LAW AND ECONOMICS

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LAW AND ECONOMICS

Week 6

Contracting

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Structure of the week

I. What is an enforceable promise?
II. Contents of a contract?
 – What is an incomplete contract?
 – Enforcement beyond the explicit terms of a contract?
III. What is not enforceable? Coercion
IV. What is not enforceable? Information problems
V. Modification

Requirements

Today:

1. **information**
2. **search**
3. **precision**
4. **risk allocation**
5. performance

6. care
7. reliance
8. mitigation
9. **modification**

I. What promises are enforceable?

1. Offer and acceptance

- Necessary and sufficient – binding what is mutually accepted, but what is mutually accepted *is* binding.

2. Boilerplate contracts

- One-sided terms:
  - Terms of a boilerplate it may be challenged before court even if the parties knew the term ex ante but it provides one-sided advantage for the maker of boilerplate (not counter-balanced by other terms)
  - If no boilerplate: acceptance implies no right to suit
  - Market power? Where?
    - Cf. initial agreement (if information was available).
    - No coercion: contracting makes the customer better off than no contracting
- „Same terms in all boilerplate contracts" (= no competition, cartel?)
  - *Monopoly explanation*: easier to control cartel-members (no quality competition) + only the price must be set.
  - *Market explanation*: homogenous goods because best quality (risk allocation) wins the competition.

I. Unenforceable promises

Are contracts by anyone enforceable?

No: incompetence

- Example: children
- Transaction costs: who defends their rights, interests: parents or contracting parties – lower transaction cost if contracting party

Are all contracts enforceable?

- **No.** For example…
- **…liquidated damages, penalty clauses** (remedies defined by contract IF too high – US; IF too low – Hungary)
- …immoral contracts – unconscionability
  - *Non-equivalent trade* – Williams v. Walker Thomas Furniture Co. (credit for sale, non-performance: secured by all products bought from the same store)
  - Economic question: is it efficient?
  - „Non-equivalence” increases the chance of payment (by performance or from the pledge) => lower risk, lower price for products – i.e. if unenforced, a given non-performing party gains, but all others in similar situation lose (because of higher prices).
- What is „lack of enforcement”?
  - Mandatory rule
    - procedural (e.g. information requirements)
    - substantive (laesio enormis)

II. Incomplete contracts

- Beyond written contracts
- Contract interpretation, amendment, modification by courts – majority default rules
  - risks not allocated ex ante
  - 1. Who should bear them? Least-cost risk-bearer
  - 2. Modification of price (remedies)
- Other options: penalty default rules, sticky default rules

III. Coercion

1. Duress:

Law differentiates between acceptable pressure and illegal threat (e.g. last chance, last offer vs. threat)

Duress: What is offered? What are the options? What if offer is refused?

- Status quo vs. utility of victim is reduced (the „promisor” reduces it)
- Redistribution – does someone lose?
- E.g. hold-up problem in case of expropriation

- WHY persecute duress? Incentives!
  - Not because of the transfer (it is simple redistribution – maybe even utility increase if the object has higher value for the person who takes it)
  - BUT always wasting of resources: to produce credible threats (practicing, tools, etc.) – rent-seeking, unproductive profit-seeking

2. Contract in necessity

- Duress (utility is reduced because of the ‘promisor’s’ action) vs. necessity (utility is reduced because of no action taken)
- Transaction cost – obligation to rescue + reward (cost-compensation)
  - example *Post vs. Jones* (1857) – ship Richmond
- Amount of reward: incentives – motives of rescue team (planned, anticipated, fortuitous) – firefighter vs. neighbour; reward for financing capacity

- *Usury:* necessity (lack of experience, incompetence, improvidence) + taking advantage (cf. laesio enormis)

- WHY? Incentives!
  - Type of insurance: reducing cost of failure – no disincentives for taking risks

IV. Information: mandatory disclosure

- Basic problem: incentives – gathering vs. sharing (disclosure)
- Contract based on false belief
- Lack of information
  - Unilateral – solutions: forbidding fraud, obliging disclosure
  - Bilateral mistake (no one knows) – solutions: no enforcement (excuse for non-performance) based on impossibility

1. Unilateral: Fraud

- Problem as in the case of threat
  - Pure transfer, BUT waste of resources
  - Maybe inefficient allocation (or may not…)
  - Efficient allocation (Cooter and Ulen): Information and product (service) in the same hand
    - To the person who gets higher utility from the product (cf . Posner's rule:
      decision in favour of the person with a higher stake)

2. Unilateral mistake: mandatory disclosure?

- Information and product in the same hand – BUT why mandatory disclosure?
  - Mandatory disclosure: if no disclosure, no enforcement
  - „Strict enforcement rule": if party with more information is allowed to buy (without disclosure)
  - If information reduces the price – disclosure anyway
  - If information increases the price – he can buy it more cheaply, but information and product end up in the same hand
- Choice between the rules: incentives to gather information? Is this a goal?
- Example: *Laidlaw v. Organ* (1815): one party buys tobacco a day before the end of blockade – gets information a day before others: payoff for this?
  - Productive vs. redistributive (rent-seeking): private and social value of information (social benefit = productive information).
  - Possibility of incentive? No, if fortuitous information.

	Puposeful	By fortuity
Productive	***Enforcement***	no
Redistributive	no	no

IV. Information: Bilateral problems

3. Bilateral information problems – Basic situations:

- *Mutual mistake about facts or the identity of object – at the time of contracting*
  - *Raffles v. Wichelhaus* (1854) – cotton arrived „ex Peerles from Bombay”, but two ships with this name.
  - *Sherwood v. Walker* (1887) – cow thought incapable of pregnancy – turns out to be pregnant.
  - Information and property in the same hand. Whose hand? Who would value it more (with full information)?
- *Something changes – frustration of purpose, impossibility*
  - *Krell v. Henry* (1903): coronation case.
  - Leases of windows on the street where coronation parade is take place – court: no remedy for leaser
  - Leases of boats (owned by entrepreneurs) for organized cruise on the Thames to see parade when new king visits the Navy – same court: price must be paid.
- **Why/when?**
  - Decision about the better risk-bearer
  - Risk-bearer test:
    - Learn in easier way?
    - Reduce the risk in easier way?
    - Insure himself in easier way? – here: self-insurance (i.e. window can be leased for the real coronation
      – small lost; vs. boat s: entrepreneurs take more risk)

4. Impossibility, impracticability

- Problems after signing the contract (not before).
- Physical (impossiblity) vs. economic (impracticability)
  - Impracticability: only when cost is too high (potential bankruptcy).
- Legal answer: some of the basic assumptions changed.
- Economic analysis based on least-cost risk-bearer test: if promisor, he must pay – independent of physical problems (impossibility)
  - Példa: *Taylor vs. Caldwell* (1863) – concert hall burns down – should the leaser compensate the leasee?

- European law (pacta sunt servanda): impossibility – two steps
  - 1. not enforceable (but a remedy may be judged)
  - 2. no remedy (cf. impossibility in US law)

- Why/when?
  - Same as two-sided information problem

V. Modification

Important incentives:
- efficient breach;
- efficient specific investment (reliance)

1. Breach

- Modification prevents inefficient breach (and inefficient performance) – mutually beneficial modification!

1. $v>c$ and $c>d$ (inefficient breach, suboptimal damages – see next week) => BUT *transfer (t) from promisor to victim* – promisor:
   $c - t < d$ and victim: $v - t > d$; (all $t = v - d + a(v - c)$ where $0<a<1$)

2. $v<c$ and $c<d$ (inefficient performance) => transfer (t) from
   buyer to promisor => $p - c < t < p - v$ (all $t = v - p + a(v - c)$
   where $0<a<1$)

2. Reliance: specific (idiosyncratic) investment

- Effects of modification – debated
- Hold-up: higher probability of opportunism: price increase for expropriating the quasi-rent (increasing function of specific investment)
- BUT
  - Prevention of overreliance (see next week);
  - Special governing (modification) mechanism as a solution
    e.g. yes-no contract: only investor is allowed to make offer, the other party may only accept or refuse it (no counter-offer).

3. Why may modification fail?

- If quick response is necessary – transaction cost, information problem, sunk cost

Practice

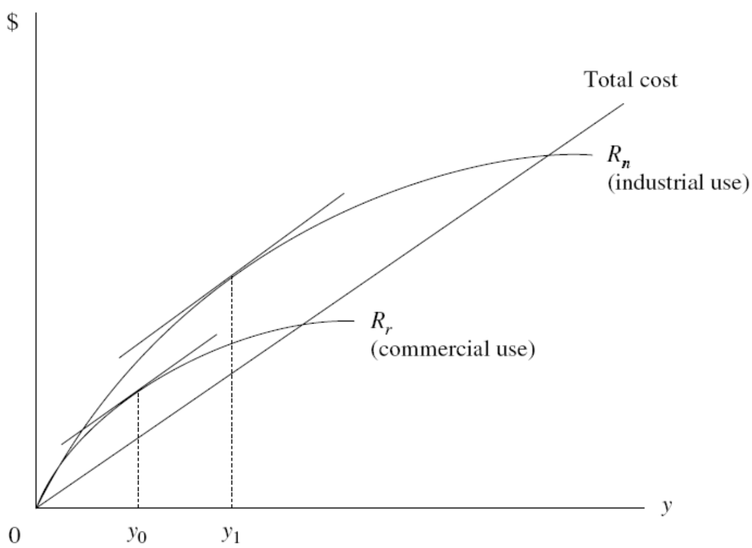
Requirements

Incentives:

1. *information*
2. *search*
3. *precision*
4. *risk allocation*
5. *performance*
6. *care*
7. *reliance*
8. *mitigation*
9. *modification*

Revision

- When is breach efficient?
- What is the paradox of compensation – in the case of expropriation?



Problem

For certain types of products, the law prescribes obligatory warranty periods. These may be enforced either by the consumers, who may file a suit if the product breaks down during the obligatory warranty period, or by a consumer protection authority, which makes trial purchases and fines those producers or retailers who sell their products under contractual terms which do not comply with the law.

Should the law prescribe such obligatory warranty periods?

Should there be a government agency to monitor the implementation of the legal rule? Or is it better simply to make illegal warranty clauses unenforceable in court?

Solution

- Basic issue: mandatory rule
- Constraining freedom of contract: no lower price (for lower quality)
  - Is bounded rationality an appropriate reason?
- Disclosure (about quality), incentive for improving quality …
  - Voluntary disclosure? (depends on exact situation)
  - Only if private information on the manufacturer's (seller's) side – what if not? if neither seller knows?
- Private or public enforcement
- Risk-bearer test
  - Mandatory guarantee assumes it is always the manufacturer.

Problem

A municipality wants to apply for a grant to reconstruct the main square and create a park there. They make an oral agreement with a local landscape engineer to make plans for the project. The agreement includes a fixed fee for the planning and that the municipality needs the plan because of the grant (i.e. the fee is independent of the success of the application for the grant).

A debate starts when it is found out that the plan is not suitable for the grant because the application procedure requires a written contract for the planning. However, the agreement between the municipality and the engineer was oral.

When the engineer realises that he will never receive the original fee without a trial and fears that he will only get the fee after a very lengthy legal process, he accepts a reduced fee, which the municipality is willing to pay him. However, the engineer subsequently decides to sue the municipality for the difference between the original fee and the eventual lower amount plus the foregone rate of return.

What would be an efficient court judgement?

Solution

- Basic problem 1: Bearing the legal risk.
- Who should bear it? Who can be given stronger incentives for information gathering?
- Difference in risk-aversion?
- Basic problem 2: Modification as a consequence of threat?
- Prohibit modification = no efficient modification (inefficient breach/ performance remains)
- If necessity: what incentives change?

Problem

The prohibition of insider training means that corporate managers face a choice: they either make a piece of information public or must refrain from trading in the shares of their company. Many countries are considering to abolish this regulation and allow everyone to trade shares freely.

What are the efficiency arguments pro and con the proposed deregulation?

Solution

- Basic problem: mandatory disclosure.
- No disclosure = redistribution – resources used for keeping information secret? (e.g. trade secret)
- Gathering redistributive information? – Is this the reason of *gathering*?
- Incentives – purposeful gathering? Or by-product (of investment decisions)?
- Should innovation be encouraged in this way?
- Real alternative: no trading in shares (and no disclosure) – if there was trading (without disclosure), it would provide the market with information.