Law and Economics
Session 16
Contract Law 2

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Outline

- This lecture extends our material on contract law.
- We will look at how contract remedies act as incentives.

Broadway Tickets Example

- The Broadway tickets market:
  - Ticket Agency M offers advance Broadway tickets for $10.
  - Ticket Agency L offers advance Broadway tickets for $5.
  - Ticket Agency H offers same-day Broadway tickets at $15 each
- Consumer reserves 10 tickets from L for $50.
- But on the day of the performance, Agency L receives an offer of $40 per ticket from a group of wealthy tourists.
  - Agency L breaches, and Consumer has to buy 10 tickets from Agency H ($150).

Expectations Damages

- Puts victim of the breach to the same position as he would if there were no breach.
  - **Under perfect expectations damages, potential victims are indifferent between performance and breach.**
- In the tickets example, the consumer expected to go to the Broadway show for $50, but instead went to the show for $150.
  - Under expectations damages, Agency L pays $100 to Consumer.
- As discussed last time, expectations damages induces efficient breach decision but creates excessive reliance incentives.

Reliance Damages

- Compensates the cost of reliance for the promisee; put him in the same position as before he signs the contract.
  - **Under perfect reliance damages, potential victims are indifferent between no contract and breach.**
- In the tickets example, consumer would have to buy from Agency H for $15 without the contract, and the consumer made no reliance investments.
  - So in this case reliance damages are $0.
- Reliance damages are generally less than expectations damages because the expected payoff from performance is normally higher than the payoff without a contract.
- With reliance damages, there are inefficient incentives for breach (breach will occur to often), and inefficient incentives for reliance (there will be too much reliance).

Opportunity cost damages

- Compensates for the opportunity cost of taking the breached contract; puts the promisee in the same position as if he had taken the next best alternative opportunity.
  - **Under perfect opportunity-cost damages, potential victims are indifferent between breach and performance of the best alternative contract.**
- In the tickets example, this was Agency M, which offered tickets for $10.
  - So in this case the opportunity cost damages are $15 - $10, times 10 tickets, equals $50.

Specific Performance

- Requires the promisor to do what she promised in the contract.
- In our example, this would mean that Ticket Agency L would have to sell for \$5, which will cost it \$35 relative to the offer of \$40 per ticket it just received.
  - This would be inefficient performance.
- Generally:
  - Specific performance is used when promised performance has no perfect substitute and when it is difficult to assess the promisee's value of performance.
  - For example, figuring out someone's valuing of a unique house is difficult, so specific performance is appropriate.

Restitution

- Restitution can be used in a deferred exchange; the seller just returns the buyer's initial payment.
  - In our tickets example, Agency L would return the $5 per ticket initially paid.
- Restitution gives less compensation than any of the other damages types, but simple and cheap to administer.

Disgorgement

- Disgorgement means the promisor has to pay the promisee for any extra profits it gained from breach.
  - **Disgorgement makes the promisor indifferent between performance and breach.**
- In our tickets example, Agency L would have to compensate the Consumer its extra profit from the sale to the wealthy tourists:
  - $35 times 10 tickets = $350.
  - Note that this is still an efficient outcome; but the consumer reaps the surplus.
- Disgorgement can be used in trust-based contracts where there is scope for moral hazard.

Liquidated Damages

- Contract may stipulate the damages paid in the event of breach – this is called liquidated damages.

- In a perfect world, the parties should be allowed to stipulate any damages.
- But courts may not enforce privately stipulated damages, if they exceed actual harm.
  - Contract penalty = difference between liquidated damages and expectations damages.
- On the other hand, most penalties can be restructured as bonuses.

The case for liquidated damages

- Information argument:
  - Parties know more about the values than the courts.
- Insurance argument:
  - Insurance for subjective value of performance – that is, the contract is specifying the expected utility gained by the promisee
- Signaling role:
  - High liquidated damages may be used as an informative signal about the promisor's reliability.

Example: Quality Investment

- Seller contracts to perform for Buyer:
  - If the seller makes quality investment which costs $50, the value of the project to the buyer is $200.
  - If the seller does not invest, then the project is worth $100 to the buyer.
  - => Investment is efficient because it creates $50 in surplus value.
- The buyer pays $80 after the delivery of the good.
- However:
  - Seller invests and performs before Buyer pays, and the investment cannot be verified in court.

Expectations Damages

- Sequential game, seller moves first, with these payoffs:

		Seller	
		Low Quality	High Quality
Buyer	Pay	20, 80	120, 30
	Breach	-80, 80	-80, 30

- Buyer always pays, but seller always chooses low quality.

Liquidated Damages

- Now assume a new contract price of $120, but liquidated damages where buyer only pays $10 damages for breach.

		Seller	
		Low Quality	High Quality
Buyer	Pay	-20, 120	80, 70
	Breach	-10, 10	-10, -40

- Remember this is a sequential game where the seller moves first.
- Buyer will only pay when there is high quality, so Seller chooses high quality.

Liquidated Damages as option contract

- The parties can use liquidated damages to create an option for the buyer to accept performance if she likes it:
  - Can serve as an incentive for the seller to provide quality.
- Examples of option contracts:
  - Publishing contracts
  - Contracts for advertising pilots
  - Real estate agents