ECON 522 - CONTRACT LAW PART 1

(Purpose of Contracts, Bargain Theory, Efficient Breach)

I Contracts

When we were studying property law we were looking at situations in which the exchange of goods/services takes place at the time of trade, but sometimes in trade situations the actual exchange is delayed. Contract law covers trade in which exchange does not take place all at once, which essentially makes contracts promises to perform in the future. Most of our analysis of contracts examines how to design the law so that individuals make contracts when there are potential gains from trade, and also break contracts when performance becomes so costly that it is inefficient.

I.1 Contracts and Information

We also said contracts can solve problems with asymmetric information. Recall the experiment with asymmetric information that we did in class: Sellers had chips worth 2 times the number shown on a die to them and 3 times the number to a buyer; furthermore, the seller knew the number before trading. Prof. Quint specified that no contingent trades could take place: that is, no trades where the price was contingent on the die roll. This would make trade easy: every seller would agree to a contract that specified that the good would trade now, and the price paid later would be 2.5 times the number shown on the die. This contrasts with the example without contingent prices (contracts), where we showed that trade would only take place half the time, even though gains from trade are always present.

I.2 Bargain Theory

A contract is a promise, but should every promise be a legally binding contract? The answer, for efficiency's sake, is definitely no. But if not all promises are legally enforceable, we need to figure out which types of promises should be enforceable. The Bargain Theory is one attempt to answer this question. Think of the bargain theory as theoretical guidelines for a court to decide when a promise (contract) should be enforceable. This does not necessarily imply that courts only enforce contracts if they fit the bargain theory criteria, or that they enforce all contracts that do, but the theory is a good benchmark to get us thinking about efficient enforcement.

The lecture notes lay out and explain the theory, but remember that it says in order for a promise to be a legal contract it must be part of a bargain, and a bargain has three components:

(i) **Offer:** An offer is what one side proposes to give up in the trade

(ii) **Acceptance:** The acceptance is the other aside agreeing to the offer

(iii) **Consideration:** Consideration is what the accepting side gives up in the trade. This is equivalent to this side's offer.

Thus consideration and offer play the same role. For example, if we decide to write a contract saying that you will buy my car in two weeks for $500, then we could say that I'm offering you my car, you choose to accept, and the $500, or your promise to pay $500, is your consideration. However, as far as we're concerned, this is equivalent to your $500 being your offer to me, I accept, and my car is my consideration.

I.3 Damages and Breach

Contracts are promises, but only certain promises should be enforceable as contracts. Now we need to decide what enforcement mechanisms will be efficient.

One key concept that pops up throughout our contract law studies (and pretty much everything else too) is that an individual's actions can produce *externalities*. With contracts, if the promisor decides to *breach* (break) a contract, then there is the negative externality of lost benefit to the promisee. The point is that when deciding to breach, the promisor only takes into account his own costs, not the costs to the promisee, so he may breach even if total social welfare would be higher without breach. The solution is to force the promisor to *internalize* the externality, by requiring him to pay the promisee whatever expected value is lost due to the breach. This penalty is called *expectation damages*.

Example. Suppose that I sign a contract to be a professor at Minnesota for the next year. My salary is \$100,000 and my arrival is expected to make the Minnesota economics department \$130,000 better off. However, a few days later UC Berkeley tells me that they are interested and want to work out a contract. My arrival will only make the Berkeley econ department \$120,000 better off. I'd rather work at Berkeley: the weather is nicer, I'd be closer to home, and it's a better department, so I'd be willing to pay some positive amount \$x to work there instead of Minnesota.

(i) What is the efficient place for me to work if

- $x = 40,000$?
- $x = 20,000$?
- $x = 5,000$?

(ii) Suppose I would have to pay \$50,000 in damages to Minnesota if I breach. What will I choose to do if

- $x = 40,000$?
- $x = 20,000$?
- $x = 5,000$?

(iii) Suppose I would not have to pay any damages if I breach. What will I choose to do if

- $x = 40,000$?
- $x = 20,000$?
- $x = 5,000$?

(iv) Suppose I would have to pay \$30,000 in damages to Minnesota if I breach. What will I choose to do if

- $x = 40,000$?
- $x = 20,000$?
- $x = 5,000$?

Solutions.

(i) It's efficient for me to work in Berkeley if $x = 40,000$ or $x = 20,000$, and in Minnesota if $x = 5,000$.

(ii) Berkeley is willing to pay me up to \$120,000 to come work for them, so they'd be able to pay me enough to take the job there if $x = 40,000$ but not if $x = 20,000$ or $x = 5,000$.

(iii) Berkeley would be able to afford hiring me at all three levels of x, so I'll end up in Berkeley no matter what.

(iv) Berkeley could afford me if $x = 40,000$ or if $x = 20,000$ but not if $x = 5,000$.