Economics 522: Law and Economics
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Handout #6: Contract Law Basics

Review

1. **The Language of Contracts**[1]

   – **Contract:** A *contract* is a specification of actions to be taken by the contracting parties under various conditions.[2]

   – **Complete Contract:** A contract is *complete* when it account for every condition which can possibly be realized.

   – **Incomplete Contract:** A contract which is not complete is called *incomplete.*

   – **Gaps:** Contingencies not accounted for in a contract are called *gaps.*

   – **Promisor:** The party which makes a promise in a contract is called the *promisor.*

   – **Promisee:** The party which receives a promise in a contract is called the *promisee.*

2. **The Bargain Theory:** An early theory of contract enforcement which states: "A promise should be enforced if it was given as part of a bargain, otherwise it should not."

   – **Components of an Enforceable Bargain:**

   (i) **Offer:** One side offers a contract.

   (ii) **Acceptance:** The other side accepts the contract.

   (iii) **Consideration:** The legal term for the thing the promisee gives the promisor to induce the promise

   – **Reciprocal Inducement:** If the promisee gives consideration, we have *reciprocal inducement*, or an exchange between the two parties.[3]

   – **Expectation Damages:** The remedy prescribed by the bargaining theory is damages which leave the promisee as well-off as if the promise had been kept.

   – This theory leads to inefficiency (i) by failing to enforce promises which both sides would have wanted to be enforceable when they were made, and (ii) by enforcing promises which should not be enforced.

3. **Breach of Contract:** When a party fails to perform the action specified in a contract.

   – **Efficient Breach:** Breach is efficient when the cost of performance to the promisor is greater that the promisee's benefit. Performance is efficient when the cost of performance to the promisor is less that the promisee's benefit.

   – However, the promisor will choose to breach only when the promisor's cost to perform exceeds their liability.

   – Expectation damages would (i) internalize the externality imposed on the promisee by the promisor's breach, (ii) result in efficient breach when negotiations are impossible, and (iii) lead to the promisor investing efficiently in performance.

4. **Reliance:** Actions which are value-enhancing to the promisee, conditional on the promisor's performance.

   – **Efficient Reliance:** A reliance investment is efficient when the expected value of that investment is positive.

   – **Two Approaches to Reliance Damages:**

   (i) **Efficient Reliance Damages:** In the view of Cooter and Ulen, damages should include only efficient reliance.

   (ii) **Foreseeable Reliance:** In practice, damages usually include foreseeable reliance.

5. **Default Rules:** Rules that tell the court what to do with gaps in a contract.

   – **Majoritarian Default Rule:** An attempt to will a gap with the terms that most parties would have agreed to.

   – **Efficient Default Rule:** An attempt to fill a gap with the rule the parties would have wanted, had they thought to specify it. Such rules work well when gaps exist due to a high transaction cost of filling them, and not due to strategic omission.

   – **Penalty Default Rule:** An attempt to fill a gap with a rule the parties would not have wanted in order to encourage the parties to disclose information and fill the gap with something efficient. Such rules may work well when gaps are left for strategic reasons.

   – **Immutable Rule:** An immutable rule is like a default rule, but it can't be negotiated around.

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[1]The definitions in this section are drawn largely from Steven Shavell's book, *Foundations of Economic Analysis of Law.*

[2]Shavell notes: "The actions typically pertain to delivery of goods, performance of services, and payments of money, and the conditions include uncertain contingencies, past actions of parties, and messages sent by them."

[3]These exchanges can be "Money-for-a-promise," "goods-for-a-promise," "service-for-a-promise," or "promise-for-a-promise."

6. **Invalid Contracts:** Contracts are usually upheld by law, but may be invalidated to either (i) protect parties inside a contract (from exploitative terms) or (ii) protect parties outside a contract (from externalities arising from the contracted action). Contracts may be invalidated if the following can be convincingly demonstrated:

(a) **Formation Defense:** A claim that the requirements for a valid contract are not met.

    (i) **Derogation of Public Policy:** Performance of the contract violates or circumvents the law.
- When either (i) both parties are informed about the illegality of the contracted action or (ii) when only the promisee is informed about the illegality of the contracted action, the promisor cannot be held liable for breach.
- When only the promisor is informed about the illegality of the contracted action, the promisor may still be held liable for breach.

    (ii) **Incompetence:** Individuals agreeing to the contract were not rational at the time.
- Parties are often not held liable for decisions made by "irrational/incompetent" agents (e.g. children), both for reasons of paternalism and of efficiency.
- Irrationality/incompetence resulting from personal choice (e.g. drinking) is generally not protected. Doing so would encourage inefficient contract formation (e.g. inefficiently high monitoring expenses).

    (iii) **Dire Constraints:** A contract was signed under *necessity* or *duress*.
- **Necessity:** Applies when the contracting party *is not* responsible for for the dire situation. When incentives for efficient activity are misaligned for parties making a contract, ex-ante optimal terms are more likely to achieve efficiency than terms negotiated under necessity.
- **Duress:** Applies when the contracting party *is* responsible for for the dire situation. Enforcing contracts made under duress would (dynamically) incentivize activity which places parties in dire situations.

(b) **Performance Excuses:** A claim that a properly-formed contract should not be enforced due to changed circumstances.

    (i) **Impossibility:** Circumstances make it impossible to perform on the contract.
- Usually contract specifies liability. Otherwise uses default rule.
- Efficiency requires assigning liability to the party that bears the risk at least cost.

    (ii) **Frustration of Purpose:** A change in circumstances made the contract pointless.

(c) **Bad Information:** Contracts signed when one or both parties possess bad information *may* be invalidated.

    (i) **Fraud:** One party deliberately tricked the other.

    (ii) **Failure to Disclose:** One party failed to disclose critical information to the other.
- Under civil law, parties have a duty to disclose important information.
- Under common law, generally only safety risks need be disclosed. Exceptions include new products which come with an "implied warranty of fitness," and (some) large transactions where full disclosure is often necessary for efficient contract formation.

    (iii) **Mutual Mistake:** Both parties made a mistake, without which the contract would not have been signed.

    (iv) **Unilateral Mistake:** One party has mistaken information.
- These contracts are typically upheld, as they incentivize the efficient collection of information.

    (v) **Vague Contract Terms:** Ambiguity in the terms of a contract.
- Similar to penalty defaults, refusing to enforce vague contracts incentivizes careful contract formation.

Notes:
- Efficiency generally requires "uniting knowledge and control," putting control in the hands of the party with the most efficiency-enhancing information.
- Cooter and Ulen argue that contracts based on one party's knowledge of *productive* (wealth-increasing) information should be enforced, while contracts based on one party's *redistributive* (wealth-shifting) information should not.

(d) **Monopoly Defenses:** A monopolist is the only seller of a product for which no close substitutes exist and can dictate the price and nonprice terms of the contract offered to many buyers. The buyer must respond by accepting the monopolist's offer or doing without the good. Some extreme contract terms (often arising from monopoly power) may be invalidated.

    (i) **Contract of Adhesion:** Contracts offered as "take-it-or-leave-it" deals, where terms are non-negotiable, are generally upheld.
- Some states void terms of a contract which would not have been agreed to had they been noticed.

    (ii) **Unconscionability/Lesion:** Overly one-sided contracts may not be upheld.
- "Absence of meaningful choice" on the part of one party may be grounds for invalidation in the presence of unequal bargaining power.

Note: Contracts are generally not binding if one party had *no opportunity* to review it.

Math Review: Calculating Expectations

1. **Discrete Expectations:** Consider the following scenario with N possible outcomes:

    – N possible outcomes: $\{X_1, \ldots, X_N\}$

    – Each outcome X_i is associated with a probability, $P(X_i)$, where these probabilities add up to 1. That is:

    $$\sum_{i=1}^{N} P(X_i) = 1.$$

    – Each outcome X_i gives a utility payoff, u_i.

    Then the expected utility is:

    $$\mathbb{E}[u] = \sum_{i=1}^{N} P(X_i) u_i$$

2. **Continuous Expectations:** Now consider the scenario where there is a continuum of possible outcomes:

    – An outcome x can take any value on the interval: $[a, b]$.

    – There is a probability density function $\rho(x)$, which assigns an instantaneous density to every $x \in [a, b]$. This density integrates to 1. That is:

    $$\int_a^b \rho(x) dx = 1.$$

    – There is a utility function $u(x)$ which assigns a utility to every $x \in [a, b]$.

    Then the expected utility is:

    $$\mathbb{E}[u(x)] = \int_a^b u(x) \rho(x) dx$$

Notes:

– When your possible outcomes are indivisible (e.g. how many parties your neighbor holds this year), use the discrete expectation.

– When your possible outcomes are divisible (e.g. how loud is the music at the party in decibels), use the continuous expectation.

– Often our probability density function will be a constant. That means that all outcomes are "equally likely." In this case we say that outcomes are *uniformly distributed*, and the constant density will always have to be $\frac{1}{b-a}$ to integrate to 1. To see this, let $\rho(x) = c$ for all $x \in [a, b]$. Then we have:

$$\int_a^b \rho(x) dx = \int_a^b c \, dx = c(b - a) = 1 \implies c = \frac{1}{b - a}$$

– The discrete analogue to this is when each of the N options is equally likely. That is, $P(S_i) = 1/N$ for all S_i. We can say that outcomes are *discretely uniformly distributed*.

Problems

1. Suppose that I sign a contract to be a professor at Minnesota for the next year. My salary is $100,000 and my arrival is expected to make the Minnesota economics department $130,000 better off. However, a few days later UC Berkeley tells me that they are interested and want to work out a contract. My arrival will only make the Berkeley econ department $120,000 better off. I'd rather work at Berkeley: the weather is nicer, I'd be closer to home, and it's a better department, so I'd be willing to pay $20,000 to work there instead of Minnesota.

   (a) What is the (socially) efficient place for me to work?

   (b) Suppose I must pay $50,000 in damages to Minnesota if I breach. What will I choose to do? What if the damages are $30,000 instead? What if there are no damages?

   (c) What is the expectation damage? Does it lead to efficient breach?

   Anticipating that I will show up with an 80% probability, the econ department at Minnesota opens the registration of a class under my name, but fails to notify me. The class would generate a value of $2,000 to Minnesota, but if I fail to show up, Minnesota has to pay students $10,000 as compensation.

   (d) What is the efficient level of expectation damage now?

   (e) Does the expectation damage lead to efficient reliance? What should the amount of damages be according to Cooter and Ulen?

   (f) What damages ruling would you expect from a real-life court?

2. Fortunate Contingency (from midterm exam, Fall 2008) (From Thomas Miceli, The Economic Approach to Law, 2009, Stanford University Press)

   A buyer hires a manufacturer to build a specialized machine for delivery on a certain date. The value of the machine to the buyer is $2,000, and the price, payable on delivery, is $1,500. Suppose that after the machine is completed but before delivery, a second buyer arrives and offers the manufacturer $2,500 for it.

   (a) From a social (efficiency) perspective, who should get the machine?

   (b) Calculate the value of expectation damages for the first buyer and show that it gives the seller the correct incentives regarding breach of the original contract.

   (c) Suppose the first buyer went to court, and was granted a specific performance remedy. How will this affect the ultimate ownership of the machine compared to expectations damages? (Assume that the first buyer is aware of the second buyer's offer and that the two buyers can bargain.)

   (d) The arrival of the second buyer created a "surplus" of $500 (the excess of his offer over the valuation of the first buyer). Describe how this surplus is divided between the seller and first buyer under the two breach remedies.

3. Anticipating a rent boom in Madison in the coming year, three housing developers, Adam, Bob and Chloe, attempt to acquire an old dilapidated townhouse to convert into a new student apartment. The developers have the following plans in mind.

	Adam	Bob	Chloe
Cost of converting to apartment	$60,000	$80,000	$120,000
Total anticipated rent	$150,000	$180,000	$160,000

   The homeowner values his house at $30,000. To prepare the house for sale, the homeowner re-decorates the walls and cleans up the basement, at a cost of $10,000.

   (a) Assuming free bargaining, which developer will the homeowner sign a contract with? Assuming equal bargaining power (i.e. equal split of surplus), what is his payoff?

   (b) Now, suppose that rent level plummets, and the housing developer only anticipates a future rent revenue of $140,000. Therefore, he attempts to back out of the contract. The homeowner sues for damage payments.

      (i) What is the amount of expectation damages?
      (ii) What is the amount of reliance damages?
      (iii) What is the amount of opportunity cost damages?
      (iv) Does each of these damage rulings generate the efficient outcome?

   (c) Suppose that instead of a damage rule, the court actually grants the homeowner a specific performance remedy. What do you expect to happen afterwards, if the homeowner and the developer could bargain freely?

   (d) The housing developer makes an appeal and tries to invalidate the contract. What legal doctrines could he refer to? What doctrine could the homeowner use to argue for the enforcement of the contract?

4. Buyer Breach and Default Rules (from sample exam questions)

Ed walks into a car dealership and agrees to buy a car. The dealer doesn't have one in stock in the color he wants, so the dealer arranges to have the car delivered from another dealer.

(a) When he goes to pick up the car, Ed might realize he doesn't like the color quite as much as he thought he would. Assume the dealer can costlessly return the car to the other dealer, but expected to earn substantial profits on the sale. Explain why a rule allowing Ed to void the sale and pay nothing will lead to inefficient breach, while a rule forcing Ed to pay the dealer his "lost profits" (the amount he expected to profit from the transaction) will lead to efficient breach.

(b) Aside from not liking the color, there are several other risks that might result in Ed needing to get out of the contract: he might fail to get a car loan, lose his job, or be unable to get car insurance. Suppose that for 75% of buyers, the buyer is the efficient bearer of these risks; while for the other 25% of buyers, the seller is the efficient bearer of these risks.

   (i) Explain what a majoritarian default rule would say about liability for buyer breach in these situations.
   (ii) Under this rule, what should happen for efficiency in the 25% of cases where the seller is the efficient bearer of these risks? Would you expect the price paid for the car to be higher or lower in those cases?

(c) Finally, suppose that car dealers are very familiar with contract law, but that most car buyers are not, and might not suspect that they would owe anything if they backed out of a sales contract. Explain why the majoritarian rule in part (b) might not always lead to efficient outcomes. Explain why a default rule allowing a buyer to breach without paying anything unless the contract specified differently could lead to efficiency, and why this could be referred to as a penalty default.