

REVIEW NOTES - THE ECONOMICS OF CONTRACT LAW

I. Introduction

- 2 questions that must be answered in Contract law
 - o What promises should be legally enforced?
 - o What remedies should be available for breach of a legally enforceable promise?

II. The Classical (Bargain) Theory of Contracts

- What promises are enforceable?
 - o only those which are part of a bargain
- What is a bargain?
 - o it must have offer, acceptance, and consideration (what are those?)
 - o consideration
 - must consideration be objective or can it be subjective also?
 - how about adequacy of consideration?
 - how is the "new" or modern theory of contracts different than the old?
- gift promises as compared to bargain promises
 - o what is a gift promised?
 - o according to classical theory, should it be enforced?
 - o according to economic theory, should it be enforced?
 - What is the economic purpose of enforcing any promise?
 - examples.
 - how can we make gift promises enforceable?
 - classical bargain theory
 - modern theory
- remedies for breach of enforceable promises (Bargain theory of contracts)
 - o expectation damages
 - definition
 - why is this the correct remedy under the bargain theory?
 - o reliance damages
 - o specific performance
 - o restitution damages

III. An economic theory of Contracts

- what is a "perfect contract"?
 - o definition
 - o when should perfect contracts be enforced?
- perfect contracts as compared to a perfectly competitive market
 - o what happens in a perfectly competitive market?
 - exchange
 - efficiency
- => exchange in a perfectly competitive market should be efficient (i.e., contracts written under perfectly competitive conditions should be efficient).
 - o What are the assumptions of a perfectly competitive market?
 - individual rationality (what does this mean?)
 - stable, well-ordered preferences (what does this mean?)
 - constrained choice (i.e., scarcity)
 - individuals are maximizing their utility

- legal doctrines associated with each
- perfectly competitive market environment
 - many buyers and sellers
 - Full information to both parties
 - no negative externalities
 - zero transaction costs
 - legal doctrines associated with each
- What is a perfect contract?
 - o results from perfectly competitive market conditions
- The economic theory of contracts evaluates legal doctrines to see how they fill the gaps caused by violations of a perfectly competitive market.

IV. According to the economic theory of Contracts, what should be a legally enforceable promise?

- Formation and performance defenses for breach of contract
 - o definition of both
 - o 2 general economic themes for both defenses for breach of contract
 - o how can a particular defense be constructed to maximize the flow of relevant information between the bargaining parties?
 - o how can a particular defense be constructed to improve the allocation of risk between the parties?
 - what risk?

V. Analysis of Formation defenses

- Coercion or Duress
 - o all bargaining involves threats (why?)
 - o what type of threats should not be allowed (i.e., allow the contract to be breached?)
 - o economic justification
- Incapacity/Incompetence
 - o law assumes competency with two exceptions
 - immature (children)
 - insane/mentally handicapped
 - o economic justification?
- Mutual Mistake
 - o what is a mutual mistake?
 - o what is a unilateral mistake?
 - o which is enforceable and which not?
 - o economic justification?
 - is the mistake based upon redistributive or productive information?
 - definition of both
 - how do we tell the difference between the two?
- Fraud (misrepresentation and the duty to disclose)
 - o what is destructive information?
 - o definition of fraud
 - o economic justification?
 - o recent expansion in the doctrine of fraud. why?
- Unconscionability
 - o substantive unconscionability
 - o procedural unconscionability

- how might "unconscionable" contracts actually benefit consumers from an economic standpoint.
 - o examples? (for each what is the definition? and the economic justification?)
 - Add on clauses
 - exclusion of consequential damages in warranties
 - termination at will clauses in franchises
- 4 proposed grounds for allowing unconscionability defense (for each know the economic justification)
 - o distress (duty to rescue)
 - o transactional incapacity
 - o unfair persuasion
 - o price ignorance

VI. Analysis of Performance Defenses

- Defendant:
 - o admits that a valid contract was formed
 - o claims circumstances have changed since formation which should excuse performance
 - o => talking about contingencies that arise that should invalidate performance
- The court can:
 - o grant defense and excuse performance
 - o declare breach and design a remedy
- Economics of performance defenses
 - o what is the correct allocation of risk?
 - is risk explicitly allocated in the contract?
 - is risk implicitly allocated in the contract?
 - if neither, how should the court decide?
- impossibility performance defense
 - o 3 valid excuses for impossibility
- Economics - is the risk foreseeable at reasonable cost? If so => the contract should assign risk.
 - o example = Tsakiroglou v. Noble Thorl G.M.B.H. House of Lords (1962)
 - facts of the case
 - does the contract assign risk? how?
 - suppose the contract does not assign risk, then what?
- Commercial impracticability defense
 - o 3 conditions for excuse of performance
 - o economic justification?
 - o example = westinghouse case

VII. The economics of remedies for breach of contract

- types of remedies
 - o liquidated damages
 - o legal relief
 - expectation damages
 - reliance damages
 - restitution damages
 - o equitable relief = specific performance
- efficient breach
 - o definition of an efficient breach (example)
 - breach is efficient iff the costs of performance exceed the benefits of performance

- contingencies which can lead to efficient breach
 - windfall contingency
 - accidental loss contingency
- Which remedy is most likely to result in breach only when it is efficient?
 - if transaction costs are zero?
 - if transaction costs are positive?
 - the best remedy is the one which minimizes transaction costs and court costs.
 - tradeoff between the two
 - legal relief (which cost is highest?)
 - equitable relief (which cost is highest?)
- Liquidated damages
 - will courts enforce?
 - is it efficient to enforce?
 - what if the liquidated damage clause includes punitive damages?
 - might enforcement cause inefficient performance?
 - might enforcement induce breach?
- Legal relief = court appointed damages
 - look at expectation and reliance damages
 - what are the differences between the two measures?
 - the efficiency of expectation damages
 - game theory model
 - result =?
 - expectation damages and reliance
 - expectation damages cause over-reliance => inefficient
 - reliance damages cause inefficient breach => inefficient
 - what is the solution?
- Specific performance
 - why is specific performance not much used?
 - the economics of specific performance
 - are transaction costs low or high?
 - relationship between court costs and transaction costs - which is highest? (why does it matter?)
 - what are the advantages of awarding specific performance?
 - criticisms and problems