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 promisee to invest efficiently in performance
  - Incentivize the promisor 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**:
       * **Acceptance**:
       * **Consideration**:

         (leads to concept of **reciprocal inducement**:

).
     - Remedy under the bargain theory: **Expectation damages**
     - 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

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

    - Should reliance be included in damages? **Paradox of compensation**:
        - If expectation damages *include* anticipated benefits from reliance:
        - If expectation damages *exclude* anticipated benefits from reliance:

- 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?

   (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 amount of expectation damage that lead to efficient breach 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. 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.