

Western University

Law and Economics

Lecture 10



---

---

---

---

---

---

---

---

**Chapter 9. II.  
Formation Defences and  
Performance Excuses**

- When transaction costs are zero, parties to a contract may be able to write a perfect contract which is complete and efficient. Parties to a perfect contract need the state to enforce their agreement (no need for regulation).



---

---

---

---

---

---

---

---

- Formation Defences:
  - Defendants can claim that they have no legal obligation to the plaintiff because no contract exists between them.
  - The conditions for creating a contract were not satisfied
- Performance Excuses:
  - Defendants can concede that a contract exists, and then claim that they were excused from performing under the circumstances
  - Unusual contingencies prevented performance.



---

---

---

---

---

---

---

---

## A. Incompetence

- If the promisor's preferences are sufficiently unstable or disorderly, then he or she is legally incompetent and cannot conclude an enforceable contract.
  - (children, the insane, and some mentally retarded adults)
  - cf. temporary incompetence, transactional incapacity.
- Since incompetent people cannot look after themselves, others must look after them. Law assigns responsibility for protecting incompetent people from harmful contracts to the competent people with whom they deal.
  - Q.7.20 A young girl found an attractive stone in the woods and sold it to a jeweller for \$1. Later, her family discovered that the stone was a rough diamond worth \$700.



---

---

---

---

---

---

---

---

## B. Dire Constraints (constrained choice) and Remote Risks

- Sometimes one of the parties to a bargain faces a dire constraint that leaves the decision-maker with little or no choice.



---

---

---

---

---

---

---

---

## 1. Duress

- If the beneficiary of a promise extracted it by threats, then promise-breaking is excused by reason of duress.
  - ex) A victim signed a contract with a gun held to his head.
  - ex) Make threats such as, "Work for me if you want your sister to come home safely from school."
- forbidden threats vs. permitted demands
  - a. voluntary bargain: productive, facilitates cooperation
  - b. coerced promise under duress: redistributive, allocatively inefficient
- In general, failed bargains do not create, whereas failed coercion can destroy.



---

---

---

---

---

---

---

---

## Holdup problem

- The captain of a boat in California contracts with the crew to make a fishing voyage to Alaska. After the boat reaches Alaska, the crew demands a bonus to finish the voyage. The captain cannot find replacement for the crew in Alaska, so he agrees. After the ship returns to California, the captain refuses to pay the bonus on grounds of duress.



---

---

---

---

---

---

---

---

## 2. Necessity

- If a promise is extracted from a desperate promisor, the court may excuse nonperformance on the ground of necessity.  
ex) A surgeon runs out of gas on a lonely desert road where she might perish. A passerby offers to sell her five liters of gas for \$50,000.
- Duress concerns a dire constraint imposed on the promisor by the promisee, whereas necessity concerns a dire constraint imposed on the promisor by someone other than the promisee.
- With duress, the promisee threatens to destroy by acting. With necessity, the promisee threatens to destroy by *not* acting.



---

---

---

---

---

---

---

---

## 3. Impossibility

- If a contingency makes performance impossible, the court may excuse nonperformance on the ground of impossibility.  
ex) A surgeon may promise to operate and then break her hand before the scheduled operation.
- Q) Should the promisor be held liable?
- With duress and necessity, the dire constraint precedes the promise. In impossibility, a dire constraint follows the promise and prevents performance.



---

---

---

---

---

---

---

---

## Impossibility

- The issue with the impossibility doctrine is the allocation of risks.
  - 1) Explicit contractual allocation
  - 2) Filling in gaps concerning remote risks
    - a. The explicit terms provide guidance to filling in a gap.
      - ex) A company promises to drill a well for a landowner, but the drill runs into impenetrable granite rock. (contract price)
    - b. The custom of industry may provide guidance.
    - c. The courts may provide guidance.
      - ex) Strict contractual liability



---

---

---

---

---

---

---

---

## Physical impossibility

- ex) The estate of a famous painter is not liable if death prevents the artist from completing a contract to paint someone's picture.
- ex) A manufacturer may be excused from fulfilling its contracts to deliver goods because lightning ignited a fire that destroyed her factory. (act of God, or force majeure)
- ex) If performance become illegal before it could occur, breach is excused. A shipping company is excused from its contract to carry civilian cargo in time of war if the government commandeers its ships to carry military cargo.



---

---

---

---

---

---

---

---

## Economic impossibility (or commercial impossibility)

- Q. 9.29: Westinghouse Co. case.
- Efficient rule: If a contingency makes performance impossible, assign liability to the party who can reduce or spread the risk at least cost.
- ex) The factory owner might install a sprinkler system to reduce the damage caused by fire. The factory owner might bear the risk of fire at least cost if she can easily purchase fire insurance whose coverage includes liability for not delivering goods.
- If the parties had explicitly allocated the risk, they would have assigned it to the party who can bear it at least cost.



---

---

---

---

---

---

---

---

## 4. Frustration of Purpose

- If a contingency destroys the purpose of a contract, the court may excuse nonperformance on the ground of frustration of Purpose.

ex) A coronation parade was planned for June 1902 in London. Many owners of property along the parade route leased rooms for the day to people wishing to observe the ceremony. When the king's illness caused the parade to be postponed, many people refused to pay the rent, and some of the property owners sued to enforce the contracts. The courts held that the contracts were unenforceable because their purpose was destroyed by postponing the ceremony.



---

---

---

---

---

---

---

---

- Efficient rule: If a contingency makes performance pointless, assign liability to the party who can bear the risk at least cost.

ex) The property owners who rented rooms could eliminate their losses caused by postponement of the coronation parade by renting the rooms a second time for the rescheduled parade.



---

---

---

---

---

---

---

---

## Mutual mistake about facts

- A mutual mistake about facts occurs when a contingency materializes before the parties sign the contract, without them knowing it.

ex) Buyer contracts to buy a track of timber land from Seller. Both Seller and Buyer believe that the land has timber, but in fact a forest fire has destroyed it. The parties have made a mutual mistake about the fact concerning the object of sale.

- Efficient rule: If a contingency makes performance pointless, assign liability to the party who can bear the risk at least cost.

ex) If Seller can prevent forest fire or insure against them more cheaply than Buyer, then Seller should be unable to enforce the contract against Buyer.



---

---

---

---

---

---

---

---

## Mutual mistake about identity

- A mutual mistake about identity occurs when the buyer and seller have different objects in mind, so their "minds do not meet."
- There is no true agreement to exchange.  
ex) The seller and buyer agreed to a price of \$1,000 for a car, but the seller intended to sell a rusty Chevy and the buyer intended to buy a shiny Cadillac.
- Efficient rule: Set aside contracts based upon mutual mistake about identity.



---

---

---

---

---

---

---

---

## Raffles v. Wichelhaus (1864)

- The plaintiff entered into a contract to sell 125 bales of Indian cotton to the defendant. The contract specified that the cotton would be arriving in Liverpool on the ship *Peerless* from Bombay ("to arrive ex *Peerless* from Bombay"). It so happened that there were two ships named *Peerless* arriving from Bombay, one departing in October and another departing in December. The defendant, according to statements presented in court, thought the contract was for cotton on the October ship while the plaintiff thought the contract was for the cotton on the December ship. When the December *Peerless* arrived, the plaintiff tried to deliver it, however the defendant repudiated the agreement, saying that their contract was for the cotton on the October *Peerless*.
- The issue before the Court was whether the defendant should be bound by the agreement to buy the cotton of the plaintiff's *Peerless*.



---

---

---

---

---

---

---

---

## The ship *Peerless* (I'm not sure which one)



Though courts will strive to find a reasonable interpretation in order to preserve the agreement whenever possible, the court in *Raffles* could not determine which ship named *Peerless* was intended in the contract. Consequently, as there was no *consensus ad idem* (as plaintiff alleged), the two parties did not agree to the same thing and there was no binding contract.



---

---

---

---

---

---

---

---

## C. Information

- Consider contract doctrines that allocate information.
- Private information often motivates exchange. Assume that someone knows how to get more production from a resource than its owner. To increase production, knowledge must be united with control, which requires the owner to acquire the information or the informed person to acquire the ownership of the resource.
- Private bargaining usually solves the problem of asymmetrical information well. Consequently, the law usually enforces contracts based on asymmetrical information.



---

---

---

---

---

---

---

---

## Unilateral Mistake

- When one party to a bargain knows the truth and other party does not, the exchange is based on a unilateral mistake. Courts usually enforce contracts based on unilateral mistakes.
- ex) The seller of a car may think that it is merely old, whereas the buyer may know that it is a classic.
- When the buyer acquires the classic car, the buyer will probably take better care of the car because he or she knows its worth.
- Discovering information often requires investing time and resources, which requires a reward.
- **Efficient principle:** Withhold enforcement from contracts involving involuntary exchange, and enforce contracts that reward discovery and unite knowledge with control.



---

---

---

---

---

---

---

---

## *Laidlaw v. Organ (1815)*

- Organ purchased 111 hogsheads of tobacco (111,000 pounds) from Laidlaw Co. on February 18, 1815. The purchase was made between 8 and 9am on the same day that news broke that a peace treaty had been accepted between America and Britain lifting a naval embargo that drastically affected the price of tobacco by 30 to 50 percent (Treaty of Ghent).
- Organ was aware of the lifting of the embargo while Laidlaw was not.
- During the discussion of the contract Organ was asked he was aware of any reasons for the price to be higher. Organ stayed silent over the news of the embargo lifting.
- Two days later, on the 20th, Laidlaw & Co. repossessed the tobacco by force from Organ. Organ filed sue to for breach of contract to regain the tobacco or be awarded damages.



---

---

---

---

---

---

---

---

- Productive information vs. redistributive information
- 1) Productive information can be used to produce more wealth.
  - ex) discovery of a vaccine for polio
- 2) Redistributive information creates a bargaining advantage that can be used to redistribute wealth in favor of the informed party.
  - ex) knowing before anyone else where the state will locate a new highway.
- Efficient principle: Contracts based upon one party's knowledge of productive information should be enforced, whereas contracts based upon one party's knowledge of purely redistributive information should not be enforced.




---

---

---

---

---

---

---

---

### Q. 9.33 Sherwood v. walker (1887)

- In May 1886, Hiram Walker, a cattle breeder, made a contract with Theodore Sherwood to sell him a cow. If the cow was barren (or a heifer), it was worth only about \$80 - compared to upwards of \$1,000 if it were able to breed, give birth to calves and thus produce tons of milk per year. Sherwood purchased an apparently barren heifer, Rose 2nd of Aberlone for 5.5 cents per pound. Before the exchange was completed, Walker discovered the cow was pregnant and refused to complete the sale. Sherwood sued him.
- The issue was, (Under Michigan contract law) "Can the defendant (Walker) refuse to sell the cow, because the parties did not know that the cow was actually fertile?"




---

---

---

---

---

---

---

---

### Q. 9.33 Sherwood v. walker (1887)

- The court held, that if both parties thought the cow was barren (a question for the jury), the contract was voidable on grounds of mutual mistake.
- The court reasoned by using the traditional test of the mistake "relating to the substance of the consideration." In other words, because both parties were mistaken, the consideration failed for the cow as she actually was a cow, not a barren animal or heifer.




---

---

---

---

---

---

---

---

## The Duty to Disclose

- The law treats safety information that helps people to avoid harm differently from productive and redistributive information.
- The law does not generally require an informed person to disclose productive or redistributive information to uninformed people. However, the law typically requires informed people to disclose safety information to uninformed people.  
ex) Manufacturers must provide safety information concerning their products or assume liability when accidents occur.



---

---

---

---

---

---

---

---

## *Obde v. Schemeyer (1960)*

- The seller of a building knew that it was infested with termites. The seller deliberately withheld the information about the termites from the buyer. Not long after the sale, the buyer discovered the termite infestation and sued the seller.
- By enforcing a duty to disclose, the court diminished the need for future buyers to undertake defensive expenditures against this sort of concealment by sellers.
- Efficient principle: When bargaining to a contract, the parties should divulge safety information.
- Q. 9.35 (Geologist)



---

---

---

---

---

---

---

---

## Fraud and Misrepresentation

- Fraud at common law requires a lie -- a false assertion made with the intention to deceive. The victim of fraud is entitled to damages for harm caused by fraud.



---

---

---

---

---

---

---

---

## D. Monopoly

- A monopolist is the only seller of a product for which no close substitutes exist.
  - Allocative inefficiency
  - Unfair (?)

cf. antitrust law: prohibiting a cartel



---

---

---

---

---

---

---

---

## Fill in a form

- Most written contracts use standard forms. Some terms in a standard-form contract are fixed; others may be variable.
  - ex) new car warranty
  - ex) cartel fixing price: Monitoring "cheating" in the cartel is much easier when all sellers use the same contract with fixed terms.



---

---

---

---

---

---

---

---

## Contract of Adhesion

- Standard-form contracts indicate the existence of a monopoly, which deprives buyers of bargaining power.
- The courts sometimes use "contract of adhesion" as a term of opprobrium to undermine the enforceability of a contract. This court practice can be justified when sellers use standard-form contracts to reduce competition.
- Standard-form contracts can promote efficiency in two ways:
  - A. Reduce product differentiation (and intensify price competition).
  - B. Reduce transaction costs.



---

---

---

---

---

---

---

---

## Unconscionability

- When a contract seems so one-sided that its enforcement would violate the conscience of the court, it may be set aside according to the common law doctrine of unconscionability.



---

---

---

---

---

---

---

---

## *Williams v. Walker-Thomas Furniture Co.* (D.C. Cir. 1965)

- The purchase of a durable good from a retailer on credit.
- Collateral: The item that a borrower is buying
- Add-on clause: Any goods that the borrower has previously purchased on credit from the lender-retailer will serve as additional security for the current purchase.
- Lesson: The paternalistic protection of Mrs. Williams by legal restrictions on the credit market imposes high costs on poor consumers as a class.



---

---

---

---

---

---

---

---

## *Walker-Thomas Furniture Co.*



---

---

---

---

---

---

---

---

## Unconscionability

- 1) *Substantive* unconscionability refers to a price that is utterly disproportionate to market value.
- 2) *Procedural* unconscionability consists of circumstances and procedures present at the formation of the bargain that violate widely accepted norms of fairness.



---

---

---

---

---

---

---

---