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 objective 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?
    - 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
    - definition of both
    - 2 general economic themes for both defenses for breach of contract
    - how can a particular defense be constructed to maximize the flow of relevant information between the bargaining parties?
    - 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
    - all bargaining involves threats (why?)
    - what type of threats should not be allowed (i.e., allow the contract to be breached?)
    - economic justification
- Incapacity/Incompetence
    - law assumes competency with two exceptions
        - immature (children)
        - insane/mentally handicapped
    - economic justification?
- Mutual Mistake
    - what is a mutual mistake?
    - what is a unilateral mistake?
    - which is enforceable and which not?
    - 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)
    - what is destructive information?
    - definition of fraud
    - economic justification?
    - recent expansion in the doctrine of fraud. why?
- Unconscionability
    - substantive unconscionability
    - procedural unconscionability

- how might "unconscionable" contracts actually benefit consumers from an economic standpoint.
    - 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)
    - distress (duty to rescue)
    - transactional incapacity
    - unfair persuasion
    - price ignorance

VI. Analysis of Performance Defenses

- Defendant:
    - admits that a valid contract was formed
    - claims circumstances have changed since formation which should excuse performance
    - => talking about contingencies that arise that should invalidate performance
- The court can:
    - grant defense and excuse performance
    - declare breach and design a remedy
- Economics of performance defenses
    - 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
    - 3 valid excuses for impossibility
- Economics - is the risk foreseeable at reasonable cost? If so => the contract should assign risk.
    - example = Tsakiroglou v. Noblee 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 impractibility defense
    - 3 conditions for excuse of performance
    - economic justification?
    - example = westinghouse case

VII. The economics of remedies for breach of contract

- types of remedies
    - liquidated damages
    - legal relief
        - expectation damages
        - reliance damages
        - restitution damages
    - equitable relief = specific performance
- efficient breach
    - 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