

MATT KENYON



EE 403

Law & Economics

Economics of Contract Law 3

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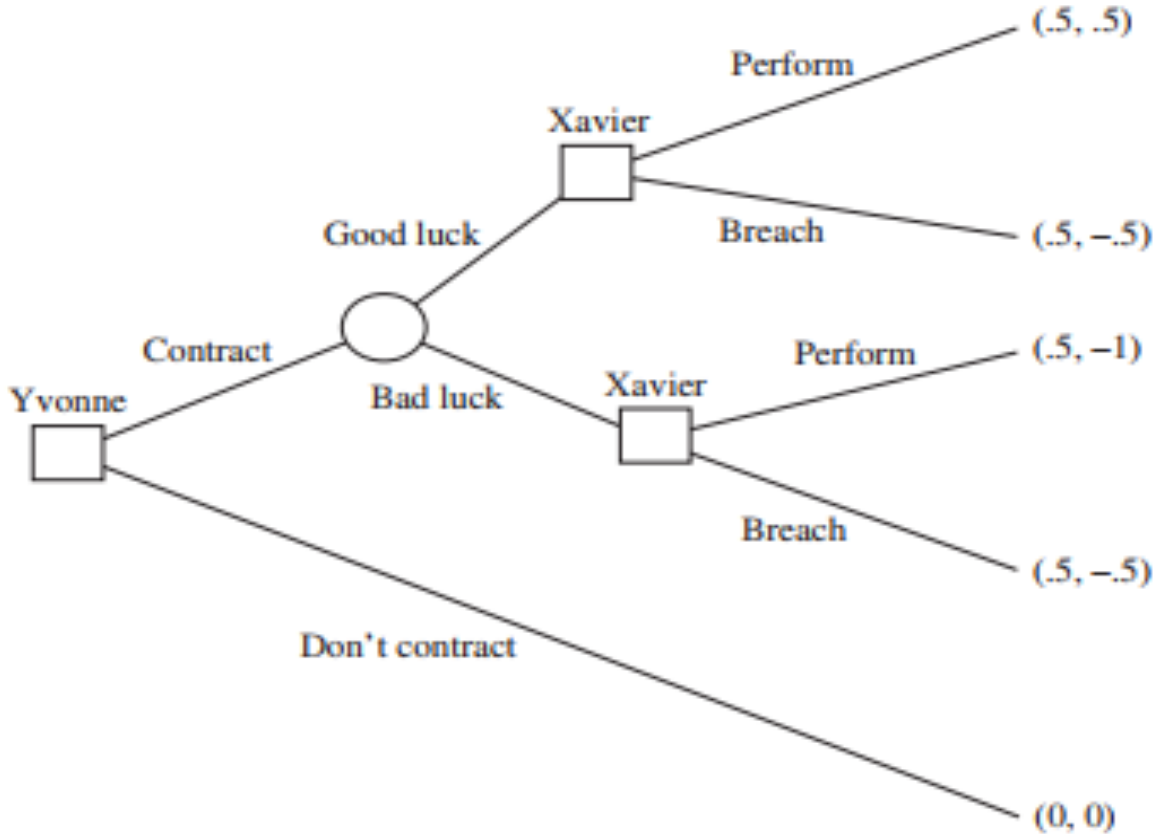
Efficient Breach and Performance

- When circumstances change, not performing a promise can be more efficient than performing.
- In these circumstances, nonperformance occurs in two ways.
- First, the promisor can *breach* the contract by breaking his promise.
- Second, the parties can renegotiate and modify the contract to allow nonperformance of the original obligation.

Unfortunate Contingency

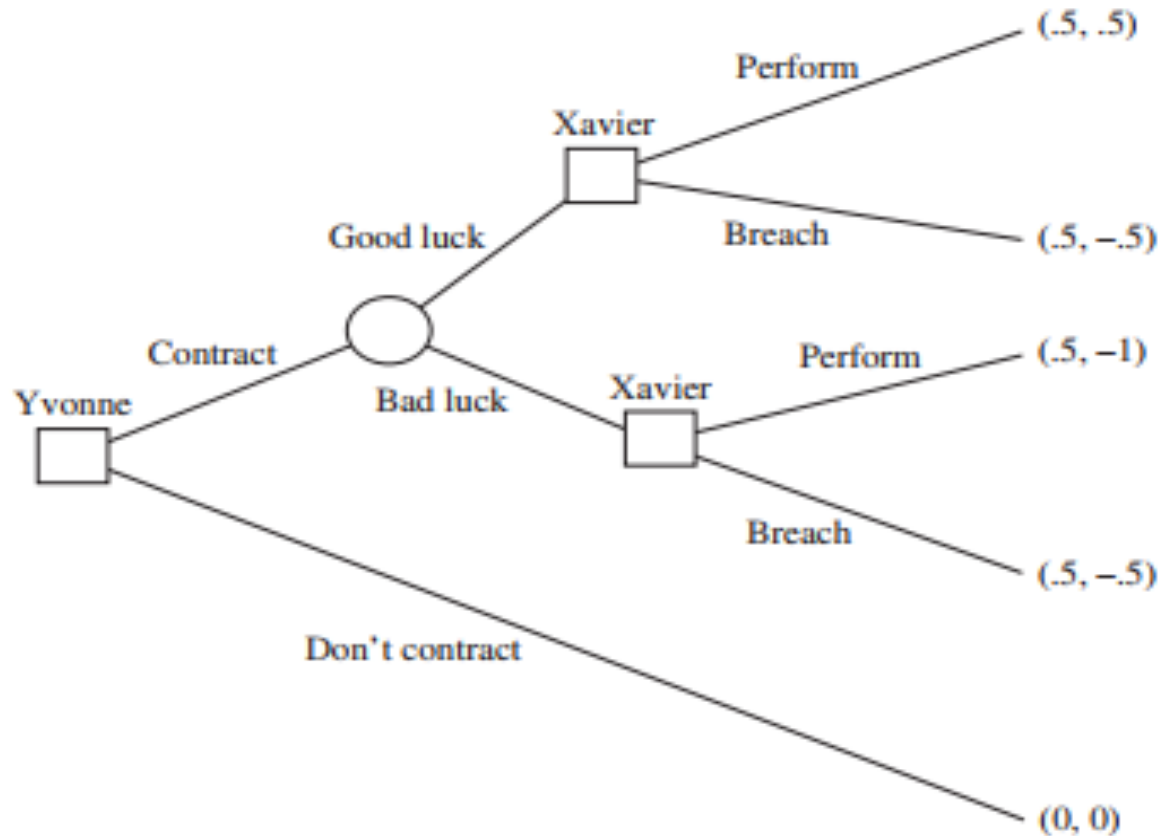
- In the relevant version of the agency game, the agent (second player) promises to cooperate with the principal (first player). When making the promise, the future cost of cooperating remains uncertain. The cost of cooperating might be low or high. Low costs are likely and high costs are unlikely. High costs of performing are an unfortunate contingency that makes breach efficient.

Unfortunate Contingency



- Assumes the Xavier must pay expectation damages to Yvonne.
- Now consider the remedy of specific performance. This remedy gives the principal a right to the agent's performance, regardless of its cost.
- If the principle forces the agent to perform at high costs, the agent receives -1.0 and the principal receives $.5$.
- Successful renegotiation allows the parties to share the surplus of $.5$
- The principal must receive at least $.5$ in order to benefit from renegotiating the contract. In addition to $.5$, the principal will want a share of the surplus.

Unfortunate Contingency



- Efficiency requires the players to choose the actions that maximize the sum of the payoffs to the principal and agent
- The remedy of **damages gives the promisor the choice of performing or breaching** and paying damages. The promisor can choose the cheaper alternative.
- In contrast, the remedy of specific performance gives the promisee the right to performance, regardless of its costs. Exercising this right in the wrong circumstances causes the inefficiency
- To avoid the inefficient exercise of the right to specific performance, the parties must succeed in renegotiating the contract.
- Successful renegotiation can restore efficiency to the decision to breach.

Fortunate Contingency

- A fortunate contingency is typically an alternative contract that is even more profitable than the original contract.
- When a fortunate contingency makes the promisor want to avoid performing on the original contract in order to profit even more from an alternative contract, the injunctive remedy increases the promisee's bargaining power in the ensuing negotiations relative to a damages remedy.
- With increased bargaining power, the promisee can extract a larger share of the surplus created by the fortunate contingency.

Fortunate Contingency

To demonstrate this fact, assume that person *A* values living in his house at \$90,000, and person *B* values living in *A*'s house at \$110,000. *A* promises to sell the house to *B* for \$100,000, which will create a surplus of \$20,000. Before completing the sale, however, person *C* appears on the scene and offers to buy the house from *A*. *C* values the house at \$126,000. *C* offers to pay \$118,000 for the house. *C*'s appearance creates a new, more profitable alternative to the original contract. Transferring the house from *A*, who values it at \$90,000, to *C*, who values it at \$126,000, creates a surplus of \$36,000. Figure 3 summarizes these numbers in the first column, which is labeled "Value placed on house."

Fortunate Contingency : No remedy

	Value placed on house	Distribution of surplus if no remedy	Distribution of surplus if remedy is specific performance	Distribution of surplus if remedy is expectation damages
Person A	\$90,000	\$28,000	\$10,000	\$18,000
Person B	\$110,000	\$0	\$18,000	\$10,000
Person C	\$126,000	\$8,000	\$8,000	\$8,000
Total		\$36,000	\$36,000	\$36,000

Fortunate Contingency : Specific performance

	Value placed on house	Distribution of surplus if no remedy	Distribution of surplus if remedy is specific performance	Distribution of surplus if remedy is expectation damages
Person A	\$90,000	\$28,000	\$10,000	\$18,000
Person B	\$110,000	\$0	\$18,000	\$10,000
Person C	\$126,000	\$8,000	\$8,000	\$8,000
Total		\$36,000	\$36,000	\$36,000

Fortunate Contingency: Expectation damages

	Value placed on house	Distribution of surplus if no remedy	Distribution of surplus if remedy is specific performance	Distribution of surplus if remedy is expectation damages
Person A	\$90,000	\$28,000	\$10,000	\$18,000
Person B	\$110,000	\$0	\$18,000	\$10,000
Person C	\$126,000	\$8,000	\$8,000	\$8,000
Total		\$36,000	\$36,000	\$36,000

Perfect contracts

- ◆ In a world without any transaction costs, the two sides to a contract could spell out exactly what should occur in every possible contingency
 - ◆ what happens if the cost of sheet metal rises
 - ◆ what happens if another buyer appears who wants the plane I'm building you
 - ◆ what happens if a shipment is delayed, and so on
- ◆ But perfect contracts is costly.

Imperfect contracts

- ◆ However, in reality, some circumstances are unforeseeable
- ◆ the cost and complexity of writing a contract to deal with every possibility would make perfect contracts unworkable
- ◆ **Gaps**: risks or circumstances that aren't specifically addressed in a contract
- ◆ Gaps can be inadvertent or deliberate
 - ◆ Our contract to sell you the airplane might not have addressed another buyer wanting it.
 - ◆ We could have imagined that it is possible for the price of raw materials to go up significantly, but we might have felt it was such a remote risk that it was not worth the time and effort to build it into the contract.

How should we fill these gaps? Default rules

- ◆ Why are gaps left?
 - ◆ Because it wasn't worth the cost to fill them
- ◆ **Default rules**: rules applied by courts to fill gaps
- ◆ Normative Coase: design law to minimize transaction costs
- ◆ In this case: make it “safe” to leave gaps in contracts
- ◆ How to do this?
 - ◆ When there's a gap in a contract impute the rule the parties would have wanted, if they had chosen to think about this issue
 - ◆ What would the parties have wanted? Whatever was efficient!

Efficient contracts

- ◆ Example
 - ◆ A family hires a construction company to build a house
 - ◆ Risk a worker strike might cause a delay
 - ◆ 1 in 50 chance of a strike
 - ◆ If company is responsible, they'll have to pay for a hotel for the family, cost of \$3,000 (company bears the risk)
 - ◆ If not responsible, family can stay with friends, cost of \$1,000 (family bears the risk)
- ◆ Expected cost is \$60 if company bears it, \$20 if family does
 - ◆ **Efficient contract would make company not responsible**
 - ◆ (If family was paying X for the house and company was liable for delay, BOTH parties would prefer a price of X - 40 and the company not being liable!)

Efficient contracts

- ◆ Efficient contracts generally allocate each risk to whoever can bear (or prevent, or hedge) that risk at least cost
 - ◆ “low-cost avoider”
- ◆ So, the default rule should be to allocate risks that way
 - ◆ If something happens that wasn’t specified in the contract...
 - ◆ ...figure out what efficient rule would have been...
 - ◆ ...and allocate the loss to whoever the efficient contract would have allocated the risk!

Who is the efficient bearer of a particular risk?

- ◆ several bases for making this determination
 - ◆ **Who is in the better position to spreading losses** across many transactions
 - ◆ who is in better position to **influence outcome**?
 - ◆ who is more **aware** of risk, even if he can't do anything about it?
- ◆ “...The party with **control** over some part of the production process is in a better position both to **prevent** losses and to **predict** them. It follows that an efficient contract will usually **assign the loss** associated with something going wrong to the **party with control** over that particular something.”

Default rules

- ◆ Example: 50% chance that the cost of construction will increase by \$2,000 (the cost of construction will be \$1,000 higher due to this risk)
- ◆ The company chooses not to hedge this risk; the price of copper pipes does go up
- ◆ The company builds the house and bills the family \$2,000 more than they had expected and the family refuses to pay, and the case goes to court
- ◆ The original contract does not say anything about the risk of rising copper prices.
- ◆ So how would the court address this?

Default rules

- ◆ Assume that the construction company can hedge this risk for \$400
- ◆ Family can't do anything about it
- ◆ Construction company is **efficient bearer** of this risk
- ◆ So efficient contract would allocate this risk to construction company
- ◆ Should **prices** be adjusted to compensate?

Was the risk foreseeable?

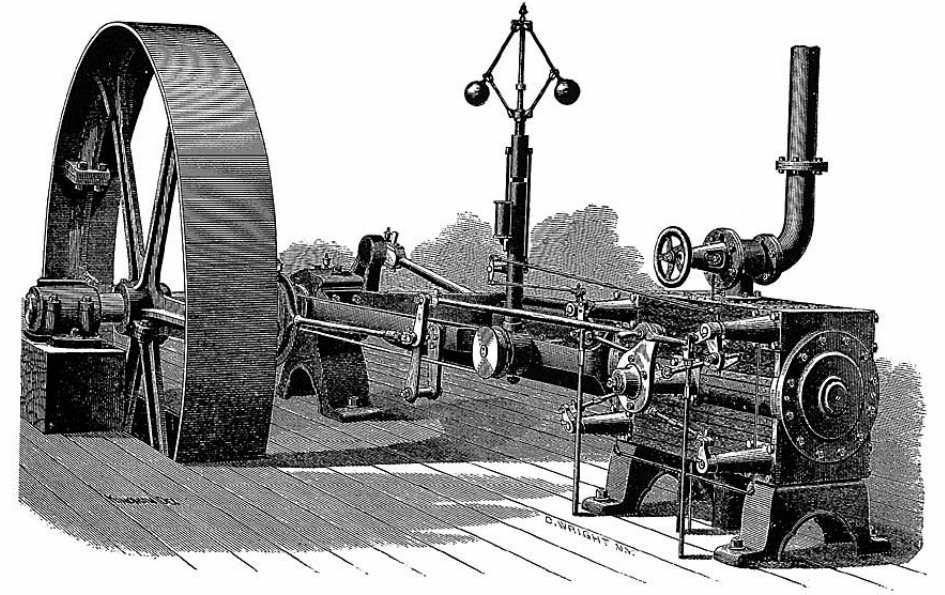
- ◆ The construction company foresaw, or should have foreseen, that this risk was present
- ◆ So the court could assume that the price the parties negotiated already included compensation for bearing this risk

Default rules

- ◆ But some risks that are unforeseeable
- ◆ Suppose copper miners' union strike → led to the increase in copper prices
- ◆ In this case, the construction company might still be the efficient bearer of this risk. But since the risk was unforeseen, it was not included in the negotiated price
- ◆ So the court might adjust the price paid to the construction company, to compensate them for the risk; but then still hold the construction company responsible for the extra \$2,000 in costs
- ◆ Thus, the ruling might be that the family should pay some smaller amount – say, \$700 – which is what the company would have needed to receive as compensation for bearing this risk – but that the company was then responsible for the rest of the \$2,000.

Hadley v Baxendale

- ◆ 1850s England
 - ◆ Hadley ran flour mill, crankshaft broke
 - ◆ Baxendale's firm hired to transport broken shaft for repair
 - ◆ Baxendale shipped by boat instead of train, making it a week late
 - ◆ Hadley sued for the week's lost profits

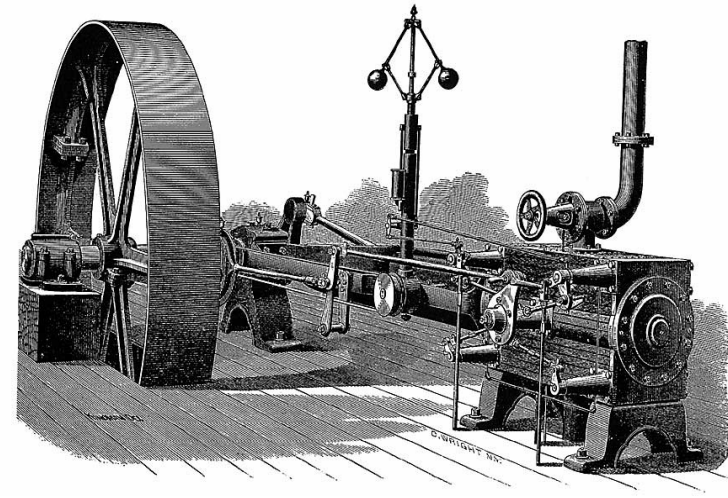


“Before you can award damages for wages paid and lost sales while the mill was idle, you must first find that at that time they entered into the contract to ship the crankshaft, **the shipping company contemplated that the mill owner would suffer those idleness damages** as a result of late delivery.”

To award damages for lost sales, Hadley should have to prove that Baxendale could have predicted those losses

Hadley v Baxendale

- ◆ “The shipper assumed that Hadley, like most millers, kept a spare shaft. ...Hadley did not inform him of the special urgency in getting the shaft repaired.”
- ◆ “The ruling was that the lost profits were not foreseeable
 - ◆ the court specifically listed several circumstances in which a broken crankshaft would not force a mill to shut down – and therefore why it was reasonable that Baxendale would not have imagined the harm from delay would be so high
 - ◆ Baxendale was only held liable for damages he could reasonably have foreseen



Default rules

- ◆ So, Cooter and Ulen say: set the default rule that's efficient in the majority of cases
 - ◆ Most contracts can leave this gap, save on transaction costs
 - ◆ In cases where this rule is inefficient, parties can contract around it
- ◆ One purpose of contract law is to minimize transaction costs of negotiating contracts by supplying **efficient default rules**
 - ◆ Do this by imputing the terms most parties would have chosen if they had addressed this contingency

Default rules: a different view

- ◆ Ian Ayres and Robert Gertner, “Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules”
- ◆ Ayres and Gertner argue that in some cases, gaps are left not because of the transaction costs of filling them, but for strategic reasons
- ◆ One party might know that the default rule is inefficient; but negotiating around the default rule would require him to give up some valuable information, so he might be tempted not to
- ◆ A penalty default would force him to disclose it
 - ◆ To give incentive to address an issue rather than leave a gap
 - ◆ Or to give one party incentive to disclose information
- ◆ They refer to this type of intentionally-inefficient default rule as a **penalty default**

Penalty defaults: Hadley v Baxendale

- ◆ Baxendale (shipper) is only one who can influence when crankshaft is delivered; so he's efficient bearer of risk
- ◆ If default rule holds Baxendale liable...
 - ◆ Hadley has no need to tell him the shipment is urgent
 - ◆ Baxendale doesn't know and bad outcome is reached
- ◆ If default rule **doesn't** hold Baxendale liable for unforeseen damages...
 - ◆ Hadley would have to tell him about urgency...
 - ◆ ...leading to Baxendale making more efficient choices (trading off cost vs speed/reliability correctly)
- ◆ Even though it's efficient for Baxendale to bear risk, efficient default rule might instead "penalize" Hadley for withholding information!
- ◆ So it's a penalty default: it penalizes the better-informed party, giving an incentive to contract around the default.)

QUESTION 1: Buyer *B* pays \$10,000 to New Orleans grain dealer *D* in exchange for *D*'s promise to deliver grain to buyer *B*'s London office on October 1. As a result of signing this contract, *B* decides not to sign a similar contract with another dealer for \$10,500. *D* contracts with shipping company *S* to transport the grain. Buyer *B* agrees to resell the grain on arrival in London for \$11,000 to another party. *B* pays \$100 in advance (nonrefundable) as docking and unloading fees for the ship's projected arrival in London.

The ship begins taking water several days out of New Orleans and returns to port. Inspection reveals that the grain is badly damaged by salt water, and *D* sells it as cattle fodder for \$500. *D* conveys the news to *B* in London, who then purchases the same quantity of grain for delivery on October 1 at a price of \$12,000.

- a. How would you measure expectation damages for *D*'s breach of contract with *B*?
- b. How would you measure reliance damages?
- c. How would you measure opportunity-cost damages?