Chapter 4
The statute of frauds
The holdup problem

The statute of frauds

The Statute of Frauds was originally passed by Parliament in 1677 and required contracts exceeding a certain value (most commonly, contracts for the sale of land) to be in writing. Nearly every state in the U.S. has some version of this statute. Is there an economic rationale for such a requirement? In particular, what are the offsetting costs and benefits, and why would contracting parties have to be compelled to put certain contracts in writing?

When a contract is not in writing, two types of legal error can result: the court can find an enforceable contract when none was intended (a type I error), or it can find that no contract exists when one was intended (a type II error). A type I error can arise when a party falsely claims that another party had made a contract with him, and a type II error can arise when a party seeks to get out of a contract that has turned out to be unfavorable to him. Written contracts enhance efficiency by reducing the likelihood of these types of errors, but the gain must be weighed against the cost of putting the contract in writing. It follows that not all contracts should be in writing. Since the more valuable a contract is the costlier will be an enforcement error, it makes sense that more valuable contracts should be the ones put in writing.

But why is a statute necessary to achieve the efficient outcome? Although the immediate parties to a contract internalize the cost of putting it in writing, as well as the cost of non-enforcement of their intended contract (a type II error), they do *not* internalize the cost of false claims by third parties that a contract exists (a type I error). As a result, contracting parties will tend to put too few contracts in writing, absent a statutory requirement.

The holdup problem

The problem of contract modification as discussed in the context of the *Alaska Packers* and *Goebel* cases illustrates what economists call the "holdup problem." This arises when two parties enter a contract that requires one of them to make a non-salvageable investment prior to trade, which then confers some bargaining power on the other party. Thus, even if the parties had agreed upon an initial price of the transaction, once the first party's investment has been made, thereby locking them into the transaction, the second party can seek a price increase in an effort to capture a larger share of the surplus from the exchange. Note that this happened in both of the above cases. In *Alaska Packers*, the fishing company outfitted a ship at some expense and then went out to sea, at which point the sailors demanded a wage increase. In *Goebel*, the brewery brewed a quantity of beer that would have spoiled without ice, so the ice company was able to demand a price

increase. The problem that this subsequent renegotiation creates is that the first party may be less willing to make productive investments, knowing that the second party will be able to extort a higher price later. This possibility is why binding contracts are valuable in such situations. Specifically, they protect the first party's expected gain from making the initial investment.

The difference in the two cases was that the price increase in *Goebel* was justified by a genuine rise in the cost of ice, which was the reason the court allowed the increase to stand. The general rule that courts have arrived at is that cost-justified increases are enforceable, whereas purely opportunistic increases (like the one in *Alaska Packers*) are not. This turns out to be exactly the efficient rule. (See T. Miceli, "Over a Barrell": Contract Modification, Reliance, and Bankruptcy, International Review of Law and Economics*,* Vol. 22, 2002: pp. 41-51.)