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Inflation as an Assessment Factor in Contract Damage Awards

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COMMENTS

INFLATION AS AN ASSESSMENT FACTOR IN CONTRACT DAMAGE AWARDS

Few people will argue with the statement that we are living in an inflationary era. That prices have continued to escalate since 1947 is readily apparent—in the thirty years from 1947 to 1977, prices soared 169 percent.[1] No single theory of inflation is accepted by all economists, but a layman would define inflation as a persistent rise in the general level of prices. A more accurate definition of inflation is a condition in which any additional increase in aggregate demand "produces no further increase in output and entirely spends itself on an increase in the cost-unit."[2] However one chooses to define inflation, courts are being forced to deal with the decreased purchasing power of the dollar which flows from it.

Money has three functions in society today. First, it serves as an instrument of payment in that the law obliges a creditor to accept money in payment of a pecuniary obligation. Second, it functions as a measuring device in that it is the common denominator of all values. Third, it serves as an object of appropriation in that it is a reservoir of value that one can utilize for expenses of consumption or investment. While inflation affects these three inextricably bound functions of money, it is through money's role as a measure of value that inflation presents problems for the courts.

Inflation becomes an issue for a court in three situations: (1) pre-performance inflation; (2) pre-assessment inflation; and (3) inflation affecting future losses. In the first situation, inflation prior to performance of a contract may make such performance unprofitable for one party to a contract. In this instance, the party whose performance has become more burdensome due to inflation asks the court to rescind or alter the contract on the grounds of changed conditions and circumstances. In the second situation, when inflation occurs between the breach of a contract and a judgment awarding damages and thereby alters the measurement of damages, the court is asked to determine whether plaintiff or defendant should bear the risk of price changes. In the third situation, when inflation affects future losses, the court is asked to decide how these losses

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1. W. Peterson, Income, Employment, and Economic Growth 459 (4th ed. 1978).
2. J. Keynes, The General Theory of Employment, Interest and Money 303 (1946).

should be assessed.[3]

Presently, courts are addressing the issue of the effect of inflation only in relation to future losses and then only when future losses are involved in tort cases.[4] This comment proposes that inflation be taken into account in awarding damages in contract cases where pre-assessment inflation or inflation affecting future losses occurs, but *not* where pre-performance inflation occurs. This comment also proposes a method of determining and applying such an inflation factor.

The Compensatory Nature of Damages for Breach of Contract

A brief review of the theory of compensatory damages is helpful in understanding the necessity of taking inflation into account in assessing damages in breach of contract cases. The purpose of awarding damages is to place the plaintiff in the same position as if the contract had been performed, so far as this may be accomplished with money.[5] Among the reasons for making contract damage awards compensatory is to promote confidence in contractual relations,[6] to encourage efficient breach and discourage inefficient breach,[7] and to allocate the risk efficiently between the parties.

During inflationary periods, the interaction of three factors—the nominalist principle, the proper date for assessing damages, and the inadequacy of the legal interest rate—causes contract damage awards to fall short of achieving the purpose of compensatory damages.[8] One kind of contract commonly affected by inflation is the loan of money. Nominalism, expressed in Louisiana Civil Code article 2913, would set the creditor's damages for the debtor's non-payment at legal interest under Louisiana

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3. Rea, Inflation and the Law of Contracts and Torts, 14 Ottawa L. Rev. 465, 465 (1982).

4. Jones & Laughlin Steel Corp. v. Pfeiffer, 103 S. Ct. 2541 (1983); Culver v. Slater Boat Co., 688 F.2d 280, 306 (5th Cir. 1982); Byrd v. Heinrich Schmidt Reederei, 688 F.2d 324, 325 (5th Cir. 1982); Hoskie v. United States, 666 F.2d 1353, 1355 (10th Cir. 1981); Doca v. Marina Mercante Nicaraguense, S.A., 634 F.2d 30 (2d Cir. 1980); Semmes v. Employers Fire Ins. Co., 181 So. 2d 54, 56 (La. App. 2d Cir. 1965), cert. denied, 248 La. 906, 182 So. 2d 660 (1966); Kaczkowski v. Bolubasz, 491 Pa. 561, 421 A.2d 1027 (1980).

5. Restatement of Contracts § 329, comment a (1932); 5 A. Corbin, Corbin on Contracts § 1002, at 31 (1964); 11 S. Williston, A Treatise on the Law of Contracts § 1338, at 198 (3d ed. 1968).

6. Note, Pre-Assessment Inflation as a Factor in Damages, 48 U. Cin. L. Rev. 999, 1003 (1979).

7. Efficient breach is a refusal to perform a contract because such refusal is more profitable than performing. Inefficient breach results from any cause other than the profitability of not performing. See Rea, supra note 3, at 468.

8. K. Rosenn, Law and Inflation 234-35 (1982). The nominalist principle states that the obligation that results from a loan of money is always only the numerical sum stated in the contract. Id. at 38-40.

Civil Code article 1935. Nominalism prevents the creditor from recovering for the depreciation in the value of money because the value of money is presumed to be permanently unchanging. One commentator considers it sensible to impose the risk of inflation on the creditor until time for payment since the creditor can allow for inflation in the interest rate he charges, but this same commentator finds it illogical to presume that the creditor assumes the risk of inflation after the time for repayment. He proposes distinguishing pre-time-of-performance inflation from post-time-of-performance inflation with only the former being at the creditor's risk.[9]

The rule in Anglo-American jurisdictions is that damages for breach of contract are assessed as of the date of the breach. This rule places the risk of inflation on the non-breaching party since inflation between the breach and judgment will reduce the value of the award. Most civil law jurisdictions assess contract damages as of judgment, thus placing the risk of inflation on the defaulting party by revaluing the amount of the obligation to reflect inflation.[10]

In assessing contract breach damages, the court should use a two-step approach.[11] First, it should determine if the requested item of damages is appropriate for compensation. In doing so, the court should consider the factors within the contemplation of the parties when entering the contract, the causation of the loss, the remoteness of damages, and the plaintiff's duty to mitigate damages. This step is also known as establishing a measurement value, that is, assigning a monetary value to the violation of the plaintiff's legal right.[12] If the item is found to be appropriate for compensation, the court must then determine the value of that loss. This second step is also known as establishing an assessment value. The court, in essence, is determining what the defendant is to pay. This assessment value is affected by considerations different from those affecting measurement value. These considerations include interest from the date of harm to the date of assessment, attorneys' fees, nominal damages, and punitive damages.[13] It is at this second step that inflation should be considered. The following hypothetical situations illustrate how ignoring inflation can frustrate the aim of adequate compensation of the plaintiff for his loss resulting from the defendant's breach.

Assume that in 1983 B agrees to furnish A certain materials in January 1984 for $1,000.00, knowing that A has contracted to resell these items

9. Id. at 235.

10. Id. at 237.

11. Note, The Inflation Factor in Damages for Breach of Contract: Leitch Transport Ltd. v. Neonex International Ltd., 27 O.R. (2d) 363 (C.A. 1979), 12 Ottawa L. Rev. 489, 491 (1980).

12. Note, supra note 6, at 999.

13. Id. at 1000.

to C for $1,500.00 later in January of 1984. Due to inflation, the price of these items rises between the time of the making of the contract and the time for performance to the extent that B will lose money if he performs. Therefore, B breaches by refusing to deliver, thereby causing A to breach his contract to resell to C and to lose his $500.00 profit. Clearly, the profit of which A was deprived is an item appropriate for compensation since this profit was within the contemplation of the parties and since B's breach caused A's loss. The problem arises in assessing A's loss. Under Anglo-American principles of compensatory damages, A's damages are fixed as of the breach—1984, when the loss is $500.00. If judgment is not rendered in the case until December 1986, and if inflation rises seven per cent in each of the three years from the making of the contract until judgment, A's award of $500.00 does not fully compensate him for his loss. A sum of $500.00 in 1984 provides twenty-one percent less purchasing power in 1986. Thus A receives only seventy-nine percent of his loss. A is not placed in the position in which he would have been had B performed to the extent that it is possible for money to so compensate him.

A second example further illustrates how inflation prevents the plaintiff from being fully compensated. B agrees to sell A a tract of land for its market value of $50,000.00. Due to the general inflationary trend, the value of the land increases to $65,000.00 by the time for performance. B refuses to perform. By the time of the judgment for A, the land is worth $75,000.00. Had B performed, A would be $25,000.00 richer. However, A's damages are fixed as of the time of the breach at $15,000.00. And absent a contractual provision allowing pre-judgment interest the court will give interest only from the time of judgment until the time of payment. A is thus denied compensation for the $10,000.00 of loss he suffered due to the increase in value caused by inflation.

Interest and Inflation

The issue of inflation first arose judicially in connection with the discounting of future lost wages to present value. Judicial refusal to take inflation into account in damage awards seemed particularly unfair to the plaintiff in light of the fact that his award of future losses was to be discounted to present value under the Supreme Court's ruling in *Chesapeake & Ohio Railway v. Kelly.*[14] This unfairness led courts to consider inflation in tort cases in which lost future wages were involved. An explanation of the relation of interest rates, inflation, and discount rates is necessary to understand what courts have elected to do in tort cases.

Whenever the plaintiff is awarded a lump sum for lost future wages, the award is discounted to present value, that is, it is reduced to the

14. 241 U.S. 485, 36 S. Ct. 630 (1916).

amount which, if safely invested, would grow to an amount equal to the total lost future earnings. The Supreme Court in *Chesapeake* explained that the discount rate should be the interest rate obtainable by an unsophisticated person through a safe investment available at the time and place of the trial.[15]

The problem with discounting the award without considering the effect of inflation lies in the nature of the rate of interest set by lending institutions. The interest rate which a bank charges consists of three components: (1) a net return on money lent called the real rate of interest (typically two to three percent), (2) a risk factor that varies according to the debtor's financial condition and his plans for use of the money, and (3) a factor representing anticipated inflation.[16] The interest rate that the bank charges is thus designed to compensate the lender for the decreased purchasing power of the money lent. Therefore, when the defendant is allowed to reduce the amount he owes the plaintiff by the rate of interest a bank charges, the defendant is being allowed to subtract any increase in that amount resulting from inflation because the inflation rate is contained in the interest rate. When a plaintiff is then denied any opportunity to increase the sum awarded in order to obtain the same buying power, the effect is to prohibit the plaintiff from considering inflation while at the same time allowing the defendant to do so.[17]

These future earnings cases have highlighted the effect of inflation on damage awards. Courts have worked out various ways to handle the discount-inflation problem, but always within the context of tort cases in which lump sum awards for lost future earnings were involved. When courts have decided to adjust for inflation, the solutions have seemed to fall into three categories:[18] (1) the total offset method by which the court conclusively presumes that the rate of inflation and the discount rates are equal and thus cancel each other out,[19] and therefore orders the defendant to pay the full amount awarded; (2) the net rate method by which the inflation rate is subtracted from the interest rate and the balance (called

15. Faris, New Vistas of Damages in Maritime Personal Injuries, 43 La. L. Rev. 913, 933 (1983).

16. Mackaay and Fabien, Civil Law and the Fight Against Inflation—A Legal and Economic Analysis of the Quebec Case, 44 La. L. Rev. 719, 723 (1984).

17. Faris, supra note 15, at 934.

18. Silverman, Death of a Wage Earner: The Calculated Effects of Interest, Inflation, and Taxes on Award, 19 Trial 40 (Feb. 1983); Comment, Adjusting Damage Awards for Future Inflation, 1982 Wis. L. Rev. 397, 405.

19. Gallemore v. United States, 530 F. Supp. 136 (E.D. Pa. 1982); Barnes v. United States, 516 F. Supp. 1376 (W.D. Pa. 1981), aff'd, 685 F.2d 66 (3d Cir. 1982); Funston v. United States, 513 F. Supp. 1000 (M.D. Pa. 1981); Jones v. Harrisburg Polyclinic Hosp., 496 Pa. 465, 437 A.2d 1134 (1981); Kaczkowski v. Bolabasz, 491 Pa. 561, 421 A.2d 1027 (1980).

the inflation adjusted discount rate) is applied to discount the award[20] so that the defendant pays this lesser amount; and (3) the upward adjustment method by which the lump sum award is multiplied by the inflation rate and then discounted by the interest rate,[21] the amount owed by the defendant again being decreased. When courts use either the net rate method or the upward adjustment method, they arrive at the discount rate in one of two ways: the trier of fact is allowed to choose the discount rate using independent economic evidence and projections, or the court sets a fixed adjusted discount rate as a matter of law.[22]

Louisiana law recognizes that the decreased purchasing power of the dollar due to inflation is a proper element for consideration in determining awards in tort actions,[23] and the first circuit has used the net rate method with expert evidence on the inflation rate and the discount rate.[24]

Contract Damage Awards Proposal

The major argument that plaintiffs faced in tort cases was that inflation was too speculative to prove.[25] Now that this obstacle has been overcome in tort cases, there seems to be no reason not to allow consideration of inflation in contract cases. Fairness dictates that the tort plaintiff should not be given an advantage in calculating future losses that the contract plaintiff is denied merely because the latter's suit is in contract.

Taking inflation into account in contract cases would not be a judicially created doctrine in Louisiana. The idea of giving the obligee the current value of the debt due him runs through the Civil Code, though the word *inflation* is never used. The first example of this concept is found in the articles on loan for consumption. Louisiana Civil Code article 2915 provides that "[i]f provisions have been lent, whatever be the increase or diminution of their price, the debtor is still bound to return the same quantity and quality, and he is bound to return no more." This provision illustrates the concept of a debt of value which by its nature includes the inflationary changes in value.[26] Civil Code article 2921 provides for

20. Doca v. Marina Mercante Nicaraguense, S.A., 634 F.2d 30, 39 (2d Cir. 1980), cert. denied, 451 U.S. 971 (1981); España v. United States, 616 F.2d 41, 44 (2d Cir. 1980); Feldman v. Allegheny Airlines, 382 F. Supp. 1271, 1293 (D. Conn. 1974), aff'd, 524 F.2d 384 (2d Cir. 1975).

21. Hoskie v. United States, 666 F.2d 1353, 1356 (10th Cir. 1981).

22. Comment, supra note 18, at 405.

23. Cage v. Shainberg's Stores, 413 So. 2d 564 (La. App. 1st Cir. 1982); Semmes v. Employers Fire Ins. Co., 181 So. 2d 54, 56 (La. App. 2d Cir. 1965), cert. denied, 248 La. 906, 182 So. 2d 660 (1966); Scott v. Claiborne Elec. Coop., 13 So. 2d 524, 532 (La. App. 2d Cir. 1943).

24. Hirstius v. Louisiana Materials Co., 413 So. 2d 611, 614 (La. App. 1st Cir.), cert. denied, 415 So. 2d 943 (La. 1982).

25. Silverman, supra note 18, at 40.

26. A debt of money is defined by money and fixed at its creation. Its value is directly

the possibility that the debtor cannot return things of the same quantity and quality:

> If it be impossible for him to fulfill his engagement, he is bound to pay the value of the things lent, taking into consideration the time and place when they ought to have been returned according to the agreement.
>
> If the time and place have not been regulated, the payment is made according to the price which the thing is worth at the time and place where the demand is made.

The articles clearly provide that the value of the debt in money is assessed at the time return is due. Such a calculation would take into account any inflation in the value of the things lent between the time of making the contract and the time of performance.

A second example of this kind of accounting is found in the articles on the right of accession. Civil Code article 494 provides that when the owner of an immovable makes improvements on it with the materials of another, he may retain the improvements by "reimbursing the owner of the materials their current value and repairing the injury that he may have caused to him." The redactors clearly intended that inflation be considered in assessing the debt of the owner of the immovable. Provisions were made for the same kind of assessment, that is, current value, in Civil Code article 495 which stipulates that the owner of an immovable may elect to keep component parts incorporated into or attached to his immovable by another by paying the person who made the incorporation the "current value of the materials and of the workmanship or the enhanced value of the immovable." Civil Code articles 496 and 497 contain similar provisions for payment for constructions made by a possessor on an immovable belonging to another.

A third example of a debt of value is found in the matrimonial regimes provisions. Civil Code article 2368 gives one spouse the right to one-half of the increase in value of the other spouse's separate property if its value is increased as a result of the uncompensated common labor or industry of the spouses. This is the value of the property at the termination of the community, though the labor may have been performed many years prior thereto. The increase could also be due to inflation. Thus, the uncompensated spouse is given the value of his labor at current value.

These provisions show that the concept of inflation was not foreign to the redactors. They considered it and provided for it in these situations. It is especially significant that they provided for inflation in the

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affected by inflation unless indexed. A debt of value, on the other hand, has for its object neither a thing nor a sum of money but a value. As long as this debt remains unliquidated, it escapes the effect of inflation.

area of contracts in the provisions on loan for consumption. Thus, a court that takes inflation into account in breach of contract damages would be applying a general principle found throughout the Civil Code.

The introduction to this comment enumerated three situations in which the issue of inflation arises. The first situation occurs when inflation before performance makes the obligation so burdensome that the obligor sues for rescission or modification of the contract on the theory of changed circumstances. It is suggested that courts not interfere in the contractual relations of the parties to the extent that it is possible for the parties to index their contracts to provide for the effects of future inflation. The general philosophy underlying contract law is not to protect contracting parties from their own unwise decisions but to leave them with the results of their bargain. With future inflation virtually certain, a party who fails to provide for its effects cannot credibly claim that inflation was so unanticipated that he should be relieved of his duty to perform. There should be a presumption that the parties have provided for inflation in their contracts. However, situations may arise when the court's intervention is necessary because the parties cannot index their contracts due to price-control laws or long-standing union contracts, but since in the majority of cases indexing is easy and inexpensive, court action would seldom be justified.

However, it is suggested that the courts *should* consider inflation in situation two—when inflation occurs between the breach of contract and the assessment of damages at judgment. Plaintiff's damages must be measured as of the breach but assessed as of judgment because "[f]ailure to recognize the difference between measurement and assessment in computing contract damages subverts the compensatory ideals on which such damages are based."[27] Considering inflation, therefore, compensates the plaintiff for the change in the average real value of money.[28] Such consideration of inflation in determining contract damages is not prohibited by the Civil Code. Article 1934 limits damages to those reasonably supposed to have entered into the contemplation of the parties at the time of the contract. Since inflation has been persistent for more than thirty years, the parties could reasonably be deemed to have contemplated the effects of inflation. Under Civil Code article 1938, absent a contractual provision for interest from time of the breach to the time of assessment, the plaintiff receives no interest. The basis of this article is the idea that the debt is not due until the court determines liability and the debt is thus liquidated. Thus, without interest for the pre-assessment period, there is a greater necessity to consider inflation in order to compensate the plaintiff fully.

27. Note, supra note 6, at 1006.
28. Note, supra note 11, at 499.

As to pre-assessment inflation, it is suggested that two types of cases be distinguished. First, when specific performance is still possible at the time of judgment but a monetary award is ordered,[29] damages should be measured and assessed as of judgment. This obviates the need for determining an inflation factor, is easy and efficient, and yet fully compensates the plaintiff. It also follows the general civil law rule for the date for assessing damages. This kind of case is exemplified by the breach of a contract to sell land. In cases where specific performance is no longer possible, the court should measure plaintiff's loss as of the breach and then apply the inflation factor to convert that loss into the present amount of money that represents the same purchasing power, similar to converting dollars into foreign currency. The inflation factor could be determined by hearing expert evidence, but since such a method would lengthen the trial and require costly experts, the rate could more effectively be determined from the Consumer Price Index. Reference to special indexes for particular items is not recommended since the purpose of considering inflation is to compensate the plaintiff for the change in the average real value of money.[30]

It is suggested that in situation three, in which inflation affects future losses, courts follow the same rules for contract cases that they are presently using in tort cases. There is no reason to distinguish the two by making future tort losses a debt for which the plaintiff is paid according to the value of that debt, while future *contract* losses are only a loss of a sum of money to be paid regardless of the change in value of that sum.

Conclusion

In order to compensate a plaintiff in a contract case, when judgment is rendered in his favor long after the breach occurs or when the award is for future losses, an inflation factor should be applied to the damage award to compensate the plaintiff for the decreased purchasing power of that award. Pre-performance inflation will not justify the court's interference to rescind or alter the contract if the parties could have easily included a cost-indexing clause in their contract to provide for the effects of inflation. However, where pre-assessment inflation is involved, an inflation factor should be applied to any monetary award measured as of the breach. (To avoid the necessity of determining that factor, however, the damages should be measured at the time of judgment when possible, that is, when specific performance is still possible at the time of judgment.) Where inflation affects future losses, contract cases should be

29. Inflation need not be considered if specific performance is granted because the plaintiff is placed in the same position as if the contract had been performed.
30. Note, supra note 11, at 499.

treated like tort cases in that lump sum awards are discounted and adjusted for inflation. No legislative action is necessary in this area since measuring and assessing damages is one of the routine duties of the court and since the basis for such action is found as a general principle running throughout the Civil Code.

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