

REVIEW ESSAYS AND BOOK REVIEWS

Accounting for Profit for Breach of Contract: Theory and Practice, by Katy Barnett (Oxford, U.K., Hart Publishing, 2012, xxiv, 232 pp., \$110.00)

In her engaging and useful book, *Accounting for Profit for Breach of Contract: Theory and Practice*, Katy Barnett presents a theory of disgorgement damages for breach of contract. This is a welcome publication, as disgorgement damages continue to present both theoretical and practical puzzles for the law of contract, and Barnett makes a valuable contribution to this important topic.

By way of background, it pays to recall Lord Atkinson's remark in *Wertheim v. Chicoutimi Pulp Co.*, that:¹

[I]t is the general intention of the law that, in giving damages for breach of contract, the party complaining should, so far as it can be done by money, be placed in the same position as he would have been in if the contract had been performed.

Damages awarded according to this principle — the default measure of damages for breach of contract — have become known as *expectation damages*, and are designed to compensate the plaintiff for what she has lost as a result of the contractual breach.

Extraordinarily, however, damages for breach of contract are sometimes measured by reference to what the defendant has gained through his breach. So, for example, in the Israeli case of *Adras Building Material v. Harlow & Jones*,² the defendant agreed to sell the plaintiff some steel, but then sold the steel to a third party when the price of steel spiked. The Israeli Supreme Court awarded the plaintiff damages in an amount equal to the profit realized by the defendant. But this is *prima facie* puzzling for at least two reasons. First: why should the plaintiff be entitled to damages measured by reference to the defendant's *gain*? And second: assuming that the measure of damages should be gain-based, why should the *plaintiff* be entitled to those damages? What, in other words, is the normative link between the plaintiff's remedy and the defendant's gain?

Barnett's stated aim in *Accounting for Profit for Breach of Contract* "is to create a workable interpretive theory of the law of

1. *Wertheim v. Chicoutimi Pulp Co.*, [1911] A.C. 301 (Canada P.C.), at p. 307.

2. 42(1) PD 221 (Israel S.C., 1988) (translated in (1995), 3 Restitution L. Rev. 235.

disgorgement damages according to which parties to a contract can predict with reasonable accuracy the remedy which a court will award if they breach their obligations.”³ Barnett’s methodology is *interpretive*: she seeks to articulate a theory that *fits* the data it is trying to explain; that is *coherent*, consistent, and intelligible; that justifies the law’s claim to be a *morally justified* authority; and that is *transparent*, in the sense that it explains the legal reasoning of the legal actors themselves. The core of Barnett’s thesis is that the aim of disgorgement damages is to deter and punish defendants who breach their contracts in certain sorts of cases. As she puts it, “[t]he deterrent rationale is at the heart of the remedy.” (p. 47) In articulating and defending this claim, Barnett focuses on two sorts of cases in particular: what she calls *second sale* cases and what she calls *agency problem*, or *negative covenant*, cases. What emerges is an enlightening analysis of a fascinating and complex area of law. The book itself is well organized and contains eight chapters. They include chapters on the rationales behind disgorgement damages (Ch. 2), on the role of the principle of substitutability (Ch. 3), on second-sale and agency problem cases (Chs. 4 and 5), on the role of “restitutionary damages” (Ch. 6), and on allowances and bars to relief (Ch. 7).

There is much to admire in Barnett’s book. It is thoughtful, comprehensive, and clearly written, displays a good grasp of the relevant literature, and presents interesting arguments in support of the deterrence and punishment perspectives on disgorgement damages. The book will be of interest to legal academics working in contract law and the law of remedies more generally, and legal practitioners who wish to learn more about the doctrinal and theoretical dimensions of disgorgement damages. Moreover, I find myself in agreement with much of Barnett’s analysis of the *practice* of accounting for profit for breach of contract. All the same, there are elements of her arguments concerning the *theory* of that practice that seem to me to be unpersuasive. Consequently, in what follows I would like to focus on Barnett’s arguments against the so-called compensation rationale for disgorgement damages. My hope is to provide some reasons for thinking that, notwithstanding her very detailed analysis of the positive law, there is room to question her analysis of the theoretical underpinnings of that body of doctrine.

Barnett argues that it is not possible to understand disgorgement damages as a compensatory form of remedy. The underlying

3. At page 1. Unless otherwise noted, all in-text citations are to this book.

reason for this, according to Barnett, is that the concept of loss appealed to by the compensatory analysis is unstable: sometimes loss is taken to mean factual loss, whereas at other times loss is understood normatively, as when compensation is given as a substitute for a violation of a right. And as Barnett points out, the problem for the compensation approach is that, in most cases, it seems that the plaintiff has not suffered a factual loss where that loss is measured subjectively, that is, with respect to the plaintiff's position. The problem is that in cases involving disgorgement damages, the loss is measured by reference to the defendant's gain, and this makes trouble for the idea that disgorgement damages can be understood through the lens of compensation.

In response to this general complaint, a number of authors, myself included, have attempted to analyze disgorgement damages in broadly normative terms, according to which disgorgement damages flow from the misappropriation and misuse of certain contractual rights.⁴ On this approach — which I will call the normative approach — the puzzle raised by disgorgement damages can be resolved by reflecting on what is acquired at contract formation, and by thinking about the nature of contractual performance. In particular, the normative approach begins with the following uncontroversial observation: that when a contract is formed, a normatively significant relationship is created between promisor and promisee. This relationship is based on the fact that what the promisee acquires at contract formation is a right to another's choice to perform an action.⁵ Consequently, the wrong involved in a breach of contract consists in the promisor's acting in a manner that is inconsistent with the promisee's acquired right. This can be understood as follows: having acquired, via the formation of a contract, another's choice to perform an action I am now entitled to exercise certain rights with respect to it. Thus, when somebody deals with that right in a way that I have not authorized, that person wrongs me. Sometimes this will require the breaching party to put me — insofar as it can be done with money — in the same position I would have been in had the contract been performed.

4. See Andrew Botterell, "Contractual Performance, Corrective Justice, and Disgorgement for Breach of Contract" (2010), 16 *Legal Theory* 135; and Peter Benson, "Disgorgement for Breach of Contract and Corrective Justice: An Analysis in Outline" in J. Neyers, M. McInnes, and S. Pitel, eds., *Understanding Unjust Enrichment* (Oxford, Hart Publishing, 2004), p. 311.

5. See Immanuel Kant, *The Metaphysics of Morals*, Mary Gregor, ed., (Cambridge, U.K., Cambridge University Press, 1996), at section 6:247.

These are expectation damages. But where the breaching party realizes a profit as a result of her wrongful conduct, I may be entitled to that profit on the grounds that it flows from what is properly mine. I say “may be” advisedly, since not every breach of contract giving rise to profit will result in an award of disgorgement damages. It is only when the action contracted for is suitably unique — where there is no appropriate market substitute available — that disgorgement damages will be appropriate. Barnett usefully terms this the requirement of *non-substitutability* and devotes a full chapter to its elaboration and defence. In a nutshell, this requirement holds that disgorgement should only be available when the subject matter of the contract is non-substitutable, and with this claim I am in general agreement.

To be sure, the normative approach sketched above has an obvious proprietary flavor: it views what is acquired at contract formation in much the same way that we might view the acquisition of a chattel or a parcel of land. But there are good theoretical reasons for taking this analogy seriously. And if the analogy is taken seriously, we have a response to the objection — discussed by Barnett at p. 21 — that the reason why the compensation rationale cannot succeed is that in many cases the plaintiff would not have been in a position to recoup the defendant’s gain had the contract not been breached. For the point of the normative approach is precisely that it is irrelevant to the defendant’s liability that the plaintiff would not have been in a position to recoup the profit that the defendant realized. Rather, what is relevant is the fact that the defendant has used something of the plaintiff’s in a way that she was not authorized to do.

The general idea is that you wrong me if you determine the ends to which my means are to be put even if I am not in a position to put those means to use at all. The classic case of *Edwards v. Lee’s Administrator*⁶ illustrates this principle. In that case, the defendant invited tourists to explore caves under his property and, in so doing, led them underground to caves located under the plaintiff’s property. Because the only entrance to the plaintiff’s caves was located on the defendant’s property, the plaintiff had no way to exploit the caves to his own advantage. Nonetheless, the court had no trouble concluding that, in using the caves without the plaintiff’s consent, the defendant acquired an obligation to disgorge his profits. The reason is simple: because the caves belonged to the plaintiff, the defendant’s use of those caves was

6. 96 S.W.2d 1028, 1033 (Ky. 1936), rehearing denied October 30, 1936.

inconsistent with the plaintiff's ownership of them, and any gains realized by that use were owed to the plaintiff. Or again, consider the well-known egg-washing machine case, *Olwell v. Nye & Nissen Co.*⁷ In *Olwell*, the plaintiff and defendant had been co-owners of an egg business. The plaintiff eventually sold his interest in the business to the defendant, but not included in the sale was an egg-washing machine; rather, the plaintiff retained ownership of the machine and stored it on its property. Sometime after the sale of the business, however, the defendant, without discussion or consent, took the machine out of storage and used it about once a week for three years. While it was accepted that the plaintiff — who had, in fact, forgotten that the machine was on its property — would not have used the machine in those three years, the court nonetheless held that the defendant was liable as a result of using the machine. Again, the natural explanation for the award of damages is that the defendant's liability flowed from the fact that, given that the plaintiff owned the machine, the plaintiff was the only one who was entitled to determine the purposes to which the machine should be put. In using the machine without the plaintiff's consent, the defendant was violating the plaintiff's rights, and so was bound to transfer to the plaintiff any profits realized thereby.

In sum, on the sort of picture to which I am attracted three things are of particular importance when thinking about disgorgement damages: first, that at contract formation the plaintiff acquires a right to the defendant's performance of a certain action; second, that sometimes a defendant may realize a profit by dealing with that right in a wrongful manner; and third, that in cases where the performance of the contract is non-substitutable the appropriate remedy may be to require the defendant to give up any gains realized as a result of the wrongful conduct. To be sure, there are potential problems with the view, since not all cases of disgorgement involve land or egg-washing machines; there are cases that involve quasi-fiduciary relationships, and contracts for personal services. Still, the basic analysis in these latter cases remains the same. Consider, for example, a

7. 173 P.2d 652 (Wash. S.C., 1946), rehearing denied January 6, 1947. Note, however, that the measure of damages actually awarded was based on the amount of money that the defendant saved by not having to wash the eggs by hand, rather than the amount of money that it would have cost to rent a similar machine. But the principle remains the same: the plaintiff is entitled to damages because the defendant dealt with the plaintiff's property in an unauthorized manner.

case involving a quasi-fiduciary relationship in which A is entrusted with property belonging to B. If A deals with the property inappropriately, any profits realized by A ought to be disgorged to B on the grounds that those profits are the result of a wrong committed by A against B, involving B's property. And this should be the case even if B would not have been in a position to deal with the property at all.

With these remarks in mind, let us return to our two initial questions, namely: Why, in a case involving disgorgement damages, must the defendant give up her *gains*? And why must the defendant hand over those gains to the *plaintiff*? On the view I have just sketched above the answer is simple: because the defendant was using what was properly the plaintiff's in a manner to which the plaintiff had not consented and therefore any profits or gains realized by the defendant belong to the plaintiff as a matter of right.

It is perhaps worth noting that the answers to these two questions appear to rest on the same underlying idea: that disgorgement damages tie the defendant's profit, via his wrongful conduct, to the plaintiff's entitlement to damages measured by reference to the defendant's gain. In short, disgorgement damages are appropriate because as a result of the defendant's use of what was properly the plaintiff's *a profit was made*; and because the profit was made by the defendant's use of what was properly the plaintiff's, the profit must be disgorged *to the plaintiff*. Indeed, I am inclined to say that any adequate analysis of disgorgement damages must answer these two questions in a unified manner, since only then will the needed normative link between the defendant's profit and the plaintiff's entitlement be justified.

Unfortunately, Barnett does not, it seems to me, offer a unified response to these questions; rather, she offers a grab bag of conditions and cases. On her view we have, quite generally, second sale cases where a defendant, having contracted with a plaintiff to sell her certain goods, turns around and sells those goods to a third party for a profit; and negative covenant cases, where the subject-matter of the contract is the defendant's promise not to do something, but where the defendant does the very thing that he has contracted not to do, and in so doing realizes a profit. Within the negative covenant cases Barnett argues that non-substitutability is a necessary but not a sufficient condition for an award of disgorgement damages. In addition, she says, the court must

identify a non-financial interest that the contract is designed to protect, and singles out five categories of such contract:

- (1) Contracts involving a propriety or quasi-proprietary interest;
- (2) contracts involving national security or the national interest;
- (3) contracts involving the resolution of a legal dispute;
- (4) contracts involving the protection of third-party family members; and
- (5) contracts involving the public interest that do not fall under one of the preceding heads.

Now Barnett may be correct in highlighting these five different categories of contracts involving non-financial interests; certainly the examples she discusses suggest that these are cases in which courts do, or should, give disgorgement damages. But I cannot help but wonder: what makes these five categories hang together? What is it about them, and them in particular, that gives rise to a remedy of disgorgement when a profit is made as a result of the defendant's breach, and when the object of the contract is non-substitutable? Barnett's explanation is that a broadly distributive justification — one that focuses on deterrence and retribution — can do the required normative work. Says Barnett, "it is far better for courts to be transparent about what they are really doing when they make disgorgement damage awards: they are redistributing the defendant's profit to the claimant." (p. 26) But two things are worth noting here. First, while it may be descriptively true that in awarding disgorgement damages courts are redistributing the defendant's profit, that observation seems to me to be normatively neutral. For a deeper question remains, namely: On what *basis* is the redistribution made? A friend of the compensatory analysis can surely agree that when disgorgement damages are awarded a redistribution is effected, but insist that the reason *why* the defendant's profit is redistributed is because the plaintiff was entitled to it, as a matter of right. Redistribution in Barnett's sense is entirely consistent with the compensation rationale.

Second, it does not follow from the fact that disgorgement damages deter that their rationale is deterrence. Consider an analogy. It may be that, as a matter of fact, many drivers are deterred from driving too quickly by the threat of having to pay damages should they injure another driver or pedestrian while driving at an excessive speed. Nonetheless, even if this is true, it

does not follow that when such an injury does occur, the explanation for why damages are owed is that such damages serve a deterrence rationale. To the contrary, a better explanation is that, having harmed another driver or pedestrian via his wrongful conduct, the defendant must make it as if the wrong had never happened.⁸ That is, the defendant must compensate the plaintiff for her loss, and restore to her — insofar as it can be done by money — what she had prior to the wrongful act that caused her loss. For all that Barnett has argued it could be that disgorgement damages have a similar structure. It could be, in other words, that disgorgement damages are deterrent in their threat but compensatory in their execution. In short, despite Barnett's able arguments, I remain unconvinced that a broadly normative interpretation of the compensation rationale for disgorgement damages for breach of contract cannot succeed.

In the end, however, it may be that my quibbles about disgorgement and compensation are by the by. For despite my disagreements with Barnett about the conceptual underpinnings of disgorgement damages, *Accounting for Profit for Breach of Contract: Theory and Practice* remains engaging, challenging, and comprehensive. Moreover, it is perhaps unfair to devote so much attention to the theoretical aspects of the book when Barnett's primary aim is avowedly pragmatic and practical: to fashion a workable account of disgorgement damages that is descriptively and predictively accurate. In this she succeeds quite well. As an account of the positive law of disgorgement, Barnett's book is extremely useful and anyone interested in the nature of disgorgement damages for breach of contract will surely benefit from reading it.

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8. See Arthur Ripstein, "As If It Had Never Happened" (2007), 48 *Wm & Mary L. Rev.* 1957.

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