University of Zurich

Faculty of Law

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Law & Economics

Economic Analysis of Law

Contract Law

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Economic Theory of Contract (1)

- **Economic requirements for enforceability**
  - Conclusion of contracts which lead to Pareto-efficient solutions
- **Example: „Agency-Game“ without contract**

Investment of 100 by principal		second player (agent)	
		cooperate	retain
first player (principal)	invest	50 (100) + 50	100 -100
	don‘t invest	0 0	0 0

Economic Theory of Contract (2)

- **Example: „Agency Game“ with contract**

Investment of 100 by principal		second player (agent)	
		perform	breach
first player (principal)	invest	50 (100) + 50	–50 (100) + 50
	don‘t invest	0 0	0 0

- **Contracts enable people to cooperate**

Economic Theory of Contract (3)

- **Does this cooperation enhance welfare?**
  - Welfare without contract: +/- 0
  - Welfare with contract: + 100
- **Games with inefficient solutions convert to games with efficient solutions**
- **Economic approach consistent with law**
  - Pareto-criterion (economics): Nobody is worse off
  - Reciprocity, expression of will (law)
    - Only possible, if nobody is worse off
    - Or if damage is compensated (Kaldor-Hicks)

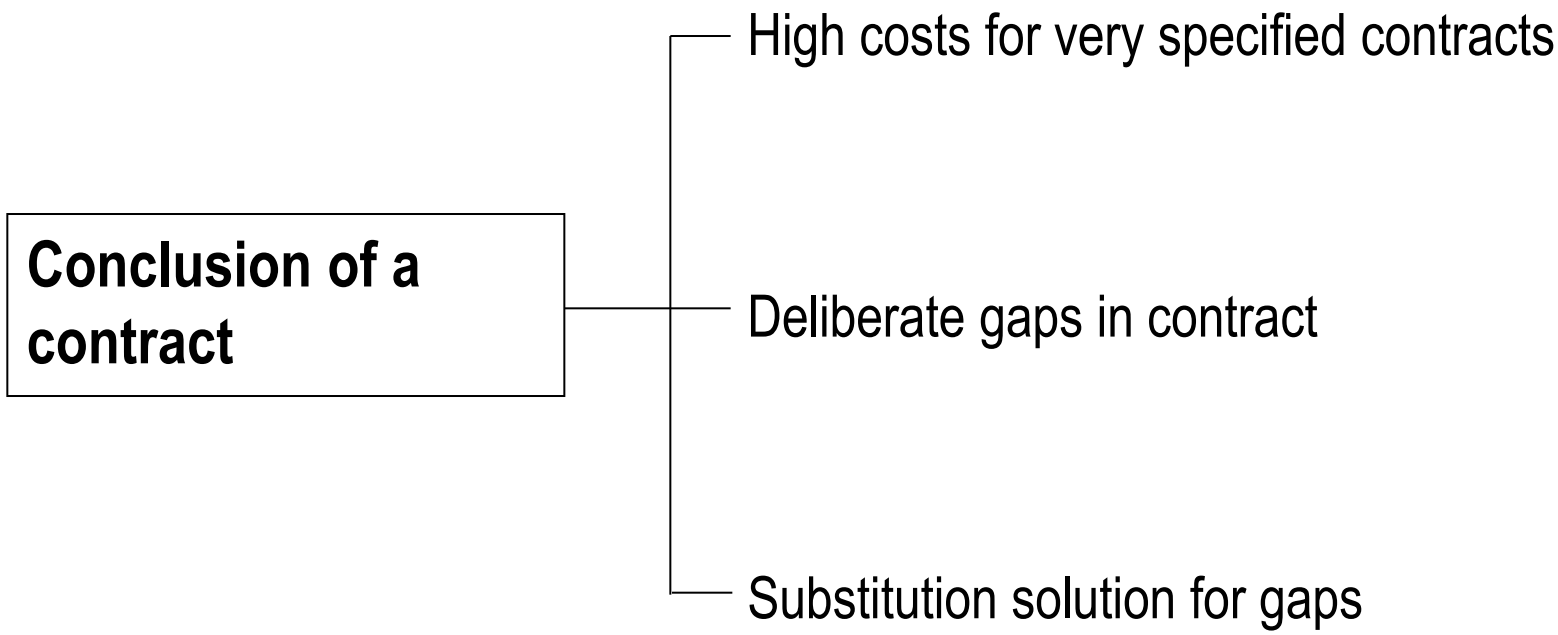
Economic Theory of Contract : Why Contracts? (1)

1. **Enabling cooperation in „efficient games“**
   - Pareto-criterion
2. **Efficient disclosure of information within the contractual relationship**
   - Exchange of asymmetric information
   - Prevention of liability due to uncertainty
3. **Secure optimal commitment for performance**
   - K (performing) > K (liability for breaching) => breach
   - K (performing) < K (liability for breaching) => perform

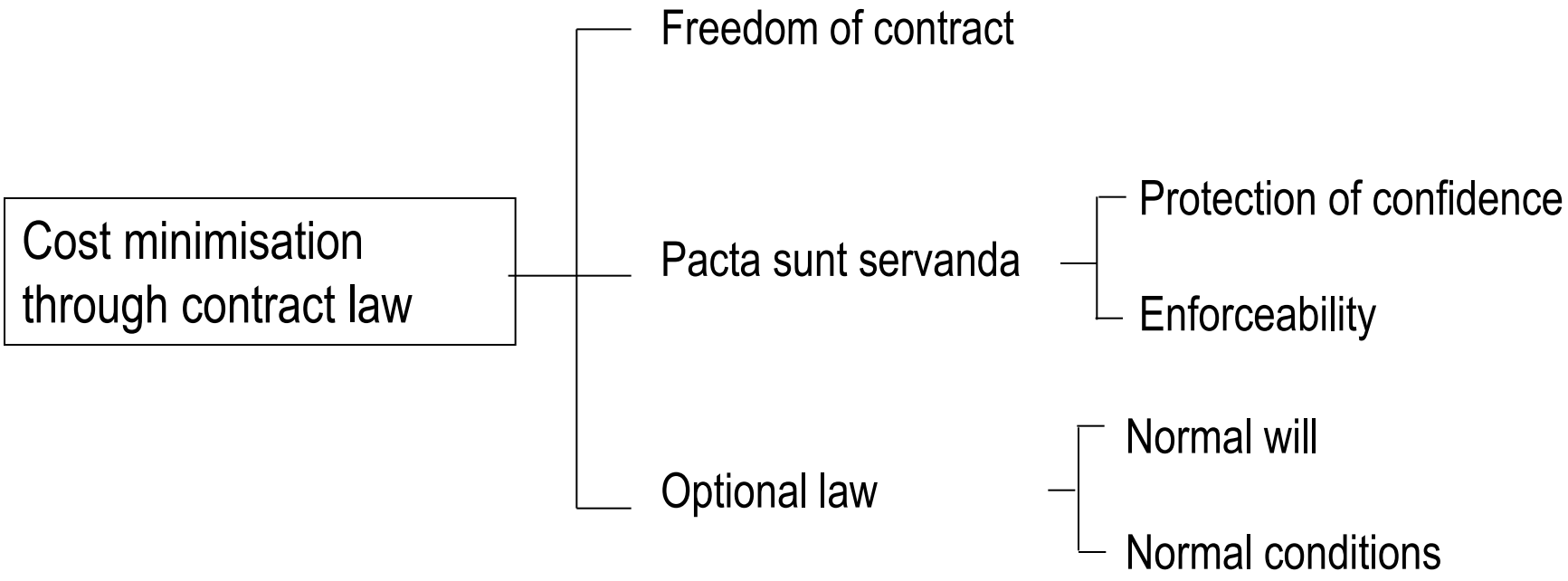
Economic Theory of Contracts: Why Contracts? (2)

4. **Securing optimal reliance**
   - Breach of confidence, good faith (culpa in contrahendo)
   - Probability of performing x additional value of performance caused by increased reliance > K (additional reliance) => more reliance
5. **Minimising transaction costs of contract negotiations**
   - Rational gaps
   - Efficient punishment for non-performance
   - Gap-filling by courts
6. **Promoting long-term relationships**
   - Mitigates the cooperation problem => reliance

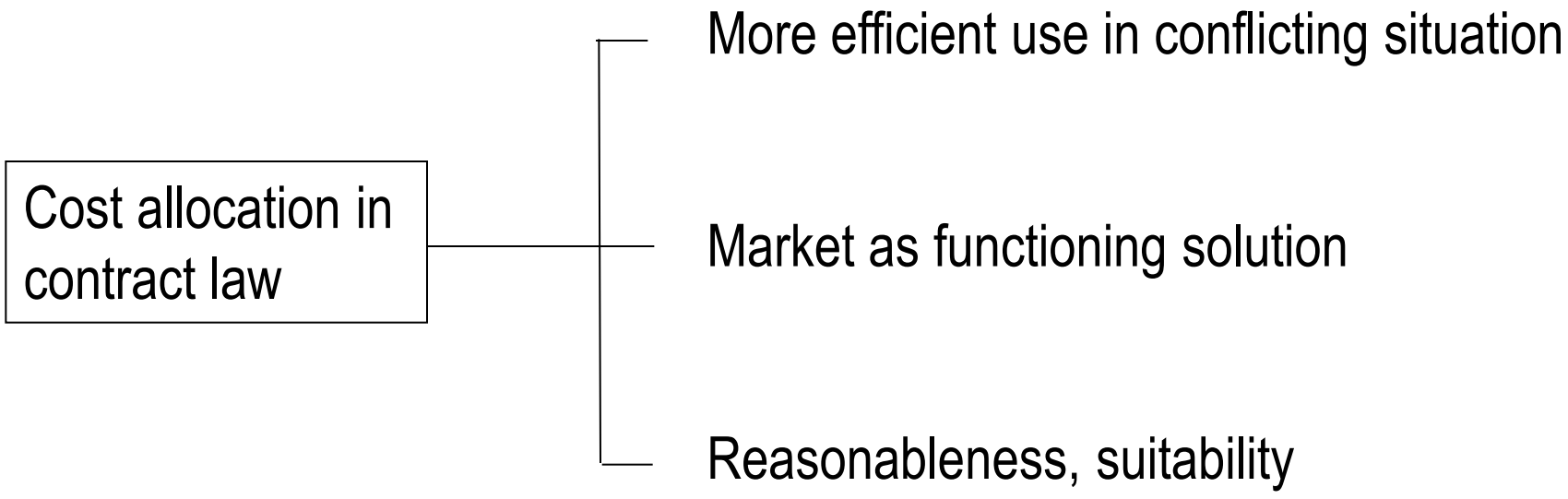
Efficient Conclusion of Contract



Cost Minimisation



Cost Allocation



Example: Efficient Contract (1)

The producer of electronic elements A concludes a contract with the producer of electronic household equipment B on specialised products (10‘000 switching elements) , for 1 CHF a per item. The cost per unit for A is CHF 0.50 (totally CHF 5.000). Costs per unit develop linear.

Example: Efficient Contract (2)

After conclusion of the contract but before starting production, B realises that she will only be able to sell 7‘500 products instead of the scheduled 10‘000, i.e. her need of switch elements is reduced accordingly. An alternative use for the components doesn‘t exist. Hold up on the output figure of 10‘000 under these circumstances may cause inefficient input of means. Resources would have to be used for the production of non-usable goods without bringing any return.

What now?

Example: Efficient Contract (3)

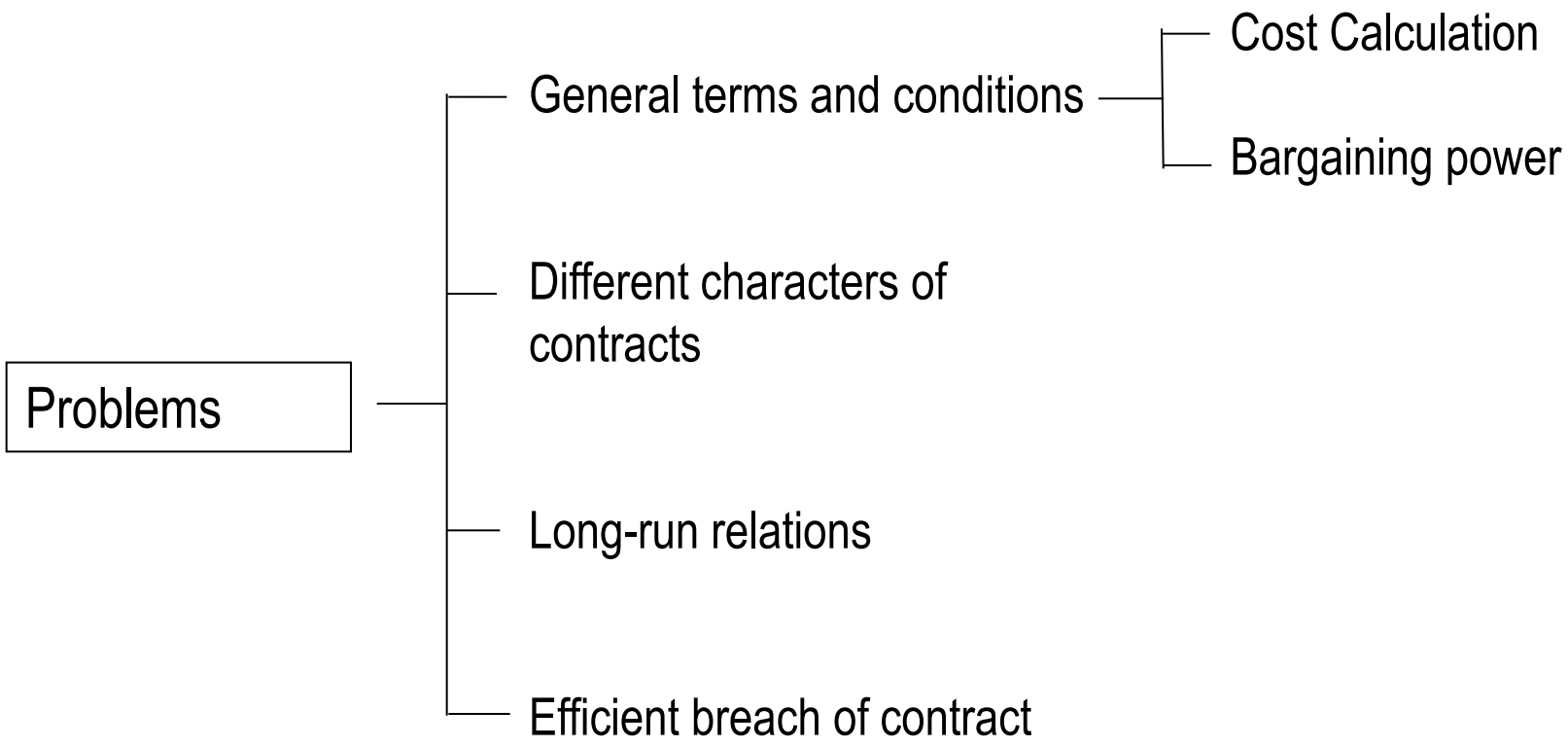
Through an adaptation of the contract an efficient outcome would result: A could limit the production to 7‘500 pieces and reduce her costs to CHF 3.750. Until she receives totally CHF 8.750, she won‘t be financially worse off. For B each reduction of the purchase price is advantageous. If A and B act rationally, they will adapt the initial contract and agree on the supply of 7‘500 elements for a total price of at least CHF 8.750 and CHF 10.000 at most.

Implementation in Legislation

Example: legislative coverage of innominate contracts

- Functional types
- Fulfilment of tasks
- Precedent effects

Areas of Concern



Breach of contract: Different types of remedies (1)

- **Common Law (USA, UK)**
  - **Expectation Damages**
    - Injury caused by the nonperformance of contract
  - **Reliance Damages**
    - Indifference between no contract and breach
  - **Opportunity Damages**
    - Indifference between breach and performance of the best alternative contract
  - **Subjective Value => Problems**
    - Hawkins vs. McGee

- **Civil Law (Swiss Law)**
  - **Positive damages**
  - **Negative damages**
  - **Positive damages?**

Breach of Contract: Damages (2)

- **Restitution**
  - Restitution of the agreed
- **Disgorgement**
  - Eliminate the injurer‘s profit from the wrongdoing (managers vs. stockholders)
- **Specific performance**
  - Requires the promisor to do what was promised in the contract (no substitution)
- **Party designed remedies:**
  - Specific remedy against breach the contract terms
  - „Penalty“ in the contract

- **Reversion of transaction**
- **Disgorgement**
- **Specific performance**
- **Contract clauses**
  - Contract penalty
  - Lump sum compensation

Phelps v. School Dist. No. 109 (1922)
Breach of Contract – Who is liable?

(302 Ill. 193, 134 N.E. 312.)

- **Phelps is an employed teacher for 50 $ a month**
- **School was closed for two months during its regular term because of a flu epidemic**
  - State board of health ordered the closing
- **School pays Phelps 33 $**
  - Phelps can teach and is teaching during 14 days
  - Phelps has prepared all lessons and homework duties
- **Teacher Phelps sues school, 100 $**
  - She wants to work during the whole two months

How is the court arguing?

Neri v. Retail Marine Corp. (1972)

(285 N.E.2d 311)

Damages for Breach of Contract? (1)

- **Contract between Neri and Marine Corp. regarding the sale of a boat**
  - Price: 12‘587.40 $ / Deposit: 4‘250 $
  - Delivery as soon as possible
- **Neri falls ill**
  - Neri‘s attorney informs Marine Corp., that Neri repudiates the sale due to an upcoming operation
  - Neri requests the repayment of his deposit of 4‘250 $
- **Retail Marine Corp.**
  - Boat had already been delivered from the factory (prior the receipt of the attorneys letter)

Neri v. Retail Marine Corp. (1972)

(285 N.E.2d 311)

Damages for Breach of Contract? (2)

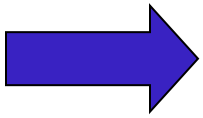
- **Neri sues:Withdrawal from contract**
  - Repayment of 4‘250 $
- **Retail Marine Corp. sues: Breach of contract**
  - Full payment of 12‘587.40
  - Acceptance of the boat

Neri v. Retail Marine Corp. (1972)

(285 N.E.2d 311)

Damages for Breach of Contract? (3)

- **Further information:**
  - At court hearing (4 months later) Retail Marine Corp. had sold the boat at the same price
  - Expenditure incurred during 4 months: 674 $
  - Attorney‘s fees: 1‘250 $
  - Profit by sale: 2‘579 $



How is the court arguing?

Neri v. Retail Marine Corp. (1972)

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Damages for Breach of Contract? (4)

- **Is it efficient that the ill Neri pays damages?**
  - Nevertheless Retail Marine Corp. was able to sell the boat
  - The court obliged Neri to pay the consequential costs (674 $), what is the effect thereof?
  - Keyword: Efficient Breach
- **What would be the situation if it had been a private boat seller who just sells this one boat?**

Campbell Soup Co. vs. Wentz (1)

- **Campbell Soup Co., soup producer**
- **Wentz, farmer (produces carrots)**
  - Wentz had contracted with Campbell to sell a specific sort of carrots for 23 – 30 $ per ton
  - Price for delivery in January 1948: 30$
  - Wentz harvested approximately 100 tons of carrots
  - Wentz denied the delivery at contract price
  - The price for carrots raised to 90$ per ton, it was almost impossible to get such carrots on the free market
  - Wentz sold 62 tons to Lojeski, an adjacent farmer
  - Lojeski sold 58 tons on market, 29 thereof to Campbell Soup Co.

Campbell Soup Co. v. Wentz (2)

- **Campbell Soup Co.**
  - Stopped purchasing carrots from Lojeski due to suspicion that these carrots were originally from Wentz
  - Campbell Soup sues:
    - Wentz may not sell carrots to others
    - Supply in accordance with contract terms
    - Repayment of the price difference to Lojeskis‘ carrots

How does the court arguing?

Campbell Soup Co. v. Wentz (3)

- **Decision of the court:**
  - Wentz is obliged to supply to contract terms
- **Reasons**
  - The carrots where almost unavailable on the open market
  - Shape, colour, and consistency were unique
  - No substitutes available
  - Campbell needed the carrots for 15 of its 21 soups
  - Campbell was a famous, national brand
  - Campbell had pre-planned target

Campbell Soup Co. vs. Wentz (4)

- **Efficient solution(s) for such situations?**
  - Wentz finds another party being willing to buy all carrots for 85$
  - Which questions rise?
- **Coase Theorem:**
  - Under which circumstances can a breach of contract lead to an inefficient allocation of resources?
  - Are there allocative or distributive effects in case of non-delivery?