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EXTENDING THE LESSONS OF *HADLEY V. BAXENDALE*[1]

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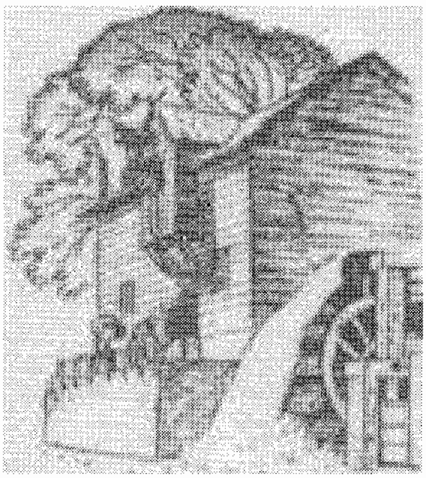
INTRODUCTION

I have taught the venerable case of *Hadley v. Baxendale* more than thirty times to students in Contracts I and an additional thirty or more times to students in a Remedies course. I recently realized that I had underestimated the potential of the case. This Conference, and some conversations with my colleague Bill Whitford led me to realize that *Hadley* can be used more ambitiously. The trick to doing this is easy. One has simply to ask students to imagine that the notice of special circumstances *had* been given, and then ask what the victims of the breach would have needed to prove in order to recover significant damages, and whether Baxendale would have had any remaining credible defenses.



The first, and most interesting, of these issues requires a preliminary foray into the facts of the case. The summary in the report of *Hadley v. Baxendale* tells us little about the mill or Gloucester.[2] It says only that "it appeared that the plaintiffs carried on an extensive business as millers at Gloucester . . . ."[3] One suspects that many—and perhaps most—know little about Gloucester, less about milling, and are inclined to picture, in their minds' eye, a quaint rural mill with a water-

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1. 156 Eng. Rep. 145 (Ex. 1854).
2. *Id.* at 146–50.
3. *Id.* at 147.

wheel at its side, giving little weight to the adjective "extensive" in the summary of the evidence.[4] This Author and Professor Whitford (and one suspects many others), with nothing but an image of rural England in our minds, have presumed that the mill probably processed grain brought to it by farmers in the region. We presumed, again without evidence, that the mill made its money by providing the milling service, and that it probably did not own the grain that it milled. Perhaps this picture was built by some splinters of information about mills picked up in high school or college, or from visits to New England mill-sites on family vacations. If our picture had been a correct one, then the mill might lose profits, when it was shut down, as the result of customers taking their grain to a competing mill for milling. Or, even if the mill bought the grain, and so made its profits partly by adding value to grain by milling it and partly by taking the entrepreneurial risk of market price fluctuations in the flour trade, it would have lost its profits when area farmers took their grain elsewhere for sale.

But . . . our bucolic image must give way to the facts. In 1854 Gloucester was not a sleepy English village, but an ancient and important city—a major inland port.[5] The mill, doing business as the City Flour Mills, was a substantial commercial enterprise.[6] It imported grain from abroad, apparently for its own account (though it may also have bought or processed grain from area farmers—we do not know).[7] Just as Richard Danzig taught us that we should understand the case as a case-study in "the Industrialization of the Law,"[8] so we should appreciate that the City Flour Mills itself was apparently a part of the Industrial Revolution.

The Hadleys[9] initially alleged losses of £300 arising from a five-day delay in delivery of the mill shaft.[10] It is easy to overlook that this was a serious amount of money, and suggests the size of the enterprise. One estimate is that £300 in 1854 would be the equivalent of more

4. *Id.*

5. Hugh Conway Jones, *The Historical Setting for* Hadley v. Baxendale, 11 TEX. WESLEYAN L. REV. 243 (2005).

6. *Id.*

7. *Id.*

8. Richard Danzig, Hadley v. Baxendale*: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249 (1975). Danzig's article remains the classic study of the case and should be read by everyone who teaches it.

9. Joseph and Jonah Hadley were the proprietors of the mill. *Id.* at 251. The caption of the case is "Hadley and Another v. Baxendale and Others." It is fair to assume that, together, Joseph and Jonah Hadley are "Hadley and Another." Subsequent references to the plaintiff will be to "the Hadleys."

10. Danzig, *supra* note 8, at 251. Danzig elaborates by indicating that Baxendale offered to settle for £25, which they deposited in court. *Id.* The plaintiffs declined to settle for that amount, and the jury ultimately returned a verdict for the plaintiffs in the amount of £50, which was £25 in addition to that which had already been deposited with the court. *Id.* at 251–52.

than £14,000 today.[11] If a business could make profits of nearly £3,000 a day, this suggests annual profits, in today's terms, in the neighborhood of £750,000 or $1,400,000.[12]

So . . . we have a five-day interruption in the business of a quite substantial commercial enterprise. The plaintiffs' claim foundered on the rocks of forseeability.[13] But for purposes of getting the most teaching mileage from the case, it may be worth assuming, for argument purposes, that the notice of special circumstances *had* been given. What issues would have remained? If you had been the lawyer for the defendant, Baxendale, what arguments would you have raised to defeat, or cast doubt on, plaintiffs' claim? The balance of this brief Essay is intended to explore those issues in an order, the extent to which they appeared provocative, rather than by an order dictated by logical necessity.

A NERI CASE?

In most contracts and remedies courses, students learn of the plight of poor Mr. Neri (or poor Retail Marine, depending on your sympathies).[14] We learn from this case that if we take seriously contract law's remedial admonition to seek to put the injured plaintiff in the

11. Lawrence H. Officer, *Comparing the Purchasing Power of Money in Great Britain from 1264 to 2002*, Economic History Services, *at* http://www.eh.net/hmit/ppowerbp/ (last visited Mar. 2, 2005) (on file with the Texas Wesleyan Law Review).

12. *Id.* This assumes 260 business days a year. The assumptions underlying these calculations, of course, approach the heroic. The arithmetic is simple, but one must be cautious about accepting the underlying assumptions. I accepted, on faith, the work of Mr. Officer without verification. Some numbers were rounded and 260 working days per year was assumed. An exchange rate of $1.80 equals £1. Remember, we are not making a bank loan here, but only verifying that the enterprise was a substantial one. Even if some of the assumptions are not quite right, the conclusion that this was a relatively large business seems a conservative one. Richard Danzig underscores the same point in footnote 8 of his article, providing more information about the buying power of British Pounds in the 1850s. Danzig, *supra* note 7, at 251–52 n.8. Not as important, but interesting nevertheless, the report of the case notes that the charge for transporting the shaft was £2, 4 shillings; relying again on Officer, this would represent approximately £110 or $200 today. *See* Officer, *supra* note 11.

13. Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. 1854).

14. Neri v. Retail Marine Corp., 285 N.E.2d 311 (N.Y. 1972). Though the case is widely taught, it might not be *universally* taught. The case concerns a purchaser (Neri) who breaks a contract to buy a boat. *Id.* at 396. The retailer (Retail Marine) sells the particular boat (which was to have been delivered to Neri) to another buyer, and sues Neri for breach. *Id.* Neri, by way of defense, sought to reduce any damages owed Retail Marine by urging that he was entitled to take into account the sale to the other buyer. *Id.* That is, the case concerns the measure of damages to which a retailer is entitled, and whether that customer is entitled to "due credit" for any subsequent resale. *Id.* The court ruled against Neri and interpreted U.C.C. 2-708(2) to mean that a retailer may be entitled to the profit it lost when a customer defaults even when the goods are sold to another buyer. *Id.* at 400. After all, the retailer may have made two sales and earned two profits. Since the remedial goal is to put any retailer in the place that performance would have, the second sale does not reduce the seller's damages. Thus, the lost profit of the lost-volume seller is preserved.

position performance would have done, sometimes businesses lose profits when their customers breach contracts, and sometimes not. The *Neri* case illustrates that sometimes retailers who lose sales of fixed price goods are entitled to recover the profits they would have made if the defaulting party had completed the transaction, and sometimes not. The outcome depends on whether the seller is a lost-volume seller. If the retailer would have been able to make two sales (and hence two profits) had the customer not reneged, then the customer should be responsible to pay the retailer an amount equal to the profit that was lost due to the breach, as well as any other incidental damages. Courts generally give the retailers the benefit of the doubt on this question—they are presumed to be lost-volume sellers. But what does this have to do with Hadley's mill?

The same issue can arise in breach of contract cases that do not involve lost retail sales. A case which raises this issue in another context is the 1921 case of *Mount Pleasant Stable Co. v. Steinberg*.[15] In that case, a stable recovered damages arising from the breach of a contract to rent teams of horses.[16] The court, rejecting defendant's argument that the stable could have mitigated damages by renting the horses to others, held that the plaintiff could presumably have supplied different horses to the hypothetical second customer and made two profitable contracts rather than just one.[17] This is consistent with the presumption that service-suppliers can readily expand to serve more customers. So lost-volume service providers can sometimes receive treatment analogous to lost-volume retailers of standard-priced goods.

To move this one-step closer to *Hadley v. Baxendale*, let us hypothesize two mills. Mill #1 is the mill that many of us have always imagined—a mill that made a profit by providing the service of milling grain for area farmers. During the five days that the mill was shut down waiting for the mill shaft to arrive, Mill #1 had to turn away a certain number of farmers who arrived with grain. Those farmers took their grain elsewhere to have it milled. The profits that Mill #1 would have made on the five extra days it was shut down are lost forever, unless they can be recovered from the contract breacher. Of course, the plaintiff would face other obstacles such as the need to prove the breach in fact caused the loss, the need to prove losses with the requisite degree of confidence, and so forth. If those obstacles can be overcome, then it seems a straightforward case for recovery of the proven losses.

Now imagine Mill #2. Mill #2 is probably more like the actual mill in *Hadley v. Baxendale*. Mill #2 buys grain in both nearby and distant markets, mills it into flour, and sells the flour. It profits by adding

15. 131 N.E. 295 (Mass. 1921).
16. *Id.* at 295.
17. *Id.* at 296.

value to the flour, as well as (perhaps) by making wise purchases and sales in the grain and flour market. What damages does Mill #2 incur if it is shut down for five days? Does it not depend on whether the mill was operating at full capacity? If it *was* functioning at full capacity, then it loses five days worth of the use of its capital and labor, which it can never recover except from the defendant. But if it was functioning at less than full capacity, then it has fewer losses, and perhaps not worth troubling about. If it was functioning at eighty-five percent capacity, then it would take some time for it to get back on schedule, but the profit earned by milling the grain would merely be delayed and not lost. It is here that the spectre of Mr. Neri appears.[18] Just as Retail Marine's profits were held to depend on whether it would have sold one or two boats,[19] the lost profits of a mill whose operations are interrupted would seem to depend on whether it lost profitable opportunities permanently, or if those opportunities were not lost, but just delayed.

So the Hadleys might have expected an argument from the Baxendales about the extent and nature of their losses while the mill was shut down. Were the revenues that the plaintiffs were claiming lost forever, or was their receipt merely delayed? As we think about those losses, we might address additional troublesome questions: how can one practically prove commercial losses with requisite certainty? What about the recovery of overhead? What about the losses that might have been avoided?

Reasonable Certainty

It is worth pausing to remind ourselves how difficult it is to establish losses when those losses involve a complex enterprise. Time does not permit lingering long on this topic, but the cases in which a plaintiff suffered from an inability to cost-effectively prove losses fill the reports. The burden of proving losses is, of course, on the plaintiff. One suspects that defendants have effectively utilized the legal analogue to

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18. The more one teaches contracts and remedies, the more often the Neri issue seems to appear. Another famous contract case, *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887), inspired Professor Brainerd Currie to write an epic poem about Rose of Aberlone, the barren cow that wasn't. Currie's poem closes with the lines:

In many a hypothetical
With characters alphabetical,
In many a subtle and sly disguise
There lurks the ghost of her sad brown eyes.
That she will turn up in some set of facts is
Almost as certain as death and taxes . . .

Brainerd Currie, poem, *available at* http://www.law.berkeley.edu/faculty/rubinfeldd/LS145/roseofaberlone.htm (last visited Mar. 3, 2005) (on file with the Texas Wesleyan Law Review). The same might be said about Mr. Neri. Had we but world enough, and time, . . . a poetic tribute to Mr. Neri would make a nice project. (My apologies to Andrew Marvel.)

19. *Neri*, 285 N.E.2d at 312.

the "rope-a-dope" boxing technique.[20] A defendant can often gain a bargaining advantage simply by challenging the plaintiff to "prove it." Though discovery techniques may assist a plaintiff in this process (and may prove to be a kind of counter-weapon, since discovery requests by plaintiff can impose substantial costs on defendants), it would have been no simple matter for a large industrial enterprise to *prove* just how much damage would have resulted by the business interruption. How much grain would have been milled? What were the costs of that grain? What were the costs of milling?

The examples of such cases are legion—one should suffice. In *Holt Atherton Industries, Inc. v. Heine*,[21] the defendant failed to make timely repairs on a bulldozer owned by the plaintiffs. The defendant failed to respond to the complaint, and a default judgment was entered in favor of the plaintiffs.[22] In such a case, Texas law requires a hearing and the introduction of sufficient evidence to substantiate plaintiff's claim for damages.[23] The trial court had entered a judgment in favor of plaintiffs for $159,665, including $120,000 in lost profits.[24] Despite this, the Supreme Court of Texas ruled that the evidence as to lost profits failed to meet the minimum standard, which required that plaintiffs establish lost profits "by competent evidence with reasonable certainty" and so remanded the case for further proceedings as to the amount of damages due plaintiffs.[25] The dissent accused the majority of "insensitivity to the realities of independent business" and argued that the proof offered satisfied the Texas requirement.[26] The case is interesting partly because the majority and dissent took such different views of the same record, and partly because, in a 1996 law review article,[27] Marshall and Beron cite *Holt Atherton* as a case in which the use of the statistical technique of a multivariate regression analysis might have allowed the plaintiffs to satisfy the reviewing court.[28] The Marshall and Beron argument is an interesting one, but one wonders whether the stakes in most business-loss cases would be high enough to justify resorting to the regression analysis method they recommend. Clearly, expert testimony would be required, and expert testimony in such cases, designed to satisfy the reasonable-certainty standard, creates its own difficulties.

20. For those unfamiliar with this strategy, in his 1974 championship fight against George Foreman, Muhammed Ali leaned against the ropes and allowed Foreman to tire himself out, by punching at Ali, using lots of energy, but without much damage to Ali.

21. 835 S.W.2d 80 (Tex. 1992).

22. *Id.* at 82.

23. *See id.* at 83.

24. *Id.*

25. *Id.* at 84.

26. *Id.* at 86 n.1 (Doggett, J., concurring and dissenting).

27. Kevin S. Marshall & Kurt J. Beron, *Statistics and the Law: Proving Lost Profits*, 2 TEX. WESLEYAN L. REV. 467, 496 (1996).

28. *Id.* at 477–78.

One extreme case that demonstrates this difficulty is *Eastern Airlines, Inc. v. McDonnell Douglas Corp.*[29] Douglas was late delivering ninety passenger jets to Eastern Airlines, and Eastern sued to recover its losses.[30] Eastern's expert testified that the delay caused the airline to lose $23,400,000 in profits.[31] McDonnell's expert, on the other hand, testified that the delay actually *saved* Eastern $1,294,000 because the tardy delivery reduced financing costs![32]

Overhead

Although businesses hope to make profits, in the short run what they gain or lose are revenues. Whether they lose profits is something they often discover only after the accountant has done the books. While we often speak of businesses losing profits as the result of a breach and of claims for lost profits, this can be slightly misleading. When an *un*profitable business loses the benefit of a transaction that would have helped defray fixed expenses, it has suffered a loss. The victim of a breach should be able to recover the expenses that it reasonably incurred in connection with the transaction *and* any net profits it lost by virtue of the breach. The plaintiff needs to establish the costs and the profits with the appropriate degree of reliability, which can be difficult. It is relatively uncontroversial that a breach victim should be able to recover the direct costs that it can prove it has incurred. Recovery of the indirect expenses, or overhead, has proven more controversial and confusing.

Overhead is something of a mystery to many. U.C.C. section 2-708(2) reminds us that in the appropriate cases involving goods, "the measure of damages is the profit *(including reasonable overhead)* which the seller would have made from full performance . . . ."[33] The issue is essentially the same whether or not the case is a sale of goods case. For example, in the classic case itself, the issues could easily have arisen if a seller of custom-made mill shafts had been five days late in delivering a mill shaft ordered by the Hadleys. Without the need for citation, there are many arguments, in the cases, as to the extent of overhead expenses that can fairly be attributed to any particular transaction.

When retailers sell goods, or service providers provide services, they receive revenue, which for purposes computing damages can be usefully seen as consisting of three parts. The first portion of the revenue can be allocated to cover the direct costs associated with the sale. These direct costs would include the wholesale cost of the product and any commission paid to a sales agent, or in the case of services, the

29. 532 F.2d 957 (5th Cir. 1976).
30. *Id.* at 962.
31. *Id.* at 965.
32. *Id.* at 999.
33. U.C.C. § 2-708(2) (2000).

wages paid to the workers who labored to provide the service. The second portion of the revenue must be allocated to cover the indirect costs of selling the product, or service. These indirect costs, such as rent, utilities, interest on loans, and so forth, are often called *overhead*. Overhead expenses are those expenses associated with running a business and not clearly connected to any particular transaction. But if a business is to at least break even, it needs to cover these indirect costs from the revenues for selling its goods or services. Finally, any amount left after recovering *all* costs, both direct and indirect, represents the *net profit* on the transaction.

Quite unfortunately, many business people refer to the difference between revenue from the sale and direct costs as "profit." It is unfortunate because the use of the unmodified word "profit" creates the risk of confusing *net* and *gross* profit. Gross profit is the difference between revenue and direct costs or, to look at it another way, gross profit is the sum of net profit plus overhead. To say it still again, in yet another form, the difference between net and gross profit is overhead.

When the Hadleys sought to prove their losses, what kinds of losses might they have claimed? One would imagine that a significant part of the claim might be for losses that could be categorized as overhead. The Hadleys may have incurred the expenses of owning and operating the plant with no corresponding opportunity to benefit from the use of those assets. An example of a case in which the court confronted the recovery of overhead might be instructive.

Vitex Manufacturing Corp. v. Caribtex Corp.[34] involved a seller that had closed its plant.[35] Seller then negotiated a contract with Buyer to process woolen material.[36] Seller reopened its plant, ordered the necessary chemicals, and recalled its work force.[37] Buyer then breached.[38] The trial court found that seller's gross revenues would have been $31,250, its direct costs associated with the processing $10,136, and so its damages were $21,114.[39] Buyer argued that the trial court had erred by not subtracting seller's overhead expenses from the contract price in determining lost profits.[40] The Third Circuit upheld the trial court's decision to allow recovery of overhead:

> Although there is authority to the contrary, we feel that the better view is that normally, in a claim for lost profits, overhead should be treated as a part of gross profits and recoverable as damages, and should not be considered as a part of the seller's costs. A number of cases hold that since overhead expenses are not affected by the per-

34. 377 F.2d 795 (3d Cir. 1967).
35. *Id.* at 797.
36. *Id.*
37. *Id.*
38. *Id.*
39. *Id.* Because it avoided incurring the direct costs when buyer breached, those costs were avoided, and therefore unrecoverable.
40. *Id.* at 798.

formance of the particular contract, there should be no need to deduct them in computing lost profits. . . .

. . . .

Buyer] may argue that this view ignores modern accounting principles, and that overhead is as much a cost of production as other expenses. It is true that successful businessmen must set their prices at sufficient levels to recoup all their expenses, including overhead, and to gain profits. Thus, the price the businessman should charge on each transaction could be thought of as that price necessary to yield a *pro rata* portion of the company's fixed overhead, the direct costs associated with production, and a "clear" profit. Doubtless this type of calculation is used by businessmen and their accountants . . . . However, because it is useful for planning purposes to allocate a portion of overhead to each transaction, it does not follow that this allocated share of fixed overhead should be considered a cost factor in the computation of lost profits on individual transactions . . . .[41]

One might argue that the court itself is a bit confused here, as if it were accepting the buyer's argument that if something can be categorized as a cost, then that cost is credited to the breacher.[42] It is struggling with a formula that it understands requires subtracting "costs" from the revenues lost to the breach's victim.[43] The defendant is trying to take advantage of this by pointing out that overhead expenses are "costs" and should therefore be deducted.[44] Confusion arises because this formulation fails to directly acknowledge that the costs to be deducted are costs that either were not incurred, or could reasonably have been avoided.[45] There is no need to deny that overhead expenses are costs in order to justify their recovery.

By the very nature of this allocation process, as the number of transactions over which overhead can be spread becomes smaller, each transaction must bear a greater portion or allocated share of the fixed overhead cost. Suppose a company has fixed overhead of $10,000 and engages in five similar transactions; then the receipts of each transaction would bear $2,000 of overhead expense. If the company is now forced to spread this $10,000 over only four transactions, then the overhead expense per transaction will rise to $2,500, significantly reducing the profitability of the four remaining transactions. Thus, where the contract is between businessmen familiar with commercial practices, as here, the breaching party should reasonably foresee that his breach will not only cause a loss of "clear" profit, but also a loss in that the profitability of other transactions will be reduced . . . . Therefore, this loss is within the contemplation of "losses caused and

41. *Id.* at 798–99 (emphasis added) (citations omitted).
42. *See id.*
43. *Id.* at 797 n.1.
44. *Id.* at 798.
45. *Id.*

gains prevented," and overhead should be considered to be a compensable item of damage.

Mitigation

One suspects that, in the case of Hadley's mill, many of the mill's expenses may have been overhead expenses. The mill suffered a loss when it lost a revenue-producing transaction. If the mill needed to be heated while it was shut down, then this expense should be recoverable because it is an expense that can never generate any benefit for the mill owners. If the Hadleys were obligated to pay workers while the mill was shut down, and those workers had no other beneficial work to do, then that is an expense the Hadleys would undoubtedly claim and should be recoverable.

But this last example provides an opportunity to introduce, or review, another remedial principle. The previous paragraph hypothesized an obligatory payment to the workers. But a claimant can only recover losses it could not have reasonably avoided. In this case, may the defendant not plausibly contend that some of the mill's expenses could have been avoided during the shut-down? If workers were paid while the mill was idle, for example, is the mill owner entitled to recover those amounts? Were the workers idle, or were they assigned to do other valuable work such as deferred maintenance? If they were idle, should they have been sent home? One suspects that most workmen in the middle of the nineteenth century were paid only when they worked and had no right to be paid when their employer was not using their labor. This suggests that worker's wages might not be recoverable.

Suppose the employer chose to pay them, although it was not obligated to do so? Mitigation of damages rules generally apply a principle of reasonableness. If an employer might reasonably conclude that in order to preserve employee good will, maintain morale, and minimize the risks that valuable employees might seek other employment, a decision to pay them while idle would be reasonable and such payments should be recoverable.

Conclusion

This brief Essay is not intended to be an authoritative account of all of the lessons of *Hadley v. Baxendale*. Its modest goal is simply to suggest that it is easy to extend the lessons that can be drawn from the case, either to introduce issues anew, or to review them. I will stop here, lest I run afoul of Benjamin Franklin's warning: "The most exquisite Folly is made of Wisdom spun too fine."[46]

46. POOR RICHARD'S ALMANACK, BENJAMIN FRANKLIN'S BEST SAYINGS 9 (Dean Walley ed., 1746).