ECON 522 - CONTRACT LAW PART 1

(Bargain Theory, Efficient Breach, Reliance)

I Contracts

When we were studying property law we were looking at situations in which the exchange of goods/services takes place at the time of trade, but sometimes in trade situations the actual exchange is delayed. Contract law covers trade in which the exchange of goods takes place after the deal, which essentially makes contracts promises to perform in the future. Most of our analysis of contracts examines how to design the law so that individuals make contracts when there are potential gains from trade, and also break contracts when performance becomes so costly that it is inefficient.

I.1 Bargain Theory

A contract is a promise, but should every promise be a legally binding contract? The answer, for efficiency's sake, is definitely no. But if not all promises are legally enforceable, we need to figure out which types of promises should be enforceable. The Bargain Theory is one attempt to answer this question. Think of the bargain theory as theoretical guidelines for a court to decide when a promise (contract) should be enforceable. This does not necessarily imply that courts only enforce contracts if they fit the bargain theory criteria, or that they enforce all contracts that do, but the theory is a good benchmark to get us thinking about efficient enforcement.

The lecture notes lay out and explain the theory, but remember that it says in order for a promise to be a legal contract it must be part of a bargain, and a bargain has three components:

(i) Offer

(ii) Acceptance

(iii) Consideration

An offer is what one side proposes to give up in the trade, and the acceptance is the other aside agreeing to that offer. Consideration is what the accepting side gives up in the trade. Thus consideration and offer play the same role. For example, if we decide to write a contract saying that you will buy my car in two weeks for $500, then we could say that I'm offering you my car, you choose to accept, and the $500, or your promise to pay $500, is your consideration. However it's also true that your $500 is your offer to me, while my car is my consideration.

I.2 Damages (Part 1)

Contracts are promises, but only certain promises should be enforceable as contracts. Now we need to decide what enforcement mechanisms will be efficient.

One key concept that pops up throughout our contract law studies (and pretty much everything else too) is that an individual's actions can produce *externalities*. With contracts, if the promisor decides to *breach* (break) a contract, then there is the negative externality of lost benefit to the promisee. The point is that when deciding to breach, the promisor only takes into account his own costs, not the costs to the promisee, so he may breach even if total social welfare would be higher without breach. The solution is to force the

promisor to *internalize* the externality, by requiring him to pay the promisee whatever expected value is lost due to the breach. This penalty is called *expectation damages*.

Expectation damages guarantee efficient breach. However, there are other dimensions of a contract that we also want to be performed efficiently...

I.2.1 Reliance

Reliance is the investments made by the promisee to improve the value of the contract (e.g. a hangar for a plane, or furniture for a new house). The main point in our analysis of reliance is that it's very difficult to design an enforcement mechanism that provides incentive for both efficient reliance and efficient breach. Once again the problem is externalities, which we'll discuss below.

If the promisee has relied at all, then clearly the expected benefit of the contract increases for the promisee (recall the airplane and hangar example: if I don't get my plane, then the hangar isn't worth anything to me, but my plane is worth a lot more to me if I have a hangar to put it in). However, if we include reliance in expectation damages, then people will *over*-rely.

The reasoning is as follows: if I know that any dollar that I invest in reliance is going to give me my expected return with probability one (with certainty), then I will invest as if the probability of breach is zero. However, if the probability of breach is not zero (there's some probability that the contract will be broken by the promisor), then the promisor is forced to pay me for my investment, at no cost to me. Thus every dollar that I decide to invest in reliance imposes a negative externality on the promisor. Since I don't have to pay at all for that negative externality, I will over-rely.

Solution: Don't include reliance in expectation damages. If reliance is not included in expectation damages, then every dollar that I invest in reliance only gives a return if the contract is not breached. Thus I pay the total cost of any investment in reliance; I internalize the externality, so that I rely the efficient amount. However, excluding reliance from expectation damages means the promisor no longer pas the full externality caused by breach in damages, and thus breaches too often.

Example. I sign a contract with Monona Terrace to hold a conference there next August. After signing the contract I decide to start planning the event, and I must choose how much to invest in advertising for the conference. I can spend \$500 on a newspaper ad in the Wisconsin State Journal, or I can spend \$5000 on a TV ad during the local nightly news. If the conference ends up happening, then the benefit to me of a WSJ ad is \$1500, while the benefit of a TV ad is \$7000 (this is not net of cost). Suppose there is some probability p that Monona Terrace will realize they double booked the conference hall and breach the contract.

(i) Given the probability of breach $p = 30\%$, which ad is it efficient for me to buy? What will I choose to do if expectation damages include reliance? What will I choose to do if expectation damages do not include reliance?

(ii) What would the probability of breach need to be for the other ad to be efficient?

Answers

(i) The efficient ad is the one with the highest expected positive payoff. The expected payoff is:

$$\begin{aligned}&(\text{Payoff from ad given contract upheld}) \times (\text{ Probability contract upheld }) \\ &+ (\text{Payoff from ad given contract breached}) \times (\text{ Probability contract breached })\end{aligned}$$

For the TV ad this is:

$$2000(.7) - 5000(.3) = -\$100$$

Clearly not efficient. For the WSJ ad this is:

$$1000(.7) - 500(.3) = \$550$$

Thus the newspaper ad is the efficient choice. However, if expectation damages include reliance, then I'm comparing a return of $2000 for a TV ad to a return of $1000 for a WSJ ad, thus I choose the inefficient TV ad, since I do not pay the loss if there is a breach of contract. If expectation damages do not include reliance, then I'm comparing a payoff of -$100 for the TV ad to $550 for the WSJ ad, thus I would choose the efficient newspaper ad.

(ii) It would have to be that

$$\begin{aligned}2000(1-p) - 5000p &> 1000(1-p) - 500p \\ 2000(1-p) - 1000(1-p) &> 5000p - 500p \\ 1000(1-p) &> 4500p \\ 1000 - 1000p &> 4500p \\ 1000 &> 5500p \\ p &< \frac{10}{55} \approx 18\%\end{aligned}$$