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Damages--Breach of Contract--Accounting Analysis [*Vitex Manufacturing Co. v. Carbitex Corp.*, 377 F.2d 795 (3d Cir. 1967)]

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give some indication as to the rule the Court will ultimately adopt. In *Gault*, the Court held that:

{T}he Due Process clause of the Fourteenth Amendment requires that in respect of proceedings to determine delinquency *which may result in commitment to an institution in which the juvenile's freedom is curtailed*, the child and his parents must be notified of the child's right to be represented by counsel retained by them, or if they are unable to afford counsel, that counsel will be appointed to represent the child.⁴³

It is significant that the standard of due process adopted by the Court in *Gault* requires the appointment of counsel whenever the juvenile's freedom is put in jeopardy. Given that juvenile proceedings are nonadversary and that traditional notions of due process have previously afforded greater protection to adults in criminal prosecutions, it would seem to be an a fortiori proposition that indigent misdemeanants facing curtailment of their liberty must be accorded a standard of due process equal to that now guaranteed to juveniles.

WILLIAM S. PADDOCK

DAMAGES — BREACH OF CONTRACT — ACCOUNTING ANALYSIS

Vitex Manufacturing Co. v. Caribtex Corp.,
377 F.2d 795 (3d Cir. 1967).

The recognized objective of a damage award in a breach of contract case is to put the nonbreaching party in the same position he would have been had the contract been performed.¹ In a case where the nonbreaching party is a manufacturer-seller the damage suffered because of the breach is equal to the lost profit. Generally, damages for the buyer's breach are computed by deducting the cost of manufacture from the contract price which equals the lost profit.² With these general principles in mind, consider the following hypothetical.

Suppose a manufacturer enters into five contracts for the year at a unit price of \$20 per contract. Each contract entails a "variable cost"³ of \$5. The "fixed cost"⁴ for the company is \$10 per year. What should be the damage award if a buyer breaches one of the

⁴³ *Id.* at 41 (emphasis added).

contracts? There is a division of authority on this question. One line of thought would conclude that the damage incurred is \$13.⁵ This figure is computed by deducting the variable cost (\$5) and an allocated share of the fixed cost (\$2)⁶ from the contract price (\$20). Accountants and some courts reach this figure because of the general acceptance of an accounting theory called absorption costing. This theory includes in the product cost all overhead costs — fixed and variable — that are incurred by the manufacturing organization.⁷ The rationale for this approach is summed up in the following quotation:

The full cost approach assumes that all fixed costs, both traceable and common, are variable in the long run in linear proportion to variations in the volume of activity. This is based on the further optimistic assumptions that the common fixed costs have been allocated to the activity on some basis that reflects their long-run variability and that there are no indivisibilities in the cost structure. In a specific case these assumptions need to be questioned; in the general case they cannot be allowed to stand.⁸

One of the main reasons that the absorption cost approach is favored by many accountants and some courts is that the approach is recognized for tax purposes by the Internal Revenue Service.⁹

The damage award of \$13 however is inadequate to fully com-

¹ 5 A. CORBIN, CONTRACTS § 992 (1964).

² UNIFORM COMMERCIAL CODE § 2-708(1); see Harris, *A Radical Restatement of the Law of Seller's Damages: Sales Act and Commercial Code Results Compared*, 18 STAN. L. REV. 66 (1965).

³ Variable costs are "those which are expected to fluctuate in total, directly in proportion to sales, production volume, or other measure of activity." C. HORNGREN, ACCOUNTING FOR MANAGEMENT CONTROL 187 (1965). Examples of variable costs are: direct labor, direct materials, and power.

⁴ A fixed cost is "a cost which, for a given period of time and range of activity called the relevant range, does not change in total but becomes progressively smaller on a per unit basis as volume increases." *Id.* at 485. Examples of fixed costs are: rent, insurance, executive salaries, and depreciation.

⁵ See *Willhelm Lubrication Co. v. Bratrud*, 197 Minn. 626, 268 N.W. 634 (1936); *Perfecting Serv. Co. v. Product Dev. & Serv. Co.*, 259 N.C. 400, 131 S.E.2d 9 (1963); *Worrell & Williams v. Kinnear Mfg. Co.*, 103 Va. 719, 49 S.E. 988 (1905).

⁶ The \$2 figure is computed by dividing the fixed cost by the number of contracts for the manufacturing period: $\$10 \div 5 = \2 . The accounting term for this procedure is allocation. All fixed costs are lumped into one sum and then divided by the total production units to attain a per unit cost.

⁷ G. SHILLINGLAW, COST ACCOUNTING 611-12 (1961).

⁸ Shillinglaw, *The Concept of Attributable Cost*, 1 J. ACCOUNTING RESEARCH 73, 78 (1963).

⁹ See Treas. Reg. § 1.446-1(a)(2) (1957). The accounting systems that are not approved by the Internal Revenue Service for tax purposes are those systems that are specifically disapproved. The Commissioner of Internal Revenue is the decisionmaker as to the acceptability of an accounting system.

pensate the seller for the injury resulting from the buyer's breach. Assuming that all the contracts were completed, the company would have a net income of \$65;¹⁰ if only four of the contracts were completed the company would have a net income of \$50.¹¹ Therefore, if one of the five contracts is breached the loss of profit amounts to \$15.¹²

The accounting theory that supports the \$15 figure is called direct costing. The direct costing technique considers product cost to include only the variable costs of the manufacturing process. Fixed costs are considered "period costs"¹³ or as a general charge against the manufacturing process for the period involved.¹⁴ The employment of this system makes one aware of the difficult task of attempting to allocate fixed costs on a rational basis to the amount of production for the period. For example, what basis could be formulated to allocate the fixed cost of research and development to present production?

An income statement based on the direct costing method follows:

Gross Sales Revenue	\$100
-Variable Costs (cost of manufacture)	-25
Contribution Margin ¹⁵	<u>75</u>
-Fixed Costs (period costs)	-10
Net Income	<u>\$ 65</u>

Note that when a manufacturer sets his selling price per unit above the variable cost per unit, the residual amount will cover the contribution margin. If a court includes fixed costs in the cost of manufacture the amount of damages will be insufficient to generate the same net income that would have been generated if the

¹⁰ \$100 (gross sales) minus \$25 (variable cost) minus \$10 (fixed cost) equals \$65 (net income).

¹¹ \$80 (gross sales) minus \$20 (variable cost) minus \$10 (fixed cost) equals \$50 (net income).

¹² \$65 (net income for five contracts) minus \$50 (net income for four contracts) equals \$15.

¹³ "Period" refers to the amount of time that an accounting cycle covers: for example, annual, semiannual, and quarterly.

¹⁴ See NATIONAL ASSOCIATION OF COST ACCOUNTANTS, DIRECT COSTING (1953) (Research Series No. 23).

¹⁵ The contribution margin is composed of fixed costs and net income. This concept does not necessitate allocation of fixed costs because the selling price is planned by setting the price above the variable cost per unit. The portion of the selling price that exceeds the variable cost "contributes" to the fixed cost and then to profit.

contract had been performed.¹⁶ This result however is avoided by including only variable costs in the cost of manufacture. The Third Circuit Court of Appeals in *Vitex Manufacturing Co. v. Caribtex Corp.*¹⁷ followed the direct costing procedure.

Vitex was a seller of cloth processing services and Caribtex was an importer-exporter of cloth. Vitex had completely shut down its plant for the calendar year because of a lack of business. Soon after the shutdown the two parties entered into negotiations and Vitex contracted to process cloth for Caribtex. The Vitex plant was reactivated in anticipation of Caribtex's performance but no cloth was processed because Caribtex repudiated the contract. Vitex sued for lost profits.¹⁸

As mentioned earlier, in a breach of contract case the object of awarding damages is to put the nonbreaching party in the same position he would have been if the contract had been completed.¹⁹ With this objective in mind, the *Vitex* court computed damages by including only the variable costs in the cost of manufacture.²⁰ The court stated that "in a claim for lost profits, overhead should be treated as a part of gross profits and recoverable as damages, and should not be considered as part of the seller's costs."²¹ The court reasoned that since the fixed costs remained constant and were not affected by the Caribtex contract there would be no reason to deduct such costs from the gross profits.²² It was recognized that the accounting procedure of allocating all costs in order to attain a per unit cost is merely a tool to be used in the planning process for managerial decisions.²³ Although the words "direct costing" do not appear in the court's opinion, the procedure used is the practical equivalent of direct costing. In light of the example at the begin-

¹⁶ By including fixed costs, the cost of manufacture would be higher thereby resulting in a lower damage award which would not equal the lost profit.

¹⁷ 377 F.2d 795 (3d Cir. 1967).

¹⁸ Note the unique fact situation. When the plant reopened the only costs incurred were variable costs. The fixed costs had been incurred at the beginning of the period and did not increase as a result of the Caribtex contract. This unique fact situation, however, does not restrict the application of the direct costing principle. In the ordinary course of business the same "cost" distinction — fixed and variable — is valid. Normal production does not necessitate fixed cost expenditures in relation to the level of production.

¹⁹ 5 A. CORBIN, *supra* note 1, § 992.

²⁰ 377 F.2d at 798.

²¹ *Id.*

²² *Id.*

²³ *Id.* at 799. The *Vitex* court called the allocation an "analytical construct." See A. MATZ, O. CURRY & G. FRANK, *COST ACCOUNTING* 10 (3d ed. 1962).

ning of this article, it is apparent that the objective of making the nonbreaching party whole is best accomplished by the direct costing method; or, at least, it can be concluded that the direct costing method accomplishes the objective better than does the theory of absorption costing.

The *Vitex* court used the *Uniform Commercial Code* (UCC) as a guideline in reaching its decision even though the case involved a service contract and not a sales contract.²⁴ Section 2-708(2) of the UCC reinforces the opinion that only variable costs should be included in the cost of manufacture,²⁵ and states that the sellers damages for the buyer's repudiation are to include the profit and "reasonable overhead" if the difference between the market price and the contract price does not put the seller in the position he would have been with full performance.²⁶ "Reasonable overhead," however, is not defined in the UCC. Assuming that the direct costing approach is the most acceptable method for determining seller's damages, there is a need for a refined definition of "reasonable overhead" since overhead is composed of both fixed and variable costs. Only the fixed overhead costs should be recoverable²⁷ with lost profits because the variable overhead costs are actually part of the cost of manufacture; this approach would be consistent with the direct costing technique advocated by the Third Circuit.

There is prior case law concerned with the question of inclusion or exclusion of fixed overhead costs in the cost of manufacture.²⁸ One leading case included the fixed costs in the cost of manufacture.²⁹ Fixed costs were identified as "general running expenses"³⁰ and, once determined, were held to be allocated to the cost of manufacture. The reason for inclusion was that fixed costs were *essential* to the manufacturing activities and, therefore, were to be included

²⁴ Article 2 of the CODE only applies to the sale of goods. UNIFORM COMMERCIAL CODE § 2-102. Although the CODE by its terms is not applicable to service contracts, its use as a guideline may be desirable since presently there is not a codified body of law, uniform in nature, for service contracts.

²⁵ *Id.* § 2-708(2).

²⁶ *Id.*

²⁷ In this context "recoverable" means that the fixed costs should not be included in the cost of manufacture. This procedure leads to a tacit recovery of the fixed costs because the damage formula is contract price minus cost of manufacture.

²⁸ For a discussion of cases that were concerned with the inclusion or exclusion of overhead expense in damage awards, see Annot., 3 A.L.R.3d 689 (1965).

²⁹ *Worrell & Williams v. Kinnear Mfg. Co.*, 103 Va. 719, 49 S.E. 988 (1905).

³⁰ *Id.* at 722, 49 S.E. at 989.

in the cost.³¹ There was no other rationalization for the inclusion. Another court stated that "the cost of manufacture is to include the cost of materials necessary to manufacture the undelivered units, the cost of direct labor thereon, and overhead and fixed charges. Overhead, of course, includes such items as factory overhead, administrative costs, and selling costs."³² Both of the above definitions are unacceptable in light of the access to modern and sophisticated accounting theories that aid discernment of fixed costs, semivariable costs, and variable costs.³³

On the other hand, there are cases which have excluded fixed costs from the cost of manufacture but not for the same reasons articulated by the Third Circuit in the *Vitex* decision. For example, in *Oakland California Towel Co. v. Sivils*³⁴ the following rule was formulated:

[T]he true rule seems to be that the prospective profits should be diminished by charges composing an essential element in the cost of manufacture, or, as in this case, of service. Essential elements in such costs do not include remote costs, overhead or otherwise, but are confined to expenditures that would necessarily have been made in the performance of the contract. . . . If the fixed expenses neither increased nor decreased as a consequence of the nonperformance of the contract, there would be no loss or benefit from that factor.³⁵

The problem created by this rule is that it does not follow a rational theory that can be applied in analogous situations. The result of the case is similar to the result in the *Vitex* decision but the reasoning is different because the *Oakland* decision does not explicitly precipitate out those expenses which are variable to the production. The *Oakland* court failed to mention *why* fixed costs should not be included in the cost of production but only mentioned *if* they should be included.

The *Vitex* decision is a step towards the realization of the concept formulated in *Hadley v. Baxendale*;³⁶ that is, the damages

³¹ *Id.* at 723, 49 S.E. at 989. Note the inadequacy of the definition of "costs" that are to be included in the cost of manufacture. Any cost can be said to be essential to manufacturing activities.

³² *Perfecting Serv. Co. v. Product Dev. & Serv. Co.*, 259 N.C. 400, 417, 131 S.E.2d 9, 22 (1963).

³³ A semivariable cost has both variable and fixed cost characteristics. Only the variable element of the cost would be charged to the cost of manufacture.

³⁴ 52 Cal. App. 2d 517, 126 P.2d 651 (1942).

³⁵ *Id.* at 520, 126 P.2d at 652.

³⁶ 156 Eng. Rep. 345 (1854); see McCormick, *The Contemplation Rule as a Limitation upon Damages for Breach of Contract*, 19 MINN. L. REV. 497 (1935).

which the nonbreaching party is to receive are those that the parties had reasonably contemplated at the time of making the contract should the contract be breached.³⁷ There can be little doubt that the nonbreaching party should receive the same amount of profit as expected on completion of the contract. In light of the accounting methods available for resolving the problem, the *Vitex* decision is clearer than other decisions have been on how to best attain this objective.

No one accounting method is a panacea for damage computation, but judicial notice of accounting methods, not necessarily approved by the Internal Revenue Service, may bring to fruition the damage objectives of *Hadley v. Baxendale*.³⁸ The Third Circuit recognized that the direct costing theory best approaches the objective of placing the seller-manufacturer in the same position as if the contract had been performed. The unique fact situation of *Vitex* does not limit the application of direct costing to damage computation; the method is also applicable to seller-manufacturers who are on a normal production schedule. The fixed costs in either case are constant and will be incurred by an organization whether there is a complete shutdown or full production.³⁹

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³⁷ 156 Eng. Rep. at 354.

³⁸ See Treas. Reg. §§ 1.471-2, -3 (1958). These regulations discuss the unacceptable accounting methods for inventory evaluation purposes; the theory of direct costing is one of them.

³⁹ The inclusion of fixed costs in the cost of manufacture leads to a punitive result to the manufacturer. "[A]n inability or unwillingness to incur fixed costs reveals an aversion to risk that will shut out a company from potentially profitable ventures. The launching of new products and new business often entails exceedingly large fixed costs for research, advertising, equipment, and so forth." C. HORNGREN, *supra* note 3, at 194.