Law & Economics of Contract Law

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Complete Contract

- Explicitly exhaustive
- All possible conditions, actions, implications, consequence are completely specified
- Fiction & Theoretical benchmark like perfect market
- Full information is necessary & full agreement as to the actions and implications i.e. terms of contract are necessary

Incomplete Contracts

- Not completely specified
- Contract remains silent about the risk
- All consequences are not stated
- Inadvertent or deliberate
- In reality all contracts are incomplete
- Gaps in contract

Costs of Contracting and Risk Allocation

- For complete contract costs are involved
- Parties to consider ex ante risk and ex post losses
- Ex ante risk – risk of future losses
- Ex post losses – losses that actually materialize
- Leave the gap

$$C_{\text{risk allocation}} > C_{\text{loss allocation}} \times P_L$$

- Fill the gap

$$C_{\text{risk allocation}} < C_{\text{loss allocation}} \times P_L$$

Reasons For Incomplete Contract

1. Effect and cost of anticipating possible contingencies
2. Involves subsequent cost of enforcing
3. Some variables can not be verified by Court
4. Expected consequence may not be very harmful
5. May concern contractually irrelevant event
6. Low probability events with minimum loss

Filling the Gaps

- Gap filling by Court
  - Use of default rules – in Contract law
  - Hypothetical bargain – impute the term that party would have agreed if bargained over the relevant risk
  - Allocating obligations efficiently
  - May replace express terms by Court terms
- Interpretation by Court

Default Rules

- Contract Law provides default rules
- Save parties negotiating and drafting costs
- Mandatory rules and default rules

Default Rules

- Mandatory Rules
  - Parties can't contract around the mandatory default terms
  - Even if the parties do that, it will be ignored by Courts and mandatory default rule will be applied
- Default Rules
  - Parties can agree to different terms
  - These rules provide guideline to parties to formulate their intention

Optimal Performance

Efficient to perform

Promisor’s cost of performance	$<$	Promisee’s benefit from performing

Efficient Breach

Efficient to breach

Promisor’s cost of performance $>$ Promisee’s benefit from performing

Optimal Reliance

- Promisee invests in reliance upon the promise

  To enhance the value of performance

- Optimal reliance

  Efficient reliance when

$(P_{\text{Promisor's performing}}) \times$ (Increase in the value created by additional reliance) $\geq$ cost of additional reliance

- Converse less reliance

Breach & Enforcement of Contract

- Enforcement by State Established Court
- Other modes of enforcement
  - Arbitration Tribunal
  - Trade Associations
  - Religious bodies
  - Mechanism within firm
- Enforcement action – by the affected party

Role of Court in enforcement action

- Considers validity of contract and formation defences
- Considers breach excuses and responsibility for breach
- Considers implied terms or default rules for gap filling
- Interprets ambiguous terms
- Considers remedial action
  - Specific performance
  - Damages
  - Injunction

Interpretation of Contract

- Textual – Plain meaning of the term is used to determine the meaning
- Contextual- Consideration of commercial context to ascertain the objective meaning of the clause. Needs more evidence and cost and expertise of the Court

Damages

- Restitution
- Expectation
- Reliance
- Direct damages are awarded and not indirect or consequential
- Mitigation is considered
- Damages are for compensation and not as penalty

Restitution Damages

- Minimal remedy
- To reverse the transfer that has taken place e.g. refund of money paid
- Baseline initial position before contract

Expectation Damages

- Based on value of expected performance
- Baseline is performance
- Damages replace the income that would have accrued
- Affected party is equally well off and therefore indifferent between performance or breach
- Perfect expectation damage is perfect substitute of performance
- In civil law – Positive damages

Reliance Damages

- Reliance investment – Promisee makes investment based on the promise. To add value to a contractual benefit.
- Reliance damage replaces reliance investment or value.
- Baseline is no contract.
- Perfect reliance damage – Promisee is indifferent between no contract and breach.
- In civil law – Negative damages

Opportunity Cost

- Loss of opportunity to make alternative - Second best contract.
- Lost opportunity is the baseline.
- Damages replace the value of lost opportunity.

Therefore the promise is indifferent between breach and performance of alternative contract.

Liquidated Damages

- The sum is stipulated by the parties in a contract that should be payable in case of breach
- Reduces enforcement cost and Courts work

Specific Performance

- Requires the promisor to do what was promised in the contract
- Granted when the party who seeks specific performance is willing to carry out his part of the contract
- Granted by the Courts in situations where damages alone cannot compensate for the breach of contract
  - Contract for purchase of immovable property
  - Contract for personal services eg. Artists, professional