More on Reliance

1. Study PPT File: EE301-403 1 Nov.pptx pp. 1-7

2. **Reliance as a Proxy of True Valuation**

Reliance can be used to unveil the valuation of contract by the innocent party. In fact, once the contract has been breached, the innocent party has (an incentive for having) *ex post* opportunistic behaviour or *moral hazard* by overstating the damage to the court. Using reliance damages, the court can extract the information from the innocent party since the real valuation of that contract by the innocent party is unknown (to anyone).

Most contracts are not instantaneous. Performance of contract requires time and hence there is uncertainty. Therefore, it is costly for contracting parties to invest in monitoring each other to ensure the performance. Reliance damages, thus, imposes the burden of uncertainty to the innocent party prior to the breach. Whenever we are contracting, we shall be aware of a chance or opportunity that our contracting party may breach the contract and make the decision upon that.

Moreover, by investing in reliance assists contracting parties to earn more utility from the contract or making the contract more useful/beneficial.

Calculation of individual's reliance reflects the optimality and rationality in individual's decision-making.

*Notes on Breach of Contract

-It can be seen from all samples given, if the market is perfectly competitive, the breach of contract is less attractive particularly to get something at the cheaper (more expensive) price for consumers (producers).

-Compensation for the breach of contract also forces contracting parties to behave in such a way that it will create the perfect competitive market. No one will buy (sell) a more expensive (cheaper) product than the market price.

Awarding Compensation

1. Discretion of the Court: The court has the discretion to use any of these methods (or the mixture of) to calculate the damages.

2. **Double Trade-offs**: The discretion is there to make a proper trade-off in two dimensions

<u>2.1 *Ex ante* and *ex post* efficiency</u>: if the innocent party is more capable of taking more risk, the court can shift the burden towards the lower risk avoider by increasing *ex ante* efficiency = lower amount of compensation; if the breaching party is more capable of taking more risk, the burden shall be shifted toward *ex post* efficiency = amount of compensation closer to the perfect expectation damages.

<u>2.2 Precision and Economy</u>: to ascertain the real damage, the court incurs a lot of cost to extract information from contracting (disputing) parties and sometimes these costs may outweigh the real damage. By having discretion, the court can decide how far the procedure shall go and when to stop and deliver the verdict.

3. Implications on Contracting Parties' Behaviour: knowing that the court has discretion to implement whatever method it sees fit, disputing parties cannot know for sure how much (s)he has to pay as a breaching party and how much (s)he would get for compensation as an innocent party. The court would never award the compensation to make the innocent better off (the highest compensation is equal to what (s)he would get if the original contract were performed). Therefore, this allows '*contract of compromise*' to be agreed. The discretion provides incentives for both sides to reconcile privately and propose their compromise to the court. This will reduce the burden to the court and economise the cost of judicial processes.