

## Chapter 4

### The Economics of Contract Law I: The Elements of a Valid Contract

This chapter begins the analysis of contract law by describing the elements that constitute a valid contract. Specifically, it asks what must be true of a promise for it to be legally enforceable.

#### Key Points

- Contract law provides the legal background for economic exchange by enforcing voluntary agreements.
- Contracts cannot always provide for contingencies that might arise between the formation of the contract and the performance date. The economic theory of contract law says that courts should supply the missing terms in these *incomplete contracts* so as to maximize the gains from trade.
- From a legal perspective, a valid contract includes three elements: *offer*, *acceptance*, and *consideration*. When offer and acceptance are present, the parties are said to have achieved a “meeting of the minds.”
- Consideration is the return promise that makes a contract mutual. Consideration need not be a monetary payment. It can also be a voluntary surrender of a legal right. Under traditional contract law, courts only inquire into the presence of consideration, not its form or adequacy.
- A contract is invalid if one or both of the parties is *mentally incompetent*; if one of the parties entered the contract under *coercion* or *duress*; if the contract involves a *mutual mistake*; or if the terms of the contract are *unconscionable*. These excuses are referred to as formation defenses.
- The proper economic interpretation of coercion or duress is that it concerns prevention of monopoly.
- The doctrine of mistake concerns the rules for disclosure of private information prior to contracting.
- Economic theory says that the disclosure rule is irrelevant when information was casually acquired (i.e., without deliberate effort).
- However, the disclosure rule matters when information was deliberately acquired. In this case, the court should require disclosure of information that was deliberately acquired but is purely distributive, whereas it should not require disclosure of information that was deliberately acquired but is socially valuable.

- The doctrine of unconscionability invalidates contracts whose terms appear to be grossly unfair at the time of performance. This rule is economically justifiable if the unfairness reflects a true defect in the formation of the contract (for example, fraud, coercion, or incompetence), but not if it merely reflects an unfavorable outcome for one of the parties. The problem is that it is not always possible to distinguish these two types of situations after the fact.