

LAW AND ECONOMICS

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Week 7

Performance of contract

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Structure of the week

- I. Forms of remedies
- II. Paradox of compensation
- III. Liquidated damages, penalty clauses
- IV. Specific performance
- V. Disgorgement

Requirements

Today:

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

I. Forms of remedies

- *Damages*
 - *Expectation damages* – victim is compensated for the utility which he would have received from performance
 - *Cost* – after compensation, victim's utility is at the same level as before the contract (as if no contract) – incentive for efficient contracting (search, precision).
 - *Opportunity cost* – victim's utility is at the same level as if he contracted for the second best option.
 - In a market: no differences among the three methods? Second best = first best (no rent).
- *Liquidated damages: set by the contract*
- *Specific performance – see pacta sunt servanda*
- *Disgorgement: based not on loss of victim but profit of breaching promisor*

II. Paradox of compensation

- *Efficient performance, breach*
 - Judge Holmes: When is breach efficient?
 - IF savings of breaching party > loss of promisee.
 - *Groves vs. John Wunder Co.*
 - Defendant contracted to restore the land after finishing mining – the original owner should receive the land back in the original condition
 - No restoration.
 - Cost of performance: \$ 60.000,
 - But (due to recession) maximum value (price) of land is \$ 12.000.

Optimal incentives for performance

- Efficiency: breach if and only if $v < c$
- Private incentives – without remedies: breach if $p < c$

- With expectation damages:
 $d = v - p$
- Private incentives: breach if and only if
 $v - p = d < c - p \Rightarrow v < c$
- Efficient rule: *expectation damages*
 - Ex post (at the time of performance/breach): not Pareto-efficient, BUT Kaldor–Hicks efficient.
 - Ex ante (at the time of contracting): Pareto-efficient.
 - Harder rule (higher remedies): higher price;
 - Softer rule (lower remedies): promisee willing to pay a higher price for a higher remedy (Shavell)

Optimal incentives for care

- Now: only on the side of promisor
- Social optimum:
 - $\max B = (1 - P(x))(v - c) - x$
 - $\min P(x)(v - c) + x$
- Case of expectation damages: $d = v$
 - $\max B = (1 - P(x))(p - c) - P(x)(d - p) - x$
 - $\max p - c - (P(x)(v - c) + x)$
 - $\min P(x)(v - c) + x$

Optimal incentives for specific investment – reliance

- Reliance (trust): specific investment to increase the value of performance – depends on trust, chance of performance (breach)
- *Paradox of compensation*: expectation damages („considering all reliance, investment) – supraoptimal reliance, investment, trust.
 - Same as in the case of compensation for expropriation
- Example: *Hadley v. Baxendale*
 - Repair is delayed, promisee (miller) suffers high loss – much higher than average (unforeseeable for promisor)
- Example: development of film unsuccessful (no option for repeating) – film about expedition in Himalayas
 - Buyer did not say that the film had extra (unexpected, unforeseeable) value.
- Hadley rule: remedy = foreseeable loss...
 - Goal: incentives for over-relying party
 - Goal: incentive to disclose information (*penalty default rule*)!

Optimal incentives for specific investment – reliance!

- Private benefit

$$\max B = v(r) - p - r \Rightarrow v'(r) = 1$$

- Joint (social) benefit: $\int_0^{v(r)} (v(r) - c)g(c)dc - r \rightarrow \max$

where $g(c)$ is probability distribution of cost

- Optimal investment (r^*): $v'(r)G(v(r)) = 1$
($G(\cdot)$ is cumulated probability distribution)

- Efficient rule: $d = v(r^*)$
- Private optimum: $G(v(r^*)) (v(r) - p) + [1 - G(v(r^*))] (v(r^*) - p) - r \rightarrow \max$
 $v'(r)G(v(r^*)) = 1$

III. Liquidated damages

- US rule:
 - Liquidated damages above *ex ante* expected loss (penalty) are not enforced.
 - Liquidated damages below *ex ante* expected loss are enforced as they are.
- Hungarian rule:
 - Liquidated damages above the real (*ex post*) loss are enforced (not reduced)
 - Liquidated damages below real (*ex post*) loss are increased by court up to the level of loss.
- Example: Gas industry: „Take or pay”
 - Even if no delivery, price in contract must be paid –
 - Not merely the difference between price and cost, or price in contract and second best buyer.

- Pros:
 - High fixed cost
 - Threat of underestimation of loss – uninsurable loss
 - Signaling – is it optimal?
 - Both parties interested in excess capacity (built by the seller)
- Cons:
 - Moral hazard (incentive for seller to make the buyer breach)
 - More difficult modification
 - More suits
 - Higher chance of bankruptcy – external effects

IV. Specific performance

Example:

- A: seller of the house – evaluation: 9 million
- B: original buyer – evaluation (willingness to pay): 11 million.
- Price in contract: 10,5 million.
- C: new buyer makes an offer to A – evaluation (willingness to pay) 12,5 million
- C: offers 11,5 million
- Remedy (compensation of B = expected gain ex ante) vs. specific performance

	Value	No remedy	Specific performance	Remedy
A	9	2,5	1	1,5
B	11		1,5	1
C	12,5	1	1	1
SUM		3,5	3,5	3,5

- Comparison
- Differences in distribution –
 - Buyer’s payoff is higher if there is remedy.

- Minimizing costs:
 - Contract (between A and B is a sunk cost),
 - Court's cost of determining remedies
 - Cost of administration to enforce specific performance.

- *When?*
 - Assessment problem: false remedies; no substitution
 - Favourable event – e.g. better offer; sale (vs. performance, service).
Shavell: if third party is able to make an offer to the buyer as well (not only to the seller)?
 - Cost of enforcement?

V. Disgorgement

- Incentives: not only against inefficient breach
- When:
 - Fiduciary relationship
 - Hard to define explicitly the tasks of parties
 - Intentional (opportunistic) breach
 - Utility directly from the loss (suffering) of the victim (e.g. ex ante motivation for contracting was to cause loss by breach)

Practice

Problem

- Tenant of an apartment does not pay the rent and the owner finds another tenant. Should the remedy be reduced by the amount of the rent paid by this second tenant?
- (YES)

- Contract: 1.000 units of product promised. Buyer does not want to perform – seller sells them to another buyer. Should the remedy be reduced by the amount of the payment by the new buyer?
(NO)
- WHY?
- Amount of remedy = damages – depends on
- ...elasticity of supply
 - Apartment: inelastic
 - Production: it is possible to produce more (for old and new buyers at the same time)
 - But changes in marginal cost must be calculated.

A CEO of a company takes the company's money and invests it in an attractive financial asset. This abuse of his position is detected and he must pay damages.

How much damages should he pay?

- a) Damages equal to the foregone benefit of the company during the same period (foregone rate of return)?
- b) Damages equal to the benefit the manager obtained from the alternative investment (i.e. disgorgement of benefit)?

Solution

- **Basic problem: Disgorgement**
- When is it efficient?
- Problems of assessing the loss?
- Explicitness of management contract?
- „Preventing efficient breach” – what does it mean here?
 - No investment for higher return... OR
 - No investment for higher return in the NAME OF COMPANY?

Revision

Property vs. liability rule?

- Property: the good may be used only with permission
 - if violated: damages + punishment
- Liability: good may be used if user compensates for loss (damages)

Goal?

- *Reduction of transaction costs*
- Is bargaining possible (at how much cost)?
- Mistakes of courts

Revision

- Risk-bearer test?
 - Lower cost of...
 - ...gathering information
 - ...reducing probability
 - ...insuring himself
- Paradox of compensation?