Econ 522 Review 2: Contract Law, Tort Law Part 1

Spring 2014

This document is by no means comprehensive, but instead serves as a rough guide to the material we have discussed on contract law and tort law. I would suggest that you use other study aids as well (such as the lecture slides, discussion handouts, textbook, and exams from previous semesters) in your study for the midterm.

1 Contracts

In class we said a contract is a legally binding promise. Contracts exist in order to facilitate trade when transactions don't happen simultaneously. Contract law mainly deals with two questions:

- Which contracts should we enforce?
- What should we do if a contract is breached? There must be some adverse consequence to breaching a contract, or contracts are unenforceable.

1.1 Bargain Theory

The *bargain theory* of contracts is an early legal theory which says that a contract should be enforced if three things are present:

- Offer: One side offers the contract.
- Acceptance: The other side accepts the contract.
- Consideration: Each side gives up something of value.

However, modern courts do not always behave according to bargain theory. For efficiency, we generally want to enforce those contracts that both parties wanted to be enforceable when they signed the contract.

1.2 Enforceability

- Contracts designed to get around a law are unenforceable: this is called *derogation of public policy*
- Contracts that cannot be performed without breaking the law are unenforceable
- Exception: if the promisor knew the contract violated (or tried to get around) the law, but the promisee didn't

- Contracts made by incompetent individuals (i.e. children or mentally ill people) are unenforceable.
- Contracts made under *dire constraints* are unenforceable:
  - *Necessity*: There was no meaningful choice by the promisee, perhaps because of an emergency
  - *Duress*: Not only was there no meaningful choice by the promisee, but this situation was caused by the promisor

Courts may also refuse to enforce contracts that are overly vague, are standardized take-it-or-leave-it contracts (*adhesion*), or are dramatically unfair (*unconscionability*).

1.3 Formation Defenses and Performance Excuses

- A *formation defense* asserts that a party should not be liable for breach, since there was no valid contract, perhaps for one of the reasons discussed above.
- A *performance excuse* asserts that a party should not be liable for breach, even though there was a valid contract, because circumstances have changed. We discussed several of these in class:
  - *Impossibility*: It is impossible for the party to perform the contract.
  - *Fraud*: One party deliberately tricked the other.
  - *Failure to Disclose*: One party failed to disclose critical information to the other.
    - Under civil law, parties have a duty to disclose important information.
    - Under common law, generally only dangers to safety need be disclosed. The exception is new products, which come with an "implied warranty of fitness."
  - *Frustration of Purpose*: A change in circumstances made the contract pointless.
  - *Mutual mistake*: Both parties made a mistake, without which the contract would not have been signed.

1.4 Default Rules

A *default rule* tells the court what to do when a contract fails to specify what should happen in some contingency. Such an omission is called a *gap*, and they are inevitable; it's not feasible to include every possible contingency in a contract. We've considered two types of default rules, as well as regulations:

- A *efficient default rule* is an attempt to fill a gap with the rule the parties would have wanted, had they thought to specify it. Such rules work well when gaps exist due to a high transaction cost of filling them, and not due to strategic omission.
- A *penalty default rule* is an attempt to fill a gap with a rule the parties would not have wanted in order to encourage the parties to disclose information and fill the gap with something efficient. Such rules may work well when gaps are left for strategic reasons.
- *Regulations* are like default rules, but can't be negotiated around.

1.5 Reliance

Reliance is an investment made by the promisee in anticipation of performance of the contract by the promisor which has little value in the event of breach.

1.6 Investment in Performance

Investment in performance is an investment by the promisor in reducing the probability that events which might lead to breach of contract (such as high aluminum prices for an aircraft builder, crop failure for a farmer, etc.) will occur.

1.7 Damages

- Damages equal to the benefit the promisee expected to receive are called *expectation damages*.
  - If expectation damages include benefits from reliance, we will have efficient investment in performance and efficient breach, but inefficiently high reliance.
  - If expectation damages do not include benefits from reliance, we will have efficient reliance, but inefficiently low investment in performance and promisors will breach inefficiently often.
  - If we know what the efficient level of reliance is, we can include only benefits from reliance up to that amount; such a damages rule is called *perfect expectation damages*. If we do this, we will get efficient reliance, investment in performance, and breach.
  - But in all of these cases, we may get inefficient signing.
  - Actual courts generally only include *forseeable reliance*–that is, benefits from reliance that the promisor could have reasonably expected the promisee to undertake.
- *Reliance damages* compensate the promisee for any reliance made, but not for the benefits from that reliance or the expected benefits from performance–they restore the promisee to his utility level before he signed the contract.
- *Opportunity cost damages* compensate the promisee for the benefit he would have received from his next-best option.

1.8 Other Court-Imposed Remedies

- *Restitution*: give back money already received
- *Disgorgement*: give up wrongfully gained profits
- *Specific performance*: promisor is required to perform the contract as written; more common under civil law than common law, but sometimes used under common law when the contract is to sell a unique item

1.9 Party-Designed Remedies

Party-Designed Remedies are those that are explicitly written into a contract:

- *Liquidated damages* reasonably approximate the harm done.
- *Penalty damages* are greater than the actual harm done. Common law courts often do not enforce penalty damages, whereas civil law courts generally do. However, whatever you can accomplish with penalty damages can also be accomplished with a performance bonus, which common law courts generally enforce.

2 Tort Law

- In contract law, we studied situations where people reach an agreement in advance, and then one harms another by breaking the agreement.
- But in tort law, we study situations where people can't reach agreements in advance, and then one harms another without having made any agreement.
- Tort law mainly covers accidental harm, and seeks to achieve the efficient number of accidents.

2.1 Terminology

- The *plaintiff* is the person who brings the lawsuit (the victim)
- The *defendant* is the person who is being sued (the injurer)
- *Precaution* is any step that can be taken beforehand to reduce the risk of an accident

2.2 Classic Theory of Torts

In the classical theory of torts, either two or three elements must be present for there to be a tort:

- Harm–the plaintiff needs to have been harmed
- Causation–the defendant needs to have caused the harm to the plaintiff
- Breach of Duty–the defendant needs to have failed to take the required standard of care (required only with a negligence rule)

2.3 Tort Liability Rules

- No Liability–the injurer is never liable
- Strict Liability–the injurer is always liable
- Simple Negligence–the injurer is only liable if he or she did not take the required standard of care
- Comparative Negligence–like simple negligence but if both parties are negligent then damages are less than if only the injurer is negligent

Liability rules with perfectly calibrated compensation and standard of care

	Precaution		Activity	
Liability Rule	Injurer	Victim	Injurer	Victim
No Liability	None	Efficient	Too High	Efficient
Strict Liability	Efficient	None	Efficient	Too high
Simple Negligence	Efficient	Efficient	Too High	Efficient
Comparative Negligence	Efficient	Efficient	Too High	Efficient
Simple Negligence with Defense of Contributory Negligence	Efficient	Efficient	Too High	Efficient
Strict Liability with Defense of Contributory Negligence	Efficient	Efficient	Efficient	Too High

- Simple Negligence with Defense of Contributory Negligence–if both parties are negligent, damages are zero
- Strict Liability with Defense of Contributory Negligence–the injurer is only liable if the victim was not negligent

2.4 How a Negligence Rule Works

The problem with strict liability and no liability rules is that they do not induce precaution by the victim and injurer simultaneously. To do this, we need a negligence rule. How does this work?

- The discontinuity in the injurer's cost at the efficient level means that the injurer takes efficient precaution.
- Anticipating the injurer's decision to take efficient precaution, the victim perceives that he will bear the residual risk, so he takes efficient precaution as well.

2.5 Accidents between businesses and customers

When victims are not customers:

- Under strict liability, the residual risk of an accident is borne by the business; under perfect competition, this is passed along to the customer, so customers demand the efficient amount of activity.
- Under negligence, the residual risk of an accident is not borne by the business, so the price does not reflect residual risk, and customers demand too much activity.

When victims are customers:

- Under strict liability, residual risk is again built into price, so even if customers don't perceive risk they will make efficient choices
- Under negligence, residual risk once again is not built into price, so if customers don't perceive risk they will buy too many dangerous products