Another area of law that can be discussed within the Coasian framework of bargaining among a small number of individuals is contract law. Unlike the normal nuisance law situation, however, the parties to a contract negotiate with each other before any dispute arises. Since the parties can decide in advance how to resolve potential disputes, it might be asked whether it is necessary or desirable to have general legal rules governing contract disputes. The reason contract rules are desirable is, of course, that it would be prohibitively costly (if even possible) to negotiate and draft a contract that provides for every conceivable contingency. For contingencies that are thought to be unlikely or that do not affect the parties' costs and benefits very much, it is not worth going to the trouble to specify in advance what to do if the contingency should occur.

Contract law can be viewed as filling in these "gaps" in the contract — attempting to reproduce what the parties would have agreed to if they could have costlessly planned for the event initially. Since the parties would have included contract terms that maximize their joint benefits net of their joint costs — both parties can thereby be made better off — this approach is equivalent to designing contract law according to the efficiency criterion.16

16. The statement that the parties would have maximized their joint benefits net of their joint costs obviously presumes that they would have bargained cooperatively. Also, the conclusion that the maximization of the parties’ joint benefits net of their joint costs is the goal of efficiency presumes that no one else is affected by the contract.
A Fully Specified Contract

$5,000.00 of one and only a certain value of $20,000.00, with 5% of the purchase price in advance of delivery, and any other terms with the same expected gain or loss or gain multiplied by the probability of the loss. 

The expected gain of $20,000 is $5,000.00.

If the delivery is not made or is made later than the expiration of the contract, the contract is void. The purchaser's right to the proceeds of the contract is lost.

The purchase proceeds on the contract are $5,000.00. If the delivery is not made, the contract is void. The seller's right to the proceeds of the contract is lost.

The purchase proceeds on the contract are $5,000.00. If the delivery is made, the contract is not void. The buyer's right to the proceeds of the contract is lost.

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(33)

**Efficient Breach**

Price in advance — say $180 instead of $175

S will commerce, and B will be willing to offer a higher contract.

Second Application — Reach of Contract

The contract price is $175, and B may not require $175. Therefore, the contract is valid.

Therefore, the contract is valid.

Thus far, the examples illustrate a simple but fundamental principle in the economics and analysis of contract law: A fully

**An Introduction to Law and Economics**
Second Application - Scope of Contract

In any event, the allocation of risk or the determination of the contract price, if any, is necessary to ensure that the parties are accurately reflected in their respective budgets. The contract price includes all costs and expenses associated with the performance of the contract, including labor, materials, and profit. The contract price is negotiated between the parties and is subject to change during the course of the contract due to changes in market conditions or other factors.

The contract price is also subject to change if there are changes in the scope of work, changes in the specifications, or changes in the quantities of materials or labor. Any changes to the contract price must be documented in writing and signed by both parties.

The contract price is used to determine the amount of money that is owed to the contractor and the amount of money that is owed to the owner. The contract price is also used to determine the amount of money that is owed to the subcontractors and the amount of money that is owed to the suppliers.

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more than this, then it is efficient for that buyer to have the good. Given the expectation measure of damages, the seller will have an incentive to breach in order to obtain the higher offer. If another buyer values the good less than the original buyer, a breach is not efficient and the expectation remedy will appropriately discourage breaches. Any other measure of damages for breach of contract generally will be inefficient. If damages exceed expectation damages, then a breach might not occur even though it would be efficient. For example, if damages were $260 in the example, then $ would not breach when B2 offers $250. And if damages are below expectation damages, an inefficient breach might occur. This is the problem with the reliance remedy, because it leads to a level of damages below the expectation level. The restitution remedy is even worse because it provides less than the reliance measure of damages.

Efficient Reliance

Inducing optimal breaches of contracts is not the only problem with which contract law has to deal. Another issue of concern relates to reliance expenditures. In the example, it was assumed that B1’s reliance investment was fixed at $10. In general, this expenditure can vary, and the more spent on reliance, the more valuable the contract will be to the buyer if it is completed. For example, the buyer might be able to purchase various customized pieces of equipment, each of which is capable of transforming the widget into a more valuable final product. (Because widgets are perishable, this equipment must be obtained before delivery.) In the remainder of this chapter we will analyze how remedies for breach of contract affect the amount invested in reliance.

In order to examine the reliance decision, the example used earlier must be made slightly more complicated. It still will be assumed that the original buyer B1 must spend at least $10 on reliance and that the widget will be worth $200 to him if this is all that he spends. But now he will have the option of spending an additional $24 on reliance and thereby raising
CHAPTER 8

FOURTH APPLICATION — BREACH OF CONTRACT AGAIN

In the discussion of breaches of contracts in Chapter 5, it was assumed that the parties were risk neutral. The primary conclusions there were that the expectation remedy was most efficient with respect to the breach decision and that the restitution remedy was most efficient with respect to the reliance decision. We will now reexamine breach of contract remedies when at least one of the parties is risk averse. In order to focus on the risk-allocation issue, assumptions will be made that imply that both the breach decision and the reliance decision will be efficient under all of the remedies considered.

The analysis will be undertaken using a variation of the earlier example of a seller $S$, who can produce a widget for $150, an initial buyer $B_1$, who values the widget at $200 and who has to make a reliance investment of $10, and a possible second buyer $B_2$. The contract price agreed to by $S$ and $B_1$ is again payable in advance. It is assumed in this chapter that $B_1$'s reliance expenditure is fixed, so there cannot be a problem of inefficient reliance. It is also assumed that the value $B_2$ attaches to the widget is either $0 or $250. The facts of this example are summarized in Table 6 (which is a slightly modified version of Table 2).

By eliminating the possibility considered earlier that $B_2$'s value might be $180, the problem of inefficient breach is

33. Although none of the results in this chapter depend on the specific contract price, it will be useful to keep in mind that the contract price varies with the damage payment for the reasons discussed in Chapter 5. See pp. 32-33 above.
Optimal Risk Allocation

Only issue to be discussed is risk allocation. The concept that is addressed is risk allocation, and the breach decision is efficient, the concept of making a decision to allocate risk is considered. There is the breach decision will be efficient. In other words, the breach decision will be efficient. In other words, the breach decision will be efficient. In other words, the breach decision will be efficient.

Table 6

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<th>Breach of Contract Example</th>
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between $B1$'s value of $200$ and $B2$'s offer of $250$. To the extent that the damage payment is above $200$, $B1$ bears the risk of a higher offer because the difference between $B1$'s profit when the contract is performed and $B1$'s profit when the contract is breached increases. Similarly, to the extent that the damage payment is below $250$, $S$ bears this risk because $S$'s profit becomes more uncertain. Thus, the more risk averse $B1$ is relative to $S$, the lower the optimal damage payment. Note, however, that the optimal damage payment is never below the $200$ value $B1$ attaches to the widget. It equals this value only when $B1$ is risk averse and $S$ is risk neutral.

The Effects of the Remedies

We can now reexamine the expectation, reliance, and restitution remedies to see whether, and under what circumstances, they optimally allocate the contract risks in the example. Under the expectation remedy, if the seller breaches, the buyer can recover from the seller an amount of money that puts the buyer in the same position he would have been in had the contract been completed. As seen in Chapter 5, this corresponds in the example to a damage payment equal to the $200$ value $B1$ attaches to the widget.\(^36\) $B1$'s profit therefore does not depend on whether $S$ breaches to sell the widget to $B2$, but $S$'s profit does. In other words, the beneficial risk of $B2$'s offer is borne entirely by $S$; $B1$ is in effect completely insured against this risk. Based on the earlier discussion of optimal risk allocation, we can conclude, therefore, that the expectation remedy is efficient in terms of risk allocation only if the seller is risk neutral and the buyer is risk averse.

Under the reliance remedy, the buyer can recover an amount of money that puts him in the same position he would have been in had he never entered into the contract with the seller. It was seen in Chapter 5 that reliance damages correspond in the example to $B1$'s $10$ reliance expenditure plus the contract price; it also was demonstrated that this

\(^{36}\) See pp. 33-34 above.