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An Economic Approach to
*Hadley v. Baxendale*

*EVRA Corporation v. Swiss Bank Corporation*, 673 F.2d 951 (7th Cir. 1982).

For my own part I think that, although an excellent attempt was made in *Hadley v. Baxendale* to lay down a rule on the subject [of damages], it will be found that the rule is not capable of meeting all cases; and when the matter comes to be further considered, it will probably turn out that there is no such thing as a rule, as to the legal measure of damages, applicable in all cases.

—Wilde, B.1

I. INTRODUCTION

Paralleling the technological progress found in other segments of society, the computer has revolutionized the banking industry by enabling funds to be transferred electronically.2 Electronic Fund Transfers (EFT’s)3 have replaced numerous conventional uses of the check because computer transfers are a more efficient, convenient, and less costly method of transferring funds.4 The prevalence of EFT systems, however, raises difficult legal issues stemming from the new relationships among the participants and from the possible errors that can occur.5

A Seventh Circuit decision, *EVRA Corporation v. Swiss Bank Corporation*,6 highlights the legal problems involved when a party incurs a loss of profits from a cancelled contract as a result of a

3. EFT’s have been defined as “the application of electronic technology to financial payments now made by cash and checks.” EFT’s store and process the instructions as they transfer funds electronically from one deposit account to another. *EFT and Privacy*, 64 FED. RESERVE BULL. 279, 279-80 (1978).
4. Id. at 280.
6. 673 F.2d 951 (7th Cir. 1982).
bank failing to transfer funds when requested by wire to do so. This Note discusses the court's use of Hadley v. Baxendale\(^7\) to limit the injured party's recovery for lost profits.\(^8\)

## II. THE EVRA CORPORATION DECISION

### A. The Facts

In *EVRA Corporation*, Hyman-Michaels\(^9\) chartered a cargo ship, the *Pandora*, to deliver scrap steel to Brazil. The contract between Hyman-Michaels and the Pandora Shipping Company required the rate be paid “in advance” to the shipping company's account at the Banque de Paris in Geneva, Switzerland.\(^10\) Hyman-Michaels generally paid the installment by requesting its bank, Continental Illinois National Bank and Trust Company of Chicago, to debit Hyman-Michaels' account at Continental and to wire the funds to Banque de Paris. Continental would send a telex message\(^11\) to its London office with instructions to retransmit the order to Continental's correspondent bank in Switzerland, Swiss Bank Corporation. Swiss Bank would deposit the amount of funds in the *Pandora* owner's account, and Continental would then credit Swiss Bank's account at Continental for an equal amount to complete the transaction.\(^12\)

Shortly after the contract was signed, charter rates escalated, prompting Pandora Shipping Company to look for any opportunity to cancel the contract with Hyman-Michaels.\(^13\) The opportunity

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8. Generally, the liabilities occurring as a result of improper electronic fund transfers are determined pursuant to the Electronic Fund Transfer Act (EFTA), 15 U.S.C. §§ 1693-93r (Supp. IV 1980). However, when the EFTA is not applicable, ordinary common law principles are applied. *See infra* note 24.
10. The contract was for one year with an option to extend for another year and stated the payment was to be a fixed daily rate and the ship owners could cancel if the payment was not received in advance. 673 F.2d at 952.
11. A telex system is a communication service involving teletypewriters connected by wire through automatic exchanges.
12. 673 F.2d at 952.
13. A prior, unsuccessful opportunity to cancel the contract arose when Hyman-
materialized when Continental attempted to make the payment for the period from April 27 to May 11, 1973. Continental had telexed the transfer instructions to London on April 25, 1973. The London bank tried unsuccessfully to contact Swiss Bank through Swiss Bank's general telex number and finally transmitted the message through Swiss Bank's foreign service department. However, though the message was transmitted and received, Swiss Bank mishandled the telex and failed to transfer the funds to Banque de Paris. Instead of wiring the money directly to Banque de Paris after the error was discovered, Hyman-Michaels allowed the London Bank and Swiss Bank to look for the message for several days. Meanwhile, the shipping company cancelled the contract.

Hyman-Michaels filed suit against Swiss Bank for negligence, breach of fiduciary duty, and breach of contract, claiming as damages the loss of net earnings sustained as a result of the cancella-

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Michaels mailed a check for the installment instead of using the electronic transfer method and the payment was four days late. When Hyman-Michaels was informed the contract was cancelled, they promptly wired payment to Banque de Paris. The contract was upheld at arbitration since Pandora Shipping Company had not given Hyman-Michaels advance notice that they intended to cancel the contract. Id. at 952-53.

14. Swiss Bank's foreign service number was often used by the London office when the London office could not transmit the message through Swiss Bank's general number. Id. at 953.

15. The specific error could not be determined but the possibilities included: (1) the telex machine at Swiss Bank was out of paper so the telex machine was unable to reprint the payment order, or (2) whoever took the telex message failed to deliver it to the banking department. Swiss Bank's telex machine did receive the message because the machine signaled the London machine that the message was received. Id.

16. This opportunity to cancel the contract was upheld in arbitration. The arbitrators found that Hyman-Michaels was blameless up to the time the company learned of the breach. The arbitrators held that after Hyman-Michaels learned of the breach, Hyman-Michaels did not do everything possible to deliver the funds by another means. Id. at 954.

17. In response to Hyman-Michaels' suit, Swiss Bank impleaded Continental for indemnification. Continental filed a cross-claim against Hyman-Michaels, claiming that if Continental was liable to Swiss Bank, then Hyman-Michaels was liable to Continental. Hyman-Michaels counter-claimed against Continental, claiming breach of contract and negligence on the part of Continental. Id.
tion of the contract and the fees incurred for arbitration. The district court sustained Hyman-Michaels' claims and held that Hyman-Michaels was "entitled to damages for the profits it lost due to the withdrawal of the Pandora." 

B. The Decision

The court of appeals decision, written by Judge Posner, reversed the district court. The appellate court held Swiss Bank

18. Loss due to withdrawal of the vessel:

| Period    | Days | Rate  | Earnings
<table>
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<tr>
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<tr>
<td>5/30 - 7/29</td>
<td>61</td>
<td>$5,000</td>
<td>$305,000</td>
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<td>7/30 - 9/29</td>
<td>62</td>
<td>$5,967</td>
<td>$369,564</td>
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<tr>
<td>9/30 - 11/29</td>
<td>61</td>
<td>$6,040</td>
<td>$388,440</td>
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<tr>
<td>11/30 - 1/29/74</td>
<td>61</td>
<td>$7,100</td>
<td>$433,100</td>
</tr>
<tr>
<td>1/30 - 3/29</td>
<td>59</td>
<td>$6,710</td>
<td>$395,890</td>
</tr>
<tr>
<td>3/30 - 8/27</td>
<td>151</td>
<td>$7,570</td>
<td>$1,143,070</td>
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</tbody>
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Total estimated revenue $3,015,454
Loss of net earnings $2,120,804

*Estimated daily revenue is based on actual reported fixtures on roundtrips for the dates corresponding to the above periods. The fixtures were reported in the Maritime Research, Inc. Bulletin with the exception of the last period (3/30-8/27 1974) which is based on Hyman-Michaels' charter of the M/V STOMOLEON for a period of 6 months.

EVRA Corp., 522 F. Supp. at 835 n.9.

19. Attorney fees for the 1973 arbitration amounted to $15,952.65 and arbitration costs totaled $975.00. Id.


21. The district court noted Swiss Bank breached a contractual duty that existed between Hyman-Michaels and Swiss Bank. Id. at 827-28. The district court also found that Swiss Bank breached the duty of care owing to Hyman-Michaels in tort and that this negligence was the proximate cause of Hyman-Michaels' loss. Id. at 829. The district court held Swiss Bank did not breach any fiduciary duty to Hyman-Michaels. Id.

22. Id. at 833.

23. Appointed to Seventh Circuit Court of Appeals December 4, 1981. Former Professor of Law, University of Chicago.

24. Initially, the court dismissed several secondary legal issues. A primary concern was to determine whether Swiss or Illinois law applied. The district court determined that under the Illinois "most significant relationship" test, Illinois law would apply. The district court found that Switzerland was Swiss Bank's domicile and the situs of the "conduct causing the injury," but Illinois was Hyman-Michaels' domicile and the location where the injury actually occurred. The balance was tipped in favor of Illinois because the gravity of the relationship between the parties was "unquestionably" in Illinois. EVRA Corp., 522 F. Supp. at 826-27. The appellate court avoided this choice of law problem since the outcome of the case rendered the question valueless; either way, Hyman-Michaels could not recover. 673 F.2d at 954-55. The court noted that if Swiss law applied then Hyman-Michaels claim would have been dismissed since under Swiss law there must be privity of contract before a bank can be liable, and the court held there was no contract between Hyman-Michaels and Swiss Bank. Id. The court stated:

[B]ecause we are more certain that Hyman-Michaels cannot recover
did owe Hyman-Michaels a duty to use reasonable care in handling

against Swiss Bank under Illinois law than we are that Swiss rather than Illinois law applies to this case under Illinois choice-of-law principles, . . . we shall avoid the choice-of-law question and discuss Swiss Bank's liability to Hyman-Michaels under Illinois law without deciding . . . whether it really is Illinois law or Swiss law that governs.

Id. at 955.

A second issue the court dismissed was the relevance of any state or federal statutory authority. Although article four of the Uniform Commercial Code [hereinafter referred to as Code] deals with bank transfers, the court found that article four would not be applicable. 673 F.2d at 955. Article four states the rights and responsibilities of banks and their customers in presentment, settlement, or return of a check or item. See Vergari, supra note 2, at 289-91. The applicability of article four is found in U.C.C. § 4-102(2) (1978): "The liability of a bank for action or non-action with respect to any item handled by it for purposes of presentment, payment or collection is governed by the law of the place where the bank is located." (emphasis added).

The relevant question is whether an electronic impulse is an "item" within the meaning of the Code. See WHITE & SUMMERS, supra note 8, at 646. "Item" is defined in U.C.C. § 4-104(1)(g): "'Item' means any instrument for the payment of money even though it is not negotiable but does not include money." Comment to U.C.C. § 4-104(1)(g) states: "The word 'item' is chosen because it is 'banking language' and includes non-negotiable as well as negotiable paper calling for money and also similar paper governed by the Article on Investment Securities (article 8) as well as that governed by the Article on Commercial Paper (article 3)." The appellate court expressed doubt that the draftsmen ever intended article four to include EFT's. 673 F.2d at 955. Several commentators have written that an electronic impulse is not an "item" within the meaning of U.C.C. § 4-102(2). See Dunne, The Checkless Society and Articles 3 and 4, 24 Bus. Law. 127 (1968); Dunne, Variation on a Theme by Parkinson or Some Proposals for the Uniform Commercial Code and the Checkless Society, 75 YALE L.J. 788 (1966); Penney, Articles 4 and 8 of the Uniform Commercial Code, 26 LA. L. REV. 259 (1966); Penney, Bank Statements, Cancelled Checks, and Article Four in the Electronic Age, 65 MIC. L. REV. 1341 (1967); Vergari, Articles 3 and 4 of the Uniform Commerical Code in an Electronic Fund Transfer Environment, 17 SAN DIEGO L. REV. 287, 296 (1980); Note, Alternatives to the Present Check Collection System, 20 STAN. L. REV. 571 (1968). However, not all authority has indicated that an electronic impulse is not an "item." See Houston Contracting Co. v. Chase Manhattan Bank, 539 F. Supp. 247 (S.D.N.Y. 1982); Clarke, An Item is an Item is an Item: Article 4 of the U.C.C. and the Electronic Age, 25 BUS. LAW. 109, 111-12 (1969).

Even if article four would apply to EFT's, Hyman-Michaels could not recover since Swiss Bank did not act in bad faith. 673 F.2d at 955. The Code provides in U.C.C. § 4-103(5):

The measure of damages for failure to exercise ordinary care in handling an item is the amount of the item reduced by an amount which could not have been realized by the use of ordinary care, and where there is bad faith it includes other damages, if any suffered by the party as a proximate consequence.

Federal law also was not available. The Electronic Fund Transfer Act (EFTA), 15 U.S.C. §§ 1693-93r (Supp. IV 1980), provides a basic framework establishing the rights, liabilities, and responsibilities of parties using EFT systems. However, the primary objective of the EFTA is the protection of individual consumer rights. See 15 U.S.C. § 1693(b). The EFTA would not
the transfer order. The court found Swiss Bank breached that duty but held Swiss Bank would not be liable for the lost profits Hyman-Michaels incurred as a consequence of Swiss Bank negligently failing to transfer the funds. The duty Swiss Bank owed Hyman-Michaels was described by the district court using agency principles. The district court stated: “Swiss Bank, as a correspondent bank in the subject transaction, was an agent of plaintiff and owed plaintiff the same duty of care as did Continental with whom plaintiff had an express contractual relationship.”

Posner was not as explicit in locating the source of the duty as was the district court, but he assumed a duty running from Swiss Bank to Hyman-Michaels was breached by Swiss Bank failing to properly carry out the transfer order. However, Posner concluded that

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26. It is evident from the district court opinion that the complaint alleged negligence, breach of contract, and breach of fiduciary duty. The district court discussed each theory in turn. See supra notes 18-22 and accompanying text. The court of appeals decision only states that “Hyman-Michaels... [sought] to recover its expenses in the second arbitration proceeding plus the profits that it lost because of the cancellation of the charter.” 673 F.2d at 954.
27. The appellate court largely ignored discussing the common law theories on which Hyman-Michaels elected to base its claim. See supra notes 17-22 and accompanying text. Generally, lost profits are recoverable in contract. See generally 5 A. CORBIN, CORBIN ON CONTRACTS §§ 1021-22 (1964) (lost profits recoverable if foreseeable, certain, and not too remote); Comment, Contractual Recovery for Negligent Injury, 29 ALA. L. REV. 517, 536-44 (1978) (When an injury occurs, an implied promise often exists in the form of either: (1) the defendant's failure to perform an act as impliedly promised, or (2) the defendant's failure to use due care as impliedly promised.); Note, Lost Profits and Hadley v. Baxendale, 19 WASHBURN L.J. 488, 491-92 (1980) (article explains the underlying doctrines of actions for lost profits). However, the court precluded recovery on a straight contract theory, holding there was no contract between Hyman-Michaels and Swiss Bank. 673 F.2d at 956. It is essential that to recover in contract the existence of a contract must be proved. See Comment, supra, at 519-24.

Possible tort theories include allowing a plaintiff to recover for lost profits that result when the defendant negligently injures a third person. See Comment, Foreseeability of Third-Party Economic Injuries—A Problem in Analysis, 20 U. CIN. L. REV. 283, 283-84 (1953). Generally, these economic losses are not recoverable on the grounds that they are unforeseeable. However, the author argues that these damages are not allowed because of a judicial discrimination against protecting economic interests as compared to more tangible property interests and because of a desire to limit potentially unlimited liability for negligence. Id. at 284-87.

A second possible tort theory would allow recovery on an interference with contract theory. However, an essential element of intent to interfere
Hadley required the denial of Hyman-Michaels’ claim for consequential damages.\(^{28}\)

The traditional Hadley rule makes a defendant liable for only those damages within the contemplation of the parties at the time the contract was created. The rule was stated by the Hadley court as follows:

> Now we think the proper rule in such a case as the present is this:—Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it.\(^ {29}\)

Hadley has generally been interpreted to require a court to focus primarily on the extent the defendant had actual notice of the possible consequences a breach of contract would have on the other party.\(^ {30}\) Posner's application of Hadley in EVRA Corporation departed from the established understanding of the Hadley rule.\(^ {31}\) According to Posner, Hadley is merely a specific applica-

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with Hyman-Michaels' contract is lacking on the part of Swiss Bank. Generally, commentators agree on the origin of the theory and that a majority of states have accepted its use. See Carpenter, Interference with Contract Relations, 41 Harv. L. Rev. 728, 728-32 (1928); Harper, Interference with Contractual Relations, 47 NW. U.L. Rev. 873, 874-75 (1953); Sayre, Inducing Breach of Contract, 36 Harv. L. Rev. 663, 663-72 (1923); Comment, Torts-Negligent Interference with Contractual Relations, 36 Ky. L.J. 142, 142-43 (1947). The requirements to support an interference with a contract can generally be stated to include: (1) the existence of a contract, (2) a willful or intentional act of interference, (3) an act that is the proximate cause of the injury, and (4) proof of actual damages. See Comment, Contractual Relations: When Are They also a Tort?, 28 Baylor L. Rev. 667, 669 (1976); see also W. Prosser, Handbook of the Law of Torts § 129 (4th ed. 1971); Carpenter, supra, at 734-42. The major debate concerning a widespread use of this doctrine seems to focus on the nature of the plaintiff's conduct needed to sustain an action. Originally, malice was required, but the prevailing rule is intent will suffice though many courts continue to use the rubric of malice. See Sayre, supra, at 672-75. Widening the theory to include negligence is a step courts have been hesitant to take. Though most commentators agree that contract interests are not protected against negligent interference, persuasive arguments exist for broadening the theory. See Prosser, supra, at § 129; Carpenter, supra, at 739-42; Note, Negligent Interference with Economic Expectancy: The Case for Recovery, 16 Stan. L. Rev. 664, 664 (1964).


28. 673 F.2d at 957.
30. See infra notes 43 & 52 and accompanying text.
31. See infra notes 55-70 and accompanying text.
tion of the law's general search for the most efficient risk avoider:
Swiss Bank is not liable for the consequences of negligently failing to
transfer Hyman-Michaels' funds to Banque de Paris; reason for such a
holding is found in the animating principle of Hadley v. Baxendale, which
is that the costs of the untoward consequence of a course of dealings
should be borne by that party who was able to avert the consequences at
least cost and failed to do so.

Therefore, instead of applying the traditional Hadley approach by
focusing on whether Swiss Bank had knowledge of the possible
consequences of failing to transfer the funds, Posner elected to
work from first principles and to evaluate whether Hyman-
Michaels or Swiss Bank could more efficiently have avoided the
risk that these consequential damages would occur. The appellate
court noted that Swiss Bank knew or should have known the telex
order was a payment for the hire of the Pandora, but the court
was not concerned with whether this notice was sufficient to make
Swiss Bank liable under the traditional Hadley standard. Instead, the court found Hyman-Michaels was imprudent for not wir-
ing the funds directly to Banque de Paris after Hyman-Michaels
was notified the payment was not made and the contract was can-
celled. Posner reasoned that Hyman-Michaels' imprudence out-
weighed Swiss Bank's failure to properly respond to the telex
message:
This is not to condone the sloppy handling of incoming telex messages in
Swiss Bank's foreign department. But Hyman-Michaels is a sophisticated
business enterprise. It knew or should have known that even the Swiss
are not infallible; that messages sometimes get lost or delayed in transit
among these banks, two of them located 5000 miles apart, even when all
the banks are using reasonable care; and that therefore it should take its
own precautions against the consequences—best known to itself—of a
mishap that might not be due to anyone's negligence.

Therefore, the court concluded Swiss Bank should not be liable for
the lost profits incurred as a result of the cancelled contract.

III. ANALYSIS

A. The Hadley v. Baxendale Standard

In both contract and tort, rules have been developed to measure
the remoteness of damages, and perhaps in no other area of law
have there been so many attempts to formulate ideal rules in an
effort to limit damages. Judge Posner used the English case of Hadley v. Baxendale to limit Hyman-Michaels' recovery of lost profits.

In Hadley the owners of a flour mill carried a broken shaft to the defendant's shipping office for delivery to the manufacturer to be used as a pattern from which to make a new shaft. The delivery was delayed for an unreasonable time, and as a result, the millers received the new shaft later than expected and incurred a loss of profits. Baron Alderson, who delivered the judgment in Hadley, believed an explicit rule was needed to guide the jury in its determination of the amount of damages to award. The result of Alderson's effort was a rule limiting defendant's liability for consequential damages to those damages within the contemplation of the parties at the time the contract was made.

The effect of Hadley was to structure a more favorable rule for defendants, a change from the prior law giving juries broad discretion. The general rule prior to Hadley gave the jury wide discretion to determine those damages that were the natural and necessary consequences of the breach. This earlier rule was il-

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40. Id.

41. Id. at 148.

42. Id. at 150. One commentator noted that this need for an explicit rule was a product of judges being caught up in judicial modernization, a response to the claim that damages should be more easily predicted, and an attempt to avoid the biases of the jury. See Danzig, supra note 38, at 259-74.

43. See supra text accompanying note 29; See Cooke, supra note 38, at 288. Though Hadley requires that both parties contemplate the loss, one commentator has stated that the defendant should only be charged with this knowledge since the injured party would usually have the requisite knowledge. See Samek, The Relevant Time of Foreseeability of Damage in Contract, 38 Australia L.J. 125, 129-30 (1964).

44. See Cooke, supra note 38, at 288. The idea that Alderson deliberately or thoughtlessly failed to mention the reporter's statements that the mill owners told the clerk the mill was stopped and the shaft must be delivered immediately has provided a basis for the rule that the defendant must have tacitly agreed to the special damages before the defendant could be liable. See Globe Refining Co. v. Landa Cotton Co., 190 U.S. 540 (1903). This "tacit" agreement extension of Hadley is generally not followed. See Danzig, supra note 38, at 278-80. But see Spangler v. Holthusen, 61 Ill. App. 3d 74, 376 N.E.2d 304 (1978).


Illustrated by *Black v. Baxendale*. In *Black*, the plaintiffs paid the defendants to deliver merchandise within a reasonable time. The carrier failed to make the delivery, and the plaintiffs suffered lost profits because they did not receive the goods on time. The court affirmed a jury award of damages which was considerably more than the actual amount expended, despite the defendants' argument that they should not be held responsible when they had no notice of the possible consequences. Baron Alderson, later the author of *Hadley*, stated: "Whether these expenses were reasonable was entirely a question for the jury." *Hadley*, not based on any precedent, applied a more rigorous standard to the natural consequences test by limiting the availability of consequential damages to those cases in which the defendant had contemplated such losses at the time he made the contract. Though *Hadley* has been greatly criticized, it has been widely accepted by the American courts.

B. Shift in Discourse

Posner's application of *Hadley* to limit Hyman-Michaels' recov-

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48. Id. at 174-75.
49. Id. at 175.
50. Id. The rule in *Black v. Baxendale* was affirmed in another case written by Alderson just one year prior to *Hadley v. Baxendale*. See *Waters v. Towers*, 155 Eng. Rep. 1404 (1853). In *Waters* the plaintiffs claimed as special damages lost profits for the stoppage of their mill as a consequence of the alleged breach of contract by the defendants. The defendants claimed the lost profits were too remote and the court held the lost profits were not a necessary consequence of the defendant's breach. *Id.* at 1405. However, Alderson wrote:

> The existence of a contract is evidence of the probable amount of loss sustained. Suppose the plaintiffs had said, "We should have made such and such a contract if the defendants had performed theirs," and the jury believed that the plaintiffs would have done so, that would surely have been evidence of the amount of loss occasioned by the defendants' breach of contract.

51. See Danzig, *supra* note 38, at 254-55. One commentator has suggested that the stage was set for *Hadley* because of a growing number of rules and a need for a general unifying principle. See Washington, *supra* note 45, at 97.
52. See Danzig, *supra* note 38, at 253-54.
ery of lost profits involves a shift from the traditional standard of Hadley to a standard directly reflecting Posner's economic approach to the law. This shift requires a court to make an analysis of the risk-preventative measures which could have been implemented by either Hyman-Michaels or Swiss Bank. Theoretically, Posner's economic goal of law is to maintain "efficiency" through value-maximizing. Posner explains these terms by stating: "The terms 'value' and 'efficiency' are technical terms. 'Efficiency' means exploiting economic resources in such a way that 'value'—human satisfaction as measured by aggregate consumer willingness to pay for goods and services—is maximized." Therefore, Posner believes Hadley is part of the law's effort to promote the efficient allocation of resources which requires that consequen-

55. See R. Posner, Economic Analysis of Law (2d ed. 1977). Though Posner has authored or co-authored numerous books and articles, Economic Analysis of Law is sufficiently conclusive of Posner's theory to make citations to additional material unnecessary.


57. Id. at 10 (emphasis original). Posner's explanation of "efficiency" and "value" continues:

Willingness to pay, the basis of the efficiency and value concepts, is a function of many things, including the distribution of income and wealth. Were income and wealth distributed differently, the pattern of demands might also be different and efficiency would require a different deployment of our economic resources. Since economics yields no answer to the question whether the existing distribution of income and wealth is good or bad, just or unjust (although it may be able to tell us a great deal about the costs of altering the distribution, as well as about the distributive consequences of various policies), neither does it yield an answer to the ultimate question whether an efficient allocation of resources would be good, just, or otherwise socially or ethically desirable. Nor can the economist tell us whether, assuming the existing distribution of income and wealth is just, consumer satisfaction should be the dominant value of society. The economist's competence in a discussion of the legal system thus is strictly limited. He can predict the effect of legal rules and arrangements on value and efficiency, in their strict technical senses, and on the existing distribution of income and wealth. He cannot prescribe social change. (footnote omitted).

Id.

Posner believes that economics has both a normative and positive role in law. The normative aspect of economics clarifies the value conflict and shows how to achieve given social desires by the most efficient means. The positive goal of economics explains the rules and reasoning in law as bearing a stamp of economic reasoning. Id. at 17-20.

58. Id. at 88-83. Posner argues that a rule always requiring a party to perform a contract is economically inefficient. Allowing expectation damages will protect the party's economic interests. When the party is able to breach a contract and have the "opportunity profit" for a breach greater than the "profit of completion," breach should be encouraged since the victim will be awarded his expectation costs and the breaching party will be efficiently maximizing his other economic interests. Id.
tial damages be limited to coincide with a party's expectation damages. According to Posner, consequential damages should be denied when the loss is not foreseeable since an unforeseeable loss is not considered a part of a party's expectation damages. Forseeability for Posner, however, merely involves a determination of which party is the least costly risk avoider and to award or not to award damages on that basis so as to create an incentive to take precautions. In other words, it is "efficient" to deny consequential damages to a party who can more cheaply avoid the risk but who is unwilling to pay for the necessary precautions.

Posner links Hadley with the foreseeability rules found in tort. Posner notes this relationship between contract and tort law by revealing how the traditional foreseeability rules in tort now aptly correspond to the economic standard assigned to Hadley. In EVRA Corporation, Posner cited the avoidable consequence doctrine as an example of how the defendant's imprudence may affect a subsequent tort recovery. Posner also related the foreseeability language in the Restatement to the Hand formula and the Palsgraf v. Long Island Railroad decision. Posner's sense of a close association between tort and contract law is not surprising since he had earlier written:

Observe the symmetry between torts and contract in the treatment of foreseeability. The asphyxiated trespasser is like the contract breaker in Hadley v. Baxendale: neither could foresee the consequences of his con-

59. Consequential damages are defined by Posner as being damages unrelated to the profit from the contract. Id. at 95.

60. Expectancy damages contemplate giving a party to a contract an incentive to fulfill the promise, unless the result would be an inefficient use of resources. Id.

61. For an illustration of how Posner would apply Hadley to an abstract situation, see infra text accompanying notes 71-75.

62. POSNER, supra note 55, at 94-95.

63. 673 F.2d at 957-58.

64. The avoidable consequences doctrine generally applies when further damages are not averted because the plaintiff failed to use proper care. See PROSSER, supra note 27, § 65. The doctrine of avoidable consequences is applied in the law of contracts as well as torts. See 5 A. CORBIN, CORBIN ON CONTRACTS § 1039 (1964); 11 S. WILLISTON, WILLISTON ON CONTRACTS § 1353 (3d ed. 1968).

65. The Restatement states that damages are available only if the breaching party had reason to foresee the damages as a probable result of the breach of contract. Foreseeability entails losses that occur in the ordinary course of events or special circumstances of which the breaching party had reason to know. See RESTATEMENT (SECOND) OF CONTRACTS § 351 (1981).

66. See United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947). Judge Hand stated the well-known formula of duty as being a function of three variables: (1) the probability of injury (P), (2) the gravity of the injury (L), and (3) the burden of adequate precautions (B). In algebraic terms, liability depends on whether B<PL. Id.

duct and neither was held liable for those consequences. The land developer in *Ehret* is like the commercial photographer in our variant of *Hadley v. Baxendale*: each could foresee the consequences of a failure to take precautions and should either have taken precautions himself or, if the other party could do so more cheaply, communicated the danger to the other party.\(^6\)

### C. The Effect of the Shift in Discourse

The principle effect of Posner's economic analysis is to broaden the applicability of the *Hadley* rule\(^6\) by: (1) shifting the focus from primarily analyzing the defendant's knowledge to balancing both parties' opportunities to efficiently avoid the risks, and (2) altering the time when this analysis takes place from when the contract was made to when the breach occurred.\(^7\) Posner illustrates this expanded application of *Hadley* with the following example:

A commercial photographer purchases a roll of film to take pictures of the Himalayas for a magazine. The cost of development of the film by the manufacturer is included in the purchase price. The photographer incurs heavy expenses (including the hire of an airplane) to complete the assignment. He mails the film to the manufacturer but it is mislaid in the developing room and never found.\(^7\)

Posner argues that allowing the photographer to recover his full losses would not create the incentive to avoid similar losses in the future.\(^7\) The photographer will not be prompted to take any precautions since either he would have his film developed or his expenses reimbursed. The developer will likewise have little incentive to take precautions since the costs of those precautions would outweigh the aggregate cost of such infrequent losses.\(^7\) On the other hand, if the photographer is limited to recovering the

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\(^6\) It has been stated that the principles of reasonableness and foreseeability achieve the needed workable division of the risks. *If Hadley* is to accomplish this goal then the application of *Hadley* is quite broad. See Washington, *supra* note 45, at 107-08. The goal of awarding damages for a breach of contract is an equitable apportionment of the risks which require compensating "the injured party, as far as it is politic, for the losses caused and the benefits prevented by the breach." *Id.* This economic approach ensures that the general goal of contract damages, that the plaintiff is placed in the same position he would have been in had the contract not been breached, will be limited even further than the traditional rule of *Hadley* has done. *See id.*

\(^7\) The necessary result of focusing on the preventive measures available to both parties is to shift the time when the analysis is completed from the time when the contract was made to the time when the injury occurred. Analyzing the variables at the time the contract was breached remedies a defect that is often criticized in the traditional *Hadley* rule. *See Danzig, supra* note 38, at 281-83; Samek, *supra* note 43, at 128-29.

\(^7\) Posner, *supra* note 55, at 94.

\(^7\) *Id.*

\(^7\) *Id.*
price of the film, Posner contends the photographer will be prompted to take the precaution of using two rolls of film or to request special handling when sending the film to the developer. According to Posner, this latter alternative is more favorable since it is an inexpensive and effective precaution.74 Posner argues that this example illustrates that where one party to the contract knows of the risks involved, the other party is not liable for the loss if it occurs since the party with notice can more cheaply avoid the risks.75

Posner's economic approach has been criticized by several commentators on both its theoretical grounds and its application.76 A common critique is that the narrow focus on efficiency does not adequately consider other relevant factors.77 Posner's test also has been criticized for oversimplifying complex fact patterns.78 However, it should be noted that an economic approach is not totally valueless.79 As Posner's example illustrates, the shifting of focus from considering what the defendant knew to determining which party could more cheaply avoid the risk does invite a more flexible approach for determining consequential damages than the traditional Hadley rule.80

74. Id.
75. Id.
77. See Leff, supra note 76, at 481-82.
78. See id., at 468. In EVRA Corporation, Posner dismissed two Illinois telegraph cases advanced by Hyman-Michaels as controlling, by merely stating "the defendants had more information and the plaintiffs were not imprudent." 673 F.2d at 959. Neither of the two cases, it would seem, had sufficient factual information to determine what the opportunities were for each party to avoid the risk of transmission. See Providence-Washington Ins. Co. v. Western Union Tel. Co., 247 Ill. 84, 93 N.E. 134 (1910); Postal Tel. Cable Co. v. Lathrop, 131 Ill. 575, 23 N.E. 583 (1890).
79. Leff, supra note 76, at 459-62. The author wrote:
The economic analysis of law (including The Economic Analysis of Law) continually manages to provide rich and varied insights into legal problems. Its growing popularity among legal scholars is, as I have noted, no accident. But in addition to its value as a way to continue to ignore otherwise desperate intellectual straits, it frequently serves intelligently to inform actual legal choices. For the central tenet and most important operative principle of economic analysis is to ask, of every move (1) how much it will cost; (2) who pays; and (3) who ought to decide both questions.

Id. at 459-60.
80. Flug v. Craft Mfg. Co., 3 Ill. App. 2d 56, 65-66, 120 N.E.2d 666, 666 (1954); Danzig, supra note 38, at 282-83; Sameck, supra note 43, at 129-30; Washington, supra note 45, at 107-08. The argument that the interests should be balanced is similar to the argument advanced by commentators advocating an action for negligent interference of contract. See PROSSER, supra note 27, at 129; Carpenter, supra note 27, at 745-46; Comment, Liability for Negligent Interference with
Posner's application of this flexible economic analysis in *EVRA Corporation* does not seem, on the surface, to be disturbing when the actual facts are reexamined.\(^8\) In *EVRA Corporation*, Hyman-Michaels not only had the time to remedy the effect of Swiss Bank's negligence, but the company also knew that wiring the funds directly to Bank de Paris would frustrate the *Pandora* owner's attempt to cancel the contract.\(^2\) However, since Posner's economic theory is concerned solely with determining which party can avoid the loss at least cost, the results in *EVRA Corporation* would arguably be the same notwithstanding Hyman-Michaels' unique position. Whatever value Posner's test brings to the area of consequential damages, a test that merely focuses on which party can avoid the loss with the least cost will ignore, in its application, the presence of other important variables. The electronic fund transfer situation highlights a number of problems that occur in the application of Posner's theory.

The nature of the electronic fund transfer situation allows little opportunity for individual parties to contemplate the actual risks involved in transferring funds. The transferring bank will have little, if any, knowledge to foresee what particular consequences may result if it fails to promptly comply with a transfer order.\(^3\) The transferring bank can, however, reasonably predict the frequency in which errors occur and can be charged with reasonable notice that a failure to comply with a transfer will undoubtedly have some financial repercussion to the customer.\(^4\) To require actual

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\(^{81}\) See supra notes 9-22 and accompanying text.

\(^{82}\) See supra note 13.

\(^{83}\) 673 F.2d at 956. The court stated:

> [Swiss Bank] knew or should have known, from Continental Bank's previous telexes, that Hyman-Michaels was paying the Pandora Shipping Company for the hire of a motor vessel named *Pandora*. But it did not know when payment was due, what the terms of the charter were, or that they had turned out to be extremely favorable to Hyman-Michaels. And it did not know that Hyman-Michaels knew that *Pandora's* owner would try to cancel the charter, and probably would succeed, if Hyman-Michaels was ever again late in making payment, or that despite this peril Hyman-Michaels would not try to pay until the last possible moment and in the event of a delay in transmission would not do everything in its power to minimize the consequences of the delay. Electronic fund transfers are not so unusual as to automatically place a bank on notice of extraordinary consequences if such a transfer goes awry. Swiss Bank did not have enough information to infer that if it lost a $27,000 payment order it would face a liability in excess of $2 million.

\(^{84}\) Swiss Bank failed to adopt a system to adequately control diverted messages
knowledge of the possible consequences will continually insulate the transferring bank's liability since under Posner's reasoning, preventing "unforeseeable" consequences is not efficient. 85

In EVRA Corporation, it is evident that Swiss Bank was not overly concerned with individual liability, 86 and relying on the court's holding, Swiss Bank will have little incentive to alter its business conduct in the future. 87 Likewise, though Hyman-Michaels was aware of the consequences of failing to pay on time, the company had little, if any, idea of the probability of Swiss Bank losing the telex message and failing to transfer the requested funds. This lack of knowledge seems to equally negate a duty on the part of Hyman-Michaels to affirmatively protect its interests. Under general foreseeability standards, it would not seem unreasonable to charge Swiss Bank with notice of the consequences of failing to properly handle the transfer order as the district court did in fact hold. 88 Of course Posner's idea of foreseeability is more restricted, focusing only on which party can avoid the loss at least cost. 89

Posner's focus on economic efficiency assumes that Hyman-Michaels was unwilling to pay the cost of adequate protection against the risk of nonpayment. 90 It would seem reasonable to find that Hyman-Michaels lacked the knowledge needed to calculate the extent of the necessary precautions since Hyman-Michaels did not know whether the telex order would be found in a short while or the extent of Swiss Bank's lack of adequate controls in its telex departments. To require that Hyman-Michaels should have known of these factors is to require Hyman-Michaels to potentially overinsure its interest with the effect of increasing transaction costs. 91

when Swiss Bank knew that three or four messages involving large sums of money were diverted each week. EVRA Corp., 522 F. Supp. at 829; see Danzig, supra note 38, at 278-83.

85. Posner began to analyze Swiss Bank's knowledge in reasonableness terms, but then focused on Swiss Bank's actual knowledge. See supra note 83 and accompanying text.

86. See supra note 83.

87. See Danzig, supra note 38, at 278-83. The author criticizes the traditional use of Hadley in mass transaction situations. He submits that the modern businessman computes in advance the potential costs for liability and accurately prepares for the liability through the market and insurance. Therefore, the law should not so rigidly protect him.

88. See supra notes 20-22 and accompanying text.

89. See supra notes 62 & 79.

90. One commentator has argued that by explaining efficiency in terms of what society is willing to pay, Posner ignores the initial position that anything may be as desired as anything else or that society may desire something regardless of the costs. Leff, supra note 76, at 462-69. Leff also notes that Posner's economic analysis has no room for the word or concept "unable." Id. at 478.

91. An important function of the economics of contract law is to avoid transaction
Posner's economic approach also assumes that judges and juries are insulated so as to objectively determine the most efficient method. This assumption not only ignores the distinction between "law," and "law in action," but it also fails to explain why the court system should favor efficiency. It would appear that the end result is to further limit the role of the jury since, arguably, the jury in the district court, by finding Swiss Bank negligent, indicated its belief that the consequences were foreseeable on the part of Swiss Bank.

A final problem is determining to what extent EVRA Corporation requires a transfer customer in future transactions to protect his interest. To state that Hyman-Michaels was in the position to efficiently correct Swiss Bank's negligence by wiring the payment to Bank de Paris is little comfort to other customers who use EFT systems under similar situations. This problem is significant since Posner regards precedents as fulfilling an important function of contract law by furnishing prospective transacting parties with information to assist them in efficiently planning their exchange.

IV. CONCLUSION

EVRA Corporation requires a customer to determine what preventative measures need to be taken before the risks are known. Since the customer lacks the knowledge of the probable risk, this requirement will quite probably result in overinsurance, which is inefficient, or, worse, in underinsurance. By requiring the customer to calculate the sufficiency of the preventative measure needed to affirmatively protect his interests, EVRA Corporation places the risk of overinsurance or underinsurance upon the customer.

In light of EVRA Corporation, future EFT customers should, at the very least, closely monitor each electronic transfer process so...
that remedial measures can be quickly implemented if any difficulty with the transfer is encountered. At the very most, future EFT customers may want to consider taking added precautions when transferring substantial amounts of money, especially if significant consequences would follow if the transfer was not properly completed.

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