Dis 5: Contract Law [†]

1 Review

1.1 Why do we need contract law?

- A contract is a promise that's legally binding.

  $\Rightarrow$ Contract can enable trade when transactions aren't concluded immediately.
- Since enabling mutually beneficial trade results in a more efficient allocation, contract law
  - **Facilitates trade** in situations where credible promises are required, and
  - (Most of the time) achieves a **more efficient** outcome.

  Notice "most of the time" – enabling some contracts might result in less efficient outcome.

  (ex. Contract signed under necessity or duress)

1.2 Language of contracts

- **Promisor**: The party that makes a promise.
- **Promisee**: The party that receives a promise.
- **Gaps**: Contingencies not specified in a contract.

1.3 Big idea of contract law: Design contract law to be efficient

- Write contract to achieve efficient outcome
  - Convert noncooperative solutions into cooperative ones
  - Encourage disclosure of information
- Have efficient performance from contract (in-depth in section 1.4)
  - Enforce efficient promises $\Leftrightarrow$ Not enforce contracts when it's efficient to do so
  - Have efficient breach of contract ($\Leftrightarrow$ choose efficient amount of damages for breaching)
  - Allow the promisor to invest efficiently in performance
  - Incentivize the promisee to rely efficiently
- If contract has gaps, choose default rule to fill in the gaps efficiently (in-depth in section 1.5)

[†] Adapted from Jonathan Becker's Fall 2018 handout

1.4 Efficient contract performance

- **Enforce efficient promises**: Two criteria
  1. **The bargain theory**: A promise should be enforced if it was given as part of a bargain, otherwise it should not.
     - Components of an enforceable bargain:
       * **Offer**: One side offers a contract.
       * **Acceptance**: The other side accepts the contract.
       * **Consideration**: What the promisee gives to the promisor, in exchange for the promise (leads to concept of **reciprocal inducement**: Both the promisor and promisee must give up something in a bargain).
     - Remedy under the bargain theory: **Expectation damages** – making the promisee as well off as if the promise had been kept.
     - Downside of the bargain theory:
       * Not what the modern courts do
       * Not always efficient
  2. Modern approach: A promise should be enforced if both the promisor and the promisee wanted the promise to be enforceable at the time it was made.
- **Not enforce inefficient contracts**:
  - **Formation defense**: Claim that a valid contract does not exist
    * **Derogation of public policy**: Performance of the contract violates or circumvents the law.
    * **Regulation / Immutable rule**: Regulation in place that invalidates the contract.
    * **Incompetence**: Individuals agreeing to the contract were not rational at the time
    * **Dire constraints**: Contracts are signed under dire circumstances
      · **Necessity**: The contracting party is NOT responsible for the dire situation.
      · **Duress**: The contracting party IS responsible for the dire situation.
  - **Performance excuses**: A valid contract does exist, but circumstances have changed, and I should be allowed to not perform without penalty.
- **Breach contract when efficient**:

  Breach is efficient when

  $$\text{Costs of performance to the promisor} > \text{Benefits from performance to the promisee}$$

  However, this is not how promisor makes decisions. Promisor will breach the contract if

  $$\text{Costs of performance to the promisor} > \text{Liability from breach to the primisor}$$

  Hence, if we want efficient breach, we need to set

  $$\text{Benefits from performance to the promisee} = \text{Liability from breach to the primisor}$$

  which means promisor's liability must be **expectation damages**.
- **Invest efficiently in performance**:

Need to set promisor's liability to **expectation damages**, so that promisor can fully internalize the cost of breach and invest efficiently in performance.

- **Have efficient reliance**:
  - **Reliance**: Actions that are value-enhancing to the promisee, conditional on performance.
  - Reliance is efficient when

$$\text{Expected increase in social benefits from reliance} > \text{Costs of reliance}$$

$$\begin{gathered}\text{Prob of performance} \times \text{Value increase from performance} \\ + \text{Prob of nonperformance} \times \text{Value destroyed from nonperformance}\end{gathered} > \text{Costs of reliance}$$

  - Should reliance be included in damages? **Paradox of compensation**:
    - If expectation damages *include* anticipated benefits from reliance:
      - Efficient level of breach for the promisor, but
      - Over-rely for the promisee
    - If expectation damages *exclude* anticipated benefits from reliance:
      - Efficient reliance for the promisee, but
      - Promisor breaches more than efficient level
  - Solutions to the paradox:
    - **Perfect expectation damages** (by Cooter and Ulen): Restore promisee to level of well-being he would have gotten from performance if he had relied the efficient amount.
      (Hard to figure out what would've been the efficient reliance to make beforehand)
    - Include only **foreseeable reliance** – Reliance that the promisor could reasonably expect promisee to make

1.5 Choose default rules efficiently

- **Efficient default rule**: An attempt to fill a gap with the rule the parties would have wanted, had they thought to specify it.
  - Generally allocate each risk to whoever can bear (or prevent, or hedge) that risk at the least amount of costs.
  - Such rules work well when gaps exist due to a high transaction cost of filling them, and not due to strategic omission.
- **Majoritarian default rule**: An attempt to will a gap with the terms that most parties would have agreed to.
- **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.

2 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, 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 efficient place for me to work?

   Social surplus from me going to Minnesota $= \$130,000$.

   Social surplus from me going to Berkeley $= \$120,000 + \$20,000 = \$140,000$ (my willingness to pay \$20,000 means that my value has increased by \$20,000 if I go to Berkeley).

   (Notice that wage doesn't come into the calculation of social surplus – they are just a transfer between two parties.)

   Since going to UC Berkeley generates a higher social surplus, UC Berkeley is the efficient place for me to work at.

   (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?

   Now we are evaluating the decision I'll make, so we are looking at personal surplus.

   Here, assume the wage I'll get from Berkeley is w_B. Since my arrival at the Berkeley econ department will make the department \$120,000 better off, it means that the wage Berkeley will offer to me $w_B \leq \$120,000$.

   Now evaluate the personal surplus under the two scenarios:

   - If I go to Berkeley & pay the \$50,000 damages, my personal surplus is

   $$w_B + \$20,000 - \$50,000 \leq \$120,000 + \$20,000 - \$50,000 = \$90,000$$

   - If I go to Minnesota, my personal surplus is

   $$w_M(\text{wage from Minnesota}) = \$100,000$$

   Therefore, with \$50,000 damages, my personal surplus is higher if I go to Minnesota, so I'll choose Minnesota.

   When damage is $\$30,000$,

   - If I go to Berkeley & pay the \$30,000 damages, my personal surplus is

   $$w_B + \$20,000 - \$30,000 \leq \$120,000 + \$20,000 - \$30,000 = \$110,000$$

   - If I go to Minnesota, my personal surplus is

   $$w_M(\text{wage from Minnesota}) = \$100,000$$

   Here, as long as

   $$\begin{aligned} \$100,000 \leq w_B + \$20,000 - \$30,000 &\leq \$110,000 \\ \$110,000 \leq \quad w_B \quad &\leq \$120,000 \end{aligned}$$

Meaning that if I receive a wage of somewhere between \$110,000 and \$120,000, then I'll go to Berkeley. If Berkeley offers a wage less than \$110,000, then I'll go to Minnesota.

When damages are \$0,

- If I go to Berkeley, my personal surplus is

$$w_B + \$20,000 \leq \$120,000 + \$20,000 = \$140,000$$

- If I go to Minnesota, my personal surplus is

$$w_M(\text{wage from Minnesota}) = \$100,000$$

Here, as long as

$$\begin{aligned} \$100,000 \leq w_B + \$20,000 &\leq \$140,000 \\ \$80,000 \leq \quad w_B \quad &\leq \$120,000 \end{aligned}$$

Meaning that if I receive a wage of somewhere between \$80,000 and \$120,000, then I'll go to Berkeley. If Berkeley offers a wage less than \$80,000, then I'll go to Minnesota.

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

The expectation damage makes the promisee (in this case Minnesota) whole as if the contract had been kept:

$$\begin{aligned} \text{Payoff to Minnesota if I perform} &= \text{Payoff to Minnesota if I don't perform} + \text{ED} \\ \$130,000 - \$100,000 &= 0 + \text{ED} \\ \text{ED} &= \$30,000 \end{aligned}$$

Hence, expectation damages are \$30,000. And since liability is set up as expectation damages, I (promisor) will fully internalize the costs, so I'll breach efficiently.

Intuitively, if I decide to pay the expectation damage and go to Berkeley, it must mean that the improvement in my utility from going to Berkeley exceeds Minnesota's benefit from my performance of contract, i.e. breaching the contract and going to Berkeley is a Kaldor-Hicks improvement.

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 amount of expectation damage that lead to efficient breach now?

If expectation damages lead to efficient breach, then it should internalize the add-on benefits from reliance. That is, expectation damage should now also compensate for the loss of Minnesota from reliance.

- If I performed (i.e. Went to Minnesota), then total surplus to Minnesota (i.e. The promisee) $= \$130,000 + \$2,000 - \$100,000 = \$32,000$
- If I did not perform, then total surplus to Minnesota $= 0 - \$10,000 = -\$10,000$
- Therefore, expectation damages (ED) should make Minnesota as well of as if the perfor-

mance had been carried out:

$$\begin{aligned}\text{Payoff to Minnesota if I perform} &= \text{Payoff to Minnesota if I don't perform} + \text{ED}\\ \$32,000 &= -\$10,000 + \text{ED}\\ \text{ED} &= \$42,000\end{aligned}$$

So expectation damages that lead to efficient breach are $42,000.

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

No. By paradox of compensation, the $42,000 expectation damages that lead to efficient breach will lead to over-reliance.

Now, reliance is efficient if

$$.8 \times \$2,000 + (1 - .8) \times (-\$10,000) > \text{Costs of reliance}$$

Left hand side equals to $-\$400$. But costs of reliance is certainly positive, therefore, no costs of reliance could make the above equation hold, so reliance is always not efficient.

Cooter and Ulen suggests using perfect expectation damages. That is, the expectation damage should only include efficient reliance. Here, since the reliance is never efficient, the expectation damages should not cover the additional $12,000 and stays at $30,000.

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

In real life, court usually only includes foreseeable reliance in damages rulings. Since Minnesota did not notify me of this new class, I have no way to foresee the reliance. Therefore, the $12,000 should not be covered by the expectation damage, and expectation damages should stay at $30,000.

2. 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.

   If Ed can return the car at no cost, he'll sometimes return it when that only makes him very slightly better off, while returning it makes the car dealer substantially worse off, so it's inefficient. Put another way, returning the car imposes a negative externality on the dealer, so we'd expect Ed to do it more often than efficient. On the other hand, if Ed had to pay the dealer his anticipated profits, the externality is eliminated – now the dealer is indifferent about whether Ed keeps or returns the cars, so Ed's decision affects only his own payoff, and is therefore efficient.

   (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.

      A majoritarian default rule is the rule that is efficient in the majority of cases. In this case, the majoritarian default rule says the buyer must bear these risks, meaning the buyer would be liable for the dealer's lost profits if he did not buy the car.

      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?

      In those cases, the buyer and seller could negotiate a contract which specified that the seller would bear these risks, that is, that the buyer could get out of buying the car with no penalty if one of these things happened. In those cases, I'd expect the price paid to be higher, to compensate the seller for taking on these risks.

   (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.

   The majoritarian default rule favors the seller, but for efficiency, it requires the buyer and seller sometimes negotiating a contract which specifically allocates these risks to the seller. If the buyer doesn't realize that the default rule requires them to pay damages if they need to get out of the sale, the seller has no reason to raise this during negotiations, so the efficient allocation of risks will not always be reached. On the other hand, if the default rule favored the buyer – by allowing buyer breach without damages unless the contract specified otherwise – the seller could bring this up as a point to be negotiated ("I can give you a discount if you put down a non-refundable deposit") when it's efficient for the buyer to bear these risks, so the efficient allocation would be

reached. This could be considered a penalty default as the default rule (allowing buyer breach without damages) was chosen because it penalizes the better-informed party (the seller), creating the incentive to share information (negotiate over the allocation of risks).