

Dis 6: Contract Law (Cont'd) [†]

1 Payment timing

Question 2 from HW 5: Ned contracts with Rebecca to cropdust his field, agrees to pay Rebecca \$3,000.

	Value to Ned if Rebecca cropdusts	Value to Ned if Rebecca doesn't
Ned plants corn	\$33,000	\$27,000
Ned plants wheat	\$45,000	\$15,000
Ned plants soybean	\$50,000	\$0

The question didn't specify **when** the payment of \$3,000 is made to Rebecca, but different payment timing assumption affects Ned's payoff when performance is carried out and when it's not, by extension affects the calculation of expectation damages (ED).

To illustrate, consider the case when Ned chooses to plant corn:

- If we assume that payments are made **upfront**:

$$\text{Ned's payoff when Rebecca cropdusts} = \text{Ned's payoff when Rebecca doesn't cropdust} + ED_1$$

- If we assume that payments are made **only after Rebecca performs** (what we often see in class):

$$\text{Ned's payoff when Rebecca cropdusts} = \text{Ned's payoff when Rebecca doesn't cropdust} + ED_2$$

Notice that ED_1 is exactly \$3,000 more than ED_2 . You can interpret this as you (the promisee) made the payment to the promisor upfront, so the promisor's liability should include this payment amount to pay you back when the promisor fails to perform.

On exams, the time of payment will be more clearly specified. But in case that future exam (or homework) left it ambiguous, make sure you **clearly state your assumption on when you assume the payment to promisor is made**.

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

2 Review: More on designing an efficient contract law system

2.1 More on not enforcing inefficient contracts

- **Performance excuses:** A valid contract does exist, but circumstances have changed, and I should be allowed to not perform without penalty.
 - **Impossibility:** Circumstances made it impossible to perform the contract.
 - **Frustration of purpose:** A change in circumstance made the contract pointless.

Efficiency requires assigning liability to the party that can bear the risk at least cost.

- **Bad information:** Contracts signed when one or both parties possess bad information.
 - **Fraud:** One party deliberately tricked the other.
Efficiency requires voiding the contract.
 - **Failure to disclose:** One party failed to disclose important information to the other.
 - * Note: Fraud vs. Failure to disclose
Fraud means one party lied.
Failure to disclose means one party didn't lie, but they withheld information.
 - * Under civil law: Contracting parties have a **duty to disclose**
⇒ will void the contract
 - * 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.
⇒ usually contracts are upheld, but damages will be imposed
 - **Mutual mistake:** Both parties made a mistake, without which a contract wouldn't have existed.
Efficiency requires voiding such contracts; otherwise, we would be enforcing involuntary trade.
 - **Unilateral mistake:** Only one contracting party has mistaken information.
Efficiency requires "**uniting knowledge and control**" (i.e. putting control in the hands of the party with the most efficient information), so contracts based on unilateral information are typically upheld.
Cooter and Ulen went further to define what type of unilateral mistake is made to determine whether a contract is efficient to enforce:
 - * Contracts based on one party's **productive info** (wealth-creating) should be enforced.
 - * Contracts based on one party's **redistributive info** (wealth-shifting) shouldn't be enforced.
 - **Vague contract terms:** Contracts whose terms are overly ambiguous.
Generally not enforced (from the perspective of penalty default & inefficient to figure out what the contracting parties meant when they drafted the contract).
- When one contracting party has too much contracting power:
 - **Adhesion:** Standardized "take-it-or-leave-it" contracts where terms are non-negotiable.
Generally enforceable, but sometimes terms could be voided if such terms wouldn't be agreed to had they been noticed.
 - **Unconscionability / Lesion:** Overly one-sided contract.
Generally not enforceable, since it creates situational monopolies, resulting in inefficiency.

2.2 Remedies for breaching contract

- **Party-designed remedies:** Damages specified in a contract for particular scenarios.
 - **Liquidated damages:** Damages that reasonably approximate actual harm done by breach. Typically efficient to uphold.
 - **Penalty damages:** Damages imposed that are greater than the actual harm done. Often not upheld by common law courts. But can be substituted with **performance bonus** instead, which are generally upheld by the courts.
- **Court-imposed damages:** Damages not specified in a contract, but issued by courts instead.
 - **Expectation damages (ED; “Positive damages”):** Make the promisee indifferent between performance and breach.

$$\begin{aligned} & \text{Promisee's payoff without performance of the current contract} + \text{ED} \\ &= \text{Promisee's payoff} \end{aligned}$$

- **Reliance damages (RD; “Negative damages”):** Make the promisee indifferent between not signing the contract in the first place and breach.

$$\begin{aligned} & \text{Promisee's payoff without performance of the current contract} + \text{RD} \\ &= \text{Promisee's payoff} \end{aligned}$$

- **Opportunity cost damages (OD):** Make the promisee indifferent between performance of their next best option and breach.

$$\begin{aligned} & \text{Promisee's payoff without performance of the current contract} + \text{OD} \\ &= \text{Promisee's payoff} \end{aligned}$$

- Ranking: $\text{ED} > \text{OD} > \text{RD}$ always
- Other court-ordered remedies:
 - **Restitution:** Contracting parties must return the money already received.
 - **Disgorgement:** Contracting parties must give up wrongfully-gained profits.
 - **Specific performance:** Forces the breaching party to live up to the terms specified in the contract.

2.3 Efficiency of remedies

Efficient breach	Under low TC, any remedy will lead to efficient breach per Coase theorem Under high TC, only ED will lead to efficient breach
Efficient signing	Potentially, penalty damages / performance bonus (ex. Peevyhouse case) ED may not lead to efficient signing
Efficient reliance	ED excluding benefits from reliance
Efficient investment in performance	ED (including reliance if reliance is made)

3 Problems

1. 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 future rent	\$150,000	\$180,000	\$160,000

Here, total anticipated future rent level approximates total increase in land value for the developers. The homeowner values their 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), how much payment should the homeowner get?

(b) Now, with COVID-19, the developer you contracted with expects to only receive \$150,000 in future anticipated rent. The developer attempts to back out of the contract, and 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 they refer to?

2. As the activities coordinator of the Economics department graduate student association, you have been tasked with organizing the department's annual winter party. You contract with a professional DJ service to provide the music. The DJ service must choose which of its two employees to send to your event:

- Tom (T) shows up with probability $1/2$.
- Evan (E) shows up with probability $2/3$ but costs the service an additional \$55 (Evan keeps this fee).

The winter party will make the department \$300 better off as currently planned. However, you have the opportunity to make reliance investments:

- You can purchase an additional keg of cheap beer (C) for \$175 or expensive microbrew (E) for \$250.
- These investments will increase the value of the party to the department by \$300 and \$390 respectively.

Alternatively, you can buy no beer (N) whatsoever.

If the DJ fails to show up, you will get nothing from these investments, because everyone will leave the party. The keg purchases available to you and the DJs available to the service are common knowledge.

(a) What is the efficient choice of DJ and reliance?

(b) What will you and the DJ service choose to do if reliance is included in expectation damages?

(c) What will you and the DJ service choose to do if reliance is not included in expectation damages?

(d) Is social surplus higher when reliance is included or not included? If we care about efficiency, should we include reliance in damages or not?