348 cmt. d; *see, e.g.*, *Van Gulik v. Res. Dev. Council for Alaska, Inc.*, 695 P.2d 1071, 1074 (Alaska 1985) (involving a plaintiff awarded \$5000 when a lottery sponsor breached the lottery contract with just two tickets left and the grand prize was \$10,000, but the plaintiff was also given the option to submit to a final drawing between his ticket and the other ticket so that he would have a chance at the full \$10,000 prize).

233. RESTATEMENT (SECOND) OF CONTRACTS § 348 cmt. d, *illus.* 5.

234. *See id.* § 348 cmt. d (“The value of that right must itself be proved with reasonable certainty . . .”).

chance doctrine is designed for a situation in which the plaintiff cannot prove that the loss was caused by the defendant's breach.<sup>235</sup> In a long-shot contract situation, the plaintiff has proven that the defendant's breach caused the loss. Thus, the loss-of-chance doctrine does not solve the long-shot contract problem.

An award of restitution is similarly ineffective. Restitution provides for the return of any benefit the plaintiff conferred on the defendant.<sup>236</sup> But this would often return to the plaintiff even less than the loss-of-chance recovery because the value of the chance is likely to be greater than what was paid for it (otherwise it would be a losing contract, though that is usually the case with a gambling contract). Accordingly, the doctrine of restitution does not solve the long-shot contract problem.

A court's equitable powers are also insufficient to provide an adequate remedy. Equitable remedies for breach of contract include an order of specific performance and an injunction order.<sup>237</sup> The court also has the equitable power to reform a written instrument.<sup>238</sup> An order of specific performance is inadequate because the defendant did not promise to pay the consequential losses. An injunction is inadequate because the breach has already occurred.

The doctrine of reformation is also insufficient. Reformation involves a court reforming a written instrument to accurately reflect the parties' agreement when the written instrument mistakenly reflects the parties' agreement or one of the parties fraudulently misrepresented the written instrument's contents.<sup>239</sup> In a long-shot contract situation, the written instrument accurately reflects the parties' agreement and there is no allegation of fraudulent misrepresentation. The only way for reformation to avoid the problem is to insert a provision providing for the recovery of consequential losses, but that would involve adding to the agreement, not correcting it. The doctrine of reformation therefore cannot solve the long-shot contract problem.

Accordingly, because the facts in *Offenberger* were squarely within the *Hadley* rule's ambit, and no existing doctrine can be used to avoid the result, the only way to prevent the same result in similar long-shot contract cases would be to revise the *Hadley* rule entirely or to create an exception to the *Hadley* rule applicable to long-shot contract situations. Carving out a limited exception to the *Hadley* rule for long-shot contract

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235. *Id.*

236. *Id.* § 344(c).

237. *Id.* § 345(b).

238. *Id.* §§ 155, 166.

239. *See id.* § 155 (mutual mistake); *id.* § 166 (fraudulent misrepresentation).

situations is preferable to wholesale alteration of the *Hadley* rule for several reasons.

The *Hadley* rule, in general, is supported by the various bases for the rule discussed in Part III. There is thus no compelling reason to abandon the *Hadley* rule and any argument to do so would likely be ignored by courts.<sup>240</sup>

Also, the leading proposed changes to the *Hadley* rule would not solve the long-shot contract problem because the proposed tests retain a required minimum probability of loss irrespective of the type of contract. For example, under a test proposed by Professors Diamond and Foss, the standard of liability would vary based upon the type of case and the policies involved, employing three different standards: expansive liability, intermediate liability, and limited liability.<sup>241</sup> But even their expansive liability standard has the breaching party liable for those losses “that it should have known were a *significantly* possible result of breach.”<sup>242</sup> They define “significantly possible” as not “so extraordinary as to be extremely unusual.”<sup>243</sup> Professor Melvin Eisenberg has proposed a proximate-cause standard in lieu of the *Hadley* standard, but a loss would only be recovered if the loss was reasonably foreseeable, meaning that the “prospect that the damage would occur was more than marginal, or not insignificant.”<sup>244</sup> Accordingly, even if these tests were applied to a long-shot contract situation, injured parties would still not typically recover consequential losses because the circumstances often involve situations in which the loss is extremely unusual or marginal.

### *C. Hadley’s Purposes Do Not Support the Offenberger Result in Long-Shot Contract Situations and Are Not Undermined by the Proposed Exception*

An exception to a legal doctrine is warranted when “a case arises that falls within the stated ambit of the rule but that requires different treatment given the social propositions that support the rule.”<sup>245</sup> Accordingly, each of the bases supporting the *Hadley* rule is discussed below, as well as whether an *Offenberger* result in long-shot contract situations advances those propositions and whether the proposed

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240. For example, Diamond and Foss’s excellent article proposing a modification to the *Hadley* doctrine has never been cited in a court opinion reported on Westlaw.

241. Diamond & Foss, *supra* note 38, at 693.

242. *Id.*

243. *Id.* at 699.

244. Eisenberg, *supra* note 60, at 599.

245. EISENBERG, *supra* note 124.

exception would undermine them. It should be kept in mind that because an award of expectation damages is considered the standard and appropriate remedy for the breach of a contract, any limitation on such an award requires justification. As demonstrated below, the applicable rule for long-shot contracts should be a reversion to the general rule of fully protecting the injured party's expectation interest, which includes a recovery of consequential losses.

Because this Section addresses whether the proposed exception undermines *Hadley's* purposes, the proposed exception will be provided again. The proposed exception is phrased as follows:

When both parties had reason to know that the principal purpose of the contract was to enable the injured party to obtain an opportunity for a profit or to avoid a particular loss, and the breach caused the injured party to lose the profit or suffer the loss, the requirement that a loss be reasonably foreseeable at the time of contract formation does not prevent the recovery of damages to compensate for the loss, provided the loss was not due in part to the injured party's undisclosed failure to take reasonable precautions prior to contract formation or to take reasonable precautions after formation but before breach or repudiation.

### 1. Predictability

As discussed with respect to the *Hadley* rule's legal form, a rationale for the rule is the policy of promoting predictability with respect to the amount of damages awarded in breach-of-contract actions. Whether applying the *Hadley* rule to a long-shot contract situation advances *Hadley's* goal of predictability is primarily based on the exception's legal form. The more the exception is like a standard than a rule, the more the predictability of the *Hadley* rule will be undermined.

A review of this proposed exception shows that it will not undermine the predictability provided by the *Hadley* rule because it is more like a rule than a standard. The exception applies if "the principal purpose of the contract was to enable the plaintiff to obtain an opportunity for a profit or to avoid a particular loss." Determining the rule's application will be predictable because the principal purpose of the vast majority of contracts will be to obtain a direct benefit from performance, not simply to obtain an opportunity for a profit or to avoid a loss, even if many parties perhaps expect additional benefits to flow from the direct benefit received.

To the extent that courts manipulate the *Hadley* rule to permit recovery in these types of cases (such as might have occurred in *Ligon*),

an exception to the *Hadley* rule will not undermine predictability any more than it has already been undermined. In fact, it would arguably promote predictability because currently it might be difficult to predict whether a court will manipulate the *Hadley* rule (*Ligon*) or not manipulate it (*Offenberger*). Also, the types of cases to which the exception will apply are sufficiently identifiable that parties will have reason to know whether the exception will apply and can respond accordingly.

## 2. Parties' Intentions

With respect to promoting the parties' intentions, in a case where the contract's principal purpose was to give the plaintiff an opportunity at an unlikely gain, or to prevent an unlikely loss, if the parties considered the matter, they presumably intended that the loss would be recoverable (unless there is contrary evidence, such as a contract provision precluding recovery of the loss). Otherwise, there would effectively be no liability for breach, since reliance and restitution simply return the injured party to her pre-contract position. Accordingly, precluding a recovery runs counter to what most parties who considered the matter likely intended, and is thus at odds with one of the bases underlying the *Hadley* rule.

This situation is similar to another type of situation in which a party impliedly promises to be liable for an unlikely loss—a warranty. For example, the Restatement (Second) of Contracts provides that “[w]ords which in terms promise that an event not within human control will occur may be interpreted to include a promise to answer for harm caused by failure of the event to occur.”<sup>246</sup> The Restatement provides the following illustration: “A, the builder of a house, or the inventor of the material used in part of its construction, says to B, the owner of the house, ‘I warrant that this house will never burn down.’ This includes a promise to pay for harm if the house should burn down.”<sup>247</sup> Under the *Hadley* rule, the foreseeable probability of the house burning down is very low, even if the material is defective, but the builder or inventor has impliedly promised to pay for the loss if the house burns down, irrespective of the loss's probability.

The difference between the Restatement illustration and a long-shot contract situation is that in the illustration, the defendant promised the loss would not occur, whereas in the long-shot contract situation, there will usually not be such a promise (remember, parties do not usually

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246. RESTATEMENT (SECOND) OF CONTRACTS § 2 cmt. d (AM. LAW INST. 1981).

247. *Id.* § 2 cmt. d, illus. 1.

contemplate breach). Accordingly, in the long-shot contract situation a court would ordinarily not be able to infer an implied-in-fact promise. For example, if a builder had simply promised to use a flame-retardant chemical on the house, and failed to apply it resulting in the house burning down when struck by lightning, an *Offenberger* approach to the *Hadley* issue would result in the loss not being recovered. The likelihood that the builder's breach would result in the particular loss was too small.

But the situations are similar. In each, the contract's primary purpose was to avoid a particular loss. If the parties in the long-shot contract situation did contemplate the particular loss, they presumably intended it to be recoverable upon breach. If they did not contemplate it, they would have considered it recoverable had they thought about it.

It might be argued that such an exception makes the defendant an insurer of the plaintiff's loss, and it is true that permitting a recovery of such losses will have the effect of being a type of insurance.<sup>248</sup> But this begs the question of whether the parties manifested an intention that the contract would operate as a form of insurance or whether, if they did not, it is reasonable to impose such an effect.

### 3. Information Forcing

With respect to encouraging the disclosure of special circumstances to the defendant, there were no special circumstances for *Offenberger* to disclose to the Jockey Club, and this will be true in almost all of the cases falling under the proposed exception. When the contract's principal purpose is to provide the plaintiff with an opportunity for an unlikely gain or to prevent an unlikely loss, the fact that a breach might cause the plaintiff to not make the profit or to not avoid the loss cannot be considered a "special circumstance."

In some of the cases, however, the amount of the loss might not be reasonably foreseeable as a result of special circumstances. For example, a security company might not be aware that the customer owns a priceless painting. If the jurisdiction requires that the amount of loss, in addition to the type of loss, be sufficiently foreseeable, then the special circumstances causing the excessive loss would have to be disclosed to the defendant at the time of contract formation.

### 4. Protecting Enterprises

With respect to protecting businesses from liability, long-shot contract cases do not involve situations in which a business would have

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248. *Diamond & Foss*, *supra* note 38, at 684–85.

difficulty predicting the amount of loss. These types of cases would ordinarily involve entities in the business of providing a service designed to supply the consumer with an opportunity for unlikely gain or to prevent an unlikely loss. Accordingly, it would usually be easy for these businesses to determine the extent of liability. For example, the Jockey Club in *Offenberger*, being in the gambling business, was surely well situated to assess the risk of loss. As noted by Professor Melvin Eisenberg:

Sellers of relatively homogenous commodities often sell a great many units of the commodity and develop an extensive claims experience, which presumably will be reflected in a probability distribution. Although such a seller might not know whether any *individual* buyer will likely incur supranormal damages on breach, it will often know that a given *percentage* of its buyers will almost certainly incur supranormal damages on breach. Accordingly, a high-volume seller of homogeneous commodities can reliably price and plan for supranormal damages . . . by setting an equilibrium price and level of precaution that takes into account, on a weighted basis, all losses that are a reasonably foreseeable result of the breach.<sup>249</sup>

Thus, “[h]igh-volume sellers of homogeneous commodities can often determine the equilibrium level of pricing and precautions simply by the use of statistical analysis.”<sup>250</sup> And if such sellers do not desire to be liable for such consequential losses, they can simply disclaim liability.

##### 5. Encouraging Reasonable Precautions by Plaintiff

As discussed *infra*, although encouraging reasonable pre-contract and post-contract, pre-breach precautions by the plaintiff is likely not a basis for the *Hadley* rule, it does have that effect. Accordingly, any exception to the *Hadley* rule threatens to lose that beneficial effect. Thus, the proposed exception does not apply when the loss was due in part to the plaintiff’s failure to take undisclosed, reasonable precautions prior to contract formation or to take reasonable precautions after formation but before breach or repudiation. If the plaintiff discloses that there are special circumstances in the form of the plaintiff not having taken pre-contract reasonable precautions, it is reasonable to hold the defendant liable for the loss because the defendant was given the opportunity to take those circumstances into account when forming the contract.

##### 6. Return to Full Expectation-Interest Protection

As demonstrated above, *Hadley*’s substantive purposes do not

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249. Eisenberg, *supra* note 60, at 591.

250. *Id.* at 596.

support the *Offenberger* result in a long-shot contract situation and are not undermined by the proposed exception. Because long-shot contract situations fall within the stated ambit of the *Hadley* rule but require different treatment given the bases that support the rule, the *Hadley* rule should not apply. Thus, the applicable rule for long-short contracts should be a reversion to the general rule of fully protecting the injured party's expectation interest, which includes a recovery of consequential losses.

#### CONCLUSION

When both parties are aware that a contract's principal purpose is to enable the plaintiff to obtain an opportunity for a profit or to avoid a particular loss, and the defendant's breach causes the plaintiff to lose the profit or suffer the loss, the *Hadley* requirement that a loss be reasonably foreseeable at the time of contract formation leads to an unjust result. Thus, if the contract's principal purpose was to provide an opportunity for lightning to strike, or to avoid lightning striking, the injured party should be fully compensated when lightning strikes. And when existing doctrine leads to an unjust result in a particular case, the doctrine's purposes should be examined to determine whether an exception is warranted. An examination of *Hadley's* purposes shows that they are not achieved by its application to a long-shot contract, and that an exception to the *Hadley* rule is therefore justified in such a situation.