Chapter 8
An Economic Theory of Contract

Overview: Property law encourages people to maximize the value they derive from their property by preventing involuntary appropriation. Contract law prevents opportunism in exchanges involving the passage of time.

Two Fundamental Questions in Contract Law

1. What promises should be enforced?
2. What should be the remedy for breaking enforceable promises?

I. Bargain Theory: An Introduction to Contracts

A. What promises should be enforceable at law?

1. The early view was that a promise is legally enforceable if it is part of a bargain. Three conditions were required for a bargain to have been struck: *offer, acceptance and consideration*. Of these three, consideration is the least straightforward. In the context of contracts, consideration consists of something the promisee gives the promisor in exchange for the promise. The presence of consideration was required to make a contract enforceable.

   The promisor is giving something to the promisee in the future in exchange for something the promisee gives the promisor now. For example, a home buyer (the promisee) gives a builder (the promisor) a down payment on a house that the builder will deliver to the buyer at some future date.

B. Remedies for the breach of enforceable promises

1. *Expectation damages*. Basically this is a measure of the value to the promisee if the contract had been fulfilled. The underlying assumption is that the promisee is entitled to "the benefit of the bargain". From an economic perspective, if expectation damages are set correctly, the promisee is indifferent between performance and breach.

   It is also important to recognize that if one party loses as a result of enforcement of a contact, so long as the gain to the second party is greater than the first party's loss, the exchange is efficient if judged by the Hicks-Kaldor criterion.

C. A Criticism of the Bargain Theory

1. The problem with the bargain theory approach is that, in many cases, consideration could be absent for justifiable reasons. Moreover, both parties (the promisor and the promisee) could want the promise to be enforceable *at the time that the agreement was made*, implying a cooperative surplus from the exchange. However, the lack of consideration would prevent the promise from being enforceable. Such a legal theory would prevent efficient exchange in certain cases. It is important to note that in many cases, American courts do not adhere to the bargain theory of contracts and, as such, encourage more economically efficient outcomes than would be the case otherwise.

2. *Dogmatic law* versus *responsive law*
   - Strictly adhering to the bargain theory is an example of *dogmatic law*.
   - Modifying the law to maximize the well-being of society is an example of *responsive law*.

II. An Economic Theory of Contract Enforcement

Economic efficiency would require that a promise be enforced *if both the promisor and the promisee wanted enforceability when the promise was made*. (Contrast this with the bargain theory's answer to the first question.) Changing contract law in this manner would be Pareto efficient. In this section, we replace the bargain theory with a more responsive theory of contracts.

A. Cooperation and commitment

1. Deferred exchange is a central feature of contracts (promises). In those cases where the passage of time is not an issue, enforceability of promises is not an issue.

2. In the case of deferred exchange various risks arise. Thus, the issue of enforceability arises.

3. The thrust of the game theory example in the text is that cooperation is productive, i.e., new value is created, while appropriation is redistributive. Assuming a lack of enforceability, many promises that would be productive would not be entered into due to the risks involved. In the terminology of contracts we can think of cooperation as performance of the terms of the contract and appropriation as breach of contract. Note that this does not imply that breach is never efficient; a point we consider further below. *The first purpose of contract law is to enable people to convert games with inefficient solutions into games with efficient solutions.* Stated differently, people will have an incentive to enter into promises that create value. In addition, having an enforceable contract converts some games with a non-cooperative solution into games with a cooperative solution. The concept of *credible commitments* is critically important here.

   Painting example: Assume the exchange will occur over some period of time because we live in different cities. The terms of the agreement are that B will send A $7,500 in cash (recall that A valued the painting at $5,000 and B valued it at $10,000), at which time A will send the painting to B.

   - If the parties enter the K and both parties perform, the payoff is $2,500 to each player (for a combined gain of $5,000).
   - If B performs (by sending the cash to A) and A does not perform (i.e., does not send the painting to B), A gains $7,500 and B loses $7,500 for a combined net gain of $0).

   Scenario 1: No Contract Law

		Player A	
		Perform	Appropriate
Player B	Buy		
	Don't Buy		

   - The implication is that, without an enforceable contract, the non-cooperative solution, i.e., no exchange, dominates the cooperative solution, because B's potential loss exceeds her potential gain.

Scenario 2: With Contract Law

		Player A	
		Perform	Breach
Player B	Buy		
	Don't Buy		

- With an enforceable contract, both parties have an incentive to cooperate and perform. Hence, enforceability of the contract encourages the realization of a cooperative surplus.

III. An Economic Theory of Contract Remedies
The second purpose of contract law is to secure optimal commitment to performance. (Here we are addressing the question of when to perform versus when to breach)

A. Perfect expectation damages.
Begin by assuming that something happens that increases the costs of performing a contract. Note that the promisor is going to compare the costs of performance to the liability for breach in deciding whether to perform a contract.

In determining whether performance or breach of a contract is efficient, we need to compare the promisor's costs of performance to the promissee's benefits from performance.

- So long as the costs are less than benefits, performance is efficient.
- However, when costs exceed benefits, breach is efficient.
- Thus, if we set damages for breach at a level equal to the benefits to the promisee if the contract was performed, the promisor will have the correct incentives to perform or breach.
- So long as costs of performance are less than expectation damages (recall that damages equal the benefits to the promisee from performance), the promisor will perform.
- If costs of performance exceed the expectation damages, the promisor will breach, which is efficient.

Note: ***This condition holds so long as the contract only affects the parties to it.***

House example: Buyer gets two bids for a house: $110,000 and $100,000. Buyer had determined at the outset that she would pay a maximum of $110,000 for the house. The buyer goes with the bid of $100,000.

Assume the cost to build increases to $105,000. What should we do? The builder will want to breach, but should we let him? Consider the net gain from the contract.

Production example: A agrees to sell B 500 units of an input at $10/unit. The input is used to produce 500 units of output that B has agreed to sell C for $20/unit. Assume A breaches and B cannot deliver to C. What is the value of PED?

B. Precaution against breach
When a contract only affects the parties to it, liability for perfect expectation damages gives the promisor efficient incentives to take precaution against breach.

C. Reliance
Reliance refers to opportunity costs a promisee incurs as a result of a promise made to her.

1. How is the optimal level of reliance determined? A promisee should invest in reliance up the point at which the marginal expected benefits of increased reliance are just equal to the marginal expected costs incurred.

Marginal expected benefit = probability of performance multiplied by the increase in the value of performance due to increased reliance

Marginal expected cost = probability of breach multiplied by the increase in the cost of breach due to increased reliance (increase in the cost of breach equals the net cost of the reliance)

Window coverings example: (Begin by assuming it is efficient to "mitigate damages" resulting from reliance, e.g., by reselling, at a reduced rate, items purchased as a part of reliance rather than destroying them.) House buyer has a chance to buy window coverings she had picked out at a $200 discount if she buys now (before the house is finished). Regular price is $1,200. In the event that she has to, she can resell the window coverings for $500. Assume the probability of performance by the builder is 0.9. Should she buy the window coverings?

What if the probability of performance falls to 0.7?

Additional Notes:

Production example: A promises to deliver to C based on A's contract with B. C promises A a bonus of $10,000 if the part is delivered on time. However, A will reduce the price by $50,000 if delivery is late. Assume probability of performance by B is 0.8.

IV. Economic Interpretation of Contracts

A. Perfect contracts

1. *Perfect contracts* arise when
   - the parties are rational and
   - TC = 0.

2. Under these conditions,
   - each right/resource/object is allocated to the party who values it most,
   - every contingency has been anticipated, and
   - the risk associated with each contingency is allocated to the party who can insure against it at least cost (as a result, there are no gaps in the contract).

3. In the absence of one or both of the conditions for a perfect contract, contracts are imperfect. Three possible responses of courts to imperfect contracts include:
   - enforce the explicit terms of the contract,
   - fill a gap in the contract without contradicting its explicit terms, and
   - replace the contract's explicit terms, i.e., *regulate* the contract

B. Default rules and transactions costs

Forming a contract involves transactions costs, some of which concern the allocation of risk for various contingencies. In some cases, it is efficient to allocate risks explicitly in the contract; in other cases, it is efficient to leave "gaps."

1. *Rational gaps*. Think in terms of two types of transactions costs (TC) – those associated with allocating a risk when the contract is formed and those associated with allocating losses that actually materialize.

   So long as the TC of allocating a risk, i.e., *ex ante* transactions costs, are less than the expected costs of allocating a loss, i.e., *ex post* transaction costs, the gap should be filled (provided for in the contract). However, if the TCs of allocating risk are greater than the expected costs of allocating a loss, the gap should remain.

2. *Gap-filling by courts*: Default terms are terms the court imposes in the absence of explicit terms in the contract. The gist here is that courts should supply default terms that maximize the surplus from cooperation by allocating a loss to the party who can insure against it at least cost. Note that doing this encourages parties to leave gaps when it is efficient to do so because they know that if the contingency arises, the loss will be allocated the way it would have if the parties had bargained.

3. *Hypothetical bargain*: In order to supply efficient default terms, the court should impute terms to the contract the parties would have agreed to if they had bargained over the relevant risk.

C. Mandatory Rues

Regulation of a contract occurs when the court ignores or changes certain explicit terms of a contract. The potential for regulation of a contract arises when the contract is not perfect, i.e., complete.

1. Individual rationality:
   a. Someone who is legally *incompetent* is not rational and therefore cannot enter into an enforceable contract.

   b. *Duress* and *necessity* constitute dire (as opposed to moderate) constraints (they inhibit rational behavior) and can therefore justify promise breaking.
      - *Duress* is usually attributable to actions by the promisee. The promisee is acting in a threatening manner.
      - *Necessity* is usually attributable to an action (or lack of action) by the promisor. In these cases the promisor is desperate.

   c. *Impossibility*, which is usually the result of something that happens between the time when the contract was formed and when it is to be fulfilled, may also excuse performance.

2. *Spillovers* and *derogation of public policy*. Generally, spillovers from a contract are handled by some other area of the law. In some cases, however, courts may refuse to enforce a contract because of the adverse effects of performance on the public at large.

3. *Asymmetric Information*. Actions including *fraud* (lies), *failure to disclose* (failure to supply information such as a warning about the dangers of a product), *frustration of purpose* (both parties base the contract on the same misinformation), and *mutual mistake* (both parties have something different in mind when they enter into the contract) can all void a contract.

4. *Monopoly*. In this case, limitations on the availability of trading partners can cause bargains to be very one-sided. The doctrine of *unconscionability* allows courts to set aside contracts that appear to be blatantly unfair.

V. Relational contracts: The economics of the long run: *Skip this section*