KEY

ECO 499: Seminar in Law and Economics
FINAL EXAM
Spring 2009

Name: .

4 digit # for posting grade: ____

10 point questions:

1. Under the Classical or Bargain Theory of Contracts, what are the three elements of a bargain (and hence legally enforceable promise or contract)?

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✓ ① Offer consists of a promise to deliver something to a counterparty

✓ ② Acceptance consists of the counterparty's agreement to the offer

✓ ③ Consideration is what the promisee gives up in exchange for the offer.

If all these are fulfilled, Bargain theory declares a contract was formed!

2. In **Batsakis v. Demotsis 226 SW2d 673 (1949),** involving the loan of money from Batsakis to Demotsis prior to the German invasion of Greece in 1941, the Court of Civil Appeals of Texas ruled that "mere inadequacy of consideration will not void a contract." What is "consideration" and what ramifications does this ruling have for the smooth functioning of a market system of exchange?

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Consideration is the payment or what one will do in exchange for another person's actions. In this case, there was a promise to pay back a loan that seemed to be unfair. The exact terms I cannot remember but it was something like loan me $300 to get me out of Greece, and I will pay you $1,000 later. It was agreed, and later, Demotsis did want to pay back the larger sum. This was a good ruling in that it incentivized people to carefully "consider" their consideration before entering into a contract. If the court had not upheld the contract, it would have established a precedent that some contracts would be upheld and some would not. This would not be efficient because people agree everyday to contracts that may have seemingly unequal terms, and as long as they are not under duress and are legal contract, they must be upheld.

3. Use indifference curves to explain the difference between expectation damages and reliance damages in the case of **Hawkins v. McGee, 84 N.H. 114, 146 A. 641 (N.H., 1929),** (the case where the plastic surgeon promised to repair a boy's scarred hand).

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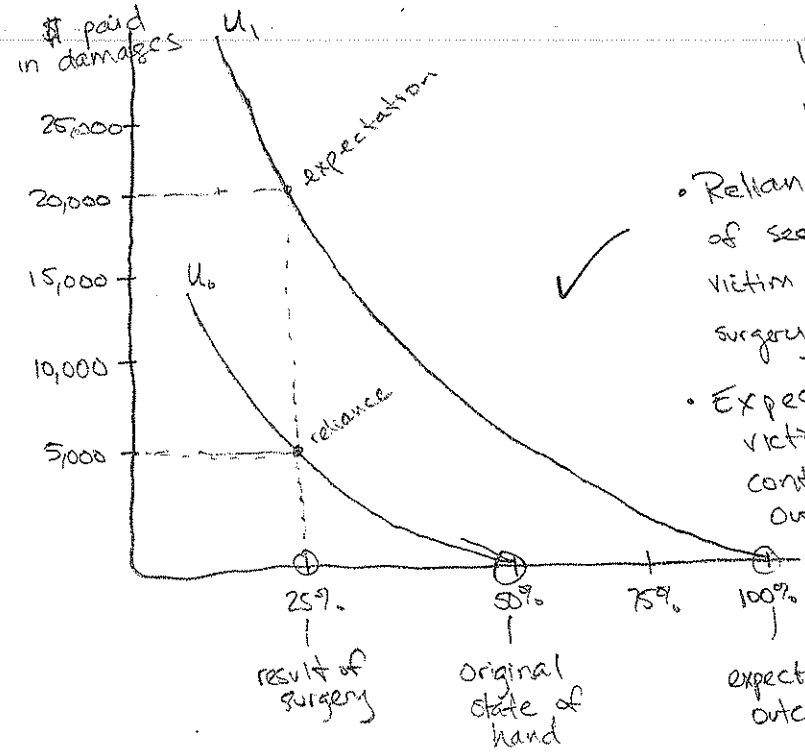

U_0 - reliance damages

U_1 - expectation damages

- Reliance damages compensate the cost of seeking out the surgery & restores the victim to their original utility before the surgery.
- Expectation damages compensate the victim for expected utility if the contract had actually been carried out as promised. Expectation costs always tend to be higher.

4. In the classical theory of tort law, what are the three elements of a tort that are essential for the decision to go to the plaintiff?

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① Breach of duty owed to the plaintiff by the defendant

✓ ② Harm suffered by the plaintiff

③ The breach of duty was the immediate or proximate cause of the harm suffered by the plaintiff.

20 point questions:

5. Omega Corporation offers to sell a crane which it values at $10,000. The Alpha Company intends to bid $12,000 for the crane, but due to a typographical error, the bid is transmitted at $15,000. The Beta Company bids $13,000. There are no other bidders. Omega turns down the bid from Beta and accepts Alpha's bid. Subsequently, the mistake is discovered by Alpha, who offers to proceed only at the lower price of $12,000. Omega sues for the full $15,000. Beta is still prepared to pay $13,000 for the crane. The options before the court are: (i) declare that there was no contract due to mutual mistake; (ii) declare that a valid contract was breached and award damages; or (iii) enforce the contract according to its terms.

12 v 15

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$3,000 damages to Omega 15,000 owed

2,000 < 3,000 But they don't get crane

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a) Suppose the court chooses option (i). How will the surplus be shared and who will end up owning the crane?

b) Suppose the court chooses option (ii). What should damages be? How will the surplus be shared and who will end up owning the crane?

c) Suppose the court chooses option (iii). How will the surplus be shared and who will end up owning the crane?

a.) In this scenario, the contract is simply voided & the biddings would reopen. Therefore, Beta company will end up owning the crane because they will bid more than Alpha. ✓

B.) In this scenario, Omega still must be compensated, so it could be the case that Alpha is forced to simply pay $2,000 in damages & then Omega proceeds to sell the crane for $13,000 to Beta. Alternatively, Alpha could simply pay the $15,000 to Omega & then sell the crane to Beta for $13,000. Either way, Omega is just as well off as if the contract was not breached and Beta ends up owning the crane regardless because a crane is only worth 12,000 to Alpha. (and even though Alpha will have to pay more than 12K because of the damages they incurred from this mistake. 14K is still < 15K.) ✓

C.) In this scenario, Alpha pays 15K for the crane and then sells the crane to Beta for 13K. Then Alpha will try to acquire a crane for 12K (making their total = 14K). (If Beta knows the scenario they could possibly try to buy the crane from Alpha for something like $12,500). In all 3 scenarios Beta winds up owning the Omega crane. ✓

6. The following is a list of possible defenses and excuses a defendant might use in a breach of contract case: (a) incompetence, (b) duress, (c) necessity, (d) impossibility, (e) frustration of purpose, (f) mutual mistake, (g) duty to disclose, and (h) fraud. Pick any five, explain what each defense or excuse means, and then give an example of it.

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A) Incompetence: Incompetance by a party to a contract establishes that the individual does not have well ordered / stable pretrences, due to age, mental capacity, or even Drunkenness. Courts should not uphold contracts involving incompetant parties, because that would incentivize exploitation, & lower efficiency

B) Duress: Duress is an excuse for breech, as the contract may have been negotiated as a result of coercion. If a coercive claim is made, the bargain or exchange would actually destroy value, not create: An example would be, "Sell me that car for $500 or I will burn your house" Duress also makes people fully constrained & therefore not rational.

C) Necessity: Any bargain made of of Necessity may also be excused from enforcement, for it can be exploitative. Suppose A limb was hanging over the roof of my house and I contract you, the only limb removal service in operation due to an emergency (ice storm). You set a price of $20,000 to remove the limb. If the limb were not to be removed it will surely fall and cause much more than $20,000 damages, so I agree to the terms. Later I renege, claiming $20,000 is too much as the normal fee under normal circumstances is only $500. Since the contract was made under Necessity to save my home and I was more than Limitedly constrained, it should be excused.

D) Impossibility: A contract should be excused if unforseen / extreme circumstance have made execution impossible. Acts of God / Nature are often good examples. Suppose I was contracted to deliver 500 pigs for slaughter, but they all got swine flu and died, it would be impossible for me to deliver upon my promises.

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F) Frustration of Purpose: Unlike impossibility, the action may still be able to be executed, however the reason underlying the demand for the action has changed/gone away; thus leaving execution of the contract moot. For example, a coronation Parade is set to take place May 7th 2009 for the Grand Baron, but due to illness it is rescheduled. Suppose a landowner rented out vacant lots along the parade route and concreted the agreement with a contract. While the vendors could still set up shop on the May 7th, their efforts would be fruitless since there was no parade. Therefore the Purpose of the contract has been frustrated and the lowest cost bearer should assume the burden.

7. If soft drinks are manufactured in glass bottles, the production cost per unit is 40 cents, the chance of an accident is 1/100,000, and the loss if an accident occurs is $10,000. If soft drinks are manufactured in metal cans, the production cost per unit is 43 cents, the accident probability is 1/200,000, and the loss if an accident occurs is $4,000. Precaution by the consumer has no impact on either the probability or the severity of an accident.
   a) What is the expected loss per unit from accidents if bottles are used? if cans are used? From society's point of view, would it be more efficient for soft drinks to be packaged in glass bottles or metal cans?
   b) Suppose consumers do not comprehend the risks of drinking soda out of either bottles or cans. Suppose also that manufacturers bear no liability for an accident. What type of container will be used and will the outcome be efficient?
   c) Now suppose that courts adopt a rule of strict liability in cases like this. What type of container will be used and will the outcome be efficient?

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Bottle $ESC = wX + P(x)A(x)$

Can $ESC' = wX + P(x)A(x)$

a) Bottles

$ESC = .40(1) + (1/100{,}000)(1)(10{,}000)(1)$

$= .40 + .1 = \$0.50$ / bottle ✓

Cans

$ESC' = .43(1) + (1/200{,}000)(1)(4{,}000)(1)$

$= .43 + .02 = \$.45$ / can ✓

Society would prefer cans because the expected social cost per can is lower than for bottles.

b) Bottles would be used because no liability means that in the case of any accident, they don't have to pay anything. Therefore their level of precaution will = 0 or at least be less than cans, and society will internalize all of the risk, leading ✓ to inefficient behavior by soda manufacturers.

c) The can will be used because, regardless of the price of precaution, the soda company can be held liable for any precaution it does not take. If they are found to be negligent, they must internalize the total cost of the accident, whereas society does not have to take any precautions at all. The outcome will be ✓ efficient behavior by soda companies, but not by consumers.