

# A NOT INTRACTABLE PROBLEM: REASONABLE CERTAINTY, *TRACTEBEL*, AND THE PROBLEM OF DAMAGES FOR ANTICIPATORY BREACH OF A LONG-TERM CONTRACT IN A THIN MARKET

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*This Note analyzes the tension between anticipatory repudiation and reasonable certainty when both doctrines are applied to a long-term contract in a thin market. It shows that each doctrine is an efficient doctrine, but that as contractual term lengthens the doctrines begin to conflict and efficiency may be lost. It then looks at the case of Tractebel v. American Electric Power as an example of this potential conflict. It shows how the District Court reached a clearly inefficient result before the Second Circuit reversed. It then shows that the Second Circuit's opinion relies on doctrine giving the court wide discretion in awarding damages. This Note concludes by suggesting that a "best shot" rule for contract damage awards is a more efficient remedy than current doctrine and would enable courts to more accurately award damages in long-term contracts in thin markets.*

"Future, *n.* That period of time in which our affairs prosper, our friends are true and our happiness is assured."

—Ambrose Bierce<sup>1</sup>

## INTRODUCTION

This Note ponders the odd history of *Tractebel v. American Electric Power*.<sup>2</sup> How could a contract worth hundreds of millions of dollars possibly breach in the first year of its twenty-year term? How could the district court decide that a breach of a twenty-year contract in year one results in no damages for the remaining nineteen years of the contract? And how, despite properly overturning the district court's result, could the Second Circuit assert that reasonable certainty as to the amount of damages (as opposed to their existence) plays no role in judicial damage awards?

The odd history of this case arose because the doctrines of anticipatory repudiation and reasonable certainty in damage awards become increasingly in tension as contract terms lengthen in an illiquid market.<sup>3</sup> This Note seeks a solution that reduces this tension. Independently, the anticipatory repudiation and reasonable certainty doctrines are efficient.

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1. Ambrose Bierce, *The Unabridged Devil's Dictionary* 92 (David E. Schultz & S.T. Joshi eds., Univ. of Ga. Press 2000) (1911).

2. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89 (2d Cir. 2007); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586 (S.D.N.Y. Jan. 20, 2006); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731(HB), 2005 WL 1863853 (S.D.N.Y. Aug. 8, 2005).

3. This Note uses the terms "illiquid market" and "thin market" interchangeably to refer to markets for goods that cannot be sold rapidly and whose disposition entails high transaction costs.

They are also usually efficient in concert. But when faced with facts such as *Tractebel's*—early repudiation of a long-term contract in an illiquid market—current contract doctrine is inefficient. This Note also explores the many and anticipatable failures of the *Tractebel* contract—failures that led directly to protracted litigation. Finally, it assesses a range of possible solutions.

Contract law allows for the creation of binding promises backed by legal enforcement.<sup>4</sup> This enforcement, however, is limited: “The only universal consequence of a legally binding promise is, that the law makes the promisor pay damages if the promised event does not come to pass.”<sup>5</sup> For reasons of economic efficiency,<sup>6</sup> these damages have been limited to expectation damages.<sup>7</sup> Within this context of perform-or-

4. See Anthony T. Kronman & Richard A. Posner, *The Economics of Contract Law* 4 (1979) (“[Contract law’s] basic function is to provide a sanction for renegeing, which, in the absence of sanctions, is sometimes tempting where the parties’ performance is not simultaneous.”).

5. Oliver Wendell Holmes, Jr., *The Common Law* 301 (Dover Publ’ns 1991) (1881) [hereinafter *Holmes, Common Law*]. Holmes also wrote that “[t]he 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.” Oliver Wendell Holmes, *The Path of the Law*, 10 *Harv. L. Rev.* 457, 462 (1897). In these statements, Holmes was not deriving theory from doctrine so much as creating doctrine from whole cloth. See Grant Gilmore, *The Death of Contract* 22 (Ronald K. L. Collins ed., 2d ed. 1995) (1974) (“It seems perfectly clear that Holmes was, quite consciously, proposing revolutionary doctrine and was not in the least interested in stating or restating the common law as it was.” (footnote omitted)). Nevertheless, Holmes’s views, especially as expounded by his acolyte, Samuel Williston, quickly became orthodoxy. *Id.* at 13–14, 21.

6. See Richard A. Posner, *Economic Analysis of Law* 120 (6th ed. 2003) [hereinafter *Posner, Economic Analysis*] (“Usually the objective of giving the promisor an incentive to fulfill his promise unless the result would be an inefficient use of resources . . . can be achieved by giving the promisee his expected profit on the transaction.”).

7. Expectation damages give the nonbreaching “promisee his expected profit on the transaction” as opposed to specific performance, which enforces the letter of the contract or some form of punitive or reliance damages. See *id.* at 120.

There is a large body of literature on contract remedies, most of it firmly within the law and economics camp. Some of it is exclusively economic and involves the creation of increasingly complex models to test efficiency under various conditions. See, e.g., William P. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 *RAND J. Econ.* 39, 41–43 (1984); Steven Shavell, *Damage Measures for Breach of Contract*, 11 *Bell J. Econ.* 466, 472–87 (1980). Other articles range across the spectrum of oft-awarded remedies (i.e., expectation, reliance, and restitution) and attempt to explain in which situations each remedy is preferred. See, e.g., Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 *Mich. L. Rev.* 341, 343 (1984) (“The purpose of this essay is to begin the development of an integrated theory of contract remedies by delineating the circumstances under which courts should simply enforce a stipulated remedy clause or grant relief to the innocent party in the form of damages or specific performance.”).

A more focused contract remedy literature examines specific scenarios. See, e.g., Robert E. Scott, *The Case for Market Damages: Revisiting the Lost Profits Puzzle*, 57 *U. Chi. L. Rev.* 1155, 1202 (1990) (examining rationale for consequential lost profit damages and concluding that default rule discourages inefficient “conditions the buyer is unable to observe except at great cost”).

pay,<sup>8</sup> contracts try to cabin the future.<sup>9</sup> A well-written contract employs the tools of contract law to smooth out information asymmetries,<sup>10</sup> level moral hazards,<sup>11</sup> assign risk, and ensure that future contingencies fall within the contractual framework.<sup>12</sup>

As the contract term lengthens, however, it becomes harder and harder to anticipate the contingencies that may arise. Time increases risk.<sup>13</sup> One risk that contracting parties assume when they sign a long-

8. “Perform-or-pay” is one way to describe American contract law. It is also a colloquial way of describing an “American option”: one where “the promisor can exercise the option [of nonperformance] by repudiating at any time between the contract and the date set for performance.” Alexander J. Triantis & George G. Triantis, *Timing Problems in Contract Breach Decisions*, 41 *J.L. & Econ.* 163, 169 (1998). Under this concept of contract-as-option, an anticipatory repudiation of a long-term contract—such as the one that is the focus of this Note—is equivalent to the breach of an option with a lengthy pre-expiration term remaining.

There is a recent and burgeoning literature on the contract-as-option. See Avery Wiener Katz, *The Option Element in Contracting*, 90 *Va. L. Rev.* 2187, 2188 (2004) (“[M]any of the major doctrines of contract law effectively operate to create or set the terms of . . . options.”); Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 *Colum. L. Rev.* 1428, 1428 (2004) (arguing that termination rights can be characterized as embedded options and that penal liquidated damages reflect value of option).

9. Technically, an instantaneous exchange is also governed by a contract. But these exchanges typically occur “without contracts, or with contracts so rudimentary or transitory as to have little interest for economists studying the phenomenon of voluntary exchange.” Kronman & Posner, *supra* note 4, at 2. The typical purpose of contract is to allow parties to rely on each other, which often has the incidental benefit of minimizing the “costs of production in a market system.” *Id.* at 3.

10. Contracting parties often lack relevant information regarding their counterparties. For instance, a seller may not know the consequential damages that would result from his breach of contract. It is possible for a buyer, however, to write a contract that informs the seller of this risk and makes him provide insurance for his possible breach. This is the principle behind the decision in *Hadley v. Baxendale*, (1854) 156 *Eng. Rep.* 145 (Ex.).

11. Moral hazard is the “tendency of an insured to relax his efforts to prevent the occurrence of the risk that he has insured against because he has shifted the risk to an [insurer].” See Posner, *Economic Analysis*, *supra* note 6, at 109. Contracts can create moral hazards, but a well-written contract recognizes moral hazards where they exist and provides contingencies against their eventuality.

12. See Victor Goldberg, *Framing Contract Law 1* (2006) (“The transactional lawyer is, in effect, a transaction-cost engineer, designing structures to cope with problems such as information asymmetry, moral hazard, and the like.”). Kronman & Posner, *supra* note 4, at 4 (“An important function of contract law is to enforce the parties’ agreed-upon allocation of risk.”).

13. The idea that time increases risk is intuitive: If there is more time for something to go wrong, it is more likely to go wrong. This phenomenon is present in myriad ways in the real world. For example, the yield curve tends to increase as the time to maturity lengthens. See Aswath Damodaran, *Applied Corporate Finance: A User’s Manual* 146 (1999) (discussing three reasons that future cash flows are worth less than present cash flows: individuals’ preference for present consumption to future consumption, monetary inflation, and *uncertainty*).

term contract is that the other party may breach the contract.<sup>14</sup> Anticipatory repudiation of a contract occurs when a promisor breaches the contract prior to contractual time of performance.<sup>15</sup> This breach may or may not be efficient, but to the extent that one party believes that a judge is unlikely to award true expectation damages, it may be encouraged to breach inefficiently.<sup>16</sup> The doctrine of reasonable certainty provides a framework for contracting parties to assess the likelihood and amount of these damage awards.<sup>17</sup> If reasonable certainty doctrine constrains judges from awarding purely speculative damages, it is an efficient doctrine.<sup>18</sup> But when breach happens early in the term of a long-term con-

14. A bilateral contract where both parties rely on the other's performance functions as if each holds an independent option to perform or pay damages. Once one party cancels, the other party loses this option, which has independent value.

15. The cornerstone case establishing a party's right to bring an action for damages immediately upon the other party's anticipatory breach is *Hochster v. De la Tour*, (1853) 118 Eng. Rep. 922 (Q.B.).

The academic literature on anticipatory repudiation focuses mostly on issues of timing (e.g., When does the statute of limitations start to run? At what date are damages measured from: repudiation or expected performance?) or else particular types of breach (e.g., letters of credit). See, e.g., Dena DeNooyer, Comment, Remedying Anticipatory Repudiation—Past, Present, and Future?, 52 SMU L. Rev. 1787, 1807–08, 1814–16 (1999) (analyzing anticipatory repudiation under UCC and finding remedy should be measured after time when nonbreaching party has had “commercially reasonable period” to cover); Brian B. Mahoney, Jr., Case Comment, Contract Law—Anticipatory Repudiation and the Running of the Statute of Limitations—*Franconia Associates v. United States*, 536 U.S. 129 (2002), 37 Suffolk U. L. Rev. 1235, 1239 (2004) (concluding statute of limitations runs when breach is recognized, which affords nonbreaching party right to determine whether to recognize repudiation as breach and thus begin statute of limitations tolling). See generally Keith A. Rowley, A Brief History of Anticipatory Repudiation in American Contract Law, 69 U. Cin. L. Rev. 565 (2001) (describing development of anticipatory repudiation rules). For a rare article questioning the adequacy of expectation damages in a long-term, fixed-price contract, see Triantis & Triantis, *supra* note 8, at 163, 165.

16. See John H. Barton, The Economic Basis of Damages for Breach of Contract, 1 J. Legal Stud. 277, 277–83 (1972) (using prisoner's dilemma to illustrate that absent enforcement of expectation, promisor will often be incentivized to dishonor the contract). Transaction costs such as litigation expense are factored into a breaching party's decision to breach, but the likelihood (or not) of paying full damages is also discounted. See *infra* note 21. In a large contract, the transaction costs are likely to scale. Litigation expenses for a \$200 million contract are unlikely to be far lower than the expense of litigating a \$500 million contract. If there is any chance that the court will award no damages, then parties with larger contracts may have more incentive to breach.

17. The black letter law of reasonable certainty is discussed *infra* Part III.A. Reasonable certainty is a “distinctive contribution of the American courts to the common law of damages.” Charles T. McCormick, Handbook on the Law of Damages § 32, at 124 (1935). Courts introduced it “in order to control the discretion of juries in awarding contract damages.” E. Allan Farnsworth, Contracts § 12.16, at 799 (4th ed. 1999) [hereinafter Farnsworth, Contracts].

18. It is a fundamental tenet of contract law that contract damages should not put an injured party “in a better position than if the contract had been performed.” Farnsworth, Contracts, *supra* note 17, § 12.15, at 807. But if one of the variables needed to determine expectation damages—sales price, cost of production, or mitigation value—is truly indeterminate, then a court is guessing at damages. This guess, unless lucky, provides a

tract, the reasonable certainty doctrine may compound the problem of inefficient breach.<sup>19</sup> Courts are usually reluctant to peer into the mists of time and divine damage remedies. They prefer to deal in certitudes and, lacking guidance, are likely to be conservative.<sup>20</sup> As a result, a party locked into a long-term contract in an illiquid market may rationally calculate that the courts will not award its counterparty's full expectancy.<sup>21</sup>

This Note argues that muddled contract law doctrine unnecessarily increases the risk of inefficient remedies in cases of anticipatory repudiation of long-term contracts in illiquid markets. It examines the doctrines of anticipatory repudiation and reasonable certainty and concludes that they are necessary and efficient. It also argues, however, that there is an underlying tension between how these doctrines interact to calculate damage remedies and the overall economic purpose of long-term contracts and explores this tension through a case study of *Tractebel v. American Electric Power*. Finally, it assesses the various alternative solutions and concludes that requiring a judge to use a “*best shot*” rule instead of requiring a *reasonably certain* outcome is the most efficient solution and the solution most likely to be aligned with the *ex ante* intentions of the parties.

Part I defines “efficiency” in contract breach within the context of the competing goals of contract law. Specifically, it uses the law and economics literature to define “efficiency” and “efficient breach” and to understand some reasons behind inefficient breach in order to provide a framework for evaluating alternative solutions.

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windfall to one of the parties. This windfall incentivizes additional breaches as future parties may seek like enrichment. Reasonable certainty defends against this possibility.

19. In our principal case, see *infra* Part V, damages were dependent on numerous variables that were difficult to forecast, and the district court refused to award damages without reasonable certainty as to their amount—even though an *educated* guess as to damage value was possible. This effectively handed a windfall to the breaching party. The Second Circuit reversed and said the court must choose a number even though the risk of inefficient damages remains. As of this writing, the final damages determination has yet to occur.

20. Different courts, however, have differing opinions as to the meaning of certitude. See *infra* Part III.D.

21. A simple example illustrates this point. A nonbreaching party sues for expectation damages of \$50 million after expending \$10 million in reliance on the contract. The breacher pleads commercial impracticability, mutual mistake, and nonbreach. If the parties assign even a minimal probability (*arguendo* 5%) to defendant's success on the merits, a larger probability (*arguendo* 20%) to plaintiff being awarded only reliance damages, and an even larger probability (*arguendo* 25%) to the court finding that only \$30 million of damages was reasonably certain, then the expected value of the lawsuit is  $(.50 * \$50M + .25 * \$30M + .20 * \$10M + .05 * \$0) = \$34.5$  million. If the contract value is larger than \$50 million, then the absolute dollar value of the discrepancy between expectancy damage and the expected value of damages will rise and the risk of inefficient breach will increase.

It should be noted in this context that improvements to contract law therefore act as a prophylactic to prevent this sort of breach. See L.L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages* (pt. 1), 46 *Yale L.J.* 52, 61 (1936) (“Whatever tends to discourage breach of contract tends to prevent the losses occasioned through reliance.”).

Part II describes the evolution of anticipatory breach doctrine and how as an independent rule this doctrine encourages efficiency. It also explores some of the practical inefficiencies of anticipatory repudiation, which are analogous to those encountered within reasonable certainty doctrine.

Part III examines reasonable certainty doctrine and concludes that it is generally efficient, but that its application to thin markets is troublesome. This Part then complicates matters by considering whether reasonable certainty refers to certainty as to the existence of damages or to the amount of damages. It concludes that there is precedent to support both a strong and weak version of the reasonable certainty standard applied to the amount of damages, but that the bulk of case law supports the weak version.

Part IV deepens the discussion, assessing how lengthening the contractual term impacts these two doctrines. It shows that extending the contractual term, and thus the time between repudiation and expected performance, magnifies contractual uncertainty and thus inefficiency.

Part V undertakes an in-depth analysis of the *Tractebel Energy Marketing v. AEP Power Marketing* decisions,<sup>22</sup> a rare instance where courts were forced to struggle with how to measure damages in the case of anticipatory breach of a long-term contract in a thin market. First, this Part examines the facts of the case and the actual contract to determine the parties' ex ante intent. Second, it analyzes the *Tractebel* district court decision and concludes as a matter of doctrine it is defensible but wrong, and from an efficiency standpoint it is clearly wrong. Third, this Part concludes that the Second Circuit's opinion reversing the district court is correct, but that its legal rationale for the decision is questionable. The opinion does not aid factfinders and thus does nothing to make the system more efficient.

Part VI responds to these troubling conclusions. It argues that given the traditional goals of contract law, the reasoning and result of *Tractebel* do not provide the optimal solution. It compares four alternative solutions: (1) a strong reasonable certainty requirement; (2) specific performance; (3) a reasonable estimate standard; and (4) a "best shot" damages award standard. While the reasonable estimate standard, the standard employed by the Second Circuit, will generally be more efficient than a strong reasonable certainty requirement or specific performance, the "best shot" solution is the best one from the standpoint of efficiency and doctrinal coherence.

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22. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89 (2d Cir. 2007); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586 (S.D.N.Y. Jan. 20, 2006); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 (HB), 2005 WL 1863853 (S.D.N.Y. Aug. 8, 2005).

## I. EFFICIENCY IN CONTRACT

This Note attempts to answer one question: What is the most efficient damage remedy for anticipatory breach of a long-term contract in a thin market? To do this, we must first define efficiency as it relates to contract remedies.

This Part accomplishes two objects. It provides a definition of efficiency useful for assessing alternative contract doctrines, and it examines how lengthening a contract's term generally undermines individual contract efficiency.

A. *What is Efficiency?*

The idea of efficiency is central to the economic theory of contract law.<sup>23</sup> Efficiency relates to value maximization. A transaction is said to be efficient if it moves resources from less to more valuable uses.<sup>24</sup> Contract law seeks to guarantee the *process* of exchange by which the value of resources is maximized.<sup>25</sup> Therefore, when the term "efficiency" is used in contract law it refers to an efficient process of exchange. To this effect, Judge Richard Posner indicates there are five distinct economic functions of contract law: "(1) to prevent opportunism, (2) to interpolate efficient terms, (3) to prevent avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the costs of resolving contract disputes."<sup>26</sup>

It is not accidental that all of these functions are *ex ante* in nature.<sup>27</sup> One way of assessing a damage remedy is to ask: If the parties were free, *ex ante*, to make their own rules concerning remedies for breach, and had the opportunity to deliberate, would they still choose the proposed remedy?<sup>28</sup>

Contract damages are meant to "giv[e] the promisor an incentive to fulfill his promise unless the result would be an inefficient use of resources."<sup>29</sup> In other words, contract law seeks to *encourage* efficient breach—breach where resources are moved to a higher value use than

23. Robert E. Scott & Jody S. Kraus, *Contract Law and Theory* 26–27 (4th ed. 2007) (describing how economic theories of contract law take *ex ante*, consequentialist perspective that seeks to encourage socially desirable (i.e. value maximizing) "promise-making behavior by future parties").

24. Efficiency is a disputed concept, but this Note will use the Kaldor-Hicks concept of efficiency, or wealth maximization, described above. See Posner, *Economic Analysis*, *supra* note 6, at 12–16 (describing different concepts of efficiency and their limits).

25. See *id.* at 93.

26. *Id.* at 98.

27. Litigation, however, happens *ex post*. A judge (or legislature) focused on future disputes will pay a great deal of attention to Posner's criteria. A judge interested solely in the disposition of the case at hand, however, may apply contract doctrine that is not efficient, either due to alternative concerns (e.g., fairness) or historical contingencies.

28. See Anthony T. Kronman, *Specific Performance*, 45 *U. Chi. L. Rev.* 351, 365 (1978).

29. See Posner, *Economic Analysis*, *supra* note 6, at 120.

the contractual use. This is accomplished by “giving the promisee his expected profit on the transaction” and allowing the promisor to sell to the user who values the goods most highly.<sup>30</sup> Expectation damages are the general rule for contract damages because they are efficient—money damages equal to their pre-deal expectation are the preferred remedy of most parties *ex ante*.<sup>31</sup>

### B. *Length of Contract Term and Efficiency*

As a contract term lengthens, there are especial risks of inefficient breach. Courts routinely do not award full expectation damages for long-term contracts. For example, courts never appear to consider the independent value of the option to breach in their damage awards.<sup>32</sup> The risk of undercompensation due to lack of reasonable certainty also grows as a contract’s term lengthens because overall market uncertainty grows as well.<sup>33</sup> Also, the standard defenses of mutual mistake, duress, or impossibility are most applicable to long-term contracts and imply that the non-breaching party’s probability of collecting expectation damages is less

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30. *Id.*

31. There are exceptions. Specific performance is the efficient remedy for unique goods. See Kronman, *supra* note 28, at 368 (“Consequently, in the case of a contract for a unique good or service, the benefits the promisee derives from a specific performance provision are apt to outweigh its costs to the promisor.”). There is also no theoretical efficiency problem with punitive damages against opportunistic breachers. See Posner, *Economic Analysis*, *supra* note 6, at 118 (“If a promisor breaks his promise merely to take advantage of the vulnerability of the promisee in a setting . . . where performance is sequential rather than simultaneous, we might as well throw the book at the promisor.”). If the expectation interest is difficult to determine, the reliance or restitution interests may be protected in its stead. See Fuller & Perdue, *supra* note 21, at 53–54 (describing expectation, reliance, and restitution interests).

The consequence of inefficient damage remedies is the awarding of windfalls. When one party gains a windfall, a benefit not bargained for (e.g., greater than expectation damages), the award undermines efficiency. Efficiency is undermined because the existence of windfalls encourages opportunism by parties seeking a windfall, and it marginally increases the costs of contracting since parties are aware of this risk of opportunism and must spend time and money attempting to contract around it.

32. Cf. Triantis & Triantis, *supra* note 8, at 189–90 (explaining that seller does not fully internalize cost of breach “because she is not required to compensate the buyer for the loss of his [option]” and because seller “might suffer an uncompensated loss of her option at some future date because of a future repudiation of the buyer”). In fact, the longer the time remaining on the contract the more valuable this option is. This observation is reflected in option pricing. The two key variables in Black-Scholes option pricing theory are volatility in the underlying asset’s price and time until performance.

33. See *infra* Part IV.B; cf. Restatement (Second) of Contracts § 352 cmt. b (1981) (“[I]f the transaction . . . extends into the future, . . . proof of the loss . . . caused by the . . . breach is more difficult.”).

than 100%.<sup>34</sup> This uncertainty may persuade a party to breach and adopt a strategy of attrition in an attempt to achieve a favorable settlement.<sup>35</sup>

## II. ANTICIPATORY REPUDIATION: A NECESSARY DOCTRINE

Our ultimate question remains: What is the efficient damage remedy for a long-term contract in a thin market breached in its first year? The answer to this question assumes that anticipatory repudiation is itself an efficient doctrine. This Part will accomplish two objectives. First, it will examine the essential soundness, doctrinally and economically, of the anticipatory repudiation doctrine. Second, it will show how this soundness is tempered by several inefficiencies caused by opportunistic breach.

### A. *Anticipatory Repudiation: Doctrinal Soundness and Economic Efficiency*

Anticipatory repudiation occurs "when a party[ ] repudiate[es] . . . its duty before the time for performance has arrived."<sup>36</sup> Initial disagreement over anticipatory repudiation's acceptability, which led some to label the doctrine as schizophrenic, has been resolved.<sup>37</sup> It is now a settled doctrine.<sup>38</sup> The Restatement and common law in forty-nine states<sup>39</sup> en-

34. For a discussion of how expected value in the litigation process impacts contract efficiency, see *supra* note 21.

In the 1970s and 1980s, companies—usually energy companies—increasingly attempted to plead impossibility or mutual mistake as defenses to contract breach. The results of their efforts were mixed. See E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 *Case W. Res. L. Rev.* 203, 213–16 (1990). In particular, the inconclusive *Westinghouse* litigation and the *Alcoa* mutual mistake litigation signal to potential breachers that these defenses may lead to successful settlement of potentially crushing liabilities. See generally *Aluminum Co. of Am. (Alcoa) v. Essex Group, Inc.*, 499 F. Supp. 53 (W.D. Pa. 1980) (allowing mutual mistake defense); Scott & Kraus, *supra* note 23, at 776 (discussing both cases).

35. Triantis & Triantis, *supra* note 8, at 176–77 (explaining that in a model of repudiation decisionmaking, "[c]learly, an important factor . . . is the magnitude of the reduction in damages that can be realized by repudiating early"). While the authors were specifically modeling the benefit the breaching party receives from the nonbreaching party's duty to mitigate, the same impact is felt if the expected value of damages falls because there is some probability of a reduced damage award. See *supra* note 21.

36. See Farnsworth, *Contracts*, *supra* note 17, at 581.

37. Gilmore, *supra* note 5, at 71–72. See generally Rowley, *supra* note 15, at 572–629 (describing early history of doctrine of anticipatory repudiation and its evolution, acceptance, and codification in American jurisprudence).

38. Holmes advocated an unsentimental, nonmoralistic view of contract that expunged subjectivity from the doctrine, which quickly became orthodoxy. See Gilmore, *supra* note 5, at 14–17, 22–23. This position was hostile to anticipatory repudiation as it led Holmes to believe that "[i]n every case [the law] leaves [man] free from interference until the time for fulfillment has gone by, and therefore free to break his contract if he chooses." Holmes, *Common Law*, *supra* note 5, at 301. Taken literally, this position does not permit anticipatory repudiation. There is breach at the time of performance or nothing. It is no surprise that Holmes's follower Samuel Williston became the chief opponent of the doctrine of anticipatory breach. Rowley, *supra* note 15, at 604.

39. The lone holdout, possibly under Williston's influence, is Massachusetts. See Rowley, *supra* note 15, at 592–93 n.162.

shrine the policy that a promisor may breach prior to the date of performance, and the promisee, upon notifying the promisor that he is treating the contract as rescinded,<sup>40</sup> may seek damages for this breach immediately.<sup>41</sup> Anticipatory repudiation is sound as black letter law.

Anticipatory repudiation is also an efficient doctrine. Without anticipatory repudiation, a party would have to wait until the time of performance to be certain the other party had breached.<sup>42</sup> A nonbreaching party would have to delay mitigation until the time of performance and also spend any necessary money in reliance on the contract.<sup>43</sup> Ex ante, it seems unlikely that any party would, upon early breach, prefer to sit around idly.<sup>44</sup> The fact that no case or commentary suggests that parties regularly contract around this rule is further evidence of its efficiency.<sup>45</sup>

1. *Inefficiencies in Implementing Anticipatory Repudiation Doctrine.* — This theoretical efficiency, however, runs into substantial implementation problems. It is predicated on a prompt award of expectation damages. There are, however, a bevy of indications that the nonbreaching party is systematically undercompensated. Expenses of litigation (e.g., attorney's fees, expert fees) are not reimbursed, and prejudgment interest is typically below market rates.<sup>46</sup> The expected value of a plaintiff's recovery is also undercut by exposure to the full range of defenses.<sup>47</sup> What is worse,

40. Notification to the breaching party that the contract is being treated as rescinded is necessary in order to ensure that the promisor does not spend additional money under the mistaken assumption that retraction is still a viable option. *Truman L. Flatt & Sons Co. v. Schupf*, 649 N.E.2d 990, 994–96 (Ill. App. Ct. 1995).

41. See *supra* notes 15–16 and accompanying text.

42. This was the situation prior to *Hochster v. De la Tour*, (1853) 118 Eng. Rep. 922 (Q.B.), which first permitted suit for anticipatory repudiation. See DeNooyer, *supra* note 15, at 1788–89 (“[P]romises could not be breached until the actual time of performance.”).

43. Fear of this possibility was precisely the motivation for the *Hochster* court to establish the doctrine. 118 Eng. Rep. at 926 (“Thus, instead of remaining idle and laying out money in preparations which must be useless, he is at liberty to seek service under another employer . . .”).

44. Ex ante, both parties “have a mutual interest in minimizing the cost of performance.” Posner, *Economic Analysis*, *supra* note 6, at 96. Anticipatory repudiation clearly accomplishes this goal by preventing parties from making needless reliance expenditures.

45. Contract rules, with few exceptions, are default rules and parties may choose alternatives. Efficient rules—rules that the parties would choose on their own—are rarely contracted around. I have found no case in the literature where the parties contract around anticipatory repudiation and insist that breach may only occur at the time of performance.

46. Scott & Kraus, *supra* note 23, at 818.

47. For exposure to mistake, duress, and impossibility defenses, see *supra* note 34. Defendants also often claim that the contract lacked consideration or was not otherwise validly formed. The defendant in *Tractebel* attempted a version of this defense by alleging that the contract in dispute constituted a type II agreement, which is an agreement to continue to negotiate in good faith, and not a type I agreement, which would be an enforceable agreement despite the need to complete a power-sharing protocol. Reply and Response Brief of Plaintiffs-Appellants-Cross-Appellees at 7–16, *Tractebel Energy Mktg.*,

whether a court will even recognize anticipatory repudiation is often a high-stakes gamble.<sup>48</sup> The decision of whether there has been an anticipatory repudiation is “[o]ne of the most difficult and potentially risky decisions that an attorney may . . . make.”<sup>49</sup> The extent of these inefficiencies depends on when a court decides the nonbreaching party must mitigate;<sup>50</sup> if the court allows the nonbreaching party to wait until the time of expected performance to mitigate, then that party is granted an unbargained-for option.<sup>51</sup> Few courts, however, grant such open-ended options.<sup>52</sup> This limits any value gained by nonbreaching parties.<sup>53</sup>

Inc. v. AEP Power Mktg., Inc., 487 F.3d 89 (2d Cir. 2007) (No. 05-4985-cv(L)) [hereinafter *Tractebel*, Reply and Response Brief].

48. Courts regularly hold that “[t]o constitute anticipatory repudiation, the words or conduct creating anticipatory repudiation must be distinct, unequivocal, and absolute.” DeNooyer, *supra* note 15, at 1789. This article refers specifically to anticipatory repudiation under the UCC, but the same requirements are present in the common law. See *In re Marriage of Olsen*, 528 N.E.2d 684, 686 (Ill. 1988) (“The doctrine of anticipatory repudiation requires a clear manifestation of an intent not to perform the contract on the date of performance. . . . That intention must be a definite and unequivocal manifestation . . .”).

49. John R. Trentacosta, *Performance and Breach of Contracts Under UCC Article 2*, 74 Mich. B.J. 548, 549 (1995). Breaching parties are rarely unequivocal. 1 Roy Ryden Anderson, *Damages Under the Uniform Commercial Code* § 9:17, at 45–46 (1988) (“[Breaching parties] may wheedle or whine or threaten or cajole, do all sorts of distasteful things, but rarely will they voluntarily put themselves in the posture of wrongdoer any earlier than is absolutely necessary.”).

50. This issue, the proper time of mitigation for anticipatory repudiation, has attracted the most scholarly attention related to the doctrine. See DeNooyer, *supra* note 15, at 1814–16 (arguing that “commercially reasonable time for performance” best resolves tension among UCC provisions); Thomas H. Jackson, “Anticipatory Repudiation” and the Temporal Element of Contract Law: An Economic Inquiry into Contract Damages in Cases of Prospective Nonperformance, 31 *Stan. L. Rev.* 69, 93–94 (1978) (suggesting that in thick markets there is no best cost avoider and mitigation should be judged from time of breach, but that in thin markets mitigation is best measured at time of repudiation).

51. Scott & Kraus, *supra* note 23, at 809. The value of this option (like the value of all options) depends largely on the strike date (i.e., the time remaining before performance during which the promisee can mitigate) and the volatility of the underlying asset. Higher volatility increases the range of expected values from mitigation; the breaching party will fear being left in a worse position.

52. Courts wish to avoid a fact-specific inquiry into the value of the option and how it affects the damage remedy. Increasingly, they grant a limited option to the nonbreaching party where they must mitigate in a “commercially reasonable time.” *Cosden Oil & Chem. Co. v. Karl O. Helm Aktiengesellschaft*, 736 F.2d 1064, 1073 (5th Cir. 1984) (using UCC’s “persistent theme of commercial reasonableness” to justify allowing mitigation within a commercially reasonable time of learning of breach); see also *Cargill, Inc. v. Stafford*, 553 F.2d 1222, 1227 (10th Cir. 1977) (allowing “reasonable time” for mitigation); *Trinidad Bean & Elevator Co. v. Frosh*, 494 N.W.2d 347, 353 (Neb. Ct. App. 1992) (same). Looked at independently, there are good theoretical reasons to believe that requiring mitigation at time of breach or at least within a commercially reasonable time period post-breach is preferable to delaying the mitigation decision until the time of performance.

53. This limited option most likely does not offset any serious inefficiencies that may arise. It almost certainly doesn’t replace the most important deterrent to breach—desire to maintain business reputation.

These practical problems do partially undercut the efficiency of anticipatory repudiation.<sup>54</sup> Nevertheless, the doctrine's long history, wide adoption, and the existence of little evidence that parties contract around it suggest that anticipatory repudiation is for most contracts an efficient term.

### III. REASONABLE CERTAINTY<sup>55</sup>

The doctrine of reasonable certainty is the second critical doctrine needed to answer the question of how to remedy anticipatory breach of a long-term contract in a thin market. This Part aims to accomplish four tasks: 1) demonstrate reasonable certainty's inherent efficiency and its place within contract doctrine; 2) show that this efficiency depends on the existence of thick markets; 3) describe the doctrinal debate over whether reasonable certainty refers to certainty of the *existence* or certainty of the *amount* of damages; and 4) show that the bulk of case law and commentary supports a "weak" reasonable certainty standard that applies to the existence of damages and not to the amount. Understanding reasonable certainty is necessary in order to understand how and why the district court in *Tractebel* arrived at its solution to the problem and why the Second Circuit correctly held this solution to be wrong. An under-

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54. There are tweaks that may make this system more efficient. Perhaps changing the mitigation rule will lead to more certainty and less gamesmanship over time of breach. See Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 Va. L. Rev. 967, 993–95 (1983) [hereinafter Goetz & Scott, *Mitigation Principle*] (suggesting that "[t]he net effect of [more immediate post-breach mitigation] remains indeterminate" and that efficient rule may depend on context). Other scholars have discussed requiring reimbursement of legal expenses as potentially promoting efficiency. See Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. Legal Stud. 399, 428 (1973) [Posner, *Economic Approach*]; Thomas D. Rowe, Jr., *Predicting the Effects of Attorney Fee Shifting*, *Law & Contemp. Probs.*, Winter 1984, at 149; Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. Legal Stud. 55, 59–61 (1982). Another possibility is attempting to value the innocent party's lost option. Cf. Triantis & Triantis, *supra* note 8, at 171 (describing how thick market that correctly values cost of performance eliminates value of breach option and how this partially eliminates promisor's incentive to breach). These may be worthwhile reforms whose implementation would result in fewer contracts breached or more contract litigation settled. None, however, will prevent all breaches of long-term contracts. Thus the basic problem remains about what to do when a long-term contract in a thin market is anticipatorily repudiated.

55. The doctrine of reasonable certainty has been the focus of little scholarly attention. But see Melvin Aron Eisenberg, *Probability and Chance in Contract Law*, 45 UCLA L. Rev. 1005, 1052–70 (1998) (arguing that "all-or-nothing rule" for establishing speculative damages is "out of touch with the reality of probability" and discussing alternative rules); Duane L. Steffey, Stephen E. Fienberg & Roberth H. Sturgess, *Statistical Assessment of Damages in Breach of Contract Litigation*, 46 *Jurimetrics* 129 (2006) (demonstrating use of statistical analysis to calculate damages to reasonable certainty in contracts case).

standing of reasonable certainty is also necessary to understand why the Second Circuit's solution leaves unnecessary inefficiency in the system.

### A. *The Inherent Efficiency of Reasonable Certainty*

The reasonable certainty requirement is exactly what the name implies: to be awarded, losses on contracts even concededly breached must be proven with reasonable certainty.<sup>56</sup> This doctrine is as entrenched in the law as the anticipatory repudiation doctrine. The Restatement (Second) of Contracts declares that a fundamental rule of contract damages is that "damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."<sup>57</sup> Cases throughout the United States adhere to the requirement.<sup>58</sup> This is not surprising; in many ways a reasonable certainty requirement is simple common sense in a remedy system designed to encourage efficient breach. Absent reasonable certainty, courts would fear that damage awards were simply windfalls to one party or the other.<sup>59</sup> When damages become a lottery, the efficiency of the entire system of contract law is undermined.

### B. *Thick Markets*

Reasonable certainty is rarely an issue in contract disputes; often the value of damages will be readily accessible. In a well-developed market the difference between contract and market price is not hard to determine.<sup>60</sup> Another way of saying this is that contracts between corporate entities in thick markets are rarely vulnerable to reasonable certainty concerns. In a thick market, even lengthening the contractual term will not

56. See Scott & Kraus, *supra* note 23, at 1952–57.

57. Restatement (Second) of Contracts § 352 (1981).

58. See, e.g., *Schonfeld v. Hilliard*, 218 F.3d 164, 172 (2d Cir. 2000) ("[A] plaintiff is entitled to recover lost profits only if he can establish both the existence and amount of such damages with reasonable certainty."); *Pepsi-Cola Co. v. Steak 'N Shake, Inc.*, 981 F. Supp. 1149, 1160 (S.D. Ind. 1997) ("Damages for breach of contract may not be awarded unless there is sufficient evidence to calculate the loss with a reasonable degree of certainty."); *V.A.L. Floors, Inc. v. Westminster Cmty., Inc.*, 810 A.2d 625, 630 (N.J. Super. Ct. App. Div. 2002) ("Profits lost by reason of breach of contract may be recovered if there are any criteria by which probable profits can be estimated with reasonable certainty." (internal quotation marks omitted)); *Kiewit Tex. Mining Co. v. English*, 865 S.W.2d 240, 245 (Tex. App. 1993) ("[T]he plaintiffs . . . had the burden of establishing with reasonable certainty the value of the expected performance.").

59. If a party's expectation is not determinable, any award (unless the court is particularly lucky) is sure to overshoot or undershoot the efficient mark. Depending on the timeframe and number of variables the award may be off by an order of magnitude. For analogous reasons courts refuse to enforce liquidated penalty clauses that function as penalties. Cf. *Cal. & Hawaiian Sugar Co. v. Sun Ship, Inc.*, 794 F.2d 1433, 1438–39 (9th Cir. 1986) (enforcing liquidated damage clause that was "proper" and not "penal").

60. Scott & Kraus, *supra* note 23, at 973.

prevent acquisition of reasonably certain future prices.<sup>61</sup> Thus this Note focuses on contracts in thin markets.

### C. *New Business Profits and the Shift to an Evidentiary Standard*

One analogy to a thin market is a new business: In a thin market there is no quoted price for the contractual good available to determine damages; similarly, a new business has no track record or operational data to use in damage determination. Yet the reasonable certainty standard in a contract action involving such a new business is an evidentiary standard and not a per se rule of law forbidding liability.<sup>62</sup> A century ago courts regularly forbade damage awards to start-up businesses on the grounds that damages were inherently uncertain.<sup>63</sup> Now prospective profits can be proved using “yardstick” comparisons, historical profits of successor firms, comparison of similar businesses owned by the plaintiff,

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61. A thick market is one where “increased volumes of trade in a particular market increase the efficiency with which the market operates.” World Bank, Annual World Bank Conference on Development Economics: Accelerating Development 119 (François Bourguignon & Boris Pleskovic eds., 2004), available at [http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2004/10/18/000160016\\_20041018174124/Rendered/PDF/302280PAPER0ABCDE02004.pdf](http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2004/10/18/000160016_20041018174124/Rendered/PDF/302280PAPER0ABCDE02004.pdf) (on file with the *Columbia Law Review*). Increased liquidity is the signature of a thick market. *Id.* The Chicago Mercantile Exchange (CME) has popularized the trading of options. An example of a thick options market is the CME’s S&P 500 Options, which have been traded on the exchange since 1983. These options are available with strike dates every month for the next two years. See Chicago Mercantile Exchange, CME S&P 500 Options, at [http://www.cme.com/trading/prd/equity/sp500\\_OCL.html](http://www.cme.com/trading/prd/equity/sp500_OCL.html) (last visited on Feb. 10, 2008) (on file with the *Columbia Law Review*). Anyone repudiating a contract whose price hinges on a future valuation of the S&P 500 can have these futures used as a means of damage assessment. This makes sense since the breacher had the ability to hedge her risk using these same futures. See Jackson, *supra* note 50, at 83–86 (giving example of indifference future buyer should feel between purchase of futures contract and waiting to pay spot price).

62. See Dan B. Dobbs, *Handbook on the Law of Remedies* § 3.3, at 155 (1973) (“Courts are now taking the position that the distinction between established businesses and new ones is a distinction that goes to the weight of the evidence and not a rule that automatically precludes recovery of profits by a new business.”); Bernadette J. Bollas, Note, *The New Business Rule and the Denial of Lost Profits*, 48 *Ohio St. L.J.* 855, 868 (1987) (“[T]he new business rule can operate as a rule of evidence ensuring that reasonable proof of lost profits is brought before the trier of fact . . . .”); see also *Rancho Pescado, Inc. v. Nw. Mut. Life Ins. Co.*, 680 P.2d 1235, 1245 (Ariz. Ct. App. 1984) (decrying per se rule denying damages to a new business as “patently unfair” and reestablishing rule that allows new business to recover “where evidence is available to furnish a reasonably certain factual basis for computation of probable losses . . . .” (citation omitted)); *Harsha v. State Sav. Bank*, 346 N.W.2d 791, 798 (Iowa 1984) (“If factual data are presented which furnish a basis for compilation of probable loss of profits, evidence of future profits should be admitted and its weight, if any, should be left to the jury.”).

63. See *Standard Supply Co. v. Carter & Harris*, 62 S.E. 150, 152 (S.C. 1908), overruled by *Drews Co. v. Ledwith-Wolfe Assocs.*, 371 S.E.2d 532 (S.C. 1988) (“When a business is in contemplation, but not established, or not in actual operation, profit merely hoped for is too uncertain and conjectural to be considered.”).

and financial experts.<sup>64</sup> This is important since the evidentiary standard for new businesses serves as a backstop for established businesses.<sup>65</sup>

D. *Certainty of Damage Existence or Certainty of Damage Amount?*

While courts are unanimous in requiring reasonable certainty before awarding damages for contract breach, the meaning of reasonable certainty applied is not consistent. Courts differentiate between reasonable certainty as to the existence of damage and reasonable certainty as to the amount of damage. Many courts imply that the certainty required as to amount is less than the certainty required as to existence, but continue to use the same term for each.<sup>66</sup> The crucial question then is whether and to what extent does the high evidentiary standard required for proof as to the existence of damages bend when the issue is proof as to the amount of damages.

The uncertainty surrounding this question is reflected in the Restatement. The section itself is invariant: "Damages are not recoverable for loss beyond an amount that the evidence permits to be established with reasonable certainty."<sup>67</sup> The comments, however, anticipate a flexible standard when they permit a court to "take into account all the circumstances of the breach, including willfulness, in deciding whether to require a lesser degree of certainty . . . ."<sup>68</sup> But this standard is not so flexible as to permit recovery for speculation. A party that fails to prove the amount of damage is allowed to collect reliance damages as a substitute.<sup>69</sup> If the standard were toothless, then this backstop would be unnecessary.

Unfortunately, denotation does not settle the problem. Reasonable certainty's Janus-like nature is embedded in the meaning of its words. Certainty means "something that is certain."<sup>70</sup> Certain has several meanings, but the two most relevant to this inquiry are "indisputable" and "reliable."<sup>71</sup> Courts have used both meanings when demanding reasonable certainty.

Courts always require a high degree of proof, bordering on the meaning of "indisputable," when the existence of damage is in question. The most common tactic courts use is to discuss only whether the amount

64. See Restatement (Second) of Contracts § 352 cmt. b (1981); *Bollas*, supra note 62, at 872–73 (listing methods for proving prospective profits).

65. This is a necessary implication of allowing recovery for new businesses upon expert and yardstick testimony, since this testimony is meant to establish what the business's track record would have been absent the breach. An established business already has this track record. The Restatement is explicit: "[I]f the business is a new one . . . proof will be more difficult." Restatement (Second) of Contracts § 352 cmt. b.

66. See *infra* notes 77–79 and accompanying text.

67. Restatement (Second) of Contracts § 352.

68. *Id.* § 352 cmt. a.

69. *Id.*

70. Webster's New Collegiate Dictionary 182 (1977).

71. *Id.*

of damages is reasonably certain and assume the necessity of damage existence.<sup>72</sup> Silence in this case equates to certainty. This pattern is not surprising since the fundamental question of almost every contract action is whether a contract was breached, and, if so, who breached it. Once that question has been answered affirmatively courts assume that breach equates with certainty of damage existence.<sup>73</sup> Other courts explicitly hold proof of existence to a higher standard than proof of amount.<sup>74</sup> Finally, some courts suggest that existence and amount both require reasonable certainty but then only apply the standard to proof of amount.<sup>75</sup>

While courts are far more vocal about the necessity of reasonable certainty as to the amount of damages, they are split as to what standard of proof to demand. Most courts agree that reasonable certainty as to damages is a flexible, inexact concept.<sup>76</sup> But a few courts insist that the same reasonable certainty standard that applies to damage existence applies without change to damage amount.<sup>77</sup> Other courts have refused to

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72. See, e.g., *F.E. Holmes & Son Constr. Co. v. Gualdoni Elec. Serv., Inc.*, 435 N.E.2d 724, 728 (Ill. App. Ct. 1982) (acknowledging that “the wrongful acts of defendant” must cause loss, but focusing on reasonable certainty standard for lost profits); *Charles R. Combs Trucking, Inc. v. Int’l Harvester Co.*, 466 N.E.2d 883, 887 (Ohio 1984) (establishing three-part test for determination of lost profits in Ohio that includes necessity that “loss of profits is the probable result of the breach of contract” and that profits are non-speculative, but discussing only speculative profits portion of test); *Szczepanik v. First S. Trust Co.*, 883 S.W.2d 648, 649 (Tex. 1994) (discussing reasonable certainty standard as applied to lost profits and implicitly assuming that proof of amount of damages equals proof of existence).

73. If breach did not equal damage, then it is unlikely that the nonbreacher would go through the expense of bringing suit.

74. See *Kenford Co. v. County of Erie*, 493 N.E.2d 234, 235 (N.Y. 1986) (“[I]t must be demonstrated with certainty that [loss of future profit] damages have been caused by the breach and . . . the alleged loss must be capable of proof with reasonable certainty.”). Existence requires certainty, but amount requires only reasonable certainty. *Id.*; see also *Cont’l Car-Na-Var Corp. v. Moseley*, 148 P.2d 9, 14 (Cal. 1944) (arguing that amount of profits must not be “uncertain or speculative” and noting that “whether the loss of profits was the result of the wrong” required different standard); *El Fredo Pizza, Inc. v. Roto-Flex Oven Co.*, 261 N.W.2d 358, 363–64 (Neb. 1978) (“Uncertainty as to the *fact* of whether any damages were sustained at all is fatal to recovery, but uncertainty as to the *amount* is not.” (quoting *Fisher v. Hampton*, 44 Cal. App. 3d 741, 748 (Cal. Ct. App. 1975))).

75. *Sanchez-Corea v. Bank of Am.*, 701 P.2d 826, 836 (Cal. 1985) (arguing that reasonable certainty is criteria for both “occurrence and the extent thereof” of lost profits, but then failing to discuss whether occurrence is reasonably certain (quoting *Gerwin v. Se. Cal. Ass’n of Seventh Day Adventists*, 14 Cal. App. 3d 209, 221 (Cal. Ct. App. 1971))).

76. See *Ashland Mgmt. v. Janien*, 624 N.E.2d 1007, 1010 (N.Y. 1993) (“The law does not require that [damages] be determined with mathematical precision.”); *Holt Atherton Indus. v. Heine*, 835 S.W.2d 80, 84 (Tex. 1992) (“Recovery for lost profits does not require that the loss be susceptible of exact calculation.”). The exceptions are those few courts that simply insist that reasonable certainty applies to both damage existence and amount without qualifying the statement. These are discussed *infra* note 77.

77. See *Beverly Hills Concepts, Inc. v. Schatz & Schatz, Ribicoff & Kotkin*, 717 A.2d 724, 736 (Conn. 1998) (reiterating that lost profit damages are recoverable only to extent there is “sufficient basis for estimating their amount with *reasonable certainty*” and rejecting damage award based on “assumptions that were not supported by the record”); *City of*

award damages to nonbreachers who have proven the existence of breach because any damages would have been too “speculative.”<sup>78</sup> Courts may still be applying a watered-down reasonable certainty standard, and the facts in these cases may not even meet a watered-down standard.<sup>79</sup> But it does prove that the standard is not toothless and, more importantly, suggests that in some states the test still relies to some degree on “certainty” and has not become a “reasonable estimate” test.<sup>80</sup>

There are some courts, though, that apply a looser standard verging on a reasonable estimate test. Courts that apply this standard insist in their opinions on their flexibility. They express this by holding that “mathematical certainty”<sup>81</sup> or “absolute certainty”<sup>82</sup> is not required and that a “reasonable basis,”<sup>83</sup> “reasonable degree of certainty,”<sup>84</sup> or “fairly approximate estimate”<sup>85</sup> is all that is needed. There is a long history of courts recognizing that damage awards need not be precise if supported by sufficient facts.<sup>86</sup> To the present day, there is a great deal of judicial

Gahanna v. Eastgate Props., Inc., 521 N.E.2d 814, 818 (Ohio 1988) (“[T]he amount of the lost profits, as well as their existence, must be demonstrated with reasonable certainty.”).

78. See, e.g., Lovett v. E.L. Garner, Inc., 511 So. 2d 1346, 1353 (Miss. 1987) (acknowledging requirement of reasonable certainty for lost profits and rejecting damage award for incomplete and misleading calculation); *Kinetico, Inc. v. Indep. Ohio Nail Co.*, 482 N.E.2d 1345, 1350–51 (Ohio Ct. App. 1985) (rejecting as speculative a damage award where calculation of net profit figure was unclear); *Lindevig v. Dairy Equip. Co.*, 442 N.W.2d 504, 508 (Wis. Ct. App. 1989) (rejecting claim for lost profits as not meeting “reasonable inference” standard after plaintiff failed to provide any evidence of expenses).

79. In *Lovett*, for instance, the court rejected a damage award based on incomplete evidence but acknowledged that “the degree of proof required usually depends on the particular facts of the case.” 511 So. 2d at 1353. See also *Midland Hotel Corp. v. Reuben H. Donnelley Corp.*, 515 N.E.2d 61, 66–67 (Ill. 1987) (rejecting damage award for basing estimate on untrue statistical trend, but agreeing to principle that damages need not be calculated with “mathematical precision” and are always somewhat “uncertain”).

80. This suggests that reasonable certainty is flexible based on factual specifics. In *Kinetico*, the award was labeled speculative, but the court in fact objected to its conclusory nature. 482 N.E.2d at 1347. Not coincidentally, *Kinetico* never suggests that reasonable certainty is a lesser standard when it comes to determining damage amount. *Id.* Likewise in *Holt* the court rejected plaintiff’s testimony as a basis for a damage award. 835 S.W.2d at 84. The loss need not be calculated exactly, but reasonable certainty still requires a great deal more than an estimate. *Id.*

81. *Tull v. Gundersons, Inc.*, 709 P.2d 940, 943 (Colo. 1985) (quoting *Riggs v. McMurty*, 400 P.2d 916, 919 (Colo. 1965)).

82. *Swiss-Am. Importing Co. v. Variety Food Prods. Co.*, 471 S.W.2d 688, 690 (Mo. Ct. App. 1971).

83. *Hemken v. First Nat’l Bank of Litchfield*, 394 N.E.2d 868, 872 (Ill. App. Ct. 1979).

84. *Frank B. Hall & Co. v. Beach, Inc.*, 733 S.W.2d 251, 258 (Tex. App. 1987).

85. *Tull*, 709 P.2d at 945 (quoting *A to Z Rental, Inc. v. Wilson*, 413 F.2d 899, 908 (10th Cir. 1969)).

86. Over 150 years ago, one court recognized that “profits or advantages which are the direct and immediate fruits of the contract” need only be estimated in the damage phase. *Masterton & Smith v. Mayor of Brooklyn*, 7 Hill 61, 68–69 (N.Y. Sup. Ct. 1845). Another court considering the issue of future damages declared that the question was only “one of evidence, rather than of rule; the difficulty [in assessing future damages] is inherent in the doctrine of ‘anticipatory breach,’ but the right to have the damage rule

sympathy for innocent parties, and many courts express the belief that such parties should not have recovery barred because of the possible inexactitude of damage calculation.<sup>87</sup> More recently the acceptance of a broader range of proof demonstrates a move toward a reasonable estimate standard for determining the amount of damages in contract actions.<sup>88</sup>

It is difficult to determine which of these interpretations of reasonable certainty is most widely held. Courts have a vast well of options from which to dip, depending on the strength of the reasonable certainty test they require. But it appears that a flexible standard of review is the majority doctrine,<sup>89</sup> with the caveat that every decision is highly fact specific.<sup>90</sup> There are available guideposts, including expert testimony, past

applied arises from acceptance of the doctrine at all.” *Goldfarb v. Campe Corp.*, 164 N.Y.S. 583, 588 (N.Y. City Ct. 1917).

87. See *United States Naval Inst. v. Charter Commc'ns, Inc.*, 936 F.2d 692, 697 (2d Cir. 1991) (“[I]t [i]s not improper, given the inherent uncertainty, to exercise generosity in favor of the injured party rather than in favor of the breaching party.”); *Computer Sys. Eng'g, Inc. v. Qantel Corp.*, 740 F.2d 59, 67 (1st Cir. 1984) (“[W]here defendant's wrongdoing created the risk of uncertainty, the defendant cannot complain about imprecision.” (quoting *Jay Edwards, Inc. v. New England Toyota Distrib.*, 708 F.2d 814, 821 (1st Cir. 1983))); *Morgan v. S. Cent. Bell Tel. Co.*, 466 So. 2d 107, 116 (Ala. 1985) (“[Rule of reasonable certainty] dictates that recovery [for lost profits] will ensue despite the fact damages cannot be calculated with mathematical certainty or without difficulty where they are clearly proximately caused by the wrong.”). But see *Milex Prods., Inc. v. Alra Labs., Inc.*, 603 N.E.2d 1226, 1235 (Ill. App. Ct. 1992) (separating determination of whether defendant's wrongful act caused loss of profit from reasonable certainty determination).

88. See *Burr v. Lichtenheim*, 460 A.2d 1290, 1295 (Conn. 1983) (“[M]ere uncertainty as to the amount of lost profits may be . . . determined approximately upon reasonable inferences and estimates.”).

89. See Robert L. Dunn, *Recovery of Damages for Lost Profits* § 1.8 (2005) (arguing that flexible standard is the general rule). Ohio and Colorado provide two examples of states where their courts seem to apply a flexible standard of judgment. Compare *Pomeranz v. McDonald's Corp.*, 843 P.2d 1378, 1381–82 (Colo. 1993) (holding that damages are not recoverable beyond amount that “plaintiff can establish with *reasonable certainty* by a preponderance of evidence” with leeway allowed “in situations where circumstances make proving the exact amount difficult or impossible”), with *Tull*, 709 P.2d. at 945 (holding that plaintiff may prove amount of damages by providing “reasonable basis for computation and the best evidence obtainable under the circumstances . . . which will enable the trier of facts to arrive at a fairly approximate estimate of the loss” (quoting *A to Z Rental*, 413 F.2d at 908)); and compare *Allied Erecting & Dismantling Co. v. Youngstown*, 783 N.E.2d 523, 535 (Ohio Ct. App. 2002) (“As a general rule, once a plaintiff establishes a right to damages, that right will not be denied because the damages cannot be calculated with mathematical certainty’ . . . . In other words, recovery is precluded only when the existence of damages is uncertain, not when the amount is uncertain.” (citations omitted)), with *City of Gahanna v. Eastgate Props.*, 521 N.E.2d 814, 818 (Ohio 1988) (“[T]he amount of the lost profits, as well as their existence, must be demonstrated with reasonable certainty.”). This exercise could be repeated for most states.

90. See *Vickers v. Wichita State Univ.*, 518 P.2d 512, 517 (Kan. 1974) (“[The] court should approach each case in an individual and pragmatic manner, and require the claimant to furnish the best available proof as to the amount of loss that the particular

financial records, and market surveys,<sup>91</sup> but interpreting these guideposts remains the factfinder's prerogative. Even courts that purport to insist on reasonable certainty may disagree as to the propriety of awards when the evidence of damages falls somewhere on the spectrum between reasonably certain and speculative.

This flexible standard of review makes sense from an efficiency standpoint. The reasonable certainty determination is a decision about whether the prospective cost of granting a nonbreaching plaintiff a damage award could exceed the prospective cost of allowing a breaching defendant to pay no damages.<sup>92</sup> Determining relative costs is a fact-specific inquiry, and the current status quo—first establish fact of breach, then give the plaintiff leeway in damage determination—appears to be an efficient compromise.<sup>93</sup> If a court can make an educated guess about damages, it will. Since the factfinder in many cases is a jury, the reasonable certainty standard gives the court a means of control over jury determinations.<sup>94</sup> Absent sufficient data to make a damage estimate that is at least “reasonable,” the court will fear an inefficient outcome and declare any award too “speculative.”

None of these cases involve an anticipatorily breached long-term contract in a thin market. For example, in this Note's principal case, defendant American Electric Power (“AEP”)—a party eager to find any case on point—argued in their appeal for a looser interpretation of reasonable certainty.<sup>95</sup> The cases involving sales of goods that they cite, how-

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situation admits.”); *Orchid Software, Inc. v. Prentice-Hall, Inc.*, 804 S.W.2d 208, 211 (Tex. App. 1991) (“Whether data exists to show the anticipated profits of a new business to a reasonable certainty will depend on the facts and circumstances of each case.”).

91. See Restatement (Second) of Contracts § 352 cmt. b (1981); see also *Rombola v. Cosindas*, 220 N.E.2d 919, 922 (Mass. 1966) (admitting expert testimony as evidence of damages from failure to race horse); *El Fredo Pizza, Inc. v. Roto-Flex Oven Co.*, 261 N.W.2d 358, 364–67 (Neb. 1978) (surveying pizza chain's financial records as relevant evidence of lost profits).

92. If the nonbreaching party receives a windfall, it may encourage future gamesmanship as parties try to induce breach. It also may slightly discourage overall contracting activity if parties fear that breach may lead to an obligation to pay more than expectation interest. On the other hand, failure to award *any* damages to the nonbreaching party is a windfall to the breaching party and a severe deterrent to contracting activity. Unless the award is far from expectation interests this second effect is likely to overwhelm the first.

93. Most courts actively try to award innocent nonbreaching parties damages and let uncertainty fall against the breaching party. See *supra* note 87. This is why many courts draw the line at refusing speculation. See *supra* note 78 and accompanying text. Speculation gives no assurance that it will not do more harm than no damage award at all.

94. See *supra* note 87 and accompanying text.

95. See Principal and Response Brief of Defendants-Counterclaimants-Appellees-Cross-Appellants at 22–31, *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89 (2d Cir. 2007) (No. 05-4985-cv(L)) [hereinafter AEP, Principal Brief]; Reply Brief of Defendants-Counterclaimants-Appellees-Cross-Appellants at 7–10, *Tractebel*, 487 F.3d 89 (No. 05-4985-cv(L)) [hereinafter, AEP, Reply Brief]; *Tractebel*, Reply and Response Brief, *supra* note 47, at 7–16.

ever, involve thick markets<sup>96</sup> and either short-term contracts or contracts whose terms had expired by the time of decision.<sup>97</sup> The most on-point case AEP could find to discuss the award of future profits was the out-of-circuit *Markowitz & Co. v. Toledo Metropolitan Housing Authority*, a case that involved breach of a twenty-year lease because of personalities and politics, not market volatility.<sup>98</sup>

In sum, the reasonable certainty standard is a useful tool for courts; it is what a court makes of it. It is a tool to achieve an efficient outcome by precluding speculative windfall damages but allowing awards with some basis in fact. The reasonable certainty standard is therefore not a bar to efficient outcomes in cases involving anticipatory breach of long-term contracts in thin markets.

#### IV. THE EFFECT OF LENGTHENING CONTRACTUAL TERM ON ANTICIPATORY REPUDIATION AND REASONABLE CERTAINTY

An odd thing happens as a contract's term is extended outwards and the underlying market thins. The doctrines of anticipatory repudiation and reasonable certainty start to work at cross purposes, and so the application of two efficient rules leads to inefficiency. This Part analyzes the impact of extending contractual term on anticipatory repudiation, on reasonable certainty, and on both together.

##### A. *Impact of Contract Length on Breaching Decision*

The lengthening of contractual term increases the likelihood of anticipatory repudiation. There are two time periods involved in an anticipatory repudiation case: the length of time between repudiation and anticipated performance and the length of time of expected performance. The longer the time between repudiation and breach the more benefit to the nonbreacher.<sup>99</sup> The longer the time of expected contract performance the more benefit to the breacher.<sup>100</sup> In the real world, breachers

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96. See *Markowitz & Co. v. Toledo Metro. Hous. Auth.*, 608 F.2d 699, 705 (6th Cir. 1979) (finding breach of contract in real estate market when housing authority refused to lease apartment complexes); *N.Y. Trust Co. v. Island Oil & Transp. Corp.*, 34 F.2d 653, 653 (2d Cir. 1929) (discussing contract dispute involving 120,000 barrels per month of oil); *John Dimon Corp. v. Fed. Sugar Ref. Co.*, 213 N.Y.S. 106, 107 (N.Y. App. Div. 1929) (discussing contract dispute involving sale of 500 long tons of sugar).

97. See *Markowitz & Co.*, 608 F.2d at 702 (ruling on twenty-year lease—that included termination options every five years—ten years after signing); *N.Y. Trust Co.*, 34 F.2d at 653–54 (denying claim for contract damages in 1929 for two-year oil contract with contractual end date in 1923); *John Dimon Corp.*, 213 N.Y.S. at 107 (finding that contract was signed on August 1, 1922, for delivery in mid-September of same year).

98. See *Markowitz & Co.*, 608 F.2d at 702–04. It is noteworthy too that the court in *Markowitz* refused to award damages for possible increases in future land values as too speculative. *Id.* at 707.

99. See *supra* notes 50–51 and accompanying text.

100. This is a result of anticipatory repudiation's interplay with reasonable certainty. The longer the time of expected contract performance that remains on the contract the

have an advantage; the majority of the cases involving anticipatory repudiation allege repudiation in time frames only weeks or months from anticipated performance.<sup>101</sup> This is not accidental. The breaching party's strategic incentive is to walk a fine line between breach and nonbreach for as long as possible.<sup>102</sup> The nonbreacher's incentive is to gain as much assurance as to breach before bringing suit.<sup>103</sup> This dynamic generally limits the amount of time between anticipatory repudiation and contract performance.

The only factor limiting the length of contract term is that intelligent counsel should be aware that longer contracts create more risks of breach. The continued existence of long-term contracts, however, suggests that some business deals simply require long-term contracts to be possible. In the face of business necessity, each firm's lawyers make a decision to do their best and try to contract around the risks.<sup>104</sup>

This dynamic—that incentives limit the time between anticipatory repudiation and actual performance and fail to limit contract length—suggests that for long-term contracts the benefit conferred on the breacher will still outweigh that conferred on the nonbreacher.

### B. *Impact of Contract Length on Reasonable Certainty*

It is a commonplace proposition that the longer a performance will take “the harder it will be for the parties to foresee the various contingencies that might affect performance.”<sup>105</sup> As a contract term lengthens the unpredictability of future prices grows, even in thick markets.<sup>106</sup> For thin

more uncertainty there is as to the valuation—and thus the likelihood—of any award the breacher will have to pay. See *supra* Part III.D; *infra* Parts IV.B–C.

101. For example, the plaintiff in *Hochster*, the original anticipatory repudiation case, had his contract as a valet cancelled a mere three weeks before he was supposed to depart to Europe with the defendant. *Hochster v. De la Tour*, (1853) 118 Eng. Rep. 922 (Q.B.).

102. See Goetz & Scott, *Mitigation Principle*, *supra* note 54, at 975 (discussing refusal of courts to require damage mitigation prior to actual breach); *supra* notes 48–49 and accompanying text.

103. The doctrine of adequate assurance has grown up specifically to provide the nonbreacher a remedy short of the all-or-nothing solution of suit for anticipatory repudiation. This doctrine encourages efficient reliance. In fact, often when a contract involves multiple deliveries a party will wait until time of first delivery—that is, actual performance—before bringing suit in order to point to an actual concrete breach as evidence. See, e.g., *Cosden Oil & Chem. Co. v. Karl O. Helm Aktiengesellschaft*, 736 F.2d 1064, 1068 (5th Cir. 1984) (describing how Cosden partially performed two of four contracts before repudiation).

104. The dearth of cases involving long-term contracts that reach trial suggests that they are often successful.

105. Posner, *Economic Analysis*, *supra* note 6, at 96.

106. This is one reason why even heavily traded commodities, like oil futures, only include delivery dates less than a decade into the future. See New York Mercantile Exchange, *Light Sweet Crude Oil*, at [http://www.nymex.com/CL\\_spec.aspx](http://www.nymex.com/CL_spec.aspx) (last visited Feb. 10, 2008) (on file with the *Columbia Law Review*) (“Crude oil futures are listed nine years forward . . .”). Beyond a certain time period, prices are simply a guess, and even speculators are not willing to make a random bet.

markets, experts may end up with wide-ranging estimates based on a hodgepodge of variables, resulting in a multiplicity of scenarios. If the only bases of an award are financial experts hired by the parties who must take long-term economic, competitive, technological, and political change into account, then any sort of certainty seems impossible.<sup>107</sup> A judge may not even permit a jury to hear such expert testimony.<sup>108</sup>

C. *The Tension Between Anticipatory Repudiation and Reasonable Certainty in Long-Term Contracts in Thin Markets*

When a court attempts to award damages for anticipatory repudiation of a long-term contract in a thin market the doctrines of anticipatory repudiation and reasonable certainty come into conflict. The conflict is clear: Doctrine and efficiency demand that anticipatory breach lead to payment of expectation damages, but doctrine and efficiency equally demand that these damages be reasonably certain.<sup>109</sup> A court attempting to award damages in this instance will face a choice; it must either stare into the mists of time, pick a number, and hope for the best or else turn back and view the choice as impossible. Learned Hand favored the brave approach: "It is, indeed, one of the consequences of the doctrine of anticipatory breach that, if damages are assessed before the time of performance has expired, the court must take the chance of forecasting the future as best it can."<sup>110</sup> Unfortunately, in context, this quote is squarely dicta.<sup>111</sup> Not only is it unsupported by citation or explanation, but the contract at issue *had already run its course*.<sup>112</sup> The court in that case did not have to look into the future at all. The courts in *Tractebel* did have to look into the future. And when they did, they disagreed about what they saw.

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107. This is the argument that Judge Baer of the Southern District of New York made when denying AEP lost profit damages. See *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731(HB), 2005 WL 1863853, at \*16 (S.D.N.Y. Aug. 8, 2005). Under *Tractebel's* facts it is probably wrong. See *infra* Part V.A.2.c.

108. *Daubert v. Merrell Dow Pharms., Inc.*, 509 U.S. 579, 589 (1993) ("[The] trial judge must ensure that any and all scientific testimony or evidence admitted is not only relevant, but reliable."). But see Dunn, *supra* note 89, §§ 7.16–18 (describing *Daubert* decision and how state courts are split on whether financial experts are scientific experts and thus whether *Daubert* extends to them).

109. See *supra* Parts II, III.

110. *N.Y. Trust Co. v. Island Oil & Transp. Corp.*, 34 F.2d 653, 654 (2d Cir. 1929).

111. Learned Hand began his opinion by stating: "We do not find it necessary to decide whether the [alleged contract breach] constituted an anticipatory breach of the contract." *Id.* Instead, the court held that the contract had not been breached, and thus no damage assessment was even required. *Id.*

112. The time for performance had already expired, thus making Learned Hand's pronouncements about the future unnecessary. *Id.*

V. THE *TRACTEBEL* DECISION: ANATOMY OF LONG-TERM CONTRACT LITIGATION IN A THIN MARKET

Reported decisions awarding or discarding expectation damages for anticipatory breach of long-term contracts are rare, whether in thick or thin markets.<sup>113</sup> Theory suggests, and lack of reported decisions most likely confirms, that many of these cases are settled.<sup>114</sup> And when they are not, the contracts at issue often provide customized damage remedies.<sup>115</sup> In fact, liquidated damages are a disfavored remedy *except* in cases like these when the measurement of expectation damages is uncertain.<sup>116</sup>

This Part explores one such reported case, *Tractebel, Inc. v. American Electric Power, Inc.*<sup>117</sup> *Tractebel* demonstrates in graphic manner the unsettled state of contract law in these situations as courts wrestle with how certain is certain enough for damage awards. The resulting protracted litigation itself is indicative of the doctrinal inefficiencies. This Part begins by examining the facts of the case with the goal of understanding the parties' *ex ante* intent. The facts will be considered in three distinct periods: 1) the optimistic period of contract signing before the collapse of the energy market, 2) the period of renegotiation, and 3) the period of opportunism and intransigence leading to breach. After examining these facts, this Part will analyze the district court's opinion and unearth and discuss the bases for its denial of future profits as damages. It will then analyze the Second Circuit's reversal of this opinion and conclude that the Second Circuit correctly reversed the district court as a matter of doctrine and policy. However, it will also conclude that the Second Circuit

113. See *supra* notes 95–98 and accompanying text.

114. See John P. Gould, *The Economics of Legal Conflicts*, 2 *J. Legal Stud.* 279, 286, 291 (1973) (suggesting that cases settle because expected costs of litigation often exceed parties willingness to pay to “bet” on the outcome of litigation); Posner, *Economic Approach*, *supra* note 54, 417–18 (explaining that cases fail to settle only where plaintiff's expected value of litigation, factoring in court costs, plus settlement costs, is greater than defendant's expected litigation losses, including courts costs, minus settlement costs). See generally Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 *J. Econ. Literature* 1067, 1075–82 (1989) (reviewing law and economics literature on choice between settlement and litigation).

115. In the 1980s the deregulation and the subsequent collapse of natural gas prices led to anticipatory repudiation of several long-term natural gas contracts. A few of these repudiations were litigated and brought to trial. These contracts were predominantly written as take-or-pay contracts. Litigation focused on whether the pay clause acted as an alternative damage remedy. See, e.g., *Roye Realty & Developing, Inc. v. Arkla, Inc.*, 863 P.2d 1150, 1155–59 (Okla. 1993).

116. See *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289–90 (7th Cir. 1985) (explaining that if “the actual damages from a breach of contract after the breach occurs” are “easy to determine” or “a reasonable upper estimate of what the damages are likely to be,” then liquidated penalty clause is invalid under Illinois law).

117. 487 F.3d 89 (2d Cir. 2007); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586 (S.D.N.Y. Jan. 20, 2006); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 (HB), 2005 WL 1863853 (S.D.N.Y. Aug. 8, 2005).

has overstated current New York state contract law and done nothing to aid the factfinders who must struggle to arrive at an efficient level of damages.

#### A. *Facts*

The disputants in *Tractebel* were Tractebel Energy Marketing, Inc. (TEMI), the U.S. energy marketing subsidiary of a large European power producer, and American Electric Power (AEP), one of the largest utilities in the United States.

1. *The Period of Optimism: Negotiation to Market Collapse.* — On November 15, 2000, a Power Purchase and Sale Agreement (PPSA), a contract, was signed by AEP and TEMI.<sup>118</sup> Under the terms of this agreement, AEP would construct a \$500 million cogeneration facility on the site of a Dow Chemical plant and operate it for TEMI's benefit.<sup>119</sup> Without the agreement AEP had no plans to construct this plant; the PPSA was a but-for cause of the cogeneration facility's construction.<sup>120</sup> TEMI gained the right to market most of the power generated and gain access to it at prices fixed by contract.<sup>121</sup> TEMI's plan was to resell this electricity at a higher price than the contract price.

At the time there was great optimism in the power industry.<sup>122</sup> It was believed that states would deregulate their utilities, and electricity would become a tradeable commodity fuelling growth in earnings.<sup>123</sup> TEMI signed this contract as part of an express strategy to "own or control" 20,000 megawatts of generating capacity in North America by 2004," presumably to have a stake in the game for electricity trading purposes.<sup>124</sup>

The seeds of this contract's remarkable demise—breaking down before even the first day of its twenty-year period—were planted in the optimistic soil of this period. The PPSA, by not utilizing basic contract

118. See AEP Power Mktg., Inc. & Tractebel Energy Mktg., Inc., Power Purchase and Sales Agreement 1 (Nov. 15, 2000) (unpublished contract, on file with the *Columbia Law Review*) [hereinafter, PPSA]; AEP, Principal Brief, *supra* note 95, at 5–6.

119. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*1–\*2.

120. AEP, Principal Brief, *supra* note 95, at 5–6.

121. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*1 ("AEP had the 'sole and exclusive right' to operate the Facility, and TEMI had the 'exclusive right' to the products it was to purchase under the PPSA.").

122. *Id.* ("The Plaquemine facility was conceived at a time of great optimism about the future of electricity prices.").

123. See, e.g., Matthew C. Quinn, Southern Foresees Smoother Trading, *Atlanta J. Const.*, June 26, 1999, at D12 (describing need to control generating sources in trading business so as to avoid wholesale price spikes). Despite this drumbeat, there were a number of easy-to-spot omens in the marketplace. Notably the California energy market fiasco in the summer of 2000 should have signaled that deregulation's momentum was idling. See James Sterngold, California Governor Offers a Plan to Save State from Energy Crisis, *N.Y. Times*, Jan. 9, 2001, at A1 ("Calling California's two-year experiment in electricity deregulation a 'colossal and dangerous failure,' Gov. Gray Davis proposed several major steps today to reassert the state's control over its power market.").

124. AEP, Principal Brief, *supra* note 95, at 5.

adjustment mechanisms, failed to anticipate any chance of serious market reversal. There were three major structural weaknesses in the PPSA: pricing, its guaranty clause, and its remedy provision.

a. *Pricing*. — Perhaps the most remarkable element of the PPSA was the pricing mechanism to which the parties agreed. The contract laid out quite detailed pricing calculations for four separate products, using both actual and target availability figures.<sup>125</sup> When these formulas are decoded, however, it turns out that the nominal price per megawatt hour is not only fixed but *escalating*.<sup>126</sup> The contract contained no mechanisms for renegotiation or pricing adjustment.<sup>127</sup> Ex ante it seems that AEP cared most about locking in a consistent revenue stream via fixed prices and TEMI cared more about ensuring timely delivery of power than pricing flexibility. Neither party planned for the possibility of a price decline.

b. *Guaranty*. — The contract did include a guaranty clause as a safeguard against preemptive breach.<sup>128</sup> The parties initially provided a guaranty of \$50 million against possible default with a mechanism for increasing it should one party believe the amount at risk to be greater than \$50 million.<sup>129</sup> This type of safeguard is a common one in many commercial contracts.<sup>130</sup> To be effective, however, the guaranty must approach the

125. PPSA, *supra* note 118, § 5.1–4.

126. To take one example, the baseload capacity payment price is defined as “the sum of (a) the capital recovery payment price and (b) the fixed O&M payment price, each . . . set forth in Exhibit 1.25.” *Id.* § 1.25. Exhibit 1.25 contains tables outlining the peak and non-peak baseload price for each year of the twenty year contract term. *Id.* at Exhibit 1.25. Each pricing schedule increases annually at 2%. It appears from this that the parties established a base price and then attempted to keep it roughly flat in real terms for the life of the contract. The four products were baseload capacity, baseload augmentation capacity, gas peaking capacity, and steam peaking capacity. See *id.* §§ 3.1–4, 5.1–4, Exhibits 1.16, 1.25, 1.88, 1.145.

127. Price adjustment mechanisms, price indexing, and cancellation provisions are common contract clauses. Even the controversial *Alcoa* contract, also involving a long-term contract, indexed its prices. *Aluminum Co. of Am. (Alcoa) v. Essex Group, Inc.*, 499 F. Supp. 53, 58–59 (W.D. Pa. 1980). It just indexed them to an index that became radically misaligned with the parties’ intent. *Id.*

128. PPSA, *supra* note 118, § 7.3.

129. *Id.*

130. This guaranty mechanism is quite similar to the adequate assurance that parties in sales of goods are allowed to receive under U.C.C. § 2-609. U.C.C. § 2-609 (2006) (“When reasonable grounds for insecurity arise with respect to the performance of either party the other may . . . demand adequate assurance of due performance and until he receives such assurance may . . . suspend any performance for which he has not already received the agreed return.”). In fact, adequate assurance is tied to anticipatory repudiation as adequate assurance is one means that parties use to discover breach or nonbreach in situations where they have not received the unequivocal breach that the doctrine demands. See *supra* note 48. Even absent explicit contractual guaranties or statutory authority, courts have found common law rights to adequate assurance in electricity contracts. See *Norcon Power Partners v. Niagara Mohawk Power Corp.*, 705 N.E.2d 656, 662 (N.Y. 1998).

expected termination fee.<sup>131</sup> It is not clear from the record why the parties chose \$50 million as the guaranty, but since this money was the most important device safeguarding the contract, it appears that ex ante the parties anticipated a relatively stable electricity pricing environment.

c. *Remedy*. — Despite the many judicial restrictions on liquidated damages, this contract is exactly the type suitable for such a remedy.<sup>132</sup> A liquidated damage clause is one that prescribes in the contract the damages to be paid upon breach.<sup>133</sup> Such a clause in the PPSA would have avoided the entire central problem of this case—the determination of damage amount. In a case like this, a strong argument can be made that liquidated damages are the most efficient solution.<sup>134</sup> But the parties opted instead for a cookie-cutter damage clause that limits “obligor’s liability . . . to direct actual damages only” and excludes consequential damages.<sup>135</sup> The impact of this clause is minimal.<sup>136</sup> Ex ante, the parties contemplated expectation damages.

131. As long as the guaranty is the same or larger than expected damages, parties lack any incentive to breach and risk losing the guaranty. In the PPSA, the termination payment roughly equates to the contract law remedy of expectation damages. See PPSA, supra note 118, at Exhibit 7.12 (“[To determine] the value of the projected Termination Payment . . . : Gains and Losses with respect to a Product shall be computed by reference to (a) the difference between the Contract Price and the market price for such Product, and (b) the relevant contract quantity.”).

132. Courts have not been hesitant to throw out any liquidated damage provision that hints of punishment. Scholars, and some judges, regularly describe this doctrine as paternalistic, unnecessary (at least with regard to commercially sophisticated parties), and inefficient. See, e.g., *Cal. & Hawaiian Sugar Co. v. Sun Ship, Inc.*, 794 F.2d 1433, 1438 (9th Cir. 1986) (arguing that “the desire of courts to avoid the enforcement of penalties” should not prevent the enforcement of contractual promises). Courts permit liquidated damages, however, when expectation damages are unclear. E.g., *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1289 (7th Cir. 1985) (rejecting liquidated damage clause, but finding that Illinois law allows such clauses in cases where liquidated damages are reasonable estimation of damages and need for estimation is shown by “reference to the likely difficulty of measuring the actual damages . . . after the breach occurs”). Given the struggles of proof and wide variance in results during the damage portion of *Tractebel*, this case seems an ideal candidate for a liquidated damage clause. Such a clause could be based on market price at the time of breach, modifications of existing forward-price curves, or a fixed sum.

133. See Scott & Kraus, supra note 23, at 979.

134. See Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 *Colum. L. Rev.* 554, 559 (1977) (arguing that contracting parties “have incentives to negotiate liquidated damages clauses whenever the costs of negotiating are less than the expected costs [of reliance] on the standard damage rule” and noting that this situation may occur when damages are hard to estimate and parties “wish to allocate anticipated risks”).

135. PPSA, supra note 118, § 13.1.

136. Its impact is to leave the expectation damages default rule in place without clarifying in any way how it should be applied. Neither the district court nor the circuit court referenced or relied on this clause. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89 (2d Cir. 2007); *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586 (S.D.N.Y. Jan. 20, 2006); *Tractebel Energy*

i. *Market Crash: The Period of Renegotiation.* — Within months of signing the PPSA, TEMI was disabused of the notion that the electricity market price was stable. None of their optimistic strategic assumptions came to fruition: The regulatory environment remained in stasis without further liberalization;<sup>137</sup> Enron collapsed, taking a good portion of energy trading liquidity and forward contracts with it;<sup>138</sup> and copycat business strategies led to a major surplus of generating power in the Entergy region.<sup>139</sup>

These developments led prices to collapse. When the deal was finalized in March 2002, TEMI projected an \$80 million positive net present value for the deal.<sup>140</sup> By September, after a span of six months, the same valuation method projected a net present value of negative \$360 million.<sup>141</sup>

It was clear that TEMI had deeply miscalculated, and it proceeded to do all it could to renegotiate the contract. It sought to eliminate the gas peaking product from the agreement<sup>142</sup> and to renegotiate the prospective delivery start dates for replacement products and actual delivery of products from the Plaquemine facility.<sup>143</sup> Lacking leverage, TEMI was

Mktg., Inc. v. AEP Power Mktg., Inc., No. 03 Civ. 6731(HB), 2005 WL 1863853 (S.D.N.Y. Aug. 8, 2005). This is particularly odd since the January reconsideration opinion relied extensively on a characterization of AEP's possible damages as consequential lost profits, a valuation specifically forbidden by this clause. *Tractebel Energy Mktg.*, 2006 WL 147586, at \*2–\*3.

137. Compare Eric Schmitt, Sides Square off on Decontrolling Electricity Sales, N.Y. Times, Apr. 14, 1997, at A1 (describing debate within Congress over attempt to pass federal electricity deregulation bill), with Tommy Denton, Making a Play for Fat Corporate Earnings, Roanoke Times, Jan. 30, 2007, at B9 (“Yet a gathering political storm in other parts of the country reflects considerable disillusionment with the siren song of electricity deregulation.”).

138. See World Gas Intelligence, Enron Effects Still Felt in US Energy Sector (Jan. 3, 2007) (“[After Enron’s collapse] such merchant dynamos as Aquila, Dynegy, El Paso, Reliant and Williams struggled to avoid Enron’s fate. Thousands lost their jobs, paper trading slowed on both sides of the Atlantic, and corporate strategies of the merchants were reined in to encompass mainly operation of regulated assets.”).

139. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*1 & n.3 (describing creation of “glut of excess capacity within the Entergy region” and describing Entergy as “a large energy utility located in the southern United States[, which] is also the transmission service provider in the area where the Plaquemine plant is located”).

140. *Id.* at \*2.

141. *Id.* Judge Baer in his district court opinion suggests that ex post, after the price drop, AEP’s conduct “can best be described as an attempt to maximize its profits by gaining the upper hand in the relationship.” *Id.* at \*1. One can speculate that ex ante AEP, a major U.S. utility with significant generating, marketing, and trading expertise, better valued the risks and outnegotiated TEMI, which lacked the full range of AEP’s expertise. But in a commercial setting involving big companies with lots of experience and outside counsel, it is difficult to extend much sympathy in TEMI’s direction.

142. *Id.* at \*2.

143. The first part of the contract was to come into effect in May 2003 with TEMI possibly obligated to purchase replacement products from AEP at that time (this was a major issue in the litigation). *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89, 103–07 (2d Cir. 2007) (holding that TEMI had, in fact, no *obligation* to purchase

not successful in changing the contract.<sup>144</sup> It was at this point that one TEMI employee declared in an email regarding the contract: “WE WANT OUT!”<sup>145</sup>

By April 2003, the present value of TEMI’s expected losses over the life of the contract exceeded \$700 million.<sup>146</sup> TEMI now changed tactics and began to negotiate with a coming “legal solution” in mind.<sup>147</sup>

ii. *Path to Litigation: Strategic Obstruction.* — From April 2003 until the first lawsuit was filed in September 2003, TEMI adopted a strategy of obstruction. As part of this strategy TEMI refused delivery of replacement products that it was arguably required to accept and refused to increase the guaranty as required by the contract.<sup>148</sup> It also began to negotiate strategically regarding the protocol needed to operate the PPSA.<sup>149</sup> In September 2003 TEMI filed suit for breach first alleging that AEP’s failure to complete the protocol was the cause of breach.<sup>150</sup> AEP countersued.<sup>151</sup> This contract failed because neither party anticipated contingencies. In the end, events endogenous—the terms of the contract—and exogenous—the collapse of energy prices—led to a lawsuit seven months before the Plaquemine facility was even completed.<sup>152</sup>

replacement products during pre-startup period); *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*6 (describing TEMI’s refusal to accept substantially equivalent replacement products). Actual delivery of products from the new Plaquemine facility was scheduled to begin in April 2004. *Id.* at \*6; PPSA, *supra* note 118, § 1.3. TEMI sought to eliminate the earlier date and push the second date further into the future. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*2.

144. Most of the proposed contract changes would have come out of AEP’s pocket with little benefit for them. TEMI was not willing to share much of the savings from these proposed changes. The district court found surprising that of projected savings from one change of \$29 to \$39 million TEMI offered AEP “just \$10 million” to make the change. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*2.

145. *Id.* at \*2.

146. *Id.* at \*2. While not explicit in the opinion, most of the ~\$800 million swing in TEMI’s valuation of the project would have passed to AEP. As energy prices collapsed AEP still had a twenty-year supply contract with prices well above market rates. Also unnoted in the opinion is that a large portion of the revenue was related to “capital recovery payment price” in order for AEP to recover its upfront outlays. PPSA, *supra* note 118, at Exhibit 1.145.

147. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*2. (quoting TEMI chief negotiator informing board that “legal solution” was likely outcome).

148. 487 F.3d at 103–07; *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*4–\*6.

149. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*3–\*4.

150. *Id.* at \*1.

151. *Id.*

152. The actual completion date for the Plaquemine plant was April 2004. *Id.* at \*6.

### B. District Court Decision

The district court made two findings. The first was that TEMI breached the contract. The second was that future damages for this breach were too speculative to award.<sup>153</sup>

1. *Breach Decision.* — The court was unequivocal as to TEMI's responsibility for contract breach. After a thorough analysis, the court rejected each of TEMI's five alternative claims that AEP had first breached the contract, describing them as a "house of cards."<sup>154</sup> Since TEMI's defense hinged on AEP's breach excusing its own, each of AEP's four claims was accepted.<sup>155</sup> TEMI was held to have breached the PPSA.<sup>156</sup>

2. *Remedy Decision.* — In the wake of TEMI's breach, the district court was left to fashion a damage remedy for a contract involving a thin market with almost eighteen years left to run.<sup>157</sup> Instead, it ruled that AEP's future damages were too "speculative" to award.<sup>158</sup> Three arguments are critical to this holding: The damages AEP sought were consequential lost profits damages; these damages were "new business" damages; and AEP's damage expert's calculation failed to satisfy the reasonable certainty standard. As this Note will illustrate, the Second Circuit correctly rejected all three arguments but failed to bring any certainty to the reasonable certainty standard.

a. *Consequential Lost Profits.* — The original district court opinion made no mention of consequential lost profits. It did refer to AEP's claim as one for lost profits, but it correctly defined this term as the difference "between the payments TEMI was required to make to AEP under the PPSA and the market value of the products TEMI was purchasing."<sup>159</sup>

Nevertheless, in the January district court opinion on motion for reconsideration, AEP's claim is characterized as one for "consequential damages."<sup>160</sup> The court argues that despite the "well defined" distinction

153. The district court did award damages for TEMI's failure to make gas peaking amendment payments or pay for replacement products or post-COD products. *Id.* at \*12–\*13. The Second Circuit, however, reversed the damage award for replacement products. *Tractebel Energy Mktg., Inc.*, 487 F.3d at 108.

154. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*7–\*12.

155. *Id.* at \*12.

156. *Id.*

157. The decision was handed down in August 2005 and the contract was supposed to run from May 2003 to May 2023. *Id.* at \*1, \*6.

158. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*13–\*16.

159. *Id.* at \*13 n.9.

160. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586, at \*2 (S.D.N.Y. Jan. 20, 2006). This result possibly stems from too casual judicial use of the term "lost profits." In contract law "lost profit damages" is often a term of art that refers to foreseeable *consequential* damages stemming from breach. The Restatement uses the term in this limited way. Restatement (Second) of Contracts § 352 cmt. b (1981). See also *Drews Co. v. Ledwith-Wolfe Assocs., Inc.*, 371 S.E.2d 532, 535 (S.C. 1988) ("The same standards that have for years governed lost profits awards in South Carolina will apply with equal force to cases where damages are sought for a new business . . ."). An example of lost profit damages is when a package deliverer is told that failure to

between general and consequential damages, the application of this distinction is more “elusive.”<sup>161</sup> It concludes that these are consequential damages because “the amount of damages sought by AEP resembles most closely consequential damages,” and “[m]ost of all, the proof is speculative.”<sup>162</sup> But the amount of damages and the level of proof of those damages have nothing to do with whether they are general or consequential.<sup>163</sup>

b. *New Business Damages.* — The August district court opinion claimed to draw support for its conclusion that damages were too speculative to award from its holding that “the Plaquemine Project appears to be a new business,”<sup>164</sup> and thus a “stricter standard is imposed.”<sup>165</sup> It drew this conclusion because AEP and TEMI had never jointly operated a facility before, both were entering a new market, and there was no established customer base.<sup>166</sup> The precedent cited, however, involved the launch of an entirely new cable news channel with no proof that plaintiffs were capable of operating a business of that scale, nor of potential audience.<sup>167</sup> The new business rule is generally applied to companies where the market for their product is uncertain, not to established companies, like America’s largest electricity generator, entering established markets within its expertise with new facilities.

c. *Too Speculative to Meet the Reasonable Certainty Standard.* — The core of the district court’s damage decision was its rejection of both parties’ expert calculations as too speculative. The court did not credit either side’s expert testimony, comparing use of these expert opinions to the

deliver a package according to the contract terms will lead to two days of business closure. The deliverer breaches and the business closes for two days. The deliverer is liable for two days of *lost profits*. This is the implication of the original consequential lost profits case *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Ex.).

“Lost profits,” however, is also used by courts to refer to the profit expectation of the nonbreaching party; in other words, expectation damages. This is the definition used in Robert L. Dunn, *supra* note 89, § 6.1 (“Lost profits damages are usually defined as . . . the contract price less cost of performance . . . or, as it is sometimes put, ‘expenses saved’ as a result of plaintiff’s being excused from performance by the other party’s breach.”). This imprecise use of language has led to courts confusing the foreseeability and certainty doctrines. *Schonfeld v. Hilliard*, 218 F.3d 164, 176–77 (2d Cir. 2000) (“Some of [the conflation of consequential lost profits and general damages] is traceable to the law of evidence. The same kind of market-value proof is sometimes required to prove general damages as to prove “hybrid” damages for the loss of an income-producing asset.”).

161. *Tractebel Energy Mktg.*, 2006 WL 147586, at \*2 (citation omitted).

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

163. As the court admits, the distinction between consequential and general lost profit damages is “well defined.” *Id.* Damage that is incidental to the breach, or a side effect of the breach, is consequential. Damage that is “the value of the very performance promised” is general. *Schonfeld*, 218 F.3d at 175–76 (citation and internal quotation marks omitted).

164. *Tractebel Energy Mktg., Inc.*, 2005 WL 1863853, at \*16.

165. *Id.* at \*13 (citation and internal quotation marks omitted).

166. *Id.* at \*16.

167. *Schonfeld*, 218 F.3d at 173.

use of “tealeaves or a crystal ball.”<sup>168</sup> It utterly rejected TEMI’s expert as “not grounded in reality” and admitted that “[i]f one had to choose, [AEP’s expert’s] pedigree suggests that he is better equipped to project lost profits.”<sup>169</sup> But it rejected both experts, including the more credible AEP expert, for three reasons. The first was that “[i]t is inherently speculative to determine lost profits by any business over a period of twenty years.”<sup>170</sup> As a result, all estimates lacked the reasonable certainty required.<sup>171</sup> The second was the inability to use the “usual technique[s]” of profit estimation: Forward price projection (i.e., thick markets) was not available.<sup>172</sup> Instead, only by presaging “a vast and varied body of facts” could one arrive at a revenue number with any reasonable certainty.<sup>173</sup> Finally, the court declared the AEP expert suspect because he:

could still only muster an estimate of lost profits falling somewhere between \$417 and \$604 million. Thus, we are left with a gap of \$187 million dollars between the low- and high-end estimates of AEP’s possible lost profits. Although the term “reasonable certainty” brings with it a measure of flexibility, it does not include a margin of error of hundreds of millions of dollars.<sup>174</sup>

The Second Circuit rejected each of these three rationales for refusing to find lost profits damages, but it did not resolve the tension between anticipatory breach and reasonable certainty.

### C. *Second Circuit Decision*<sup>175</sup>

In its decision, the Second Circuit first carefully walked through the evidence and the district court’s logic and affirmed its decision that the PPSA was enforceable and that AEP acted in good faith.<sup>176</sup> TEMI was therefore liable for damages. The Second Circuit then, as a matter of contract interpretation reviewed *de novo*, reversed the district court’s determination that TEMI was obligated to pay for replacement products offered before the actual completion of the cogeneration facility; it

168. *Tractebel Energy Mktg.*, 2005 WL 1863853, at \*16.

169. *Id.* at \*14–\*16. The TEMI expert came to the laughable conclusion that AEP *gained* \$300 million from TEMI’s breach. This begs the question: Then why did TEMI breach?

170. *Id.* at \*16.

171. See *supra* note 78 and accompanying text.

172. *Tractebel Energy Mktg.*, 2005 WL 1863583, at \*16.

173. See *id.* at \*16. These facts included assumptions regarding the “price of electricity,” the competitive position of competing forms of power generation, technological advances, and regulatory and political developments. *Id.*

174. *Id.*

175. This opinion came almost a year and a half after Judge Baer’s final damages decision. The Second Circuit panel consisted of Judges Robert Sack, Sonia Sotomayor, and Richard Wesley. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89 (2d Cir. 2007).

176. *Id.* at 94–103.

viewed the replacement products provision as an option for TEMI.<sup>177</sup> The only question remaining was whether TEMI was liable for lost profit damages or whether the district court's decision would stand.

The Second Circuit correctly rejected the district court's remedy logic. Doctrinally, the Second Circuit relied on New York case law that ostensibly limits the reasonable certainty doctrine only to "reasonable certainty as to the existence of damages," not as to their amount. It needs to be noted that this *Wakeman* doctrine, in effect, only modifies the general rule by providing a rebuttable presumption of damages against the breaching party. As we will see, it is only a slight improvement on the status quo in most states. The Second Circuit also rejected the district court's decision on policy grounds; it correctly identified the district court's remedy as resulting in an outcome less efficient than the status quo.

1. *The Wakeman Doctrine and New York State Reasonable Certainty Doctrine in Practice.*

a. *Rejection of District Court's Legal Rationale.* — The Second Circuit quickly rejected the contention that AEP sought consequential lost profits, with the resulting high evidentiary standard.<sup>178</sup> Instead, it found that the damages AEP sought were simply the benefit of the bargain signed by AEP and TEMI<sup>179</sup> and that this benefit was the difference between the contract price and the market, or mitigation, price.<sup>180</sup> The court found that the characterization of AEP's claim as one of consequential lost profits was wrong.<sup>181</sup>

The Second Circuit was even more cursory as to the district court's argument about new business damages: It ignored it. It was justified in doing so because of the district court's determination that the Plaquemine facility's status as a new business only "reinforced" its conclu-

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177. *Id.* at 103–08. This decision is not necessarily correct. It emphasizes the purpose of the replacement products provision from TEMI's perspective, participation in the market, at the expense of AEP's reliance on the capacity payments provision to provide money to payoff AEP's upfront capital expense. It also had the effect of eliminating the \$116.5 million award of the district court; thus if AEP was to receive any compensation, it would have to come from the general damages estimate.

178. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 HB, 2006 WL 147586, at \*2 (S.D.N.Y. Jan. 20, 2006) (stating that consequential lost profits require a more difficult evidentiary standard to meet than general damages).

179. *Tractebel Energy Mktg.*, 487 F.3d at 109–10 (arguing that "[t]he profits are precisely what [AEP] bargained for"); see PPSA, *supra* note 118, § 7.2.

180. See *supra* note 159 and accompanying text.

181. This was recognized even at Second Circuit oral arguments, which the author observed. Judge Sachs noted that not only was this not a case of consequential lost profits, but that the contract excluded these anyway. Also, there is in fact no difference in the reasonable certainty standard as applied to proof of general damages versus proof of consequential damages. The distinction is that proof of consequential damages demands a totally separate foreseeability inquiry. See *Tractebel Energy Mktg.*, 487 F.3d at 109 (citing *Hadley* for proposition that requirements for consequential damages are certainty as to existence of damages, reasonable certainty as to amount of damages, and foreseeability).

sion that damages were too speculative to award.<sup>182</sup> In other words, the conclusion about being a new business was dicta. It was also almost certainly wrong: America's largest electricity generator selling electricity into the power grid from a new plant is not the typical new business rule situation where the very existence of a market for the new product is uncertain.

In fact, the court went even further and argued that the district court had ignored a long line of relevant legal precedent embodied in the doctrine articulated in *Wakeman v. Wheeler & Wilson Manufacturing Co.*<sup>183</sup> The court then explained how this doctrine eliminates the need for reasonable certainty when assessing damages.

b. *The Wakeman Doctrine and Reasonable Certainty.* — The Second Circuit recognized *Wakeman's* 120-year-old precedent, which held that:

[W]hen it is certain that damages have been caused by a breach of contract, and the only uncertainty is as to their amount, there can rarely be good reason for refusing, on account of such uncertainty, any damages whatever for the breach. A person violating his contract should not be permitted entirely to escape liability because the amount of the damage which he has caused is uncertain.<sup>184</sup>

Because the breacher should not be permitted to entirely escape liability, the courts established the corollary doctrinal proposition that “the burden of uncertainty as to the amount of damage is upon the wrongdoer.”<sup>185</sup> In order to effectuate this rule, the standard for damage awards is relaxed from reasonable certainty, and all that is required is a “stable foundation for a reasonable estimate of [damages].”<sup>186</sup>

The Second Circuit went further than past courts, however, and remarked that “‘certainty,’ as it pertains to general damages, refers to the *fact* of damage, not the amount.”<sup>187</sup> This seems to provide an important degree of clarity to reasonable certainty doctrine—clarity not present in the doctrines of other states.<sup>188</sup> But certainty as to the fact of damage and certainty as to the amount of damage cannot be so carefully divided.<sup>189</sup> There are many instances where the expected value of a contract is positive, but there is a probability, often a high one, that there will

182. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 (HB), 2005 WL 1863853, at \*16 (S.D.N.Y. Aug. 8, 2005).

183. *Tractebel Energy Mktg.*, 487 F.3d at 112 (citing *Wakeman v. Wheeler & Wilson Mfg. Co.*, 4 N.E. 264, 266 (N.Y. 1886)).

184. *Wakeman*, 4 N.E. at 266.

185. *Contemporary Mission, Inc. v. Famous Music Corp.*, 557 F.2d 918, 926 (2d Cir. 1977).

186. *Freund v. Washington Square Press, Inc.*, 314 N.E.2d 419, 421 (N.Y. 1974).

187. *Tractebel Energy Mktg.*, 487 F.3d at 110.

188. See *supra* Part III.D.

189. See *Contemporary Mission, Inc.*, 557 F.2d at 928 n.17 (admitting that “[t]he determination . . . of whether the existence of damage is certain or speculative, will always be influenced to some extent by the nature of the plaintiff’s proof as to the amount of damage” (emphasis omitted)).

be no actual damages. In other words: Is it the high probability of some damage or the low probability of very high damages that provides the requisite certainty as to the existence of damages? New York is silent on this point.

Instead, New York courts use the rule of thumb that evidence of breach is evidence of damage certainty.<sup>190</sup> Otherwise, the fairly empty distinction between fact of damage and amount of damage is a clue that in practice New York doctrine is not substantially different from other states' doctrines. Other states' courts grant themselves wide discretion by employing a variable standard for assessing contract damages.<sup>191</sup> They use the terms "reasonably certain" or "reasonable estimate" as necessary.<sup>192</sup> New York uses only one standard: Its courts insist that once the fact of damages is proven the courts should employ a liberal "reasonable estimate" standard when assessing their amount.<sup>193</sup> This, however, has two wide loopholes. The first is that even in New York, damages that are too "speculative" are not awarded.<sup>194</sup> Cases concerning items that involve "taste or fancy for success"—such as books, movies, and theater, for example—are the paradigm cases in New York for those that lack even a "stable foundation for a reasonable [damages] estimate."<sup>195</sup> In the famous case of *Freund v. Washington Square Press* an established (though far from best-selling author) was awarded no damages, despite the finding that his publisher had breached the contract, because he had been unable to provide this requisite "stable foundation."<sup>196</sup> Damages certainly did exist, but, despite having past sales as a reference point, the court refused to find damages. The second loophole is that courts can argue in close cases that the existence of damages was uncertain and not even reach the issue of amount of damages. The result is that these contract cases do not reach the damages stage as courts find no breach. The net result is that New York courts retain the same wide discretion as their brethren in other states to award or not award damages based on an assessment of certainty.

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190. Courts need not be explicit about this point. The Second Circuit's opinion argued that "[t]he district court impliedly found that AEP suffered at least some damage" because it rejected the contention that AEP benefited from TEMI's breach. *Tractebel Energy Mktg.*, 487 F.3d at 111 n.24. Again, whether this means the balance of probabilities was that AEP was harmed or the expected value of the harm was positive towards AEP is left undiscussed.

191. See *supra* notes 76–88 and accompanying text.

192. See *supra* notes 76–88 and accompanying text.

193. *Tractebel Energy Mktg.*, 487 F.3d at 111.

194. See *Freund v. Washington Square Press, Inc.*, 314 N.E.2d 419, 421 (N.Y. 1974) ("His expectancy interest in the royalties—the profit he stood to gain from sale of the published book—while theoretically compensable, was speculative. . . . [H]is claim for royalties falls for uncertainty.").

195. *Contemporary Mission, Inc. v. Famous Music Corp.*, 557 F.2d 918, 926 (2d Cir. 1977) (quoting *Freund*, 314 N.E.2d at 421).

196. *Freund*, 314 N.E.2d at 421.

The only difference that this New York language makes relative to other states is that it appears to provide a presumption of damages once the court finds that a breach occurs. Unless there is no stable foundation for a damage award, which primarily acts to throw out contracts based in the arts, or no certainty as to the existence of damage, which throws out contract disputes where no breach is found, the assumption is that the trial court should award damages.

2. *Rejection of District Court's Remedy as Inefficient on Policy Grounds.* — On appeal, AEP emphasized the dire policy consequences of the district court's lost profit determination. It argued: "All hyperbole aside, hanging in the balance is the viability of long-term commercial contracts."<sup>197</sup> The Second Circuit agreed and recognized that overturning the district court's decision was needed to ensure a more efficient outcome to the tension between anticipatory breach and reasonable certainty.<sup>198</sup> If the district court were correct—that "[i]t is inherently speculative to determine lost profits by any business over a period of twenty years"<sup>199</sup>—then the result would be a heretofore unknown per se rule against the award of expectation damages in long-term contracts.<sup>200</sup> Policy concerns counsel against this holding.<sup>201</sup>

As part of this holding, the Second Circuit correctly dismissed the district court's argument that the AEP expert's provision of a range makes his calculation suspect as simply wrong.<sup>202</sup> Over a twenty-year period, it would be more surprising if the expert had *not* provided a range—even small variations in the discount rate used by AEP's expert would create large variations in the range of outcomes.<sup>203</sup> To claim that a range of values defeats the claim is to change the reasonable certainty test into a contra precedent "mathematical certainty" or "absolute certainty" test.<sup>204</sup>

197. AEP, Principal Brief, *supra* note 95, at 4. This, of course, was hyperbole.

198. See *Tractebel Energy Mktg.*, 487 F.3d at 112 ("It is not the case that all such contracts may be breached with impunity because of the difficulty of accurately calculating damages.").

199. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731(HB), 2005 WL 1863853, at \*16 (S.D.N.Y. Aug. 8, 2005).

200. Courts use the word "speculative" when they want to declare something not reasonably certain. See *supra* note 78 and accompanying text. To declare something "inherently speculative" is thus to create a per se rule against awarding damages. No other court has suggested that long-term contracts are inherently speculative.

201. If long-term contracts are inherently speculative and this makes it impossible to award future damages, then long-term contracts without liquidated damages clauses are unenforceable. Unenforceability of parties' intentions, the antithesis of contract law, is a severe deterrent to contract formation. See *supra* notes 24–31 and accompanying text.

202. See *Tractebel Energy Mktg.*, 487 F.3d at 112 (pointing out that "[t]he variables identified by the district court exist in every long-term contract").

203. See Christopher P. Bowers, *Courts, Contracts, and the Appropriate Discount Rate: A Quick Fix for the Legal Lottery*, 63 U. Chi. L. Rev. 1099, 1100 (1996) ("[A] difference of 1 percent or less in the discount rate used in the present value calculations can result in millions of dollars lost or gained in a damage award.").

204. See *supra* notes 81–82 and accompanying text.

The strongest argument that the district court made in support of its holding was that the usual techniques of estimation were unavailable. It is true that the techniques used to calculate damages in a thick market were not available.<sup>205</sup> But any valuation of a long-term contract in a thin market requires this sort of analysis, and thus any expert's work is likely to be sensitive to many variables.<sup>206</sup> To refuse expert analysis on this basis, however, is again to throw up one's hands and admit defeat.<sup>207</sup> If expert analysis is capable of arriving at an answer close to the parties' true expectation, however, it is more efficient to award damages.<sup>208</sup>

Overall, the Second Circuit correctly intuits that the district court award of zero damages is efficient, if and only if, the award to AEP contemplated by the court would produce a windfall for AEP greater than the windfall provided to TEMI by not ordering damages for future profits.<sup>209</sup> This seems unlikely. On an absolute dollar level, if the AEP expert's calculation was within the right order of magnitude, there is a wide range of more efficient damages than the zero awarded.<sup>210</sup> From a prospective standpoint, a potential obligee knows that her breach comes with the risk of paying damages.<sup>211</sup> Establishing a precedent that damages in long-term contracts are uncertain and possibly unawardable is to dramatically encourage opportunistic contract breach.<sup>212</sup> The Second Circuit correctly reasons that because the breaching party has likely determined the expected value of the contract for them is negative, then the risk of miscalculation in a damages award should rest on that party.<sup>213</sup>

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205. The electricity market is not a thick market. While electricity is a commodity, it is subject to wide demand fluctuations resulting primarily from changes in weather. Spikes in demand in one market cannot readily be satisfied by supply from other markets because electricity cannot be efficiently shipped long distances, nor can electricity be stored efficiently. As a result, electricity trading generally has a short time horizon. During the period in question, five years was the longest horizon on which AEP even contemplated signing a contract for electricity delivery. See Principal Brief for Plaintiffs-Appellants at 15, *Tractebel Energy Mktg.*, 487 F.3d 89 (No. 05-4985-cv(L)).

206. See Dunn, *supra* note 89, at ch. 6 (discussing variables involved in calculating contract damages).

207. Absent a liquidated damages clause, damages are an issue of fact. The only facts available are models built on many variables. If the factfinder rejects these models, it rejects the idea of awarding damages.

208. See *supra* notes 92–94 and accompanying text.

209. See *supra* text accompanying note 92.

210. The midpoint of the AEP expert's range was \$520 million. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731(HB), 2005 WL 1863853, at \*14 (S.D.N.Y. Aug. 8, 2005). Arguendo, if this is the true expectation damages, then any sum less than \$520 million is more efficient than zero. Also any sum up to \$1.04 billion creates less of a windfall than zero.

211. See *supra* text accompanying note 29.

212. See *supra* notes 21, 35 and accompanying text.

213. In a footnote, the opinion approvingly cites the Learned Hand quotation from *N.Y. Trust Co. v. Island Oil & Transport Corp.*, 34 F.2d 653, 654 (2d Cir. 1929) cited *supra* note 110. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, 487 F.3d 89, 110 n.22 (2d Cir. 2007).

The end result is that the Second Circuit has restored the wide discretion available to the factfinder in finding damages but also emphasized that generally this discretion should be exercised to find damages against a breaching party. This approach basically entails a rebuttable presumption to use a “reasonable estimate” standard.

#### VI. ALTERNATIVE REMEDIES FOR ANTICIPATORY REPUDIATION OF LONG-TERM CONTRACTS IN THIN MARKETS

As long as the factfinder retains discretion when awarding damage remedies, an inefficient outcome, like that of the district court, remains possible. In particular, states without New York’s reasonable estimate standard remain at greater risk of an inefficient outcome after the existence of damages is established. And this variability creates uncertainty, which only encourages opportunistic breach. This Part will examine four possible damage remedies:<sup>214</sup> 1) a strong reasonable certainty standard, 2) specific performance, 3) a reasonable estimate standard, and 4) a “best shot” rule. It concludes that the best shot rule—as of yet unadopted by any court—guarantees the efficient outcome in the majority of cases and should be adopted for all long-term contracts in thin markets where damage calculations involve competing valuation experts.

##### A. A Strict Reasonable Certainty Standard

A strong reasonable certainty standard is generally efficient because of the discretion it affords factfinders in practice. Most state courts apply reasonable certainty with sufficient flexibility and sufficient sympathy for innocent parties to ensure that the breaching party is liable for approximate expectation damages.<sup>215</sup> The status quo, however, also permits results like the district court’s opinion in *Tractebel*.<sup>216</sup> As long as the standard remains reasonable certainty, lengthening of the contractual term is likely to lead courts to discount or reject damage awards as speculative.<sup>217</sup> Under the current system, lengthening contractual terms comes at the cost of efficiency.<sup>218</sup> Parties to contracts are forced to be wary of possible opportunism by their counterparts seeking a potential windfall.

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214. Other possible remedies are liquidated damages and reliance damages. Liquidated damages are the ideal solution for this sort of case. See *supra* notes 132–134 and accompanying text. But this Note aims to come up with a solution for the *Tractebel* situation, where the contract lacked a liquidated damages clause.

Reliance damages seek to undo the harm that the nonbreaching party’s reliance on the breacher has caused him. Fuller and Perdue, *supra* note 21, at 54. They often serve as a backstop in case expectancy damages are not awarded. In this case, the district court apparently did not award reliance damages because AEP had not argued for them during trial. *Tractebel*, Reply and Response Brief, *supra* note 47, at 83.

215. See *supra* notes 89–91 and accompanying text.

216. See *supra* Part V.B.

217. See *supra* Parts I.B, IV.

218. See *supra* Part IV.

### B. *Specific Performance*

Specific performance results in a court issuing an injunction commanding performance of the contract. This solution has the advantage of eliminating certainty as an element of damage calculation: If the parties are compelled to perform the contract, then there is no uncertainty as to future damages. If specific performance is the rule for anticipatorily breached, long-term, thin market contract damages, a breaching party cannot receive a windfall.<sup>219</sup>

But if breach is efficient, then a specific performance award is inefficient.<sup>220</sup> Applied to *Tractebel*, this rule would require TEMI to purchase the contractual amount of electricity each year. But if TEMI is required to buy electricity for above-market prices, AEP will have no incentive to renegotiate or settle. This rule therefore forces AEP to sell electricity onto an already glutted market rather than invest whatever money it could save by settling the contract and possibly creating additional value elsewhere.

Specific performance is efficient when it involves unique goods because there is a high “risk . . . that the promisee’s money damage remedy will be undercompensatory” due to difficulties in valuation.<sup>221</sup> This is a different sort of valuation difficulty than faced in *Tractebel*. Specific performance, for example, protects the promisee’s subjective valuation of the handwritten manuscript of *Leviathan*.<sup>222</sup> There is no subjective valuation concern with electricity—the uncertainty is not subjective, but objective.

Ex ante, parties signing contracts for non-unique goods, who are thus likely to receive alternative offers, want to keep the option of efficient breach available.<sup>223</sup> For instance, at signing both TEMI and AEP preferred having the option of efficient breach.<sup>224</sup> Only a money damages rule retains freedom and flexibility. Specific performance converts the contract remedy into a property rule. TEMI would have to pay more

219. The breaching party will still have to perform its contractual obligations; thus, specific performance serves as a deterrent to breach. It converts a liability rule into a property rule. See Kronman, *supra* note 28, at 351.

220. *Id.* at 368–69 (discussing likelihood “that a promisor who has agreed to a specific performance provision will find himself in the undesirable position of having to decline an alternative offer that he would accept under a money damages rule”).

221. See *id.* at 366.

222. See *id.* at 359–61 (explaining that court would have difficulty calculating compensatory damage award for such situation).

223. *Id.* at 368 (“In the case of a contract for non-unique goods or services . . . [t]he promisor will . . . be anxious to retain the freedom and flexibility enjoyed under a money damages rule.”).

224. It is important to remember that had the price of electricity risen, rather than collapsed, AEP, not TEMI, would have incentives to breach.

than the liability rule of expectation damages to rid itself of this obligation.<sup>225</sup>

A court could also order *temporary* specific performance, instead of full specific performance. For example, a court could require TEMI to purchase power under the PPSA for five years at which point the parties may either continue the contract or else breach again. This has the advantage of giving parties the time to either negotiate settlement or reach agreement on continuing with their transactions, and if breach re-occurs, time has passed to make damages more calculable. This solution, however, hands the nonbreaching party a powerful five-year option. In practice, unless the party believes the court is likely to award expectation damages in five years this solution is unlikely to change the property rule dynamic of settlement negotiations. It also taxes judicial resources by putting off final decision to a later date.

The fact that this rule may not be preferred *ex ante* by most parties does have a benefit. Parties will contract around this rule, and in large commercial contracts between businesses they will have sufficient expertise and motivation to do so.<sup>226</sup> Therefore, such a rule may incentivize efficient liquidated damages clauses.<sup>227</sup>

Specific performance is not an appropriate general rule of damages for long-term, thin market contracts. Unless it drives contracting parties to adopt liquidated damage clauses *en masse*, it prevents the occasional *Tractebel*-like windfall at the expense of efficiency in the average case.

### C. A Reasonable Estimate Standard

Another solution is to adopt the New York rule and make explicit what many other states' courts have implicitly held: that the reasonable certainty standard converts into a reasonable estimate standard when calculating the breaching party's damages.<sup>228</sup> The impact of this holding is entirely beneficial as compared to a stricter reasonable certainty standard. It avoids situations where the court rejects an admittedly reasonable estimate because it lacks "certainty." This limits the possibility of large, damaging windfalls awarded to the breaching party (which would have happened in *Tractebel* had Judge Harold Baer's opinion been affirmed). Courts still retain the ability to refuse truly speculative damage awards.

The problem with this solution is that it is a mere shift in emphasis from the status quo. It does not restrict the discretion of the factfinder.

225. Kronman, *supra* note 28, at 367 (explaining that, under a specific performance regime, a promisor who wants to breach will need to pay more than his money damages liability "to buy his way out of the contract").

226. See *supra* note 45 and accompanying text.

227. See *supra* notes 132–134 and accompanying text.

228. See Dunn, *supra* note 89, § 1.8 ("While the proof of the *fact* of damages must be certain, proof of the *amount* may be an estimate, uncertain or inexact."); *supra* text accompanying note 93, 184–186.

As a result, it is a paper castle, easily overcome. A court facing the same facts as *Tractebel* could still, as Judge Baer did, describe the evidence presented as “speculative” and simply claim it fails a “reasonable estimate” standard. All that changes is that in the former case “certainty” does the work of exclusion and in the latter case “reasonable” does this work.

A change to a “reasonable estimate” standard to determine damage awards for a nonbreaching party is an improvement as it emphasizes the caution courts should use when denying nonbreaching parties damages. It also puts factfinding courts on notice that appellate courts expect them to award damages in all but rare instances. It does not eliminate the possibility of grave inefficiency, however, as it retains enough wiggle room for a determined factfinder to award a windfall to either party.

#### D. A “Best Shot” Rule

The most efficient solution to this problem is establishment of a “best shot” rule. This rule uses the adversarial method to improve the search for truth.<sup>229</sup> Much like the arbitration system in Major League Baseball, it informs the parties that the court, during the damage phase of a trial, will evaluate their experts and choose, without alteration, the calculation of the party that it deems “best.”<sup>230</sup>

The impact of this rule is that the parties’ incentives are realigned.<sup>231</sup> Previously, as typified by the nearly \$1 billion difference between AEP and TEMI’s experts’ calculations, their incentive was to spin the evidence in the best possible way for themselves.<sup>232</sup> In a best shot rule regime, the incentive is to have the more accurate model than the other party. The nonbreacher “recognizes that if it gets too greedy, the probability that the arbitrator [or judge] will choose its price declines.”<sup>233</sup> This incentive structure should lead to far tighter damage ranges.

There are several practical problems with implementing a best shot rule. The first is that post-implementation there remains some class of cases where there is contract breach but damages are truly too speculative to award. In these cases, courts will still have the power to reject damages as too speculative, but the burden of proof should shift onto the breach-

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229. Victor P. Goldberg, The “Battle of the Forms”: Fairness, Efficiency, and the Best-Shot Rule, 76 Or. L. Rev. 155, 156 (1997) [hereinafter Goldberg, Battle of the Forms] (describing motivation for best shot rule as current doctrine’s failure to “recognize the incentive question as a problem”).

230. *Id.* at 166 (“When confronted with two nonconforming forms, the court must choose only one to govern the transaction . . . [I]t looks to the *best shot*.”).

231. *Id.* (“If either side tries to tilt its offer too much in its favor, it risks having [its offer] disregarded.”).

232. AEP’s expert’s base case was \$520 million owed to AEP and TEMI’s expert’s base case was net revenue for TEMI of \$373 million—a difference of \$893 million. *Tractebel Energy Mktg., Inc. v. AEP Power Mktg., Inc.*, No. 03 Civ. 6731 (HB), 2005 WL 1863853, at \*14 (S.D.N.Y. Aug. 8, 2005).

233. Goldberg, *Battle of the Forms*, *supra* note 229, at 166.

ing party. Large disparity in damage calculations after adoption of a best shot rule may be evidence of their speculative nature.

A second practical problem involves drawing the line of when to apply the best shot rule. Declaring that lawsuits involving “long-term” contracts or contracts in “thin markets” are suitable for this rule merely shifts the line-drawing problem. A good rule of thumb may be that in any case between commercial parties where the court expects the parties as a matter of course to present economic analysis the best shot rule should apply.

The best shot rule has the potential to eliminate the possibility of *Tractebel* windfalls and improve the efficiency of damages awards without undermining the efficiency of the bulk of cases.

#### CONCLUSION

Individually, the doctrines of anticipatory repudiation and reasonable certainty are anchored in legal doctrine and are supported by efficiency analysis. Collectively, their application to a long-term contract in a thin market presents a problem for a court making a damage calculation. Anticipatory repudiation doctrine says the plaintiff is entitled to a normal, full recovery of her expectations. Reasonable certainty doctrine says that at some point uncertainty as to amount, which increases as the preperformance time period increases, is a fatal error to a damage award. The district court opinion in *Tractebel* shows the real world ramifications of this conflict.

Perhaps the most important lesson to take away is also the most elementary: Good contract drafting solves problems before they start. The PPSA that defined the AEP-TEMI relationship was a contract designed to work well in a booming energy market. It did not have mechanisms for dealing with many negative contingencies. Faced with a sudden and massive slump in underlying economic conditions, the contract fell apart before it even began.

Yet some contract disputes will always end up in the courts. And contract law made during litigation provides the framework in which all future parties contract. If courts consider efficient solutions when making this framework, society benefits. The reasonable certainty doctrine, however, is only a *usually* efficient solution, not an *always* efficient solution. And the discretion granted courts in applying reasonable certainty ensures that some courts will discount or refuse to award otherwise efficient damage awards.

While the facts of *Tractebel* were extreme, they are not unique. Long-term contracts are a persistent fact of commercial life and facilitate a great number of transactions. To the extent that contracting parties are unsure of what damage remedy is available to them, parties are deterred from entering these beneficial contracts.

Fortunately, there are solutions available. The first is a simple change in doctrinal emphasis, from requiring reasonable certainty to requiring a reasonable estimate. This pressures courts to place their sympa-

ties with the nonbreaching party. However, it offers no defense against a court determined to find an estimate speculative or unreasonable.

The most efficient solution available is the somewhat more procedural change of the best shot solution. By co-opting the adversarial process for the benefit of efficiency, the best shot rule promises to present courts with more accurate and less conflicting expert calculations.

Contract law cannot permit a party to breach a contract and receive a windfall award of hundreds of millions of dollars. Such a result deters beneficial transactions and so harms society. The best shot rule, to the greatest extent possible, eliminates this possibility without impacting the mass of otherwise efficient awards (except, maybe, by making those involving experts even more efficient). This slight change in practice can help drive inefficiency from the judicial system. Courts should adopt the best shot rule for awarding damages in anticipatorily breached, long-term contracts.