Law And Economics

Contract Law I

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Introduction

- Contracts: legal agreement to a transaction.
  - Explicit or implicit.
  - Enforced by the state.
- Contracts are incomplete.
  - Unforeseeable contingencies.
  - Transaction costs.

Introduction

- **Contract law**: what sort of promises should be legally enforceable.
- **Also**: How can a party legally break the contract, what should be the penalty for doing so.

Introduction

- Information is at the center of the question:
  - An used car buyer realizes, after a week, that the car needs a break job. This was not disclosed by the seller, who should have known about it.
  - An specialist in antiques goes 'treasure hunting' to thrift shops. He does not disclose that is a specialist and buys things with high value without reporting it to the sellers.

Elements of a Valid Contract

- Contract entails a mutual promise.
- Elements:
  - Offer: what the *promisor* will provide.
  - Acceptance: whether the *promisee* accepted the offer.
  - Consideration: the return promise.
- Example:
  - An uncle promises to pay his nephew 5000 EUR on the 21st birthday.
  - An uncle promises to pay his nephew 5000 EUR on the 21st birthday, provided that the nephew refrains from drinking or smoking until that time.

Reasons for Invalidating Contracts

- Mental Incapacity/Incompetence.
  - Those who are mentally impaired.
  - Those too young.
- Coercion/Duress.

Coercion/Duress

Example: Alaska Packers.

The Hold-Up Problem

- Classical Problem in Economics: Hart and Moore (1988)
- Model:
  - Two parties: Buyer and Seller.
  - They can trade a quantity $q \in 0, 1$ at price P.
  - Buyer values v.
  - Cost of production is uncertain c either c_H or c_L.
  - Probability of low cost p depends on investment $\phi(p)$.

Timing

- Payoffs:

$$\begin{aligned} \text{Buyer:} \quad & vq - P \\ \text{Seller:} \quad & P - cq - \phi(p) \end{aligned}$$

- Timing
  - Seller chooses investment p.
  - Cost c is realized.
  - Parties negotiate quantity q and price P.
  - Contract is executed.

First-Best

Assume that $c_H > v > c_L$.

$$q = \begin{cases} 1 & \text{if} \quad c = c_H \\ 0 & \text{if} \quad c = c_L \end{cases}$$

Investment:

$$\max_p \quad p(v - c_L) - \phi(p)$$

$$\phi'(p) = (v - c_L)$$

Equilibrium

The Buyer and Seller have something to gain if $c = c_L$.

Assumption: equal bargaining power. $P = \frac{1}{2}(v + c_L)$.

Problem of the Seller:

$$\max_p \quad p\left[\frac{1}{2}(v + c_L) - c_L\right] - \phi(p)$$

$\phi'(p) = \frac{1}{2}(v - c_L)$. Inefficient!

Solutions

- What if they can negotiate before the investment?
- Timing:
  - Buyer and seller contract: quantity q and price P (incomplete!).
  - Seller chooses investment p.
  - Cost c is realized.
  - Contract is executed.

Incomplete Contract

Suppose that they contract $q = 1$. Then seller minimizes cost of production:

$$\min_{p} \quad p \cdot c_L + (1 - p) \cdot c_H - \phi(p)$$

$\phi'(p) = (c_H - c_L)$

Also, sometimes the good is produced when $c = c_H$.

Renegotiation

But this is all fixed if we add renegotiation.

- When $c = c_H$ the seller offers to pay v to the buyer to not produce the good.