EC337 – Spring 2013 – Breach of Contract Examples

Suppose that A owns a car, and that B would like to buy the car. A values the car at $12,000 (which means that his level of utility when he has the car is the same as if he had $12,000 in cash). B values the car at $18,000. But B only has $15,000 in cash to start with, and does not possess the car. Suppose that A and B form a contract that states that A will sell the car to B in return for $15,000 in cash in one week's time.

State the utility levels of each party and the total across the two parties in each of the following scenarios:

1) Before the contract is formed;
2) If the contract is performed;
3) If the contract is breached because A sells to C for $20,000 instead (and does not pay B any compensation);
4) If the contract is breached because A sells to C for $20,000 instead, and A is forced to transfer enough cash to B so that B's utility is the same as it would be under her "expectancy" of the contract being performed.

utility levels ($k)	A	B	total
1)	12 (car, no cash)	15 (cash, no car)	27
2)	15 (cash, no car)	18 (car, no cash)	33
3)	20 (cash, no car)	15 (cash, no car)	35
4)	17 (20 – comp. in cash)	18 (15 + comp. in cash)	35

Note that the compensation paid from A to B ("comp."), by definition of "expectancy", must equate B's utility level under 4) with B's utility level under 2) (i.e. the scenario in which the contract is performed as agreed), and that B's utility level under 4) is just her starting utility (same as in 1) and 3)) plus the compensation. This gives us a very simple equation to solve and find that the compensation in this case must be $3k.

We say that this situation is an "efficient breach" because total utility under the breach ($35k) is greater than total utility if the contract is performed as written ($33k). In other words, the total surplus is higher under 3) than under 2). When the total surplus is higher, there is at least a "potential efficiency improvement". But going from 2) to 3), there is NOT a "Pareto Efficiency improvement", which would require EACH INDIVIDUAL to be made better off. Going from 2) to 3), A is made a lot better off, but B is made worse off.

However, when there is a payment of compensation to the injured party, a Pareto improvement can be effected if the compensation is enough to leave the injured party at least as well off as she would have been under the performance of the contract. The "expectancy" rule ends up granting the minimum level of compensation necessary for this to hold.

What are A's private incentives if he knows that there is an "expectancy" rule in place and he knows that B will sue him if the contract is breached? A's utility level under 4) is greater than

his utility level under 2), so A will still want to breach the contract. And we have just argued that this breach is efficient. Thus, the "expectancy" rule facilitates breaches of contract when such breaches are efficient.

What if the same contract between A and B is made (i.e. A will sell the car to B in return for $15,000 in cash in one week's time), then D comes along and makes a competing offer to buy the car from A for $16k? (Person C doesn't exist in this example.)

Again, state the utility levels of A and B, and the total across the two parties, in each of the following scenarios:

1) Before the contract (between A and B) is formed;
2) If the contract is performed;
3) If the contract is breached because A sells to D for $16,000 instead (and does not pay B any compensation);
4) If the contract is breached because A sells to D for $16,000 instead, and A is forced to transfer enough cash to B so that B's utility is the same as it would be under her "expectancy" of the contract being performed.

utility levels ($k)	A	B	total
1)	12 (car, no cash)	15 (cash, no car)	27
2)	15 (cash, no car)	18 (car, no cash)	33
3)	16 (cash, no car)	15 (cash, no car)	31
4)	13 (16 – comp. in cash)	18 (15 + comp. in cash)	31

Comparing scenario 3) to scenario 2), A would be better off, but the total surplus would be lower. So in this case, there is no "potential efficiency improvement". In other words, breaching is inefficient in this case.

But if there is an "expectancy" rule in place, A will not want to breach in this case, since, after selling to D and paying $3k in compensation to B, he will be left with only $13k, which is less than the $15k he would get under 2) by performing the contract. Thus, the "expectancy" rule does NOT facilitate breaches of contract when such breaches are inefficient.

(Note that, in both examples, instead of there being some third party – C or D – willing to pay some other price, the same arguments would hold if A suddenly changed his valuation of the car after the formation of the contract.)

How can courts calculate B's "expectancy" utility level? (Or how could A hope to accurately predict it when deciding to breach or not?) In practice, this is usually done with reference to a "fair market price" for a similar car (in the absence of other complications such as the car being

relied upon for other contracts and a much more expensive car needing to be purchased in an emergency to fulfill those other contracts, for example).

But what if there is something very specific about this car that is of great value to B specifically? That is, what if the "fair market price" for similar cars as the one in question is $15,500, but B's true valuation of this specific car is $18k due to some individual-specific sentimentality or something? Continuing with the second example in which D makes a competing offer of $16k, suppose that the court finds the "fair market price" to be $15,500 and does not attempt to evaluate any "sentimentality value", and that A knows for sure that the court will do this.

utility levels ($k)	A	B	total
1)	12 (car, no cash)	15 (cash, no car)	27
2)	15 (cash, no car)	18 (car, no cash)	33
3)	16 (cash, no car)	15 (cash, no car)	31
4)	15.5 (16 – comp. in cash)	15.5 (15 + comp. in cash)	31

In this case, the "expectancy" rule will lead to payment of just $500 in compensation to B, since B's "expectancy" value of utility if the contract had been performed is being incorrectly estimated to be just $15,500.

Breaching the contract is still inefficient under the same argument as before and under our (as analysts) better information about B's valuation relative to the court. But, unfortunately, now A has an incentive to breach: 15.5 > 15.

So the "expectancy" remedy rule can lead to inefficient outcomes if there is poor information about the injured party's valuation.

In part to address cases like the previous example, an alternative remedy rule – which is particularly popular when "intangible" value is thought to be important, such as with collectibles – is "specific performance", which literally forces the original contract to be performed as specified.

Under "specific performance", if A were found to have breached the contract in the second example, he would be forced to recoup the car from D (which might involve further legal action or expenses between the two of them), then sell the car to B under the original terms of the contract. If A knew that this remedy would be imposed, he would not have any incentive to breach the contract in the first place. So, in the second example, in which breaching is inefficient, A would not breach. The "specific performance" remedy rule does not facilitate breaching when breaching is inefficient.

What about the first example, where breaching is efficient? In this case as well, A does not appear to have any incentive to breach (because he will either have utility of 15k from fulfilling the contract, or utility of at most 15k from breaching and then subsequently being forced to fulfill the original contract). So it looks like the "specific performance" remedy rule does NOT

facilitate breaching when breaching is efficient. But it turns out that this will only be true if transaction costs are high. HOWEVER, if transaction costs are low enough, private parties will be able to bargain to the efficient outcome after a breach and a "specific performance" order.

For example, suppose that A breaches the contract with B and sells to C instead. And suppose that A is then ordered to get the car back from C and fulfill the original contract with B. At this point, A could instead just offer to share some of his profit with B and save the hassle of tracking down C. As long as B is left with a utility level of at least 18k, she will be at least as well off with A's payment and no car as she would be with the car. This would require A to pay at least $3k as a bribe – but A would be willing to pay up to $5k, since this would leave him with a utility level of 15k on net, which is the same as he would get if he followed through on the specific performance order. So there is a bargaining range, and A and B should therefore be able to decide on a payment between $3k and $5k, paid by A to B, that leaves B at least as well off as with the car. Even though C will still have the car, B will be happier and thus not inclined to insist that the specific performance order actually be carried out. So if transaction costs are low and if A can foresee all of this, A will decide to breach, which is efficient in this case.

(This is very much like the argument we made concerning injunctions in property cases: the injunction does not have to be followed through on literally if a private agreement can be struck that satisfies the injured party to the extent that no further legal action will be taken. If transaction costs are low, the bargaining between the parties will determine a suitable damages payment, and the efficient outcome will be reached just as surely as if the court had determined the right damages amount and ordered it to be paid.)

Of course, if transaction costs were low, the lawsuit would be avoided in the first place. One possible outcome is that A sells to B, then B just turns around and sells the car to C (for some price between $18k and $20k). Or, accomplishing essentially the same thing in one step, with the contract between A and B in place, C could offer something more than $15k to A for the car and something more than $3k to B as compensation, and all three will be better off as long as C pays $20k or less in total.