University of St.Gallen

# Monetary Relief from a Law and Economics Perspective

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"From insight to impact"

University of St.Gallen

# Economic Role of Contract Law

- The aim of contract law and contract remedies is to ensure that voluntary and mutually beneficial exchanges of resources can take place.
- There are frictions to such a voluntary exchange:
  - Opportunism
  - Unforeseen contingencies
  - ➢ Contract law offers remedies to address these problems.
- These frictions increase the more complex a contract becomes and the longer the term of the contract is.
  - Opportunistic behavior becomes a problem
    - if the parties do not perform simultaneously or
    - if they agree on a buying/selling an "experience good."
      - An "experience good" is a good or a service where product characteristics are ex ante difficult to observe.

# Concept of Incomplete Contracts

- A “complete contract” is foreseeing and unambiguously describing every contingency that might possibly be relevant to the agreement (including those contingencies where the contract’s terms are violated).
- In a “complete contract”, no gap remain for courts to fill and nothing can go wrong with the enforcement of the contract.
- If parties were able to agree on “complete contracts”, contracting would always lead to an efficient outcome.
- In reality, contracts are incomplete because of:
  - Transaction costs
  - Bounded reality
    - That is: people are not omniscient nor perfectly far-sighted; they cannot solve problems exactly, costlessly, instantaneously, and they cannot communicate with one another freely and perfectly.
- Allocation of risks affects the price (e.g., if there is no product warranty, the price will ceteris paribus be lower).

# Concept of Incomplete Contracts

- “Complete contracts” as framework of reference for law-makers and judges:
  - Ideally, contract law provides a “standard contract” framework where the law-makers allocate risks to the party which can reduce or bear the risks with the lowest costs.
  - What would be the contract terms, if parties had concluded a “complete contract”, i.e., if the parties had foreseen a specific contingency and if they had negotiated on this issue.
- Ex ante (before contract formation), parties can only estimate the actual risk of a contract violation.
  - They can estimate risk magnitude, probability, and how to manage a risk.
- Contract law needs to provide a solution which is equal to a “complete contract” knowing that the contract parties where not able to negotiate. (→transaction costs and bounded reality!)

# Precaution Against Breach

- **Example:**
  - A computer chip manufacturer delivers microchips to a computer manufacturer. A few months after he delivered the microchips, it becomes evident that the microchips have a hidden flaw and are of no use.
  - The computer manufacturer is seeking the delivery of defectless chips and requests damages.
- **Analysis of precaution costs:**

| Costs of production | Inspection costs of chip manufacturer | Inspection costs of computer manufacturer | Damages | Sum of costs and damages |
|---|---|---|---|---|
| 400 | | | 200 | 600 |
| 400 | | 300 | | 700 |
| 400 | 100 | | | 500 |

- A risk, which was not subject to the contract negotiation, should be allocated to the party who had the lowest cost to avoid the risk (cheapest cost avoider), if the precaution costs are lower than the expected probability and the magnitude of harm (Learned-Hand-Formula).

# “Pacta Sunt Servanda” from an Economist’s Point of View

- “Pacta sunt servanda” (agreements must be kept)
  - Keeping the agreement at any cost?
  - Design the remedies in a manner that no contract will be breached?
  - But: breaching a contract can be efficient!
  - It should be allowed to breach a contract if the resources can be allocated to a better use compared to the situation when the contract is kept.
    - ➢ “Efficient breach of contract”

- What should be the remedy for a breach of contract?

# What Should be the Remedy?

When a breach of contract is proved, the issue becomes that of the proper remedy:

- **Expectation damages / *positive damages*** (loss of the anticipated profit of the contract)?
- **Reliance damages / *negative damages*** (promisee's costs incurred in a reasonable reliance on the promisor's performing the contract)?
- **Damages specified in the contract** as the money remedy for a breach?
- **Consequential damages**; the breach's ripple effects on the promisee's business?
- **Restitution** to the promisee of the promisor's profits from the breach?
- **Specific performance**?
- A **penalty specified in the contract**, or other **punitive damages**?
- **Opportunity costs** (making a contract often entails the loss of an opportunity to make an alternative contract; damages replaces the value of the lost opportunity)?

# What Should be the Remedy?

- **Was the breach of contract opportunistic?**
  - Suppose A pays B in advance for goods.
  - B does not deliver the goods but uses the money to build a swimming pool for himself.
  - An attractive remedy in such a case is restitution. It is possible to deter A's opportunistic behavior by making it worthless to him.
    - This can be done by making him hand over all his profits from the breach to the promise.
- **Most breaches are not opportunistic**
  - Involuntary breach
    - Performance is impossible at a reasonable cost, maybe at any cost.
    - Insurance function of contracts.
  - Voluntary breach
    - From an economic point of view the same as an involuntary breach.
    - Choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform (OLIVER WENDEL HOLMES; RICHARD E. POSNER).

# Allocative Effects of Remedies

- **Example 1:**
  - Company C sells a special widget for a price of 100,000 to Firm A.
  - A installs special machines which have a value of 20,000. A needs these machines in order to use the special widget. These machines have no other use.
  - It is expected that the revenues from the use of this widget will be 90,000. Before Company C finishes manufacturing the special widget, B offers to pay 200,000 for the very same widget. C sells it to B and does not deliver to A.
- **Allocative effects:**

| Remedy | C's Wealth | Effect |
|---|---|---|
| Reliance damages | +80,000 | Breach of contract |
| Expectation damages | +30,000 | Breach of contract |
| Specific performance | Offer a compensation* | Breach of contract |
| Restitution | +0 | Adhere to contract |

* Room for negotiation: up to 30,000

# Allocative Effects of Remedies

- **Example 2:** B offers only 130,000, A incurs expenses amounting 20,000 and expects 70,000 revenues from the use of the widget.
- **Allocative effects:**

| Remedy | C's Wealth | Effect |
|---|---|---|
| Reliance damages | +10,000 | Breach of contract |
| Expectation damages | –20,000 | Adhere to contract |
| Specific performance | Offer a compensation* | Adhere to contract |
| Restitution | +0 | Adhere to contract |

* No room for negotiation

- **Reliance damages lead to "efficient breach of contract"**
  - Buyer is no worse compared to the situation when agreement is kept but C and B are better off (→ efficient).
  - Seller has incentive to break contract when profit arising from breach of contract is exceeding the damages (that is if B pays at least 150,000).
  - Efficient breach of contract leads to a better use of resources.
  - Restitution discourages breach of contract but it is inefficient.
  - Specific performance can lead to a solution where the parties renegotiate a new allocation of profits.

# Remedies as Incentives

- **Example**
  - Yvonne owns a waffle shop. Her business prospers so that she needs a larger facility.
  - She enters into a contract with Xavier, a builder, who promises to construct a new restaurant for occupancy on September 1.
  - Xavier knows that random events could jeopardize completing the building on time, such as striking plumbers, recalcitrant city inspectors, or foul weather.
  - He can reduce the probability of late completion by working overtime before the plumber's contract expires, badgering the city inspectors, or accelerating work on the roof.
  - Yvonne anticipates a surge in business when she opens the new facility.
  - ➢ **How much food should she order? If the shop opens later than September 1, she risks disposing the supplementary food.**

(COOTER/ULEN, 323 et seq.)

# Remedies as Incentives

- The promisor has an incentive to invest more on performing, when liability for breach is higher.
- Conversely, the promisee can increase the value of performance by relying.
  - But: relying also increases the loss from breach. The promisee has an incentive to rely more, when liability for breach is higher.
- We want a contract which avoids over- and under-reliance of parties.
  - Restrain reliance before breach reduces causes.
  - Mitigating damages after breach reduces harm that it causes.
- **Possible solutions:**
  - ➢ Doctrine of foreseeability: “foreseeable reliance” should equal “efficient reliance.”
  - ➢ Stipulate an exact amount of damages in the contract in order to prevent overreliance.

# Conclusion

- Ensure that voluntary and mutually beneficial exchanges can take place.
- “Complete contract” as a framework of reference.
- Remedies have allocative effects.
- Contract remedies create incentives:
  - Encourage or discourage a breach of contract.
  - They can induce under-, over-, or efficient-reliance.
- A breach of contract can be more efficient than adhering to a contract.

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