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# Contract Law

# So far, we haven't worried about the details of trade

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- ◆ When two parties want to reallocate rights...
  - ◆ I want to buy your used car
  - ◆ Or you want to “buy” my permission to have a noisy party
  - ◆ Or neighbors want to pay a factory to pollute less
- ◆ ...we've assumed they can do so...
- ◆ ...subject (possibly) to there being some transaction costs

# Timing of transactions

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- ♦ Some transactions happen all at once
  - ♦ I hand you a check for \$3500, you hand me the keys to your car
  - ♦ There might be search costs and bargaining costs...
  - ♦ ...but no enforcement costs
- ♦ But some don't
  - ♦ Neighbors pay the factory to pollute less going forward
  - ♦ Need to make sure factory sticks to the agreement
  - ♦ What if technology changes and factory wants to start polluting more again?

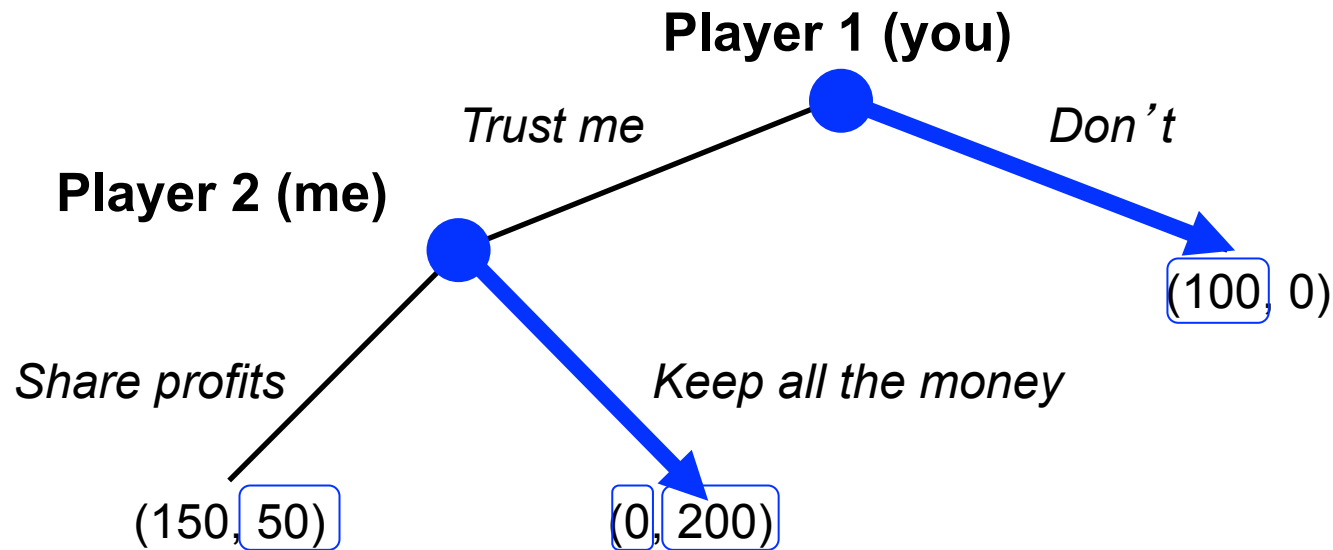
# This is what contracts are for

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- ♦ A contract is a **promise**...
- ♦ ...which is legally binding
- ♦ Point of contracts: to enable trade when transactions aren't concluded immediately

# Example: the agency (trust) game

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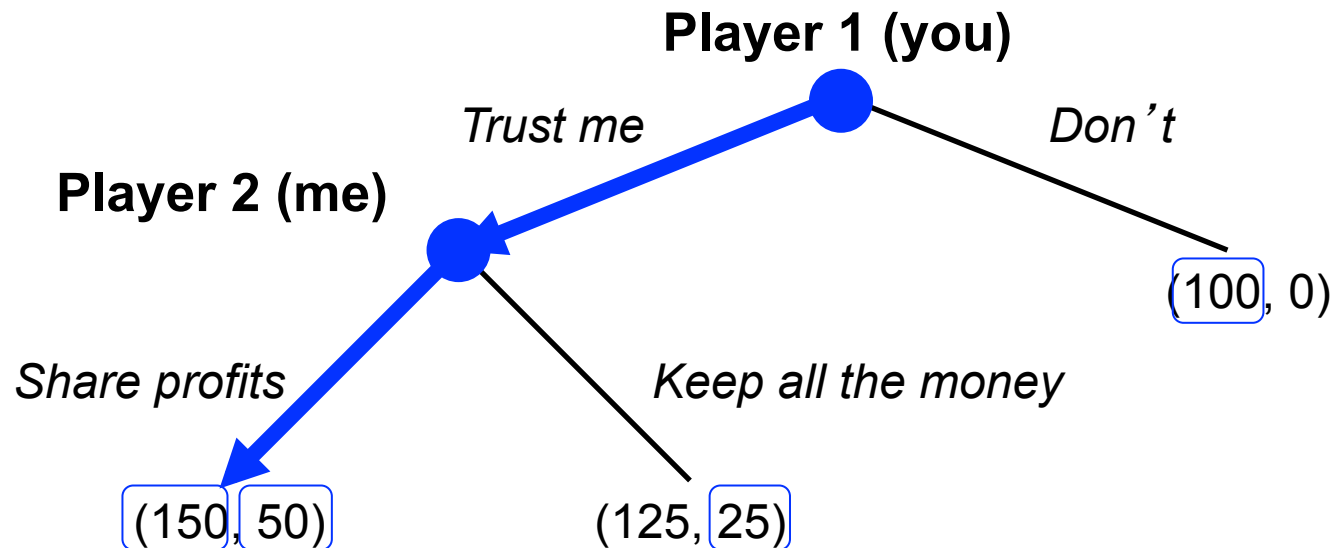
- ♦ Subgame perfect equilibrium: I'll keep all the money; so you don't trust me
  - ♦ Inefficient outcome ( $100 < 200$ )
  - ♦ And we're **both** worse off

(One solution: reputation)

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## Another solution: legally binding promises

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- ◆ Now we get cooperation (and efficiency)
- ◆ Purpose of contract law: to allow trade in situations where this requires **credible promises**

# Contract: a legally binding promise

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- ◆ Point of contracts: to enable trade when transactions aren't concluded immediately
- ◆ Obvious question: which promises should be legally binding, and which should not?



# What types of promises should be enforced by the law?

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- ♦ “The rich uncle of a struggling college student learns at the graduation party that his nephew graduated with honors. Swept away by good feeling, the uncle promises the nephew a trip around the world. Later the uncle reneges on his promise. The student sues his uncle, asking the court to compel the uncle to pay for a trip around the world.”
- ♦ “One neighbor offers to sell a used car to another for \$1000. The buyer gives the money to the seller, and the seller gives the car keys to the buyer. To her great surprise, the buyer discovers that the keys fit the rusting Chevrolet in the back yard, not the shiny Cadillac in the driveway. The seller is equally surprised to learn that the buyer expected the Cadillac. The buyer asks the court to order the seller to turn over the Cadillac.”
- ♦ “A farmer, in response to a magazine ad for “a sure means to kill grasshoppers,” mails \$25 and receives in the mail two wooden blocks with the instructions, “Place grasshopper on Block A and smash with Block B.” The buyer asks the court to require the seller to return the \$25 and pay \$500 in punitive damages.”

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# The Bargain Theory of Contracts

# The bargain theory of contracts

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- ◆ Developed in the late 1800s/early 1900s
- ◆ **A promise should be enforced if it was given as part of a bargain, otherwise it should not**
- ◆ Bargains were taken to have three elements
  - ◆ **Offer**
  - ◆ **Acceptance**
  - ◆ **Consideration**

# What is **consideration**?

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- ◆ **Promisor**: person who gives a promise
- ◆ **Promisee**: person who receives it
- ◆ In a bargain, both sides must give up something
  - ◆ **reciprocal inducement**
- ◆ Consideration is **what the promisee gives to the promisor**, in exchange for the promise
- ◆ Under the bargain theory, a contract becomes enforceable once consideration is given

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For efficiency, what promises should  
be enforced?

# What promises should be enforced?

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- ◆ In general, efficiency requires enforcing a promise if both **the promisor and the promisee wanted it to be enforceable** when it was made
  - ◆ different from wanting it to actually be enforced

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  - ◆ different from wanting it to actually be enforced
- ◆ The first purpose of contract law is to **enable people to cooperate** by **converting games with noncooperative solutions into games with cooperative solutions**
  - ◆ or, enable people to convert games with inefficient equilibria into games with efficient equilibria



# What promises should be enforced?

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- ♦ The first purpose of contract law is to **enable people to cooperate** by **converting games with noncooperative solutions into games with cooperative solutions**
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## So now we know...

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- ♦ What promises should be enforceable?
  - ♦ For efficiency: enforce those which both promisor and promisee wanted to be enforceable when they were made
- ♦ One purpose of contract law
  - ♦ Enable cooperation by changing a game to have a cooperative solution
- ♦ Contract law can serve a number of other purposes as well

# Information

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- ◆ Private/asymmetric information can hinder trade
  - ◆ Car example (George Akerloff, “The Market for Lemons”)

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# Information

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- ◆ Private/asymmetric information can hinder trade
  - ◆ Car example (George Akerloff, “The Market for Lemons”)
- ◆ Contract law could help
  - ◆ You could offer me a legally binding warranty
  - ◆ Or, contract law could impose on you an obligation to tell me what you know about the condition of the car
  - ◆ Forcing you to share information is efficient, since it makes us more likely to trade
- ◆ The second purpose of contract law is to **encourage the efficient disclosure of information** within the contractual relationship.

## Next question

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- ♦ If a contract is a promise...
- ♦ what should happen when that promise gets broken?
  - ♦ could be: I signed a contract with no intention of living up to it
  - ♦ but could be: I signed a contract in good faith, intending to keep it...
  - ♦ ...but circumstances changed, making performance of the contract less desirable, maybe even inefficient!
  - ♦ so what should happen to me if I fail to perform?

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# Breach

# Breach

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- ◆ I'm an airplane builder
- ◆ You and I sign a contract
  - ◆ You agree to pay me \$350,000
  - ◆ I agree to build you an airplane
  - ◆ You value the plane at \$500,000;  
I expect building it to cost \$250,000
- ◆ Lots of things could happen...
  - ◆ Price of materials could go up, increasing my costs to \$700,000...  
...making it inefficient for me to build you a plane
  - ◆ Costs could increase to \$400,000...  
...so it's still efficient for me to build you the plane, but I no longer want to
  - ◆ Another buyer could arrive and offer me \$600,000 for the plane
  - ◆ I could break my arm, making it impossible for me to build the plane





# Breach

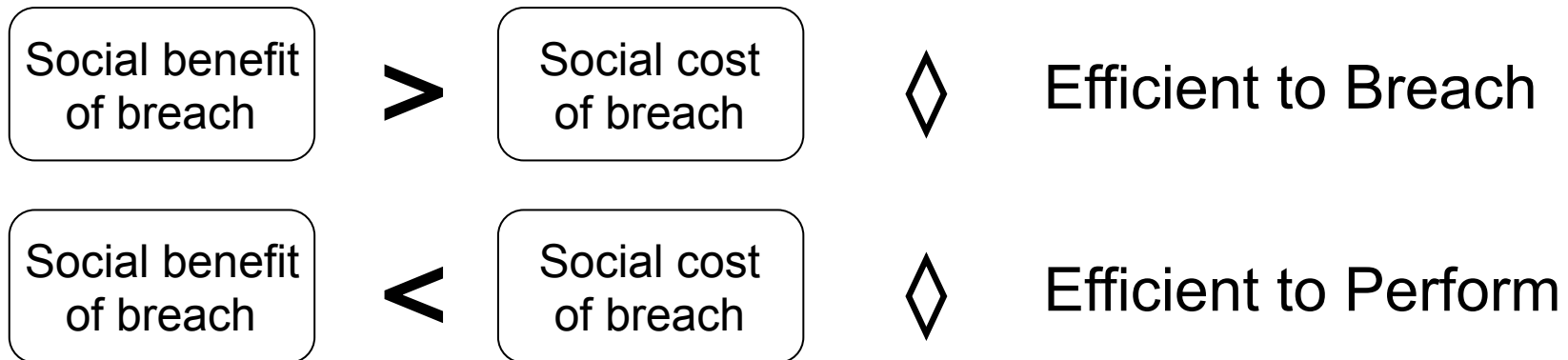
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- ♦ A contract is a promise
- ♦ **Breach of contract** is when promisor fails to keep promise
  - ♦ To make a promise legally binding, there has to be some consequence when it is broken
- ♦ So, **what should happen when a contract is breached?**
  - ♦ If penalty is too small, contract law has no bite
  - ♦ If penalty is too large, promises might get kept even when that becomes inefficient
  - ♦ **Can we design the law to get breach of contract only when it's efficient to breach?**

# When is breach of contract efficient?

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*Efficiency:*



- ♦ Social benefit of breach: promisor saves cost of performing
- ♦ Social cost of breach: promisee loses benefit from promise

# When is breach of contract efficient?

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## *Efficiency:*

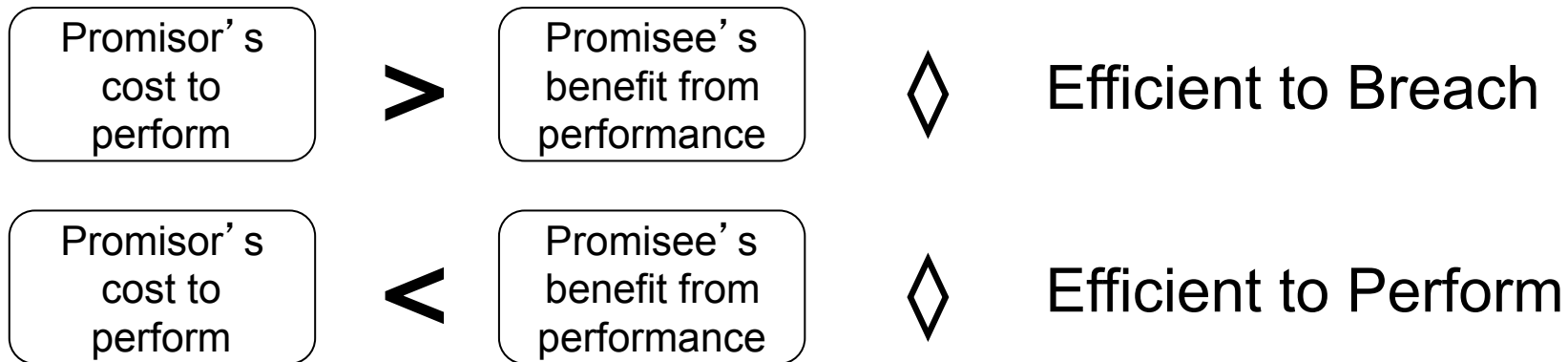


- ◆ Social benefit of breach: promisor saves cost of performing
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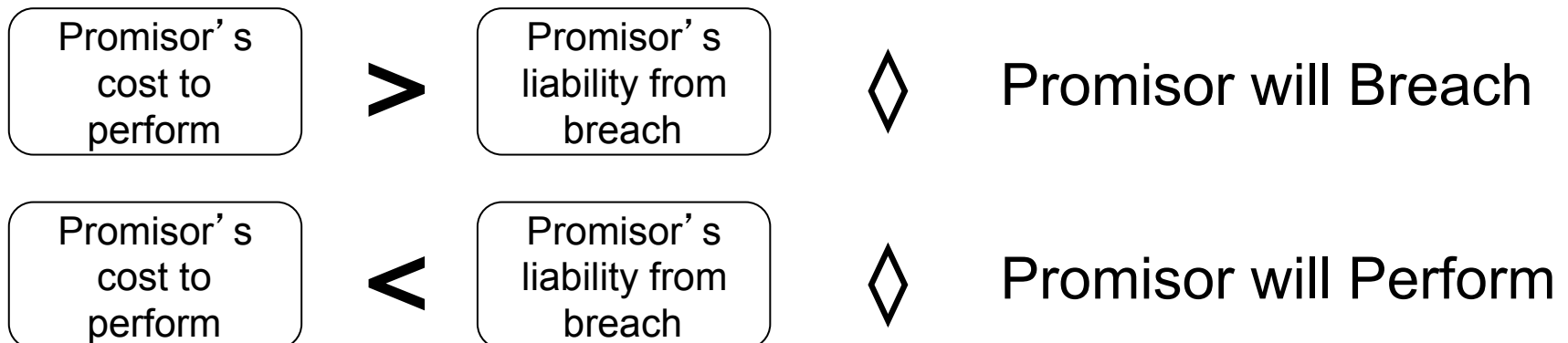
# How do we expect promisors to behave?

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## *Efficiency:*



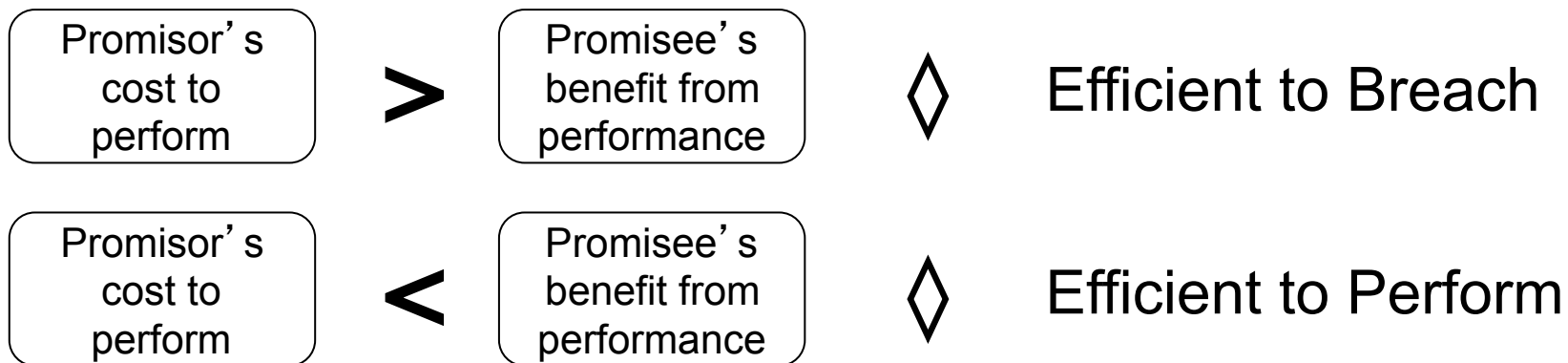
## *What will actually happen (incentives of promisor):*



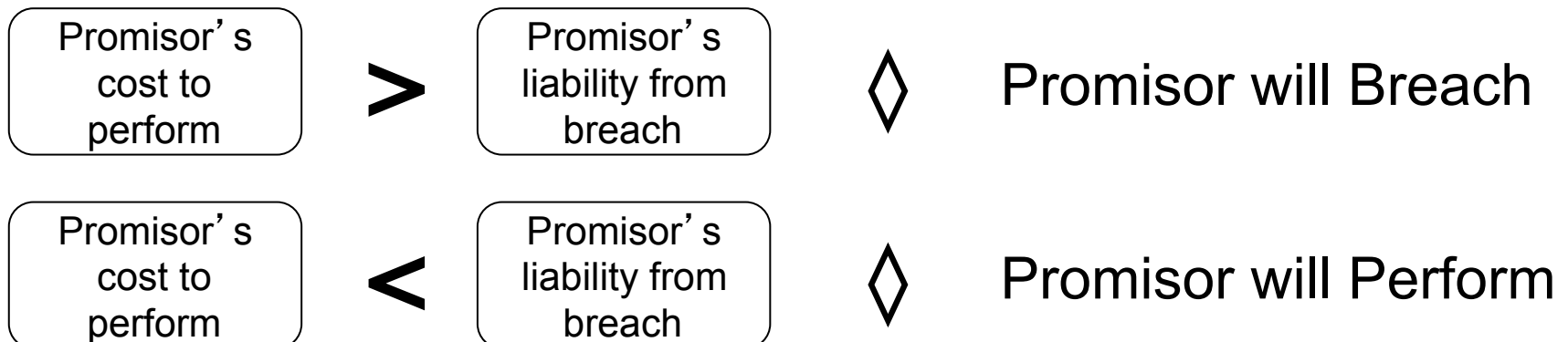
# Can we design the law to get only efficient breach of contract?

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## *Efficiency:*



## *What will actually happen (incentives of promisor):*



# Can we design the law to get only efficient breach of contract?

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- ♦ If we set **liability from breach = promisee's benefit** from performance, promisor will breach exactly when it's efficient
  - ♦ When a promisor breaches a contract, he should owe a penalty **exactly equal to** the benefit the promisee expected to receive
  - ♦ This is **expectation damages**

## Back to airplane example

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- ◆ Plane worth \$500,000 to you, agree to price of \$350,000, my cost of building the plane changes
- ◆ Expectation damages: I owe you \$150,000 if I fail to deliver the plane
- ◆ Whenever cost is less than \$500,000...
  - ◆ I'm better off keeping my promise
  - ◆ And it's efficient for me to build you the plane
- ◆ Whenever cost is above \$500,000
  - ◆ I'm better off breaking my promise and paying damages
  - ◆ And it's efficient for me to break my promise

## Another way to think about expectation damages: eliminating an externality

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- ◆ If I breach contract, I impose externality on you
  - ◆ You expected payoff of \$150,000 if I performed...
  - ◆ ...so if I breach, you're \$150,000 worse off
- ◆ If I have to pay you \$150,000 if I breach, then I **internalize the externality**
  - ◆ Now my action no longer affects your payoff
  - ◆ (You get the same surplus of \$150,000, whether or not I build the plane.)
  - ◆ No more externality → I choose efficiently when deciding whether to perform or breach



# What would happen under other remedies?

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- ◆ Plane worth \$500,000 to you, agree to price of \$350,000, my cost of building the plane changes
- ◆ No penalty
  - ◆ If costs rise to \$400,00, I'll choose to breach...
  - ◆ ...but performance would be efficient
- ◆ Penalty for breach is \$1,000,000
  - ◆ If costs rise to \$700,000, I'll choose to perform...
  - ◆ ...but breach would be efficient

## Of course, with low TC, we could always negotiate around an inefficient rule (Coase)

- ◆ Plane worth \$500,000 to you, agree to price of \$350,000, my cost of building the plane changes
- ◆ No penalty
  - ◆ If costs rise to \$400,00, I would **want to** breach...
  - ◆ ...but we could renegotiate a different price
- ◆ Penalty for breach is \$1,000,000
  - ◆ If costs rise to \$700,000, I would have to perform...
  - ◆ ...but we could negotiate a “buy-out” price
- ◆ Only expectation damages guarantee efficient breach/ performance even without renegotiation

## Another reason the remedy for breach matters: **investment in performance**

- ♦ Many things promisors can do to reduce likelihood they will have to breach a contract
- ♦ If promisor agreed to build a house, he can...
  - ♦ Buy materials ahead of time and store them in a warehouse
  - ♦ Spend more time lobbying (or bribing!) local government to ensure he can get required permits
  - ♦ Pay his assistant well, so he's less likely to quit
- ♦ Some of these things may be hard to observe/verify, so impossible to build them into the contract itself

## Another reason the remedy for breach matters: **investment in performance**

- ◆ Expectation damages (and only expectation damages) will lead to efficient level of these investments
  - ◆ If promisor internalizes the cost of breach...
  - ◆ ...then he receives the full benefit of these investments,
  - ◆ along with paying their full cost,
  - ◆ so to minimize private cost, he chooses efficient level
- ◆ If penalty for breach is less than expectation damages...
  - ◆ Breach still imposes negative externality, so investments in performance impose positive externality on promisee...
  - ◆ ...so promisor will invest less than efficient amount

## So now we've seen three things contract law can accomplish...

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1. Facilitate non-simultaneous trade when trust is required
    - ♦ Turn games with inefficient equilibrium into games with efficient equilibrium
  2. Encourage efficient disclosure of information
  3. Secure efficient level of breach, and efficient level of investment in performance
    - ♦ Via expectation damages
- ♦ Next, we'll see a fourth...

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# Reliance

# Reliance

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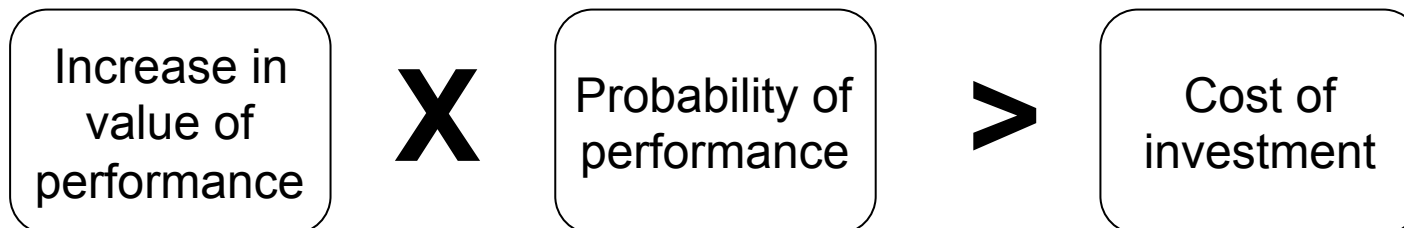
- ◆ You expect an airplane to arrive in spring – you might...
  - ◆ Sign up for flying lessons
  - ◆ Build yourself a hangar
  - ◆ Buy a helmet and goggles
- ◆ Reliance – investments which depend on performance
  - ◆ Reliance **increases the value of performance** to promisee
  - ◆ Reliance increases the social cost of breach
- ◆ Another aim of contract law is to secure **optimal level of reliance**



# When is reliance efficient?

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- ◆ When **social benefit** of reliance > **social cost** of reliance
- ◆ Social benefit: increased benefit to promisee
  - ◆ (Value of airplane + hangar) – (Value of airplane without hangar)
  - ◆ **Value is only realized if the promise is performed**
- ◆ Social cost: direct cost borne by promisee
  - ◆ **Cost occurs whether or not promise is performed**
- ◆ Reliance is efficient whenever





# How should reliance figure into damages?

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- ◆ Expectation damages = expected benefit from performance
  - ◆ If your reliance investment increases your anticipated benefit...
  - ◆ should it increase the damages I owe you if I breach?
  - ◆ Can we design damages to get **efficient reliance**, in addition to efficient breach?

## Reliance and damages: example

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Price of plane = \$350,000
Value of plane = \$500,000
Cost of hangar = \$75,000
Value of plane + hangar = \$600,000

- ◆ You're buying an airplane from me
  - ◆ Price is \$350,000, to be paid on delivery
  - ◆ Airplane alone gives you benefit of \$500,000
  - ◆ Building a hangar costs \$75,000
  - ◆ Airplane with hangar gives you benefit of \$600,000
- ◆ Without hangar, expectation damages = \$150,000
- ◆ If you build a hangar and I fail to deliver plane, do I owe...
  - ◆ \$150,000? (Value of original promise)
  - ◆ \$250,000? (Value of performance after your investment)
  - ◆ \$225,000? (Value of original promise, plus reimburse you for investment you made)
  - ◆ Some other amount?

## To get efficient breach...

Price of plane = \$350,000
Value of plane = \$500,000
Cost of hangar = \$75,000
Value of plane + hangar = \$600,000

- ◆ The only way to guarantee efficient breach is if damages included the **added benefit** from reliance
  - ◆ Once you've made investment, you anticipate benefit of \$250,000 from performance
  - ◆ If damages are anything less than that, I'll breach too often
  - ◆ (If damages exclude the added benefit, then I'm back to imposing an externality when I choose to breach the contract)
- ◆ So what happens to the incentive for reliance investments if damages will increase to include this added benefit?

## If exp damages include benefit from reliance...

Price of plane = \$350,000
Value of plane = \$500,000
Cost of hangar = \$75,000
Value of plane + hangar = \$600,000

- ♦ If you don't build hangar, your payoff will be...
  - ♦ \$150,000 if I deliver the plane ( $\$500,000 - \$350,000$ )
  - ♦ \$150,000 if I breach and pay expectation damages
- ♦ If you build hangar, your payoff will be...
  - ♦ \$175,000 if I deliver the plane ( $\$600,000 - \$350,000 - \$75,000$ )
  - ♦ \$175,000 if I breach and pay (higher) expectation damages
- ♦ So if expectation damages include the increased value of performance due to reliance investments...
  - ♦ You'll invest whenever (increase in benefit) > (cost)
  - ♦ In this case, you'll invest (because  $\$100,000 > \$75,000$ )

## If exp damages include benefit from reliance...

Price of plane = \$350,000
Value of plane = \$500,000
Cost of hangar = \$75,000
Value of plane + hangar = \$600,000

- ♦ If expectation damages include increased value of performance, you'll invest for sure
- ♦ Is this efficient?
  - ♦ Reliance is efficient if
$$(\text{increase in benefit}) \times (\text{probability of performance}) > (\text{cost})$$
$$\$100,000 \times (\text{probability of performance}) > \$75,000$$
  - ♦ Only efficient if probability of performance  $> \frac{3}{4}$
  - ♦ If probability of performance  $< \frac{3}{4}$ , reliance is inefficient, but happens anyway
- ♦ **Overreliance!**

# Overreliance

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- ♦ If reliance investments increase the damages you'll receive in the event of breach, you'll **over-rely**

- ♦ You'll rely if

$$\begin{array}{|c|} \hline \text{Increase} \\ \hline \text{in benefit} \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Prob. of} \\ \hline \text{perform.} \\ \hline \end{array} + \begin{array}{|c|} \hline \text{Increase} \\ \hline \text{in damages} \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Prob. of} \\ \hline \text{breach} \\ \hline \end{array} > \begin{array}{|c|} \hline \text{Cost of} \\ \hline \text{investment} \\ \hline \end{array}$$

- ♦ Efficient to rely if

$$\begin{array}{|c|} \hline \text{Increase} \\ \hline \text{in benefit} \\ \hline \end{array} \times \begin{array}{|c|} \hline \text{Prob. of} \\ \hline \text{perform.} \\ \hline \end{array} > \begin{array}{|c|} \hline \text{Cost of} \\ \hline \text{investment} \\ \hline \end{array}$$

- ♦ So if damages increase when you make reliance investments, we're sure to get overreliance!
    - ♦ (Your investment imposes an externality on me)

# Reliance and breach

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- ♦ Just showed: if damages include added benefit from reliance, promisee will invest more than efficient amount
- ♦ But if damages exclude added benefit...
  - ♦ Then promisor's liability  $<$  promisee's benefit from performance
  - ♦ Which means: promisor will breach more often than efficient
  - ♦ And promisor will underinvest in performance
- ♦ “Paradox of compensation”
  - ♦ Single “price” (damages owed) sets multiple incentives...
  - ♦ ...impossible to set them all efficiently!

# So what do we do?

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- ◆ Cooter and Ulen: include only **efficient** reliance
  - ◆ **Perfect expectation damages**: restore promisee to level of well-being he would have gotten from performance **if he had relied the efficient amount**
  - ◆ So promisee rewarded for efficient reliance, not for overreliance



# So what do we do?

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  - ◆ **Perfect expectation damages**: restore promisee to level of well-being he would have gotten from performance **if he had relied the efficient amount**
  - ◆ So promisee rewarded for efficient reliance, not for overreliance
- ◆ Actual courts: include only **foreseeable** reliance
  - ◆ That is, if promisor could reasonably expect promisee to rely that much

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## Remedies for breach of contract

# Three broad types of remedy for breach of contract

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- ◆ Party-designed remedies
  - ◆ Remedies specified in the contract
- ◆ Court-imposed damages
  - ◆ Court may decide promisee entitled to some level of damages
- ◆ Specific performance
  - ◆ Forces breaching party to live up to contract

# Expectation damages

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- ◆ Compensate promisee for the amount he **expected to benefit** from performance
  - ◆ You agreed to buy an airplane for \$350,000
  - ◆ You expected \$500,000 of benefit from it
  - ◆ Expectation damages: if I breach, I owe you that benefit
  - ◆ (\$500,000 if you already paid, \$150,000 if you didn't)
- ◆ **“Positive damages”**
- ◆ Make promisee indifferent between performance and breach

# Reliance damages

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- ♦ Reimburse promisee for cost of any **reliance investments** made, but **not** for additional surplus he expected to gain
- ♦ Restore promisee to level of well-being **before he signed** the contract
  - ♦ You contracted to buy the plane and built a hangar
  - ♦ If I breach, I owe you what you spent on the hangar, nothing else
- ♦ “**Negative damages**” – undo the negative (harm) that occurred

# Opportunity cost damages

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- ◆ Give promisee benefit he would have gotten from his **next-best option**
  - ◆ Make promisee indifferent between breach of the contract that was signed, and performance of **best alternative contract**
  - ◆ You value plane at \$500,000
  - ◆ You contract to buy plane from me for \$350,000
  - ◆ Someone else was selling similar plane for \$400,000
  - ◆ By the time I breach, that plane is no longer available
  - ◆ I owe you \$100,000 – the benefit you would have gotten from buying the other seller's plane

## Example: expectation, reliance, and opportunity cost damages

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- ◆ You agree to sell me ticket to Wisconsin-Ohio State football game for \$50
  - ◆ **Expectation damages**: you owe me value of game minus \$50
  - ◆ If I pay scalper \$150, then expectation damages = \$100
  - ◆ **Reliance damages**: maybe 0, or cost of whatever pre-game investments I made

## Example: expectation, reliance, and opportunity cost damages

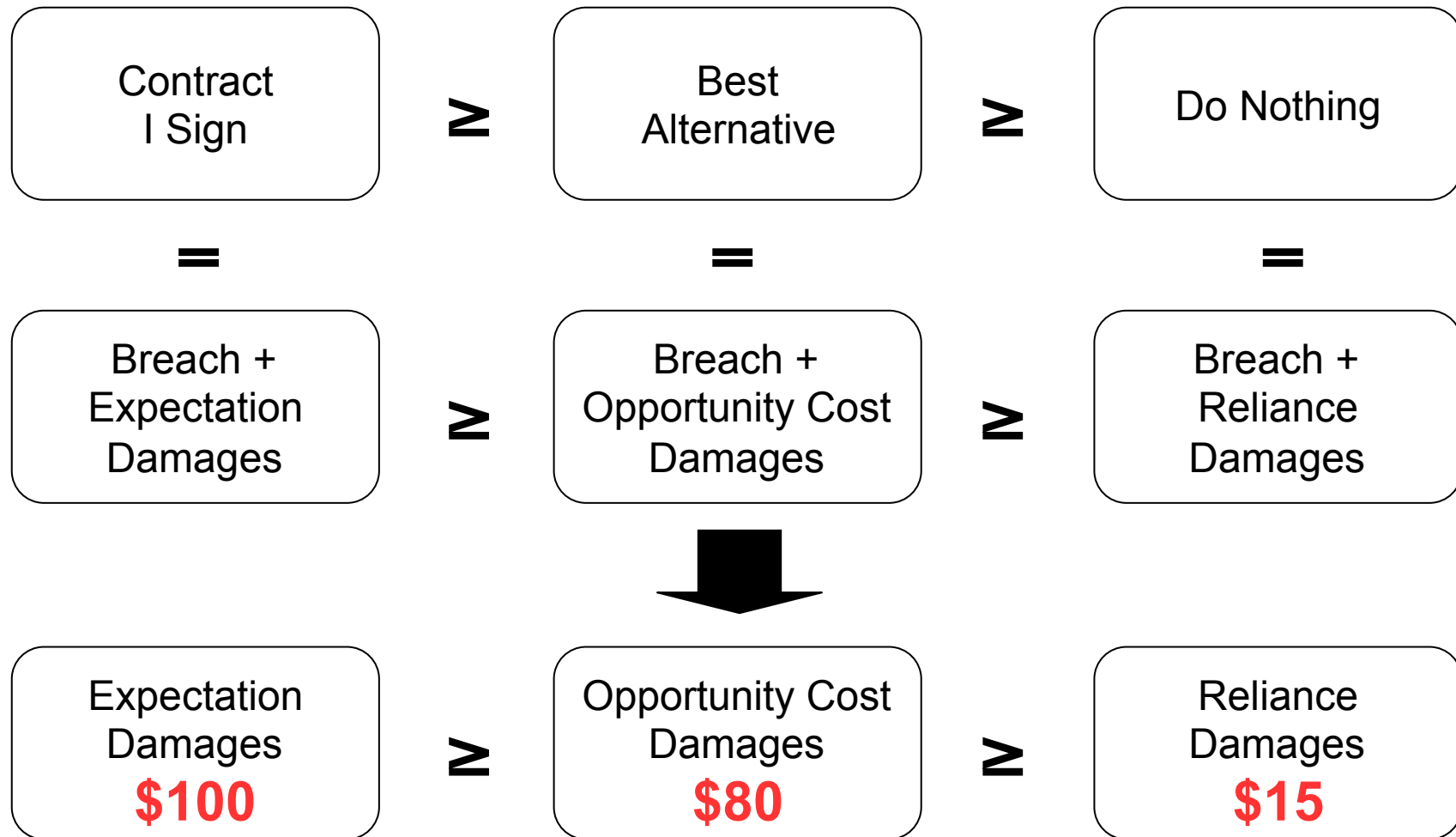
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  - ◆ **Reliance damages**: maybe 0, or cost of whatever pre-game investments I made
  - ◆ When you agreed to sell me ticket, other tickets available for \$70
  - ◆ **Opportunity cost damages**: \$80
  - ◆ (I paid a scalper \$150 to get in; I would have been \$80 better off if I'd ignored your offer and paid someone else \$70)



# Ranking damages

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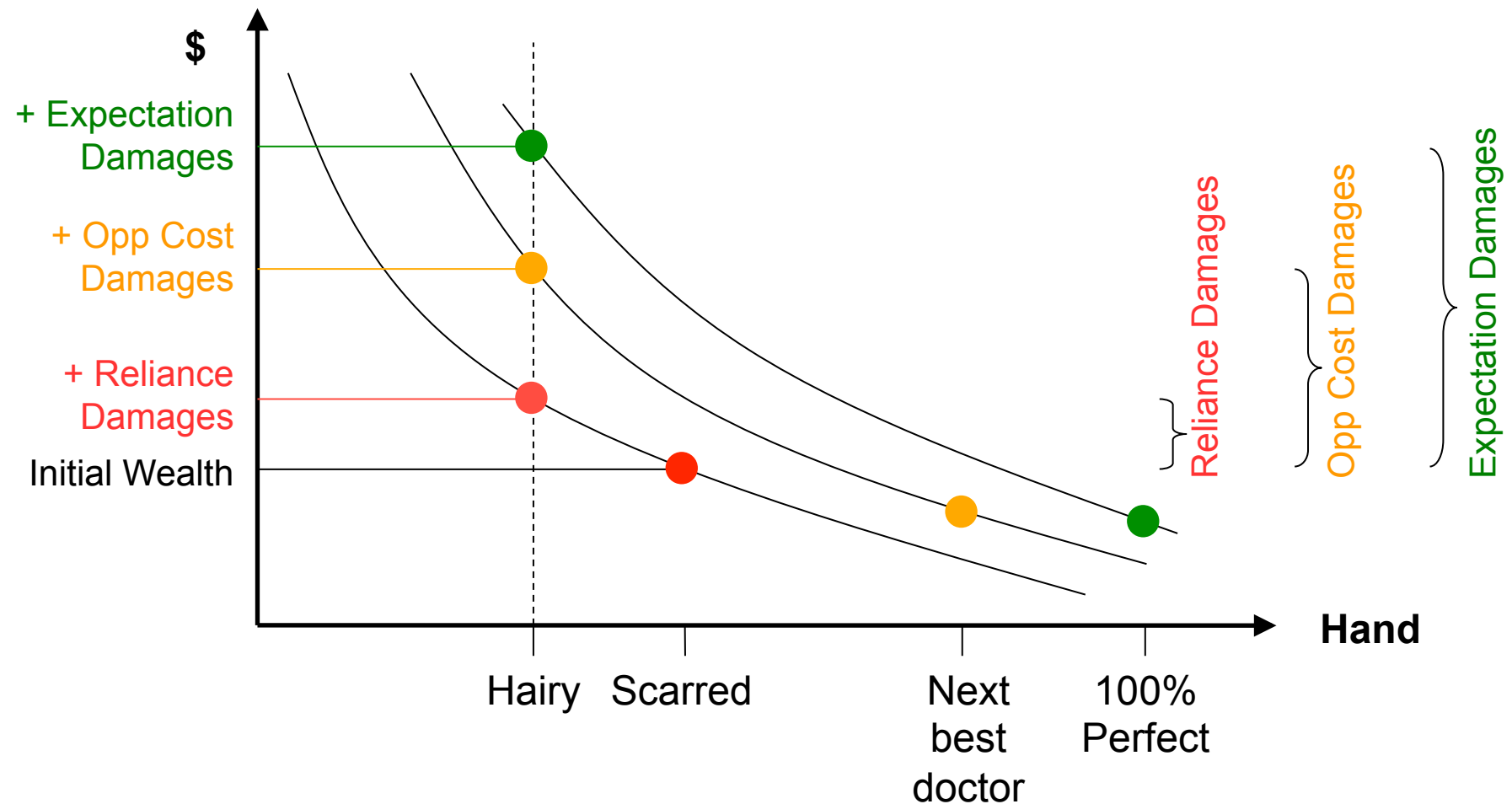


# Hawkins v McGee (“hairy hand case”)

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- ◆ Hawkins had a scar on his hand
- ◆ McGee promised surgery to “make the hand a hundred percent perfect”
- ◆ Surgery was a disaster, left scar bigger and covered with hair

# Hawkins v McGee (“hairy hand case”)



# Other court-ordered remedies

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- ◆ **Restitution**

- ◆ Return money that was already received

- ◆ **Disgorgement**

- ◆ Give up wrongfully-gained profits

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- ◆ **Restitution**

- ◆ Return money that was already received

- ◆ **Disgorgement**

- ◆ Give up wrongfully-gained profits

- ◆ **Specific Performance**

- ◆ Promisor is forced to honor promise
- ◆ Civil law: often ordered instead of money damages
- ◆ Common law: money damages more common; S.P. sometimes used when seller breaches contract to sell a unique good
- ◆ Like injunctive relief

# Party-designed remedies

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- ♦ Remedy for breach could be written directly into contract
- ♦ But common law courts don't always enforce remedy terms
  - ♦ **Liquidated damages** – party-specified damages that reasonably approximate actual harm done by breach
  - ♦ **Penalty damages** – damages greater than actual harm done
  - ♦ Civil law courts are generally willing to enforce penalty damages
  - ♦ But common law courts often do not

# Penalty clauses

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- ♦ Whatever you can accomplish with penalty clause, you could also accomplish with **performance bonus**
  - ♦ I agree to pay \$200,000 to get house built, but I want you to pay a \$50,000 penalty if it's late
  - ♦ Alternatively: I agree to pay \$150,000 for house, plus a \$50,000 performance bonus if it's completed on time
  - ♦ Either way, you get \$150,000 if house is late, \$200,000 if on time
  - ♦ **Courts generally enforce bonus clauses**, so no problem!
  - ♦ Example in Italian Public Procurement, enforced penalties can reach 10% of the value contracted, but if you re-name no penalty as performance bonus, there is no limit.
  - ♦ The problem is having managers/bureaucrats understand this...

# Contract Law

## Review and Discussion

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# Contract Law R&D 1

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- ◆ Contract law provides the legal background for economic exchange by enforcing voluntary agreements.
- ◆ Contracts cannot always provide for contingencies that might arise between the formation of the contract and the performance date.
- ◆ The economic theory of contract law says that courts should supply the missing terms in these *incomplete contracts* so as to maximize the gains from trade.

## Contract Law R&D 2

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- ◆ From a legal perspective, a valid contract includes three elements: *offer*, *acceptance*, and *consideration*. When offer and acceptance are present, the parties are said to have achieved a “meeting of the minds.”
- ◆ Consideration is the return promise that makes a contract mutual. Consideration need not be a monetary payment; it can also be a voluntary surrender of a legal right. Under traditional contract law, courts only inquire into the presence of consideration, not its form or adequacy.

## Contract Law R&D 3

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- ♦ A contract is invalid if one or both of the parties is *mentally incompetent*, if one of the parties entered the contract under *coercion* or *duress*, if the contract involves a *mutual mistake*, or if the terms of the contract are *unconscionable*. These excuses are referred to as formation defenses.
- ♦ The proper economic interpretation of coercion or duress is that it is about prevention of monopoly.

# Contract Law R&D 4

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- ♦ The role of consideration in contract law is to ensure that both parties to a contract get something. (It is up to the parties, not the court, to make sure that what each party gets is worth more to them than what they give.)
- ♦ Gift exchanges are not contracts—and hence usually not enforceable—because the giver does not receive (or does not expect to receive) anything from the recipient.
- ♦ However, courts may enforce pledges to give gifts or donations when they induce the recipient to incur a cost or make an investment in anticipation of receiving the gift (for example, making plans to use the gift in a particular way).

## Contract Law R&D 5

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- ◆ The efficient breach model says that it is efficient to breach a contract when the cost of performance exceeds the value of performance. Monetary compensation is the most common remedy for breach.
- ◆ *Expectation damages*, which is equal to the value of performance to the promisee, induces the promisor to breach only when it is efficient to do so.
- ◆ However, it also induces the promisee to overinvest in reliance because it fully insures him or her against breach.

## Contract Law R&D 6

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- ♦ Limited expectation damages, defined to be expectation damages evaluated at the promisee's efficient level of *reliance*, induces both efficient breach and reliance. This measure of damages corresponds to the remedy established in *Hadley v. Baxendale*.
- ♦ The *Hadley v. Baxendale* rule also requires promisees who would incur unusual (unforeseeable) damages from a breach to communicate that information up front to promisors. Otherwise, they will not be able to recover those damages in the event of breach.

## Contract Law R&D 7

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- ♦ *Specific performance* is a court order requiring the promisor to perform the contract as written.
- ♦ According to the Coase Theorem, this will not lead to excessive performance because the promisor can always offer to buy-out the contract if that is the efficient outcome, provided transaction costs are low.
- ♦ Compared to money damages, the main advantage of specific performance is that it protects the subjective value of performance for promisees. In so doing, it ensures that excessive breach will not occur.

## Contract Law R&D 8

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- ◆ Some contracts provide their own remedies for breach (liquidated damages), or failure of the product to perform as advertised (warranties).
- ◆ Not all products carry express (explicit) warranties. Courts nevertheless often find an *implied warranty of fitness*, which holds manufacturers liable for damages caused by a defect in the product.
- ◆ Implied warranties represent the intersection of contract and tort (products liability) law.



# Comment 1

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- ♦ The economic theory of contract law is based on the notion that contracts should only be performed when it is efficient to do so (that is, when the benefit of performance exceeds the cost). In other words, not all promises should be binding.
- ♦ That is not equivalent, however, to saying that there should be no penalty to breaking an enforceable promise. Indeed, the efficient breach model shows that in order for promisors to make efficient breach/performance decisions, they must be required to pay full compensation to promisees in the form of expectation damages.
- ♦ The imposition of damages represents a determination that the party breaking the contract has in fact committed a legal wrong.

## Comment 2

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- ◆ Recall that the Coase Theorem says that when parties to a dispute can bargain at low cost, the allocation of resources will be efficient regardless of the assignment of legal rights. In the context of breach of contract, this implies that efficient breach will occur regardless of the legal remedy.
- ◆ For example, reliance and zero damages will both result in excessive breach of contract because the damages are set too low *if parties cannot renegotiate the contract at low cost.*
- ◆ If they can, it is easy to see that the parties can always arrange a mutually beneficial side bargain that will result in efficient breach.
- ◆ This logic is the basis for the argument that courts should rely more on specific performance as a remedy for breach because it encourages the parties to make such bargains without the need for court intervention.

## Comment 3

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- ♦ In cases where performance of a contract has become physically impossible, the primary economic factor is allocation of the risk arising from the unforeseen event. This involves consideration of risk prevention and risk sharing.
- ♦ For example, if the store could have avoided the fire in this case, that would argue for assigning the risk to it (i.e., not discharging the store's obligation to pay for the elevator).
- ♦ However, if the fire was unavoidable, then the risk should be imposed on the party that can insure against it at lowest cost. For example, the store can purchase fire insurance, and the elevator company can charge a small premium to all of its customers to account for fires resulting in cancelled orders. Generally, which party is the cheaper insurer is an empirical question that must be decided on a case-by-case basis.

## Comment 4

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- ♦ Awarding money damages for breach of contract, as prescribed by the theory of efficient breach, allows promisors to break promises without the consent of promisees, provided they are willing to pay damages.
- ♦ It is analogous to allowing someone to take another's property, without first obtaining consent, provided the taker is willing to pay a price set by the court.
- ♦ Breach and theft--are thus equivalent in that both are non-consensual transfers of legally held rights in exchange for money damages. Logically, therefore, if breach is allowed on efficiency grounds, then why shouldn't theft be, provided that theft victims are compensated? This raises the further question of why some crimes should not simply be treated as torts (see Chapter 9).

## Comment 5

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- ◆ Since the decision to contract out certain activities represents a decision to replace an internal transaction with an external, or market transaction, the firm will choose whichever type of transaction is cheaper to govern.
- ◆ Internal transactions typically involve agency costs, like monitoring workers, whereas market transactions involve the costs of writing and enforcing contracts. Coase (1937) has argued that the choice between these two types of transactions determines the boundaries of the firm.
- ◆ The threat of tort liability can alter this decision because firms may be able to use the limited liability of corporations to shield themselves from liability by choosing to carry out certain activities outside the firm.

## Comment 6

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- ♦ The assignment of liability for accidental harms can be dealt with by contract law rather than tort law provided that the parties to the risky activity have a pre-existing contractual relationship, or are otherwise able to bargain. (Indeed, products liability law used to be primarily a branch of contract law)
- ♦ This is true because the parties can negotiate prior to an accident regarding the optimal assignment of liability for any accidents that may occur. As a result, the efficient accident rate and ex post assignment of liability will be achieved.
- ♦ Similarly, breach of contract can be viewed as a tort for which “victims” can seek monetary compensation from the court. And if the court sets the correct level of damages, promisors will choose the efficient levels of performance and breach.