

Western University

Law and Economics

Lecture 8



Introductory example 1

Example 1: The Rich Uncle. 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.



Introductory example 2

Example 2: The Rusty Chevy. 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 backyard, 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.



Introductory example 3

Example 3: The Grasshopper Killer. A farmer, in response to a magazine advertisement for “a sure means to kill grasshoppers,” mails \$25 and receives two wooden blocks by return post 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 to pay \$500 in punitive damages.



Contract: introduction

- What is a contract?
 - enforceable promise
- Why people make a contract?
 - Cooperation
 - Commitment



Contract: main issues

- 1) What promises are enforceable?
- 2) What should be a remedy if a contract is breached?



Classical bargain theory of contract

- A promise is legally enforceable if it is given as part of a bargain; otherwise, a promise is unenforceable.
- Three conditions for a bargain
 - Offer
 - Acceptance
 - Consideration: what the promisee gives the promisor to induce the promise.



Examples

- 1) I offer to sell you a car for \$1,000. You agree, and give me \$100 as a deposit (or you agree to pay me tomorrow).
- 2) I offer Western University a \$1,000,000 donation. They accept. I give \$50,000, then change my mind.

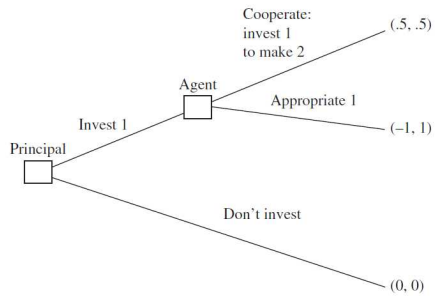


Bargain theory of contract: Part II

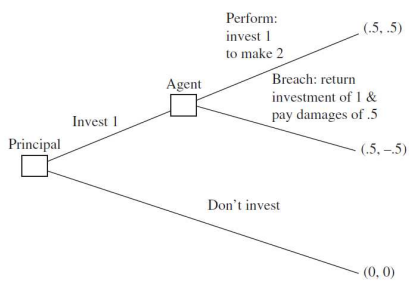
- Remedy for breach of enforceable promises
 - Expectation damages, or
 - Benefit of the bargain
- Expectation damages in introductory examples



Agency game without contract



Agency game with contract



The (first) purpose of contract law

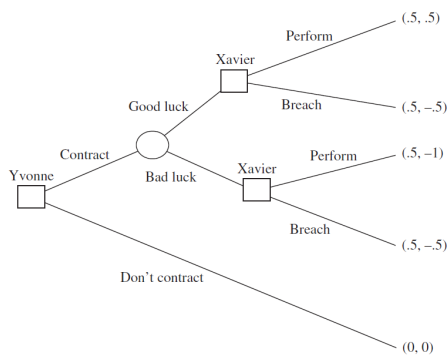
is to enable people to cooperate by converting games with non-cooperative solutions into games with cooperative solutions.

- Making a contract commits the second player to cooperate. Commitment is achieved by foreclosing the opportunity to appropriate. The opportunity to appropriate is foreclosed by the high cost of liability.

Example 4: Yvonne owns a restaurant for economists that is called the Waffle Shop. Her business prospers, and she needs a larger facility. She contracts with Xavier, a builder, who promises to expand the restaurant and complete the work by September 1. Her restaurant will remain closed while he builds. Xavier knows that events could jeopardize completing the construction on time. He is especially concerned that city officials may delay issuing the permits needed to begin construction. With good luck, he will get the permits early enough to complete construction on time at low cost. With bad luck, he will suffer a delay in getting the permits, and he will have to choose between completing construction on time at high cost, or breaching the contract and delaying completion of the building.



Contract with luck affecting performance.



Incentive to perform

- Performance is not always efficient.
 - If the (social) costs of performance are high relative to the (social) costs of breach, then breach is efficient.



Perfect expectation damages and efficient breach

- Definition: Perfect expectation damages restore the promisee to the position that he or she would have enjoyed if the promise had been kept.
- Result: Perfect expectation damages create incentives for efficient performance and breach.



Incentive to rely upon contract

- Definition: Reliance is a change in the promisee's position induced by the promise.
 - The promisor invests in performing, and the promisee invests in reliance upon the promise. Investment may take the form of money, time, effort, or forgone opportunities.
 - Reliance increases the value of performance to the promisee.



Reliance

- Reliance is Not Always Efficient
 - As (efficient) breach becomes more likely, efficient reliance investment falls.
- Damages influence reliance investment.
 - Reconsider expectation damages.



Perfect expectation damages

- Definition: Perfect expectation damages restore the promisee to the position that he or she would have enjoyed if the promisee had been kept and if reliance had been optimal.
 - The law does not allow the victim of breach to recover damages caused by over-reliance.
 - The promisor must bear the usual costs of breach (reasonably expected costs of breach), whereas the promisee must bear the unusual (unforeseeable) costs of breach.



Gaps in a contract

- Definition. Gaps are events not explicitly addressed in the contract that affect obligations created by it.
 - unforeseeable events: inadvertent gaps
 - remotely possible events: deliberate gaps (rational gaps)
- The court sometimes fill gaps by imputing a term to the contract, which means acting as if the parties had negotiated a term that they did not actually negotiate.
- Alternatively, courts may enforce only the explicit terms in the contract.



Default terms

To minimize transaction costs of negotiating contracts by supplying efficient default terms and regulations.

- Hypothetical bargain: Impute the terms to the contract that the parties would have agreed to if they had bargained over the relevant risk.



Example

- The McGuire signs a contract with the Wabash Construction company to build a house.
- At the time of contract, Wabash knows that the cost of copper pipe in the house may soar by \$2,000 with probability 0.5. Assume that Wabash can hedge against this risk for \$400.
- Wabash does not hedge and the price of copper soars. Wabash completes the construction of the house and sends the McGuires a bill for an additional \$2,000.



Perfect contracts and market failures

- Sometimes, the court sets aside the explicit terms of a contract. When the law disregards or changes the terms in a contract, we say that law regulates contract.
 - A consumer waives a right to recover for injuries caused by a defective product.
 - A sure means to kill grasshoppers.



Incomplete contracts

- Contracting is costly.
 - Articulating every possibility is impossible.
 - Specifying contingencies is costly.
- Optimal contract balances the cost of contracting against the potential incentive costs when contracts are imperfectly specified.