

## Contracts



A contract is a promise that binds both the promisor (the one making the promise) to the promisee (the one to whom the promise is made) by imposing mutual obligations on the parties to the agreement. Individuals enter into a contract because they expect a future gain. Contracts create an expected cooperative surplus between the contracting parties by providing incentives for bilateral behavior. When the promise is unilateral and nothing is expected of the promisee, there is a promise but no contract. Traditionally, a contract requires an offer, an acceptance and some consideration. It is the consideration that creates the bilateral nature of the promise. Consideration can take the form of money, service or even another promise. Without consideration there is an incomplete contract or a gratuitous promise.

Contracts are necessary when there is delayed performance. In an immediate exchange with no expectation of future performance, there is no need for a contract. Even immediate exchanges, however, may include a warranty that promises future performance. If I agree to paint your home and you agree to pay me a certain sum in return, we have a contract. Should each party fulfill their side of the bargain, we each expect to benefit from an anticipated cooperative surplus. Unfortunately, expectations are not always proven correct by future circumstances. Unexpected events can affect the expected gain. I may break my leg and not be able to paint your house, or my work may fall below the standards you expect. You may lose your job and, therefore, not have the funds needed to pay me. If the primary purpose of contracts is to promote efficiency, then when circumstances change unexpectedly it may be more efficient for one party to breach the contract. When the mutual benefits of breaching the contract are greater than the mutual benefits of performance, there is the opportunity for optimal breach.

The decision to breach will depend on the damages assessed against the breaching party. Perfect expectation damages promote optimal breaches and dissuade non-optimal breaches. *Perfect expectation damages* place the non-breaching party in the same position he would have been in if the contract had been fulfilled. When the breacher is willing to pay perfect expectation damages and, nevertheless, breach, then he should be better off than he would have been if he had completed the contract. Furthermore, since the non-breaching party is just as well as he would have been had the contract been performed, the breach must be Pareto optimal. One person has been made better-off with no one else being made worse off. Accordingly, perfect expectation damages promote Pareto optimal breaches.

### Efficient Breaches

When the incremental cost of performance exceeds damages, breaching is the preferred alternative. The cost of performance is measured in opportunity cost terms. It is the cost of additional resources that must be devoted to performance and the cost of lost

opportunities. For example, A promises to deliver B widgets for \$100 on which A plans to earn \$30 in profits. B plans to earn \$20 in profits by turning the widgets into gadgets. The cooperative surplus is \$50 and it is equal to the joint profits of the contracting parties.

Suppose circumstances change unexpectedly. A now realizes that if he delivers the widgets for \$100 he will take a loss on the sale. A must now decide to either take a loss on the sale or pay B damages. How much would A have to pay in perfect expectation damages? This will depend on B’s alternative suppliers, expected profits and reliance costs? If B can substitute widgets from other manufacturers at a price of \$100, then expectation damages are zero? If there were no other available supplies, then perfect expectation damages would include B’s lost profit. It would also include reliance costs. These are costs that B incurred in anticipation of A’s performance and that cannot be recovered. For example if B has already rented some equipment to be used in gadget production, then reliance costs might include the rental price of the equipment. If B purchased the equipment that has a resale value, then reliance costs would include only sales costs plus any net loss on resale. It would not include the purchase price of the equipment.

Lost profits under the original contract plus reliance costs is the maximum amount of damages that A can expect to pay. If B purchases widgets from an alternative supplier at a higher price than it was promised by A, then its loss will equal the price differential. This price differential can never exceed lost profits. Were it any larger than that, B could reduce damages by shutting down production. B has a responsibility to mitigate damages, i.e. to choose an alternative course of action that minimizes damages to himself and to A.

B’s Perfect Expectation Damages

	Alternative supplies at same price	No alternative supplies	Alternative supplies a higher price
Damages	None	Lost profits plus reliance costs	New purchase price less A’s contracted price
Range	Minimum damages	Maximum damages	Price differential cannot exceed lost profits plus reliance costs

Why is this result efficient? Notice that if A expects a loss, it will breach whenever there is a lower cost producer in the market. If it cost A \$110 to deliver the widgets that B has agreed to pay \$100 for, then it will incur a \$10 loss on the contract. However, if A breaches and B can find an alternative supply for \$105, A will only pay damages of \$5. Whenever there is a lower cost provider, A will have an incentive to breach. Thus, the widgets get produced by the most efficient manufacturer.

A may breach either because of an increase in the cost of production or an increase in price offered by an alternative buyer. Either change will increase A's opportunity cost of supplying B with widgets. If A receives a higher price from an alternative buyer, then he must weigh the incremental revenues from the higher price against the damages that must be paid B. If those resources are more valuable in an alternative use, then an alternative buyer should be willing to pay a price that will more than cover B's damages.

Damages are optimally set when they equal expectation damages. When they are less than or greater than expectation damages, there may be too little breaching or too much breaching.

Actual Damages > perfect expectation damages (too little breaching)  
 Actual Damages = perfect expectation damages (optimal breaching)  
 Actual Damages < perfect expectation damages (too much breaching)

It can also be argued that perfect expectation damages lead to optimal breaches by Company B. Refusal to accept delivery from Company A would also constitute a breach. Company B would now have to weigh the cost of breaching against the incremental cost of performance.

### Alternative Measures of Damages

There are two other calculations of damages that are commonly discussed in the law and economics literature, opportunity cost damages and reliance damages. Perfect expectation damages are meant to place the non-breaching party in the same position he would have been in if the contract had been completed. *Opportunity cost damages* are meant to place the non-breaching party in the same position he would have been in if he accepted the next best opportunity. Finally, *reliance damages* are meant to return the non-breaching party to the same position he would have been in if he had never agreed to the contract.

Opportunity cost damages will differ from perfect expectation damages when markets are imperfectly competitive. In a perfectly competitive market all the units are homogenous and they all sell for the same market price. Firms are producing goods that are perfect substitutes. If the market is imperfectly competitive then it can be assumed that the other offers are not perfect substitutes. Suppose alternative contracts are rejected because of an unfavorable price. For example, suppose instead of agreeing to buy A's output for \$100, B could have purchased the same product from C for \$110. Also assume that \$110 is the best alternative price it could have found at the time it contracted with A. Therefore, by contracting with A, B gave up the opportunity of contracting with C. An opportunity cost measure of damages would be based upon the \$110 purchase price rather than the actual purchase price of \$100.

Reliance damages represent less than perfect compensation for the victim of the breach. They return the victim to the position he was in immediately preceding the breach. The victim may have spent funds in anticipation of the other party's performance. Assume these expenses were meant to enhance the profitability of the contract and can not be recovered by the victim. These represent the victim's reliance costs.

Reliance damages should be based upon optimal reliance. By increasing reliance costs the profitability of the contract may be increased. However, it is possible that one party may overly rely on the other party. Therefore, if reliance damages were always reimbursed there would be an incentive for overreliance. Optimal reliance may be thought of as the amount of reliance a reasonable person would place on contract performance. It should take into account the realistic probability that unforeseen factor may inhibit performance. It is the reliance expenditure that maximizes the expected value of the expected cooperative surplus.

Restitution damages are minimal damages. They simply return any benefits the victim may have bestowed on the breacher.

In summary, damages from the largest to the smallest are arranged in the following order:

perfect expectation damages  $\geq$  opportunity cost damages

opportunity cost damages  $\geq$  reliance damages

reliance damages  $\geq$  restitution damages

Perfect expectation damages	- place the victim in the same position he would have been in when the contract was completed
Opportunity cost damages	- place the victim in the same position he would have been in if he went with the next best offer
Reliance damages	- place the victim in the same position he was in before the contract
Restitution damages	- return any benefits the victim bestowed on the injurer

### Forseeability

The concept of forseeability is contained in this ancient nursery rhyme.

For want of a nail, the shoe was lost,  
For want of the shoe, the horse was lost,

For want of the horse, the rider was lost,  
For want of the rider, the battle was lost,  
For want of the battle, the kingdom was lost,  
And all for the want of a horseshoe nail!

~Anonymous

Do we hold the blacksmith liable for the loss of the kingdom when the consequences of his actions were not foreseeable? The decision to optimally breach will depend on expected damages and expected damages depend on the costs to the victim. When the damages are not foreseeable, they cannot be accurately estimated by the breaching party. Consequently, an inaccurate assessment of the incremental costs imposed on the other party may lead to inefficient breaches. However, if the breaching promisor must bear all costs incurred by the promisee, even unforeseeable costs, then that may also lead to inefficiencies. For example, the promisor may have accepted more risk than he bargained for and, therefore, may have not engaged in efficient precautions. In addition, the promisee may have overly relied on the promise and, therefore, has not undertaken efficient precautions. It follows that there are good reasons why we may not want to hold breachers responsible for unforeseeable damages.

Just what constitutes foreseeable damages is a matter for the court to decide. Again, we could fall back on the reasonable man rule. If it is not what we would expect a reasonable person to expect, then it is unforeseeable. However, what a reasonable person expects depends on how much effort is put into collecting information and analyzing information. In economic terms, the cost of information will determine what is reasonable. It is unreasonable to assume that information will be acquired when the marginal cost of the information exceeds the expected benefit.

*Hadley v. Baxendale* is the seminal case on foreseeability. Operations at the plaintiff's mill were halted because of a broken crank shaft. The plaintiff ordered delivery of a new crank shaft from the defendant. The clerk promised delivery by the next day. Because of neglect, the shaft was not delivered for several days. As a consequence, the mill remained stopped and the plaintiff experienced substantial lost profits. Would a reasonable parts supplier expect that the failure to deliver a single part would result in hundreds of people out of work and millions of dollars in lost profits? If a parts supplier knew that he might be responsible for such damages then he might provide additional care in delivery, or he might take on additional liability insurance. In either case, he would probably charge more than the normal price for the part. If damages are unforeseen, they have no affect on behavior. Therefore, awarding damages for an unforeseen harm will not affect the decision to breach. It may, however, affect the decision to contract. The liability for unforeseen risks may deter individuals from entering into otherwise efficient contracts.

### Mistake and Imperfect Information

The courts treat unilateral mistake differently from mutual mistake. Contracts entered into with mutual mistake are typically not enforced. It is said that a contract requires a “meeting of the minds.” When there is mutual mistake there is no common set of expectations that may be shared by the contracting parties. *Sherwood v. Walker*, (1887) is the classic case of mutual mistake. The contracting parties agree to the sale of what they each believe is a barren cow. The price for the cow is much less than it would be if the cow were fertile. When the seller discovers the cow is pregnant, he wishes to rescind the contract and the low sale price.

Obviously, the only cases of mutual mistake that may be litigated are those that benefit one party and harm the other. Because the benefit is the result of mutual mistake and not a return to investment in information or human capital, the redistribution of wealth is a consequence of random circumstance that has no impact on economic behavior. In fact, individuals might more easily enter into mutually beneficial contracts if they assume that contracts based upon mutual mistake will be voided.

Unilateral mistake exists in *Harris v. Tyson* (1855). Tyson was a knowledgeable purchaser who suspected the land he was purchasing contained valuable mineral deposits. Harris, the seller, did not know that his land might have valuable mineral deposits. After discovering why Tyson was purchasing his land, Harris wanted the contract voided. Unless there is fraud, contracts accompanying unilateral mistake are usually enforced. A unilateral mistake assumes that one of the parties is knowledgeable and it is the knowledgeable individual who receives the benefits of the bargain. These benefits represent a return to the acquisition of knowledge. Since the acquisition of knowledge leads to the more efficient utilization of resources, society is generally better off when the resources are transferred to the more knowledgeable user. In *Harris v. Tyson* the seller was better off after the trade, because he would not have sold the land unless it was worth more to him in trade. In addition, the minerals, which would have remained unexploited had it not been for Tyson’s expert knowledge, would now be recovered.

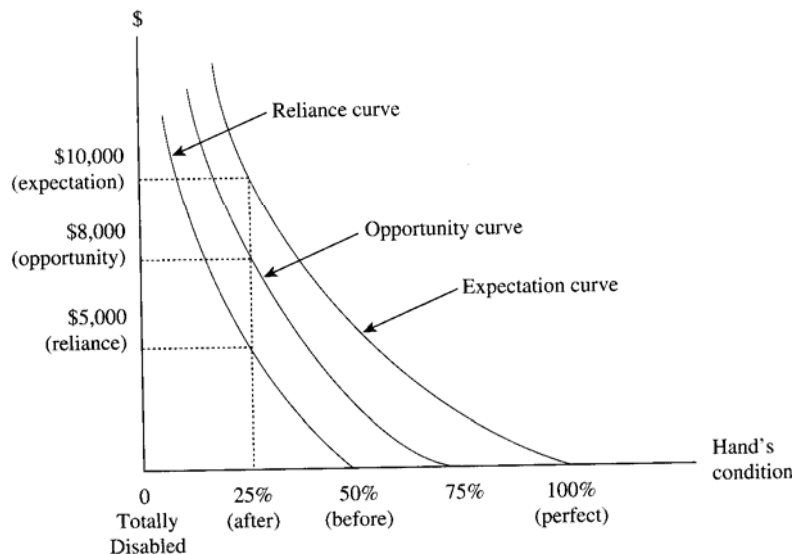
There are situations, however, where unilateral information is not the result of investment in information. It could be the result of fortuitous circumstances or what has been termed “insider knowledge.” There may be no efficient reason for enforcing such contracts. In fact, there may be good reasons for not enforcing contracts based upon insider information. Martha Steward sold her stock in a drug company because she had insider information indicating the stock would go down in value. She had this information simply because her broker was also representing the president of company. It was not the result of an investment in financial research, nor was it commonly available to all participants in the market. Disallowing the use of insider information ensures that all market participants have the same opportunity to acquire relevant information. This instills greater faith in the public market and lowers the cost of capital markets.

## Damages

Almost every first-year law student struggles with the case of *Hawkins v. McGee* (1929), also known as the case of the hairy hand. The following illustration from Cooter and Ulen nicely demonstrates the various types of damages that could be awarded in this case.<sup>1</sup> Hawkins had a scarred hand. He was promised a perfect hand by Dr. McGee. The doctor operated on the plaintiff and left him with a hideous hand that was worse than before the operation. Assuming McGee is liable for breach of contract, how should the damages be measured?

FIGURE 7.1

*Expectation, opportunity-cost, and reliance measures of damages in Hawkins v. McGee.*



Source: Robert Cooter and Thomas Ulen, *Law and Economics* 4th Ed. New York, Addison-Wesley Press.

The indifference curves indicate the combinations of money and perfection that would provide Hawkins with given level of utility. Assume that on the perfection scale the preoperative hand was at 50 percent and that McGee promised Hawkins perfection. Other doctors offered Hawkins the possibility of 75 percent. Given the malpractice Hawkins was left with a hand that was at 25 percent of the perfection scale. If Hawkins is to have the same level of utility he would have had if his expectations were realized, then

<sup>1</sup> Robert Cooter and Thomas Ulen, *Law and Economics* 4<sup>th</sup> Ed. New York, Addison-Wesley Press, 2003, p. 244.

he must receive expectation damages of \$10,000. It can also be determined in the above diagram that opportunity cost damages are \$8,000 and reliance damages are \$5,000.

Like *Hawkins and McGee*, the case of *Sullivan v O'Connor* (1973) also has to do with a surgery that went wrong. This time the defendant was promised a nose that would enhance her appearance. The result was a disfigured and deformed nose. The jury found the surgeon guilty of contract breach, but innocent of negligence. The court must determine the appropriate damages. The plaintiff has given up the claim to expectation damages. The defendant wants only reliance damages. How should these damages be determined?

*Peevyhouse v. Garland Coal* (1962) is a case that will likely arouse your sympathy for the plaintiff, especially if you read the article by Judith Maute.<sup>2</sup> Peevyhouse entered into a contract with Garland Mining that permitted the mining company to extract coal from his land in exchange for royalties on the extracted coal and a promise to restore the land to its previous state when the mining was completed. Essentially, Garland reneged on its promise to restore the land. The court must then decide on the proper amount of damages. What were the expectation damages? The cost of restoring the land is much greater than the value of the restored land. Should damages equal the cost of reclamation or the diminution in the value of the land?

What is a lost volume retailer? This is the central question in *Davis Chemical v. Disonics* (1987). Davis, the buyer, breaches and Disonics, the seller, sells the good to an alternative buyer at the same price. Other than incidental damages, can we assume that seller has not suffered any other damages on the sale? Suppose the seller would have ordinarily made the other sale, then there has been a loss in sales volume and lost contribution to profits. What are perfect expectation damages for a lost volume retailer?

### Unconscionability

Courts may abrogate a contract because the terms are unconscionable. A contract is unconscionable when it offends the conscience of the court. The terms appear so one-sided that one party would not have voluntarily accepted the result. Accordingly, one of the parties must have incompetent or a victim of duress.

An analysis of unconscionability may begin with a determination on whether the contract is one of adhesion. A contract of adhesion is prepared by the party with the superior bargaining strength and presented to the other on a take it or leave it basis. The fine print in an adhesion contract can contain unreasonable provisions. Moreover, there may be an element of unfair surprise contained in fine print.

Unconscionability may have a procedural and a substantive component. Procedural unconscionability focuses on the circumstances surrounding the formation of the

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<sup>2</sup> Judith L. Maute, "Peevyhouse v. Garland Coal & Mining Co. Revisited: The Ballad Of Willie And Lucille," *Northwestern University Law Review*, 89 Nw. U.L. Rev. (1995), pp. 1341-14-74.

contract. Was a contract of adhesion agreed to because of duress, incompetence or unfair surprise? Substantive unconscionability is based upon the benefits of the bargain. Was the price paid significantly disproportionate to the value received? A significantly mismatched bargain may imply duress or surprise.

*Williams v. Walker-Thomas Furniture* (1965) concerns an installment contract that many might consider unconscionable. Retail customers entered into an installment contract with Walker-Thomas to purchase household items. The installment contract had an add-on clause. The amount borrowed was added to the total debt owed the creditor. Each payment would be credited on a pro-rata basis over all of the items that were financed. If the purchaser missed a payment, the creditor could repossess all of the items that the debtor still owed money on. Consequently, as long as the installment loan is not fully paid off, there is a remaining balance on each and every item that was financed.

In this case, the plaintiff's missed a payment and Walker-Thomas repossessed all of the household items that were financed. Should the courts enforce the add-on clause? Is it unconscionable?