

IYB = In your book

### Contract Law

1. IYB (or, see #2 below).
2. Both parties want enforceability for the sake of coordination. So Pareto efficiency requires enforceability. The bargain theory denies enforceability because nothing is given to induce the donation (no consideration).
3. Expectation damages are generally the preferred remedy for efficient formation and breach (see 5b below for discussion on reliance). Specific performance may be preferred in situations involving a good/service that has no close substitutes (thereby making it difficult to determine the actual value of the contract).
4. Under specific performance, the court would avoid lengthy damage determination cases. Under damages, the parties can avoid extra negotiation costs (due to forced extra transactions under specific performance).
5. True or False.
  - a) False. All are necessary.
  - b) True. Expectation damages internalize the cost of breach for promisor, but not for promisee. For efficient reliance by the promisee, *perfect* expectation damages must not compensate for *overreliance*.
  - c) False. Specific performance reduces a wrongdoer's choices. A damage award leaves the wrongdoer with a choice between paying damages and performance. In general, more choices are better than less choices.
  - d) False. Repeated play provides the opportunity to punish cheaters without formal law.
6. IYB.
7. Efficiency might be enhanced by enforcement of penalty damages (awards greater than actual harms) for two reasons: First, the penalty amount might be considered as part of an insurance contract paid by a potential breacher to the innocent party. Second, a penalty damage clause might be an efficient way for one party to convey their reliability/credibility to others. (See pages 259-261 for a discussion.)
8. This is for you to ponder.
9. We discussed this one in class. A key point in your decision should be whether the information in question is productive or redistributive.
10. Widget contract.
  - a) High; \$275 (if the contract price has already been paid to S; otherwise, it would be \$75 to cover the expected profit of \$45 plus the \$30 cost of reliance).
  - b) An increase in reliance from \$20 to \$30 costs an additional \$10 and yields an expected benefit of an additional \$15 with a probability of 50%. Thus, additional reliance costs \$10 and yields an expected benefit of \$7.50. Thus, efficient reliance equals \$20 ("low reliance").
  - c) If B2 values the widget at \$150, then S will not breach. If B2 values the widget at \$400, then B2 can offer S more than \$275 to breach, and S will breach and pay damages not exceeding \$275. This behavior is efficient because it moves the widget to the party who values it the most.

11. Fireside Inn Restaurant.

- a) The promisee (restaurant owner) since he controls the probability of fire.
- b) The promisee should restrain his reliance in light of the probability that events destroy the value of performance. The chance of a fire seems too remote to warrant restraint by the mason.
- c) Frustration of purpose (maybe also impossibility or impracticability).
- d) Reliance damage is out of pocket expenses incurred by the mason plus the cost of his time or else the profit he could have made on his next best contract. Expectation damage is the profit he expected to make on the restaurant job.
- e) Expectation damages. The buyer, who controls the probability of breach, should internalize its full cost for the sake of efficiency. Damages should be "reasonable expectations" so that the victim has efficient incentives.

12. Contract questions.

- a) One could argue that the contract should be breached on the basis of incompetence. In effect, we would be arguing that a valid contract does not exist given Roger's age and the fact that he may not have sufficient information to enter into a defensible contract.
- b) We can begin by assuming that there is a gap in the contract, i.e., this contingency was not covered explicitly. On the face of it, this looks a case of impossibility. However, one would have to look deeper into the question why Joey ran into data problems. If Joey could have reasonably foreseen the problems and taken appropriate actions, the contract should be voided. If he could not, the court should rule in his favor.
- c) If the choice is between mutual mistake and unilateral mistake, this is a problem of unilateral mistake. (As we will see, however, this is not really even a question of unilateral mistake.) Franky knew what he was selling. Johnny knew what he was buying but did not have full information regarding the characteristics (in particular, reliability of the motor) of the item he purchased. Johnny should have invested more time in learning more about the boat. Assuming safety is not an issue (although it could be) and Franky did not lie to Johnny, the contract should be enforced.

13. We did this one in class.

14. IYB.

## **Tort Law**

1. IYB.

2. Power tools.

- a) Design B is an efficient level of precaution since it only costs an extra \$30 to reduce the expected damages by \$50.
- b) Strict liability will provide for the optimal level of care by the manufacturer but it will not provide the correct incentives for potential victims. In addition, too many consumers will purchase power tools (high activity level), thereby leading to too many accidents. I'll leave the last question for you to ponder.

3. Landlord liability.

- a) Strict liability is obviously the standard in effect.
- b) It is straightforward to argue that this standard is inefficient in this case. There are numerous actions the tenant and guests could take to reduce the probability of an accident, i.e., bilateral precaution is efficient. (Strict liability is only efficient in the case of unilateral action where the injurer can take precautions.)
- c) As we stated above, it is efficient for both parties to engage in some level of precaution. In addition, the probability of an accident is dependent on the activity levels of the tenants and guests. Thus, they should be the residual bearers of harm. We conclude that the appropriate standard is negligence, negligence with contributory negligence, or comparative negligence.

4. Optimal precaution?

a) In this case, the marginal costs of precaution now exceed the marginal benefits, i.e., the level of precaution is too high. Thus, precaution should be reduced, causing  $p'(x)$  to increase and marginal benefits to increase as well until  $MC = MB$ .

b) This could be interpreted two different ways. On one hand, the improved technology could result in a decrease in the per unit costs of accident prevention ( $w$ ). This would have the opposite effect of the change described in part (a), i.e., the level of precaution should be increased. Alternatively, the improvement in technology could cause the probability function to shift down (left), i.e., the probability of an accident would be lower at each level of precaution, holding the per unit cost of precaution constant. In this case, the marginal benefits of a unit of precaution have decreased. Hence, holding the per unit cost of precaution constant,  $MC > MB$ . Thus, the level of precaution should be decreased for the same reason discussed in part (a). (Note that with less precaution you still realize the same amount of reduction in harm, measured in monetary terms, that you did prior to the technological improvement.) If the technological change affects both marginal costs and marginal benefits, we have pressure to both increase and decrease precaution. The net effect will depend on which effect dominates.

c) For you to ponder.

5. Use your imagination.

6. IYB.

7. The Calabresi rule refers to attempts to minimize the overall social cost of torts, namely, the sum of expenditures on precaution, expected harm from accidents, and administrative costs. In other words, minimize  $SC = wx + p(x)A + C$ . Your answer to the first question should be pretty similar to the one you gave for 4(a) above. Does the efficient level of precaution depend on whether strict liability or negligence is in effect? Maybe. The negligence rule will be efficient only if the legal standard for avoiding negligence is set equal to the efficient level of precaution. In terms of administrative costs, there is a tradeoff between strict liability and negligence. On the one hand, strict liability saves on administrative costs because it makes the court's decision making easier: only harm and cause need to be shown. A negligence case must show harm, cause, and fault. However, a rule of strict liability may create incentives to file more lawsuits, thus raising the overall workload for courts. A rule of negligence will tend to result in fewer suits filed (because they are more costly to administer).

8. Mr. Culprit and the psychiatrist.

a) To determine whether failure to warn constituted negligence, I need to know the burden ( $w$ ) to the psychiatrist of notifying the victim or the police, the loss ( $L$ ) that occurs when the victim was killed, and the probability that Mr. Culprit will kill the victim even if the psychiatrist notifies the victim or the police (this is needed to find  $P$ ). A potential injurer is negligent if and only if the cost of precaution ( $w$ ) is less than the change in probability of harm ( $P_1 - P_2$ ) times the magnitude of the loss ( $L$ ) (i.e., the psychiatrist has a duty to warn if and only if  $w < (P_1 - P_2) * L$ . Credit would also be given to students who pointed out that imposing a duty on a psychiatrist to warn others might cause patients not to trust their psychiatrist thereby preventing patients from receiving treatment that might reduce the likelihood of harm. Credit would also be given to students who analyzed this legal problem as a question of whether the psychiatrist's omission constituted negligence.

b. In  $\{x, \$\}$  space, graph a flat (or up-sloping)  $w$  curve and a down-sloping  $p'(x) * A$  graph ( $x$  is units of care). The line  $p'(x) * A$  depicts marginal change in expected accident costs as a function of care. The curve marked  $w$  is the marginal cost of care. The intersection of the two curves,  $x^*$ , represents due care. To the left of  $x^*$ , the injurer is negligent;  $w$  is smaller than  $(P_1 - P_2)A$ . To the right where the cost of care exceeds the benefit, the injurer is not negligent (accidents are unavoidable in an economic sense).

9. Accident.

a) In contributory negligence jurisdictions, plaintiff's negligence bars his recovery. The potential victim will take precaution because the plaintiff's failure to take precaution would constitute contributory negligence. Taking precaution of  $B_{\text{victim}} = \$5$  prevents a larger expected loss of  $(P_1 - P_2) * A = (.01) * (\$1,000) = \$10$ . If the

victim takes precaution, no accident will occur. If the victim does not take precaution, the victim's recovery is barred under contributory negligence. Either way, the injurer has no liability and, therefore, no incentive to take precaution.

b) It is efficient for the injurer, but not the victim, to take precaution. The injurer is the low-cost avoider, and the injurer's burden of precaution is cheaper than the expected harm (i.e.,  $B_{injurer} < B_{victim} < (P_1 - P_2) * A$ ). If both take precaution, expenditure on precaution is excessive where, as here, each party acting alone can avoid the accident.

c) The rule of negligence with contributory negligence is not always efficient. The facts in this case provide a counterexample to Cooter and Ulen's proposition. See answers to 9(a) and (b).

10. Ending the 55 MPH speed limit.

a) Yes, the driver will operate his car at the efficient speed. Under strict liability, the injurer is liable for the full social cost of his action. A rational injurer will choose that level of precaution that minimizes his expected private costs. Because social costs are borne by the injurer, minimizing his private costs is equivalent to minimizing social costs; he "internalizes" those external costs.

b) Yes, the efficient speed will differ across the school district and the interstate highway. If  $B$  (the burden of precaution) is smaller than  $(P_1 - P_2) * A$ , the strictly liable defendant should take precautions to avoid the accident. In the school district, the probability of an accident will be higher (because of the higher number of pedestrians in the school district) thereby justifying greater precaution, lower speed.

c) If the court consistently understates damages, the injurer will not internalize the entire external cost.

Therefore, the injurer will take less precaution (drive faster) than is socially optimal (a). However, changes in the court's estimate of damages does not effect the efficient speed (b).

d. If the driver operates the car at the efficient speed, there will be accidents and the driver will have to pay the victim's damages. But those damages, discounted by the probability of the accident, are less than the cost of avoidance; avoidance does not pay.

11. Optimal precaution?

a) In this case, the residual harm should fall on the supermarket since they have more control over the amount of beef processed that could become infected. However, it can easily be argued that bilateral precaution is efficient in this case, since improper preparation could result in harm in cases where proper preparation would prevent harm. In most, if not all, cases, proper preparation will destroy the e. coli bacterium. Strict liability with contributory negligence would be the appropriate choice.

b) For you to ponder.

c) Once again, there is a clear argument in favor of bilateral precaution. Drivers should keep an eye on the horizon and adjust their speed according to conditions. However, the farmer should also be cognizant of the effects of lime drift on the visibility of drivers. The activity level in this case is the application of lime to the fields. Thus, strict liability with contributory negligence is appropriate.

d) For you to ponder.

12. Cellular telephones.

a) What would be the benefits of banning drivers from using cell phones while driving? What would be the costs of banning drivers from using cell phones while driving? If the benefits from banning cell phones are greater than the costs, then social welfare would be increased. Could you use the Hand rule to frame this discussion?

b) This question is a bit out of place because it hints at issues that we will discuss in the criminal law chapters. Nevertheless, what sort of issues might the court think about in terms of setting the appropriate damage award? Would punitive damages be necessary?

13. Worker's Compensation.

a) Since worker's compensation damages are not always fully compensatory, especially where serious personal injuries are concerned, potential victims will have an incentive to take precautions even if their failure to do so would not cut down their entitlement to damages if they were injured.

b) Injuries will rise with benefits. Higher benefits reduce the cost of incurring an injury and therefore lead employees to devote less effort to avoiding injuries. Empirically an increase in benefits is associated with an

increase in the injury rate. Higher benefits cause more workers' compensation claims. There is a potential for a moral hazard problem. By providing workers with income protection in the event of workplace injuries, public policy may inadvertently encourage workers to take greater risks on the job and thus incur even more disabilities. A moral hazard problem arises because the employees' level of safety is unobservable to employers and insurers and therefore cannot be monitored.

c) Workers' compensation can influence worker behavior by affecting incentives to rehabilitate and return to work. By replacing a portion of foregone labor income during non-work spells, workers' compensation insurance may lead workers to delay their return to work and thus increase the duration of their disability.

d) Estimates indicated that if the waiting period were increased from three to seven days, the workers' compensation recipiency rate would fall by 38.7%. Administrative data from Minnesota, which has a three-day waiting period, indicate that 29.3% of workers' compensation recipients leave the program within seven days. These findings suggest that the estimated effect of the waiting period is largely a result of the high density of short injury spells that fail to qualify for workers' compensation. (You are not expected to know the findings in data from Minnesota. However, you should be able to predict the result.)

14. Product liability in Japan. For you to ponder.

15. Speeding in Montana.

a) The determination of fault will be more difficult to determine due to the uncertainty regarding the interpretation of what is "reasonable and prudent."

b) Precaution costs are likely to be low, while the cost of accidents is likely to be high under the "reasonable and prudent" standard. Will administrative costs be higher or lower under the "reasonable and prudent" standard? Why?

c) For you to ponder.