Economics of Contract Law

Douglas G. Baird

The Oxford Handbook of Law and Economics: Volume 2: Private and Commercial Law
Edited by Francesco Parisi

BEFORE law and economics entered the scene, contracts scholarship had not advanced much beyond Fuller and Perdue's exploration of contract damages in an article in the *Yale Law Journal* published in 1936. By Fuller and Perdue's account, contract law must in the first instance confront competing theories of relief. . . . The choice between them required a normative assessment of the protection an innocent party deserved—compensation equal to the full benefit of the promise, restoration to where she had been before the promise was made, or recovery of any benefits she had bestowed upon the party who had broken the promise. . . .

The first generation of law-and-economic scholars entered this debate in the early 1970s (Posner 1972; Barton 1972). For them, notions of corrective justice and intuitions about fairness were off the mark. What mattered was that those who contemplated breaking a promise took account of the costs their conduct imposed on others. Far from being morally objectionable, keeping a promise or breaking it might be good or bad depending upon the circumstances. The role of contract law was to ensure that the incentives were aligned to ensure that breach took place only when it made economic sense. . . .

1.1. The Expectation Damages Principle

The common law, as a general matter, awarded disappointed litigants money damages. In the case of a breach of contract, those who broke promises were neither forced to perform nor punished. Instead, disappointed promisees were entitled to what Oliver Wendell Holmes called, "a compensatory sum" (1897). "Breachers" had to put their contracting opposites in the same position they would have been in had the promise been kept. They could not escape with less, but they did not have to pay more.

Richard Posner (1972) showed that there was a very simple and straightforward way of making sense of such a rule. Making promises legally enforceable allows parties to count on the other's performance. They can invest in the relationship, knowing that either the promise will be kept or they will be left in the same economic position as if it had. Because they will be compensated in the event of a breach, they will make investments that they would otherwise recoup only if the promise were performed. You can spend the resources needed to build the custom machine for me, confident that you will not be out of pocket if I breach and you are left with a machine that

no one else can use. In a competitive market, expectation damages are an excellent way to capture all the ways, direct and indirect, in which someone relies on the existence of a contract.

At the same time, the law should not give innocent parties more than expectation damages. Circumstances can change. My costs of keeping a promise may become larger than the benefits it brings to you. Keeping the promise is no longer in our joint interest. A law of contracts should focus on maximizing our joint welfare at the time of performance. It should induce parties to keep their promises when, but only when it is socially optimal that they do so.

A rule that requires me to pay a compensatory sum when I breach forces me to take account of the harm my breach has on you. When I breach, you are paid an amount that makes you indifferent to my performance. I shall breach only if it makes me better off without leaving you worse off. The law of contract forces me to take into account the costs of breaking my promises just as the law of tort forces me to take account of the costs of socially undesirable conduct. In both instances, the common law rules work to induce individuals to internalize the harm that their conduct imposes on others.

When Holmes asserted that the law of contracts gave the bad man an option to perform or pay a compensatory sum, he took no position on whether keeping a promise was good or bad. Holmes (1897) saw himself as a pragmatist giving an account of law as it was. Whether keeping a promise was required as a moral or ethical matter was not relevant to the task at hand. In providing his explicitly economic justification for the common law of contract, Richard Posner went a step further. In his view, the ethical notion that it is good to keep promises is wrong-headed. The rule of expectation damages is desirable precisely because it encourages breach when it is efficient. Society as a whole is better off if people keep promises only in those situations in which it is socially efficient that they do.

This effort to use economics to explain contract law has come under fierce criticism (Schiffrin 2007). The idea that breaching a promise was affirmatively desirable was provocative and perhaps deliberately so. The idea of "efficient breach" cuts strongly against the moral intuition that promises should be kept. But it is possible—perhaps even desirable—to talk about Posner's contribution without engaging this debate. Quite apart from the morality of breaking promises, it was a significant advance over previous accounts of contract to show that expectation damages sensibly realign incentives, and it is a long step toward understanding the foundations of contract law. . . .

1.4. Default Terms

At the same time it was wrestling with the question of expectation damages and whether it was in the mutual interests of the parties, economics was used to shed light on contract's substantive rules. Contract law simply provided the parties with terms that advanced their mutual interest. In a world in which we are committed to free contracting, these terms, like expectation damages, should be the rule only until parties negotiating at arms' length bargain for something else. Contracts are incomplete, and the law is needed to fill in the gaps. When parties enter into a deal with each other, there are many things left unspoken. It could be a warranty term, a delivery date, or questions about who bears the risk of loss when the goods are destroyed in transit. Merchants ordinarily do not have the time or the money to spell out every particular detail.

In the 1970s, the literature talked about contract law as providing parties with a set of "off-the-rack terms" (Goetz and Scott 1977). Contract law is not a set of abstract principles but rather a set of premade contract terms. Contract law saves parties the costs of drafting a long contract every time they deal with one another. Contract law provides a set of off-the-rack terms. Like off-the-rack clothes, they do not necessarily fit perfectly, but they fit most people, most of the time.

Tailoring contracts, like tailoring clothes, takes time and money. Like bespoke clothes, they are more costly. For the vast majority of people, however, ordinary terms will do. Most are content with the terms contract law gives them. You may be a special person. You may be especially large, extra tall, extra short, or extra whatever. The clothes you find on the rack do not fit you. You may want to get your clothes custom-made. Similarly, if you are a contracting party, when your needs are special, you can get your own customized terms.