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## Dodging Windfalls: Damages Based on Market Price, Actual Loss, and Appropriate Awards

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# Dodging Windfalls: Damages Based on Market Price, Actual Loss, and Appropriate Awards

John Y. Gotanda \*

## I. Introduction

Picture a situation where the seller contracts to sell a certain commodity that is traded in well-developed markets to a buyer, who is a well known broker, for a certain price. After purchasing the commodity, the buyer had planned to sell it to a third party for a profit of \$1 million. Before the sale materializes, the price of the commodity doubles due to a variety of factors. The seller informs the buyer that it will not perform its obligations under the contract and the buyer avoids the agreement. At the same time, the buyer informs the third-party purchaser about the seller's breach, and the third-party purchaser voluntarily agrees to release the buyer from its obligations under the third-party contract. The seller immediately sells the commodity owed under the contract to another party for \$10 million more than the original contract price. Under the CISG in this situation, how should damages be calculated?

There are two options. First, under Article 74, the buyer's damages could be equal to its lost profit from the resale contract, amounting to \$1 million.<sup>1</sup> However, this measure of damages would allow the breaching seller to earn \$9 million more than it would have if it fulfilled its contractual obligations. Second, under Article 76, the recovery would be the difference between the contract price and the current price at the time of avoidance.<sup>2</sup> Under this market damages scenario, the buyer could recover \$10 million. However, the buyer's actual loss is arguably only \$1 million. Under either scenario, it appears that one party will receive what looks on its face to be a windfall. The question is thus who gets the "windfall."

I believe that the CISG permits an aggrieved party to recover damages under Article 76's market damages approach even if the resulting award exceeds the aggrieved party's loss. While at first glance this result may appear to be at odds with the principles of full compensation and

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<sup>1</sup> See United Nations, *United Nations Convention on Contracts for the International Sale of Goods* 23 (2010).

<sup>2</sup> See *Id.*; Jennifer Offermanns, *Damages Arising Out of a Cover Purchase within the Framework of Articles 74 to 77 CISG*, 10 *Vindobona Journal of International Commercial Law & Arbitration* 1 (2006)..

mitigation, in reality, it is not. Indeed, policy reasons underlying the CISG generally - including that policy for encouraging parties to fulfill their contractual obligations - support giving an aggrieved party the option of seeking market based damages under Article 76, even though its actual loss may be less.

## **II. Overview of CISG Damages Provisions**

Under the CISG, if a party fails to perform its contractual obligations, the injured party has various remedies, including damages. In general, that party may recover damages under Article 74, Article 75, or Article 76. Article 77 sets forth the principle of mitigation.<sup>3</sup>

CISG Article 74 sets forth the basic rules for the recovery of damages. It provides that "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."<sup>4</sup> The primary purpose of this provision is to place the aggrieved party in the same economic position that it would have been in if the contract had been performed.<sup>5</sup> In other words, it seeks to give the aggrieved party the "benefit of the bargain."

Articles 75 and 76 are limited alternatives to Article 74.<sup>6</sup>

Article 75 sets out the method for calculating damages when the aggrieved party had avoided the contract and entered into a substitute transaction. In this situation, damages are measured by the difference between the contract price and the price in the substitute transaction, together with any further damages needed to make the aggrieved party whole.<sup>7</sup>

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<sup>3</sup> See John Gotanda, *Articles 74-77*, UN CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS 990-1041 (S. Kroll, L. Mistelis & P. Viscasillas eds. 2011); Ingeborg Schwenzer, *Articles 74-77*, COMMENTARY ON THE UN CONVENTION ON THE INTERNATIONAL SALE OF GOODS, 999-1048 (I. Schwenzer ed., 3<sup>rd</sup> ed., 2009); Catherine Piché, *THE CONVENTION ON CONTRACTS FOR THE INTERNATIONAL SALE OF GOODS AND THE UNIFORM COMMERCIAL CODE REMEDIES IN LIGHT OF REMEDIAL PRINCIPLES RECOGNIZED UNDER U.S. LAW: ARE THE REMEDIES OF GRANTING ADDITIONAL TIME TO THE DEFAULTING PARTIES AND OF REDUCTION OF PRICE FAIR AND EFFICIENT ONES?*, 28 N.C. J. Int'l L. & Com. Reg. 519, 531, 556 (2003).

<sup>4</sup> United Nations, *supra*, at 23.

<sup>5</sup> While the provision does ensure that the aggrieved party returns to its former economic position, it does not specify exactly what losses the provisions covers — apart from lost profits. Steven L. Harris et. al., § 10:76. *Buyer's and seller's damages remedies: undesignated types of losses covered*, Uniform Commercial Codes Series (2013).

<sup>6</sup> See Jeffrey S. Sutton, *Measuring Damages Under the United Nations Convention on the International Sale of Goods*, 50 Ohio State Law Journal 737 (1989).

<sup>7</sup> See Marco Torsello, *Remedies for Breach of Contract under the 1980 U.N. Convention on Contracts for the International Sale of Goods*, 9 VJ 253, 285-86 (2005).

If the aggrieved party had avoided the contract but has not entered into a substitute transaction, then Article 76 permits the abstract calculation of damages under certain conditions.<sup>8</sup> Here, damages are measured by the difference between the price fixed by the contract and the current price at the time of avoidance, together with any further damages.<sup>9</sup>

It is also important to note that Article 77 imposes on the aggrieved party a mandatory obligation to mitigate its loss.<sup>10</sup> The purposes of this provision are (1) to prevent an aggrieved party from passively sitting back and waiting to be compensated for loss that could have been avoided or reduced through the undertaking of reasonable measures, and (2) to prevent an aggrieved party from engaging in unreasonable acts or market speculative delays that increase damages.

With this background in mind, let us now return to the question of how damages should be calculated when the market based approach under Article 76 seems to provide an aggrieved party with recovery in excess of actual loss, but the concrete calculation of damages under Article 74 provides a windfall to the breaching party.<sup>11</sup>

### **III. Neither the Text of the CISG's Damages Provisions Nor Their Purposes Explicitly Prohibit Aggrieved Parties from Recovering Damages in Excess of Actual Loss**

The starting point is the text of the CISG. It does not explicitly mandate that Article 74 prevail over Article 76, or vice versa. Indeed, aggrieved parties can choose whether to calculate damages pursuant to either of them. Thus, Article 76 does not replace Article 74; it supplements Article 74 and works in connection with it.<sup>12</sup> An aggrieved party may find it more advantageous to seek damages pursuant to Article 76, as opposed to Article 74, because seeking damages under Article 74 requires an aggrieved party to prove with a requisite degree of certainty that it suffered a loss and may necessitate that the aggrieved party "open its books, i.e., ... disclose its

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<sup>8</sup> Abstract damages are "based on a fixed formula which is presumed to constitute the party's loss." Djahongir Saidov, *The Present State of Damages under the CISG: A Critical Assessment*, 13 VJ 197, 205-06 (2009).

<sup>9</sup> Offermanns, *supra*, 10 at 1.

<sup>10</sup> Jorge Galvañ, *The CISG and its provisions on damages*, University of Lund 38 (1998).

<sup>11</sup> Concrete damages are based on the circumstances surrounding the loss. Thus, unlike abstract damages, concrete damages are calculated based on the actual monetary amounts relevant to the parties and their contract. Saidov, *supra*, at 205-06.

<sup>12</sup> See Galvañ, *supra*.

internal calculations, its customers and other business connections, etc."<sup>13</sup> By contract, Article 76 does not require making such disclosures in order to recover damages pursuant to it.

The CISG does prefer the concrete calculation of damages over an abstract calculation.<sup>14</sup> That preference, however, does not apply here. The preference for the concrete calculation of damages is explicitly expressed with respect to Articles 75 and 76; there is no such preference with respect to Articles 74 and 76. Article 76(1) allows for the abstract calculation of damages if certain requirements are satisfied. The most significant requirement is that the aggrieved party "has not made a purchase or resale under article 75."<sup>15</sup> Thus, if a party has entered a substitute transaction described in Article 75, it is precluded from utilizing Article 76. Nothing in the text of Article 76 or 74, however, mandates giving a priority to Article 74 over Article 76. Furthermore, nothing in article 76 conditions using the market damages approach on damages that do not exceed the damages recoverable under Article 74. To otherwise impose such an obligation contradicts the design of the damages provisions.

Allowing an aggrieved party to have its loss calculated under Article 76 also will not disincentivize the aggrieved party from seeking cover or from mitigating its loss. Article 77 is designed to prevent an aggrieved party from (1) passively sitting back and waiting to be compensated for loss that could have been avoided or reduced through the undertaking of reasonable measures, such as undertaking a cover transaction, and (2) engaging in unreasonable acts or market speculative delays that increase damages.<sup>16</sup> The mitigation principle, however, typically operates to apply the market damages approach.<sup>17</sup> For example, if, when a seller fails to deliver goods, the aggrieved buyer fails to go into the market and cover, courts have often calculated its damages based on the difference between the market price and the contract price.

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<sup>13</sup> CISG Advisory Council: Opinion No. 8, *Calculation of Damages under CISG Articles 75 and 76*. Rapporteur: Professor John Y. Gotanda, Villanova University School of Law, Villanova, Pennsylvania, USA. Adopted by the CISG-AC following its 12th meeting in Tokyo, Japan, on 15 November 2008.

<sup>14</sup> Saidov, *supra*, at 205-06.

<sup>15</sup> United Nations, *supra*, at 23.

<sup>16</sup> See Victor Knapp, *Article 77*, Bianca-Bonell Commentary on the International Sales Law, Giuffrè: Milan 559 (1987).

<sup>17</sup> When calculating market damages, the aggrieved party "is regarded ... as having undertaken a cover transaction at the current price, *i.e.* damages are calculated on the basis of a hypothetical cover transaction. Hence, the mitigation principle typically applies to market damages. Peter Schlechtriem, *Calculation of damages in the event of anticipatory breach under the CISG*, Pace Law School Institute of International Commercial Law, Sept. 9, 2009, <http://www.cisg.law.pace.edu/cisg/biblio/schlechtriem20.html>.

If, when a buyer fails to take and pay for goods, the seller fails to go into the market and resell, the mitigation principle may result in its damages being based on the difference between market price and unpaid contract price.

Moreover, the purposes of Article 77 are simply not applicable in our example. Nothing in our example indicates that the aggrieved buyer failed to take appropriate steps to mitigate its loss. Also, our example does not address another scenario: where an aggrieved party fails to mitigate its loss and thus causes a further loss to the breaching party or reduces the overall loss. Here, the aggrieved party's actions after the seller breaches did not increase the amount of damages. Thus, calculating damages under Article 76 will not place the breaching party in a worse position than if the contract had been performed. Whether the seller performed the contract or breached the contract and paid market damages, the seller would not acquire the \$10 million. By contrast, calculating damages pursuant to Article 74 may result in a substantial windfall to the breaching party. Because the aggrieved party in our example did not cause further damage by failing to mitigate, Article 77 does not preclude the use of market damages.

#### **IV. Awarding Market Damages Effectuates the Allocation of Risk and Encourages Performance**

The awarding of market damages under Article 76 may be justified, because the article recognizes the parties' allocation of risk at the time they entered the contract. Market damages encourage parties to perform their contractual obligations, deter breaches, and create a more predictable regime where parties can calculate their exposure to risk. Let me explain.

Parties who contract for the sale of goods hedge their risks against fluctuating market prices. By entering a fixed-price contract, a seller covers its risk against falling prices, but assumes the risk that prices will increase. A buyer, on the other hand, insures against the risk of rising prices, but assumes the risk that market prices will decline.<sup>18</sup> In our example, the buyer and seller chose to avoid the risk of fluctuating market prices and entered into a fixed-price contract for a certain commodity.

Allowing the breaching seller to earn additional profit from the rising market would alter the allocation of risk that was bargained-for in the contract because the seller retains its protection against falling prices but is able to take advantage of rising prices. Based on the

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<sup>18</sup> John D. Wladis, *IMPRACTICABILITY AS RISK ALLOCATION: THE EFFECT OF CHANGED CIRCUMSTANCES UPON CONTRACT OBLIGATIONS FOR THE SALE OF GOODS*, 22 *Gs. L. Rev.* 503, 503-04 (1988).

original allocation of risks in the contract, it should be the buyer, not the seller, who should have the opportunity to profit in the event of a rising market.

Allowing the recovery of market damages would thus effectuate the parties' intent. Moreover, it would encourage performance of contract and deter breach because it would remove the incentive for a party in the seller's position to breach the contract. This would ultimately lead to a more predictable environment in which parties could better calculate their risk in advance of performance.<sup>19</sup>

## **V. Concerns with the Use of Market Damages**

Two other arguments oppose the use of market damages in our example: (1) the result is contrary to the principle of full compensation; and (2) the result would undermine efficient breaches.<sup>20</sup> Neither of these arguments are persuasive.

### **A. Market Damages and the Expectation Principle**

As noted, the primary purpose of damages for breach of contract is to place the aggrieved party in the position it would have occupied if the contract had been performed.<sup>21</sup> Traditionally, this means that the aggrieved party receives the benefit of the bargain, no more and no less. This is the expectation principle.<sup>22</sup>

Some may argue that to award market damages in our example would contradict this expectation principle because the damages awarded pursuant to Article 76 would exceed the buyer's actual loss. That is, the expectation principle mandates calculating damages by considering the resale contract, thus allowing recovery of the lost profit from that agreement.

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<sup>19</sup> The lack of accurate information and the uncertainty involved with resale contracts may cause parties to make inefficient choices if lost profits remain the dominant damage rule in our example. Lost profit damages may encourage parties to breach opportunistically to capture favorable market movements. In response, a buyer in our example could be incentivized to increase the price of the good to protect against such opportunistic breach. Also, buyers may be altogether deterred from fixed price contracts, and resort to buying goods on the spot market. Thus, parties may choose less efficient production strategies because they are considering the effects of the other party's possible breach.

<sup>20</sup> Saidov, *supra*, at 198. The principle of full compensation states that the aggrieved party should be placed in "as good a position as that in which it would have been had the contract been properly performed." *Id.* Hence, market damages seemingly opposes this principle because it places the aggrieved party in a better position.

<sup>21</sup> Robert Cooter and Melvin Aron Eisenberg, *Damages for Breach of Contract*, 73 Cal. L. Rev. 1432, 1432 (1985).

<sup>22</sup> The expectation principle states that "protection of the expectation interest requires an award such that the injured party will achieve the level of satisfaction (if a consumer) or profits (if a firm) that would have been achieved if the contract had been performed." *Id.* at 1438.

That the buyer entered a resale contract with a third party is immaterial. Expectation damages put the aggrieved party in as good as position as it would have been if *their contract* had been performed. "The contract" refers only to the initial bargain between the buyer and seller.<sup>23</sup> If the initial contract had been performed, the buyer would be in the position of having bought goods worth the current market price for the much cheaper contracted price. The buyer had expected to receive goods valued at the current market price plus the opportunity to profit from market movements. Market damages effectuate that expectation. Indeed, the resale contract could have been voided due to impossibility, settlement, or breach. In that case, the buyer could have reentered the market and captured the benefit of rising market prices. But by assuming that the resale contract will be performed, the inherent uncertainty associated with that contract is being resolved in favor of the breaching party.

In short, market damages accurately reflect the value of the opportunity that the aggrieved party has been denied.

## **B. Market Damages and Efficient Breach**

I wish to mention one other concern. Some may argue that an award of market damages here would fly in the face of efficient breach, which holds that everyone in society is made better if there is a more efficient reallocation of economic resources. When the seller breaches efficiently, it will find a second buyer willing to pay the market price at the time of breach. The seller will then compensate the original buyer for damages, mainly lost profit (at minimum). In theory, efficient breach makes the seller better off without making the buyer any worse off.<sup>24</sup> Does this theory hold true? And, is this system the most efficient? With market contracts, society is arguably best served by deterring the disruption of market functions.

In theory, in an efficient breach situation, certain players are made better off without making others worse off. The original seller is better off because it received the increased market price by breaching. Even though the aggrieved first buyer was denied the value of the commodity at the contracted price, the buyer still received the lost profit it expected to receive from resale.<sup>25</sup>

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<sup>23</sup> See Saidov, *supra*, 198.

<sup>24</sup> David W. Barnes, *THE ANATOMY OF CONTRACT DAMAGES AND EFFICIENT BREACH THEORY*, 6 S. Cal. Interdisc. L.J. 397, 407-09 (1998).

<sup>25</sup> See *Id.*; see also Catherin Piché, *supra*.



The theory of efficient breach, however, does not always hold true because gains from the reallocation of goods may be offset by additional expenses resulting from breach. Breach sets a chain of expensive transaction costs.<sup>26</sup> For example, the seller spends time to find a second buyer, the first buyer must decide how to respond to the breach and possibly search for cover goods, and lastly, the buyer will probably consult with attorneys and contemplate litigation. The third party buyer is likely to take similar steps. Moreover, even though in our example the third party releases the aggrieved party from its obligation to resell the commodity, that release may come at a cost, which may be realized in the future through lost business, lower profits from future dealings with that party, or the refusal to be so accommodating in the future. All of these costs chip away at the efficiency of the reallocation of market resources.

Awarding lost profits is contemplated in an efficient breach scenario. However, it also chips away at the efficiency of the transaction. Lost profits require costly proof of particular facts unique to the specific transaction at hand.<sup>27</sup> On the other hand, market damages require only proof of (1) the contract price and (2) the current at the time of avoidance.<sup>28</sup> As a result, market damages may provide a less expensive way to calculate loss and may be easier for parties to predict. This advantage makes it easier to settle disputes.

What would have happened if market damages were imposed? The seller would be deterred from breaching the contract and the second buyer would have had to find the commodity elsewhere. But, this may not be such a difficult task in a market economy with many sellers. In fact, if the first buyer's resale contract fell through, the first buyer could have resold to the second buyer. Under this scenario, the second buyer would have still acquired the commodity, but with fewer transaction costs. Additionally, the benefit from the increase in the market price would have gone to the first buyer, not the seller. This appears to be the fair outcome, because after all, the first buyer bargained for the right to buy the commodity at the lower price.

## **VI. Conclusion**

The result may seem on its face counter-intuitive: a buyer being awarded market damages under Article 76 even though such damages are in excess of its actual loss. This result, however,

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<sup>26</sup> See Daniel Friedmann, *The Efficient Breach Fallacy*, 18 *The Journal of Legal Studies* 6 (1989).

<sup>27</sup> See CISG Advisory Council: Opinion No. 8, *supra*

<sup>28</sup> See Victor Knapp, *Article 76*, Bianca-Bonell Commentary on the International Sales Law, Giuffrè: Milan (1987).

is consistent with the text of the CISG damages provisions. It effectuates the parties' allocation of risk in their agreement and allows the aggrieved party to take advantage of the fluctuation in the market which it bargained for. Market damages also encourages performance of contracts, deters breaches, and ultimately leads to a more predictable contract regime.