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EE 403

Law & Economics

Economics of Contract Law 2

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Remedies as Incentives

- ◆ When a party to a contract fails to perform as promised, the victim may ask the court for a remedy.
- ◆ Remedies fall into three general types:
 1. party-designed remedies,
 2. court-imposed damages, and
 3. specific performance.

Party-designed

- ◆ The contract stipulates a remedy when it contains explicit terms prescribing what to do if someone breaches.
- ◆ For example, a construction contract may stipulate that the builder will pay \$200 per day for late completion of a building.
- ◆ Because negotiating and drafting are costly, an efficient contract will not explicitly cover every contingency. When the contract omits a remedy, the court must supply one.

Court-imposed damages: Expectation Damages

- ◆ Damages for breach of contract compensate the promisee for the injury caused by the nonperforming promisor.
- ◆ In a contract setting, the term “injury” has several different meanings.
- ◆ First, the promisee is worse off than if the contract had been performed.
- ◆ **Performance provides a baseline for computing the injury.**
- ◆ Using this baseline, the courts award damages that place the victim of breach in the position he or she would have been in if the other party had performed.
- ◆ We say that *expectation damages* leave potential victims *indifferent between performance and breach*.

Reliance

- ◆ You expect an airplane to arrive, you might...
 - ◆ Sign up for flying lessons
 - ◆ Buy a helmet and goggles
- ◆ Reliance – investments whose value depend on performance of the promise
 - ◆ Reliance **increases the value of performance to promisee**
 - ◆ Reliance increases the social cost of breach
 - ◆ we know that the promisor may not always perform, so reliance investments are not a sure thing

Reliance damages

- ◆ Reimburse promisee for cost of any **reliance investments** made, but **not** for additional surplus he expected to gain.
- ◆ The well-being before the contract was signed provides a baseline for computing the injury.
- ◆ Restore promisee to level of well-being **before he signed** the contract

Court-imposed damages: Opportunity Cost

- ◆ Making a contract often entails the loss of an opportunity to make an alternative contract.
- ◆ **The lost opportunity provides a baseline for computing the injury.**
- ◆ Using this baseline, the courts award damages that place victims of breach in the position that they would have been in if they had signed the contract that was the best alternative to the one that was breached.
- ◆ We say that *opportunity-cost damages* leave potential victims *indifferent* between breach and performance of the best alternative contract

Court-imposed damages

Example 1: Seller's Breach. O Ticket Agency offers opera tickets at the price p_O . K Ticket Agency offers equivalent opera tickets at the lower price p_K . Consumer orders x_K tickets from K at the contract price p_K and promises to pay when he picks up the tickets on the day of the performance. Close to the day of the performance, K announces that it will breach and not deliver the tickets to Consumer. In the meantime, the show has succeeded and the price of tickets has risen; so, Consumer pays the higher price, p_S , for substitute tickets purchased from a third ticket agency.

Expectation Damages

Reliance Damages

Opportunity Cost

Court-imposed damages

Example 2: Buyer's Breach. K Ticket Agency offers opera tickets for sale at the price p_K . Consumer orders x_K tickets and promises to pay when he picks up the tickets on the day of the performance. In reliance on Consumer's promise, K purchases x_K tickets at the wholesale price p_W . If Consumer had not ordered the tickets, K could have contracted to sell them to an agency named O at the lower price p_O . Close to the date of the performance, Consumer announces that he will not pick up or pay for the tickets. In the meantime, the show has flopped and the price of tickets has fallen; so, K resells the tickets at the lower price, p_S , to another consumer.

Expectation Damages

Reliance Damages

Opportunity Cost

Court-imposed damages

Example 3: Buyer's Breach with Unique Good. Seller builds custom boats, and Buyer retails boats, to consumers. Seller offers to build Buyer a custom boat with any one of three compass systems for navigation, which are named K, O, and A. Buyer estimates correctly that the market value at which he can retail the boat, depending on which compass is installed, will be v_K , v_O , or v_A , respectively. These values are net of the cost of the compass. Because $v_K > v_O > v_A$, Buyer maximizes profits by ordering the boat built with the K compass. However, Seller actually delivers a boat with an A compass. Replacing the compass after installation is prohibitively expensive, so Buyer subsequently retails the boat for v_A .

Expectation Damages

Reliance Damages

Opportunity Cost

Court-imposed damages

◆ Summary

TABLE 1

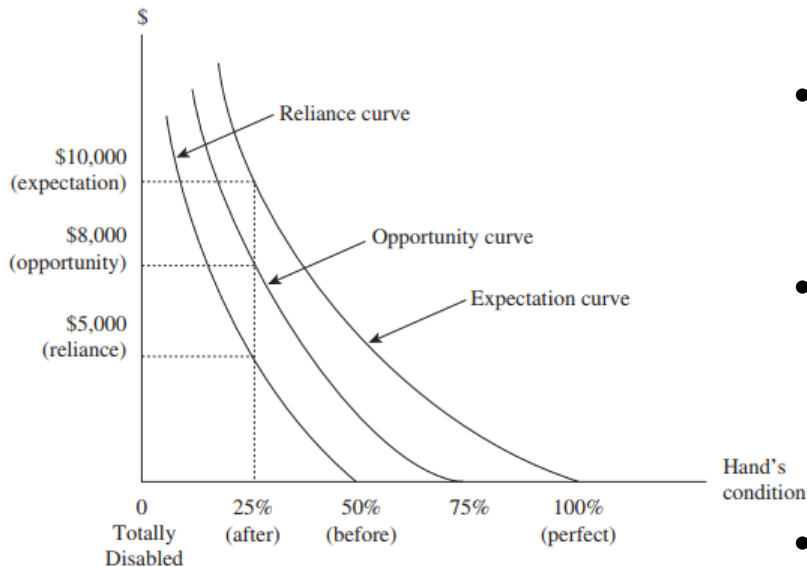
	Example 1: Seller's Breach with Substitute	Example 2: Buyer's Breach	Example 3: Seller's Breach with no Substitute
Expectation damages	$x_K(p_S - p_K)$	$x_K(p_K - p_S)$	$v_K - v_A$
Reliance damages	0	$x_K(p_W - p_S)$	0
Opportunity cost	$x_K(p_S - p_O)$	$x_K(p_O - p_S)$	$v_O - v_A$

Problem of Subjective Value: *Hawkins v. McGee*

- ◆ the distinction between the three forms of damages when subjective value does not equal market value.
- ◆ The plaintiff, George Hawkins, → a permanent scar on his hand.
- ◆ McGee, persuaded him to submit to an operation → would restore the hand to perfection
- ◆ The result was hideous. Hawkins prevailed against McGee in a suit alleging that the doctor had broken his contractual promise to make the hand perfect.

Problem of Subjective Value: *Hawkins v. McGee*

◆ “What damages should be awarded to Hawkins?”



- Assume that after the operation the patient’s hand was 25 percent perfect.
- Assume that if there had never been a contract, the patient would have had a 50 percent perfect hand
- The value of the foregone opportunity depends on how close to perfection the hand would have been after an operation by another doctor.
- To illustrate, suppose that another doctor would have restored the hand to the 75 percent level.

Efficient breach

Promissee



Promisor



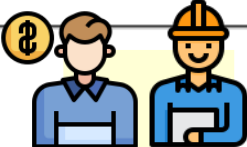


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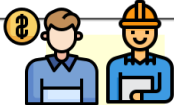


Efficient breach

- Reliance = R
- Damage = D

	Promissee	Promisor	
			
Perform	$V - R - P$	$P - C$	$V - R - C$
Breach	$D - R$	$-D$	$-R$

Efficient breach

	Promissee	Promisor	
			
Perform	$V - R - P$	$P - C$	$V - R - C$
Breach	$D - R$	$-D$	$-R$

- Efficient breach if $-R > V - R - C \rightarrow C > V$

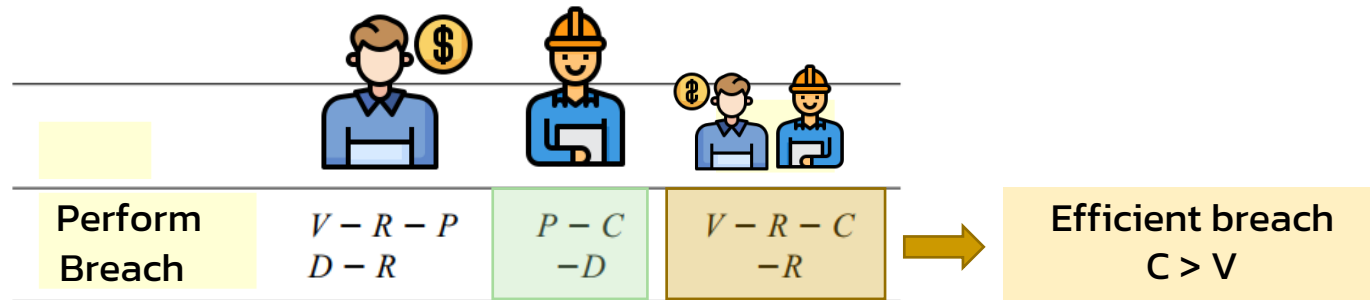
- Promisor breach if $-D > P - C \rightarrow C > P + D$

- Remedy that will lead to efficient breach is

$$D = V - P$$

“Expectation Damages” Remedy

Efficient Breach



- Efficient breach $C > V$
- **Reliance damages** $D = R$
- **Promisor breach if** $-D > P - C \rightarrow C > P + D$ when $D = R \rightarrow C > P + R$
- Since $V - R - P > 0$, $P + R < V$ which means that the Reliance damage is lower than the level that will lead to efficient breach \rightarrow not efficient breach

Restitution

- ◆ A remedy for breach is to require the breaching party to return what was given.
- ◆ For example, the buyer of a car often makes a “down payment” before receiving the car. If the seller breaches the contract to deliver the car, the court may order the seller to return the down payment.
- ◆ Although minimal, restitution often has the advantages of simplicity and enforceability.

Specific Performance

- ◆ “Specific performance” usually requires the promisor to do what he or she promised in the contract
- ◆ The typical case in which courts adopt specific performance as the remedy involves the sale of goods for which no close substitute exists.
- ◆ Examples include land, houses, antiques, works of art, and specialized labor contracts.
- ◆ In contrast, when breach involves the sale of goods for which close substitutes exist, courts typically award damages as the remedy. The victim can use the damages to purchase substitute performance. Examples include new cars, wheat, televisions, and stock in public companies.