

Contract Law

1. Describe how the bargain or classical theory of contract answers the two questions that any theory of contracts must answer: what promises are enforceable at law? And to what extent?
2. The common law typically enforces promises to make donations to universities. Explain in a couple of sentences how the economic theory of contracts can justify this common law rule, and explain why the bargain theory of contracts has difficulty justifying it.
3. To encourage efficient contract formation, efficient reliance, and efficient breach, what should be the default remedy for breach of contract—expectation damages, specific performance, or either one? Explain.
4. What costs will be minimized if specific performance is the default remedy for breach of contract? What costs will be minimized if damages is the default remedy for breach?
5. True or false--Explain:
 - a) According to the bargain theory of contracts, offer and acceptance were necessary for the formation of a contract but consideration was not.
 - b) Expectation damages ideally create an efficient incentive for breach, but not necessarily efficient incentives for reliance.
 - c) Specific performance is a remedy for breach of contract, and injunctive relief is a remedy for a nuisance. Specific performance resembles injunction because both remedies typically leave the wrongdoer party better off than she would be with a damages remedy.
 - d) Formal law is more important as a means to secure cooperation in long run relationships with repeated transactions, because the stakes are high, than in short run relationships with one-shot transactions.
6. Define perfect compensation and perfect disgorgement.
7. The law will not enforce a liquidation clause in which the amount of damages specified exceeds compensatory levels. Would efficiency be increased if the law enforced liquidation clauses regardless of the amount of damages specified? Is it possible that contracts that should be breached will in fact be inefficiently performed if punitive elements of liquidation clauses are allowed?
8. What would be the efficiency consequences of the following legal rule: "From January 1, 2000, in the event of a breach of contract, the innocent party will be entitled to recover one-half of the benefit that she expected from the performance of the contract by the other party"? (Hint: Discuss the efficiency consequences in terms of optimal breach and reliance.)
9. In many contractual settings there is asymmetric information between promisor and promisee. The problem this raises is when is this asymmetry good and when is it bad. A famous Supreme Court case involved asymmetric information about a contract to buy tobacco. During the War of 1812 the Port of New Orleans, Louisiana, was blockaded. Supplies of tobacco accumulated on the docks. As a result, the price of tobacco for export was very, very low. Organ, a buyer of tobacco, learned through private channels of information that the war was about to end and that the blockade would soon be lifted. On the basis of this information, which almost no one else had, he bought lots of tobacco at the currently low price, knowing that when the blockade was lifted, the price would shoot up and he would make a bundle of money. After the contracts were formed but before delivery was made, peace was declared. Several of the sellers refused to deliver the tobacco at the low price. Organ sued them for breach of contract. Would you enforce those contracts or not? Why?

10. Seller S promises to provide a unique widget to Buyer B1, and B1 promises to pay \$200 to S upon delivery of the widget. Another potential buyer B2 appears. B2 will value the widget more or less than B1, depending upon some uncertain events. If B2 values the widget more than B1, then B2 will offer a high price to S for the widget and thus provide a reason for S to breach the contract with B1. If B2 values the widget less than B1, then B2 will not offer to buy the widget from S. Before this uncertainty gets resolved, B1 must decide how much to rely upon the contract.

Your task is to analyze B1's decision to rely and S's decision to perform or breach. Here are some numbers needed to make the calculations:

- The contract price between S and B1 is \$200.
- An expenditure of \$20 by B1 makes the widget worth \$260 to B1.
- An additional expenditure of \$10 by B1, resulting in total expenditures of \$30, makes the widget worth \$275 to B1.
- If S does not supply the widget to B1, these expenditures will have no value and the expenditures will be lost. Consequently, these expenditures represent reliance upon the contract. An expenditure of \$20 is "low reliance" and an expenditure of \$30 is "high reliance."

The value of the widget to B2 depends upon uncertain events:

- There is a 50% chance that the widget will be worth \$150 to B2.
- There is a 50% chance that the widget will be worth \$400 to B2.
- B2 has no reliance expenditures.

Assume that expectation damages are the remedy for breach of contract.

- a) Assume that if S breaches the contract, B1 will receive expectation damages, which will be calculated based upon the value of performance given B1's *actual* reliance. How much will B1 rely? How much are B1's expectation damages?
- b) How much reliance is efficient? Explain your answer briefly.
- c) When, if ever, do you think that S will breach? Is this breach behavior efficient? Explain your answer briefly.

11. Facts: The owner of the Fireside Inn Restaurant contracts with a stonemason to install an ornate customized fireplace to serve as a focal point in his restaurant. The mason obtains materials and begins carving the restaurant's trademark crest in a large piece of valuable stone that will serve as the mantelpiece. But before the fireplace is completed, the buyer's old fireplace malfunctions, causing a fire that destroys the entire restaurant. The owner does not plan to rebuild and now has no need for a new fireplace.

- a) If there were a perfect contract between the parties, who would most likely be assigned the risk of this contingency? Why?
- b) Explain in general how to determine the efficient level of reliance by the promisee on the promise. In this example, how much reliance by the mason on the buyer's promise would seem to be efficient?
- c) The owner tries to repudiate the contract and the stonemason sues. What legal doctrines could the defendant use in this case to argue that he has no liability?
- d) Explain how to determine the difference between reliance and expectation damages in this case. Be explicit about whether you are taking into account the mason's lost opportunity.
- e) If you were the judge and you wanted the outcome to be efficient, what remedy would you give? Explain why your proposed remedy is most efficient.

12. For each of the following examples determine whether, on efficiency grounds, the contract should be performed or breached. If you recommend the former, explain in one or two sentences why. If you recommend the latter, identify the contract doctrine that would excuse promise breaking.

- a) Roger, whom is 14 and an avid collector of baseball cards, agrees to sell a particular card to a dealer for \$500, when in the fact the market value of the card is at least \$1,000. Roger's parents attempt to block the sale of the card.
- b) The Finance department at Adams College agreed to hire Joey Fudderman to teach introductory finance courses. In his application Joey indicated that he would have his Ph.D. completed by the time the school year started, a requirement for the teaching position. Upon his arrival on campus, the Finance department learns Joey has not yet

received his Ph.D. due to data problems that prevented him from completing his dissertation, and declares the contract void.

- c) Franky offers to sell Johnny a pleasure boat they have used together on many occasions. After taking delivery of the boat, Johnny discovers that the motor is unreliable and fails to start from time to time. Arguing that he was unaware of the problem when the sale took place, Johnny demands damages. Franky responds that he assumed Johnny was aware of the problem given their previous trips together and that, therefore, no damages are warranted.

13. Jones and Smith sign a contract under which Jones agrees to deliver 2000 widgets to Smith with payment to be made upon delivery.

Jones' cost per unit is \$10.

Smith values a unit at \$30.

The contract price is \$20 per unit.

Before Jones delivers any widgets, Anderson offers to buy the (undelivered) widgets for a price of \$25 per unit which is the amount at which Anderson values each unit.

- a) Is it efficient (i.e., welfare maximizing) if Jones breaches her contract with Smith? Explain briefly and show any relevant calculations.
- b) Suppose that if Jones breaches, she is liable to Smith for reliance damages. If Jones breaches, what amount will Jones pay to Smith for breach of contract? Will this measure of damages induce Jones to breach the contract? Explain briefly showing any necessary calculations.
14. What excuses or defenses can be used to justify a contractual breach? What incentive problems are corrected by the various legal solutions? Discuss three such excuses or defenses.

Tort Law

1. The standard economic theory of tort liability makes several important simplifying assumptions. Three of the most important are the following:
- i) the costs of litigation are zero;
 - ii) there is no uncertainty in the tort liability process; and
 - iii) there is no first-party or third-party (liability) insurance.

Explain how, if at all, the standard conclusions about the efficiency of the various tort liability standards might have to be amended if we relax that assumption.

2. Suppose a manufacturer of power tools has two alternative designs to use for his product. Design A costs \$50 to produce and design B costs \$80 to produce. If design B is used rather than design A, the probability of an accident decreases by 1/100. In both cases the cost of an accident is \$5000.
- a) Does the efficient outcome require selling the product with design A or B? Explain.
- b) Suppose that the probability of harm in using the product depends on the care taken by the consumer and that consumers correctly perceive expected losses. Will a rule of strict liability on the manufacturer for all damages yield an efficient number of accidents? If not, what can be done by the court (short of going from strict liability to negligence) to induce the consumer to take care?
3. Suppose that the current legal rule regarding accidental injuries on rented premises is that landlords are always liable. Thus, if a tenant or his guest slips and falls, receiving injury, anywhere on the rented premises, the landlord is liable for the resulting losses. The victim does not have to establish fault on the part of the landlord.
- a) What liability standard is obviously in effect according to the facts described above?
- b) In your opinion, is the liability standard in effect efficient? Why or why not?
- c) Assuming your answer to part (b) is no, what liability standard would you recommend as an alternative if economic efficiency is the primary objective? Why?

4. Describe how each of the following would affect the economically efficient level of precaution and explain your reasoning.
 - a) An increase in the per unit cost of precaution.
 - b) An improvement in the technologies used to avoid accidents.
 - c) Modifications, outside of the precautions that potential injurers and victims can take, that reduce the cost of an accident should one occur.

5. Provide an example which illustrates each of the changes described in question 4.

6. How does a rule of strict liability differ from a rule of no liability? Describe the conditions under which each rule is efficient? Do both rules work equally well in all cases? Why or why not?

7. Considering the Calabresi rule, explain how an increase in the per unit costs of precaution would alter the efficient level of precaution. Does it matter whether strict liability or some form of the negligence rule such as simple negligence or comparative negligence is in effect? Why or why not?

8. Mr. Culprit confides to his psychiatrist that he hears voices telling him to kill his neighbor, Ms. Victim, and that he feels compelled to follow these commands. Suppose also that the psychiatrist believes there is a probability of .2 that Mr. Culprit will actually kill Ms. Victim and that the belief is accurate. The psychiatrist does not warn the police or Ms. Victim of Mr. Culprit's threat. Mr. Culprit kills Ms. Victim, and the surviving children sue the psychiatrist for damages, claiming the psychiatrist was negligent in failing to warn Ms. Victim of Mr. Culprit's violent potential.
 - a) What information would you need to know to determine whether the failure to warn constituted negligence (or whether it is efficient to hold the psychiatrist liable for the failure to warn)? How would you use that information to reach a decision about alleged negligence (or efficiency)?
 - b) Use a graph to show the situation where the psychiatrist is found not liable of negligence in failing to warn.

9. If an accident occurs, the loss to the victim will be \$1000. The probability of the accident occurring if no precautions are taken is .01. Each party acting alone can avoid the accident (i.e., the avoidance measure by each party is sufficient to reduce the probability of an accident to zero). Suppose that all parties know that the potential victim's burden of avoidance, B_{victim} , is \$5 and the potential injurer's burden of avoidance, B_{injurer} , is \$1.
 - a) Under the contributory negligence rule, will the potential victim have incentive to take precaution? Will the potential injurer have incentive to take precaution? Explain.
 - b) Is it efficient for the potential victim to take precaution? Is it efficient for the potential injurer to take precaution? Explain.
 - c) If the potential injurer's burden of avoidance, B_{injurer} , is \$100 and the potential victim's burden of avoidance, B_{victim} , is \$1 and each party does not assume the other will act carefully, will an excessive amount be spent on accident avoidance under the contributory negligence rule? Explain.

10. On November 29, 1995, President Clinton signed a bill ending the federal 55 mph speed limit and giving the states the power to set their speed limits. Suppose that a committee in the New Jersey legislature is considering revision of New Jersey's speed limits and that the committee has asked you to provide testimony regarding the economic issues. Assume that to go from New Brunswick to Atlantic City a driver will have to drive through a district in which there is an elementary school and then proceed to an interstate highway to reach his destination. Assume also that the applicable liability rule is strict liability. Assume that the only kind of accidents which can occur involve a car and a pedestrian.
 - a) Will the driver operate his car at the efficient speed? Why or why not?
 - b) Will the efficient speed differ across the school district and the interstate highway? Why or why not?
 - c) How will your answers to part (a) and (b) change if the court consistently underestimates damages when an accident occurs?
 - d) If the driver operates the car at the efficient speed, will there be accidents? If so, who will bear the costs of these accidents?

11. For each of the situations listed below, indicate whether strict liability, strict liability with contributory negligence, or some form of a negligence rule would be preferred on efficiency grounds and explain your reasoning. In developing your answers you should consider the effects of each liability rule on both precaution and activity, i.e., the question of who is the residual bearer of harm should be factored into your analysis.
- a) A consumer falls ill as a result of eating beef purchased at a supermarket that is contaminated with the *e. coli* bacterium.
 - b) A pedestrian slips and falls, injuring herself on a snow-covered sidewalk in front of a house. (Assume there are sidewalks on both sides of the street and both are snow covered.)
 - c) A motorist on an interstate highway is injured in an accident. At the time of the accident, visibility in the area was reduced because a farmer was applying lime to his fields; some of the lime drifted south across the highway due to moderate winds.
 - d) Some of the residents in a housing subdivision become ill as a result of exposure to wastes (through drinking water from a well), including wastes classified as hazardous, that were disposed of by a manufacturing concern on its property. The manufacturing plant's property is situated adjacent to the housing development. Assume that the subdivision and the manufacturing plant moved to the area at approximately the same time.
12. Research recently published in the New England Journal of Medicine reported that talking on a cellular telephone while driving is as dangerous as driving while at the threshold of legal intoxication, and for the same reason: the risk of an accident. The study concluded that the risk of having an accident increased four-fold when drivers were talking on the telephone. The researchers suggested that a person who is not talking on the phone cannot become distracted by a shouting match with a boss or a significant other. However, the researchers added that 39% of the drivers used their phones to call for help after the crashes. A Harvard Medical School report estimates that accidents caused by cellular phones could account for at least 0.6% to 1.2% of all traffic accidents by the year 2000 and could cost the nation at least \$2 billion to \$4 billion a year.
- a) What information would you need to know to determine whether banning drivers from talking on cellular phones would increase or decrease social welfare? How would you use this information to determine whether a ban is efficient?
 - b) Suppose we want to reduce the number of accidents caused by cellular phones. In your opinion, are civil remedies in tort an adequate deterrent to talking on the telephone while driving? Or is there a need to invoke criminal penalties in addition to civil remedies? Explain.
13. Workers' compensation is the primary legal remedy for employees who are disabled by a work-related injury or illness. Workers' compensation requires employers to pay benefits to workers who are disabled on the job. Often, the amount the employers must pay to workers is set by statute at an amount less than that which would be paid under a tort system. In the event a worker is injured on the job, the employer must pay the worker a specified amount of cash benefit, medical care and in some cases rehabilitation. Typically, to be awarded compensation, the employee must prove by a preponderance of evidence that the injury or illness 'arose out of and in the course of employment.' Although employers are liable regardless of their fault or the fault of the victim, they may challenge whether the disability is actually work-related, and they may dispute the degree of the disability. Each state law requires a waiting period ranging from three to seven days before benefit payments begin. A worker whose disability does not persist beyond the specified period is not entitled to benefits. However, workers are compensated retroactively for the waiting period if their disability persists beyond a specified time period.
- a) By providing workers with income protection regardless of their fault, what incentive do workers have to take precaution to avoid work-related accidents?
 - b) Would higher benefits increase or decrease the number of accidents? Explain.
 - c) If workers' compensation benefits are proportional to wages, what effect would an increase in benefits have on the incentive of injured workers to rehabilitate and return to work? Explain.
 - d) What effect would increasing the waiting period from three to seven days have on the number of workers' compensation claims filed? Explain.

14. For some time, Japanese cars sold in Japan have not been as crashworthy as cars sent to the U.S. Japanese cars sold in Japan have lagged behind cars sold in the U.S. in terms of the number of safety devices such as air bags, anti-lock brakes, seat belt tensioners, reinforcing bars in the doors and strong pillars to prevent a roof collapse in a rollover. One report found that the death rate in Japanese subcompacts was 34% higher than in American subcompacts. The president of Honda has stated that in Japan, people in cars make up a smaller percentage of those who die in traffic accidents than in the U.S., and pedestrians a larger percentage. One engineer has estimated that skimping on safety results in a savings of \$300 to \$500 in each vehicle. Because Japan's roads are narrow and congested, Japanese drivers frequently cannot reach the speeds attainable on American roads.
- a) Product liability lawsuits are rare in Japan. You may assume that this is because Japan is not a litigious society, there are few lawyers, and product liability lawsuits seldom result in large damage awards. Can differences in the legal systems and cultural differences regarding liability lawsuits explain differences in the number of safety features between cars produced for the Japanese market and cars produced for the U.S. market? Explain your position fully and include a graph in your explanation.
 - b) Is the socially optimal number of safety devices the same for each country? If so, a difference in the number of safety devices means that the cars sold in at least one of the countries do not contain the socially optimal number of safety devices. Or is it possible that the socially optimal number of safety devices is different in the different countries? Explain.
15. In 1995 new legislation was enacted that eliminates the federally imposed speed limit on the nations' highways. As a result, states are now free to set their own limits. One state, Montana, responded by applying the following rules; during nighttime hours the speed limit will be 65 mph on all state highways, including both two-lane and four-lane roads. However, during the day, there is no official speed limit on the state's highways. Instead, drivers are required to drive at or below speeds that are "reasonable and prudent" given prevailing conditions. The determination of what constitutes "reasonable and prudent" will be left to individual state troopers on a case-by-case basis.
- a) Comment on the likely effects this new law will have on the determination of fault in the event that an accident involving two or more vehicles occurs on the state's highways.
 - b) Discuss the relative efficiency of this approach to speed limits and the more conventional approach of posting fixed limits that everyone must follow. In particular, which approach is more likely to minimize the total costs of accidents involving two or more vehicles on the state's highways? Why? (Hint: Administrative costs are a major factor here.)
 - c) Of the various negligence standards we have considered, which one would you apply in this situation (i.e., in situations involving two or more vehicles)? Why?