II. REVIEW QUESTIONS

1. For each of the following examples determine whether, on efficiency grounds, the contract should be performed or breached. If you recommend the former, explain in one or two sentences why. If you recommend the latter, identify the contract doctrine that would excuse promise breaking.

a) Roger, whom is 14 and an avid collector of baseball cards, agrees to sell a particular card to a dealer for $500, when in fact the market value of the card is at least $1,000. Roger’s parents attempt to block the sale of the card.

_The contract should be voided on the basis of incompetence. A valid contract does not exist given Roger’s age and the fact that he may not have sufficient information to enter into a defensible contract. In the case of incompetence, courts should rule to the benefit of the incompetent party so as to create incentives for competent parties to look out for the welfare of incompetents._

b) The Finance department at Adams College agreed to hire Joey Fudderman to teach introductory finance courses. In his application Joey indicated that he would have his Ph.D. completed by the time the school year started, a requirement for the teaching position. Upon his arrival on campus, the Finance department learns Joey has not yet received his Ph.D. due to data problems that prevented him from completing his dissertation, and declares the contract void.

_We can begin by assuming that there is a gap in the contract, i.e., this contingency was not covered explicitly. This is a case of impossibility. We then have to decide which party is the least-cost insurer. Because Joey presumably has a much better handle on what it will take to complete his dissertation, including data requirements, than anyone else, it is reasonable to assume he is the least-cost insurer, and therefore, we should void the contract as requested by the Finance department._

c) Franky offers to sell Johnny a pleasure boat they have used together on many occasions. After taking delivery of the boat, Johnny discovers that the motor is unreliable and fails to start from time to time. Arguing that he was unaware of the problem when the sale took place, Johnny demands damages. Franky responds that he assumed Johnny was aware of the problem given their previous trips together and that, therefore, no damages are warranted.

_This is a problem of unilateral mistake. Franky knew what he was selling. Johnny knew what he has buying but did not have full information regarding the characteristics (in particular, reliability of the motor) of the item he purchased. Johnny should have invested more time in learning more about the boat. Assuming safety is not an issue (although it could be) and Franky did not lie to Johnny, the contract should be enforced._

2. Assume that Smith and Jones entered into a contract in which Jones promised to build a bar for Smith’s house. The bar was to be constructed of Brazilian rosewood. When Jones attempted to buy the wood, he learned that a moratorium has been declared on the harvesting of Brazilian rosewood and that in order to purchase from existing stocks, he would have to pay three times the price he originally planned on when agreeing to the price for the bar stipulated in the contract. There is nothing in the contract that addresses the possibility that the price of Brazilian rosewood would increase. Smith insists that the bar must be made of wood in question and refuses to absorb the increased costs. Consequently, Jones is threatening to the breach the contract, citing commercial impracticability (a variation of impossibility). Assuming you are the court, how would you fill this gap? Explain your reasoning.
Barring the possibility that Jones and Smith will work out an agreement among themselves regarding the allocation of the loss, the court will have to allocate the loss among the two parties. To encourage economic efficiency, the court should allocate the loss in the manner that the loss would have been allocated had the two parties reached an agreement ex ante. In this case, it would seem that Jones would be in the better position to bear the loss associated with the increased cost of the wood. This assumes that Jones is a professional contractor and should have a much better understanding of the prices of materials and possible fluctuations in those prices. In addition, one could argue that Jones should take more precautions when exotic materials are specified in the contract. (However, the decision of how to allocate the loss also depends on whether the moratorium was foreseeable. Even though Jones may be the more efficient risk bearer, if the contract price did not reflect this risk, the court might order Smith to pay a portion of the increased cost of the wood, where that amount paid by Smith would be equal to the increase in the price of the contract Jones would have demanded from Smith to compensate Jones for agreeing to bear the risk.)

3. Consider the following. An elderly woman inherits a car from her son who is killed in an airplane accident. The woman, who has never driven in her life decides to sell the car. She puts an ad in the paper indicating that she will accept the best offer for a 1966 Chevrolet. A prospective buyer recognizes the car for what it actually is, a mint condition 1966 Corvette, and offers the woman $500 which she readily accepts. Once her nephew learns what has happened, he attempts to have the contract voided.

On efficiency grounds, should the contract be performed or breached? If you recommend the former, explain why. If you recommend the latter, identify the contract doctrine that would excuse promise breaking and explain why it is applicable in this case.

This contract should be performed. The woman could have easily asked someone to come and independently appraise the car to determine its approximate market value. This would have better ensured that the woman would receive the fair market value at minimal cost. There is nothing in the question which suggests that the woman was not of sound mind or that the buyer in any way “forced” her to enter into the contract. Instead, this is a case of unilateral mistake. It is reasonable to assume that because the buyer appreciates the true value of the car, it will be better cared for, maximizing its value.

4. Assume that a U.S. oil refinery entered into a contract with the government of a foreign country for the delivery of 1 million barrels of oil in six months. However, approximately 3 months before the scheduled delivery date, the country was caught up in a war and its oil fields were bombed and its oil recovery infrastructure was almost completely destroyed.

a) Which defense would you recommend the country cite for breach of contract? In this case, how would you rule in the breach of contract dispute? Why?

The country should argue impossibility. However, the ruling will depend on which party should be considered the least-cost insurer against this contingency. One the one hand, if the country knew it might be the victim of an ariel attack while the buyer (refinery) did not have this information, one might convincingly argue the country should be liable. If the country did not have such information, one might successfully argue the buyer could have entered into contingency contracts with other suppliers at relatively low cost to cover this possibility.

b) Assume that, in fact, the country that entered into the oil delivery contract was the aggressor in the war. In this case, how would you rule in the breach of contract dispute? Why?

Now we rule against the country, which could obviously insured against this contingency at least cost.
5. In June 1996, Professor Smith entered into a contract with a book publisher to write an introductory text book on psychology. The contract called for Smith to submit a rough draft to the publisher one year from the date of the contract, with a final version of the text to be submitted no later than one year after Smith received the reviews of the rough draft. For its part, the published agreed to pay Smith an advance of $10,000 and a royalty of 10 percent on each copy of the book sold in the United States (the first $10,000 in royalties would be credited against the advance). It was estimated that the book would sell for $30 (net wholesale price) and 50,000 copies would be purchased in the first year of publication. After a year had passed the publisher had not yet received the rough draft. As it turns out, Smith delayed completion of the draft to work on a more lucrative book offer he received from another book publisher. The first publisher subsequently sued Smith for breach of contract and requested that the court order specific performance.

a) In this case is there a gap in the contract? If so, in your opinion was it efficient for the parties to leave the gap? What condition must be satisfied for this to be the case?

Yes, there is a gap regarding this particular contingency. So long as the expected ex post transaction costs of allocating a loss to one of the two parties in the event that a loss arises are less than the ex ante transactions costs of filling the gap, the gap should be left in the contract. As for your opinion on the matter, make a convincing argument.

b) Considering economic efficiency, how should the court rule, i.e., should the court excuse Smith, impose legal relief (damages), or require specific performance? Why?

This involves a fortunate contingency. Smith received a better offer which, in turn, induced him to breach the existing contract. Assuming the book in question is unique, we have argued the appropriate remedy in this combination of circumstances, i.e., fortunate contingency and unique good, is specific performance. Smith should turn over the manuscript to the first publisher. If the second publisher values the manuscript more than the first publisher, the two will be able to reach a mutually beneficial agreement. (This of course in no way absolves Smith’s responsibility to the second publisher.)

6. In July 1997, Penultimate Computers, a computer manufacturer, agreed to deliver 1000 personal computers to Datarama, a business data processing firm, in October of the same year. The contract stipulated that each machine would include a number of preloaded software programs, including Visions 97. However, after Visions 97 was released, it was discovered that a flaw had been written into the program that, once activated, could corrupt the other programs on the host machine under certain rare conditions. Consequently, Penultimate decided to install an alternative to Visions 97 that was both slower and less sophisticated. Datarama subsequently sued for breach of contract. No damages clause was written into the contract to cover this eventuality.

a) What condition(s) for a perfect contract has (have) been violated in this case?

There is a gap regarding the risk that Penultimate might not be able to deliver the product as specified on time.

b) What do you consider to be the economically efficient solution in this case? Why?

The answer depends on which party we consider to be the least-cost insurer. Considering Penultimate is in the business of building computers and routinely works with software suppliers, a plausible argument could be made that Penultimate is the least-insurer and should therefore bear the cost of this contingency.
7. Referring to the previous question, assume that Penultimate had a contract with the manufacturer of Visions 97, and that, in fact, Visions was aware of the flaw, but did nothing to correct it, an act that was later revealed by an insider at Visions.

a) What condition(s) for a perfect contract has (have) been violated in this case?

   Once again there is gap regarding this particular contingency.

b) What do you consider to be the economically efficient solution in this case? Why?

   Now we are dealing with what amounts to fraud. Visions should be liable.