

ECON & LAW

QUESTIONS FROM OLD EXAMS

PROPERTY

1. When one party's otherwise legitimate use of his or her property creates a nuisance for another property owner, the former can be ordered to pay compensatory damages to the latter. This was the case, for example, in *U.S. v. Causby* (where noise from military aircraft damaged a chicken farm), in *Orchard View Farms v. Martin Marietta* (where fluoride emissions from aluminum production nearby damaged orchard crops), and in *Boomer v. Atlantic Cement* (where noise and dust from cement production reduced residential property values).
 - a. Considering only compensatory damages (and assuming that the damages are accurately estimated) what economic purpose is served by:
 - i. collecting the damages from the property owner who is the source of the nuisance;
 - ii. paying the damages to the property owner who is the victim of the nuisance.
 - iii. Does your answer in a.i. above still hold if the damages lead to bankruptcy for the owner of the nuisance? Briefly explain.
 - b. In *Orchard View Farms* the court ordered Martin Marietta to pay not only compensatory damages, but *punitive* damages as well. Are punitive damages justified by the same argument you gave in part a.i. above? Briefly explain.
 - c. In *Boomer* the court emphasized that it was departing from the traditional nuisance remedy. What was the traditional remedy and why was departure from that remedy economically sensible in *Boomer*?
2. Ronald Coase has argued that, in analyzing conflicting legal rights, it is more useful to think in terms of the *reciprocal* nature of the dispute than in terms of one party being the *cause* of the other's harm. Below I have described some of the disputes we analyzed in the latter fashion.
 - a. Pick any TWO and illustrate their reciprocal nature a la Coase.
 - i. Orchard View Farms alleges that Martin Marietta's fluoride emissions are the cause of damage to its apple crop.
 - ii. Physician Sturges argues that noise from confectioner Bridgeman's candy factory causes him difficulty in treating patients in his new examining room.
 - iii. Del Webb argues that the foul smell emanating from Spur's nearby feedlot is damaging his attempts to sell houses in his Sun City development.
 - iv. Boomer claims that dust, noise and vibrations from the Atlantic Cement plant have caused the value of his property to drop.
 - b. Coase also argued that liability should be assigned to the "best (i.e., lowest) cost avoider." Why is looking at these disputes in as reciprocal more conducive to identifying the best cost avoider?
3. Dan's Development Co. has constructed a tract of 10 new houses that he hopes to sell for \$300,000 each, or \$3 million total. However, he finds that the market value of his houses is reduced by the presence of two nearby businesses. The noise of the barking dogs in Karen's Kennel reduces the market value of the houses by \$5,000 each (\$50,000 total) and the smell from Fred's Feedlot reduces the value of the houses by another \$25,000 each (\$250,000 total). Both nuisances could be eliminated if Karen and Fred moved their businesses. Moving would cost Karen \$75,000 and Fred \$200,000. The barking dog nuisance could also be eliminated if Karen enclosed her boarding facilities at a cost of \$50,000.
 - a. Suppose that, before Dave sells any of his houses, he sues for an injunction that would shut down Karen's and Fred's businesses. Use the Coase Theorem to explain and evaluate (on efficiency grounds) the ultimate outcome of the dispute if
 - i. Dave wins
 - ii. Dave loses
 - b. What is the significance of the assumption that Dave sues *before* the houses in his tract have been

- sold? What difference would it make if all of the houses had been sold before the nuisances became a problem?
4. Daisy has converted her cattle ranch into a dude ranch but the presence of two neighbors, Fred the feedlot owner and Charlie the chicken rancher, hampers her business and depresses the value of her dude ranch. In particular, the smell of Fred's feedlot reduces the value of the dude ranch by \$125,000 and the squawking of Charlie's chickens by another \$25,000. These costs could be avoided if either Daisy moved, which would cost her \$160,000, or Fred and Charlie moved, which would cost Fred \$100,000 and Charlie \$30,000. Charlie's noise nuisance would also be eliminated if he switched from chickens to rabbits, which would cost him \$20,000. Daisy sues for an injunction that would enable her to shut down Fred and Charlie.
 - a. What is the economically efficient solution to this dispute and why?
 - b. Briefly describe the negotiations that would follow each of the following legal outcomes, and tell what the ultimate result of the negotiations would be.
 - i. The court grants both injunctions on the legal technicality that Daisy's brother happens to be the judge.
 - ii. The court denies Daisy's injunction on the grounds that, having converted her ranch, she came to the nuisance.
 - iii. The court grants both injunctions but, since Daisy came to the nuisance, orders that she indemnify Fred and/or Charlie for any moving expenses they incur.
 - c. Would Fred prefer outcome ii. or iii. above? What about Charlie?
 5. For years the noise from evening rock concerts at the Coastline Amphitheater have been regarded as a nuisance by the citizens of nearby Palo Alto, whose property values have declined by an aggregate \$25 because of the noise. Coastline could eliminate the problem in any one of three ways: (i) it could install noise baffles at a cost of \$7; (ii) it could no longer schedule rock groups but only string quartets and, as a result of decreased revenues, suffer a \$12 wealth loss; or (iii) it could move at a cost of \$18. The Palo Alphans could solve the problem themselves by soundproofing their homes at an aggregate cost of \$15, but instead they have chosen the legal route, authorizing the Palo Alto Homeowners' Association (PAHA) to act on their behalf in bringing suit against Coastline and conducting any negotiations that arise as a result of that suit. PAHA is seeking an injunction that would force Coastline to move. Describe the negotiations that would follow each of the following legal outcomes and, in each case tell what the final result of those negotiations would be.
 - a. PAHA wins its injunction.
 - b. PAHA's request for an injunction is denied.
 - c. PAHA's injunction is denied, but the court orders Coastline to schedule only string quartets.
 - d. PAHA's injunction is granted, but the court orders the citizens of Palo Alto to indemnify Coastline for its moving costs.
 - e. PAHA's injunction is denied, but the court orders Coastline to pay damages to compensate the Palo Alphans for the decline in their property values if the noise continues.
 6. Suppose that the tower the Fountainbleu (FB) wants to add to its hotel would gain it \$1,000,000 in profit but reduce the profits of its neighbor, the Eden Roc (ER), by \$750,000 unless ER moved its pool and sundeck, at a cost of \$400,000, to an area unaffected by FB's tower. FB and ER took their dispute to court, FB claiming the right to build a tower that would obstruct ER's sunlight and ER claiming the right to unobstructed sunlight. In order to resolve this conflict, the court had to determine whose right prevailed and how that right should be protected. For each of the following combinations of right and remedy, describe the court's decision and predict the final outcome in this low transactions cost setting.
 - a. The court awards the right to ER and protects it with a property rule.
 - b. The court awards the right to FB and protects it with a property rule.
 - c. The court awards the right to ER and protects it with a liability rule.
 - d. The court awards the right to FB and protects it with a liability rule.
 7. Both *Ploof v. Putnam* and *Vincent v. Lake Erie Transportation Co.* involved disputes between the owner of a dock and the owner of a boat who wishes to moor at the dock. In such disputes the right could be awarded to

either party and it could be protected by either a property rule or by a liability rule.

- a. Briefly explain the meaning of each possible combination. (Also indicate which the court choose in *Ploof* and which in *Vincent*.)
 - i. dock owner's right protected by a property rule
 - ii. dock owner's right protected by a liability rule
 - iii. boat owner's right protected by a property rule
 - iv. boat owner's right protected by a liability rule
 - b. Under ordinary conditions, which of the above makes the most economic sense and why? Does it still make sense under the extraordinary conditions of an unexpected storm as was the case in both *Ploof* and *Vincent*?
 - c. What, if any, economic rationale is there for choosing between the *Ploof* approach and the *Vincent* approach?
8. "Your rights to your property is protected by a *property rule* when it comes to other private parties who might want to take or use your property. However, by the constitutional power of eminent domain, your rights are only protected by a *liability rule* when it comes to a governmental body that might want to take or use your property."
- a. Briefly explain the meaning of the foregoing statement.
 - b. Why is protecting your right by a property rule consistent with value maximization under normal circumstances?
 - c. Under what special circumstances can one make an economic argument justifying the use of eminent domain by the government? What is that argument?
 - d. Given your justification of eminent domain in part c. above, can you conclude that coerced transfers of property (i.e., "condemnations") in eminent domain proceedings are consistent with value maximization? Briefly explain.
9. In *U.S. v. Causby*, the Supreme Court found that army air corp overflights had destroyed the value of the Causby chicken ranch and thus constituted a governmental "taking." The Court therefore ordered the government to pay "just compensation" to Causby for the loss of his chicken ranch as mandated by the fifth amendment to the U.S. constitution.
- a. What principle is used to determine "just compensation" for governmental takings?
 - b. Is the principle in part a. necessarily consistent with value maximization? I.e., does the government's willingness to pay such compensation evidence that it attaches a higher value to the use of Causby's property than Causby does? Briefly explain.
 - c. Suppose that, contrary to the facts in the case, the government had wanted to actually take physical possession of Causby's property. (For example, suppose it wanted to convert the property into an airstrip for military aircraft.) Would an eminent domain taking of that property be justified by the kind of economic argument for eminent domain that we discussed in class? Briefly explain.
 - d. In this case, Causby's rights were protected by a *liability rule*. How would things have differed if, instead, they had been protected by a *property rule*? Would the latter have guaranteed that Causby's property be put to its highest valued use? Briefly explain.
10. The citizens of the city of Los Peros have revealed in a recent election that they are willing to pay up to \$2 million for a public art gallery. The city could build a new gallery from scratch for that amount of money. Alternatively, it could use its eminent domain powers to acquire the local Chillblaine mansion for use as a gallery. Although the mansion has a market value of \$1.8 million, the Chillblaine family has agreed that they would not sell it for any amount less than \$2.3 million.
- a. Would Los Peros' use of eminent domain be justified by the kind of argument we made in class? Briefly explain.
 - b. Would Los Peros' use of eminent domain to acquire the Chillblaine mansion be justified on the grounds of economic efficiency (i.e., value maximization)? Briefly explain.
 - c. Would Los Peros' use of eminent domain to acquire the Chillblaine mansion provide the Chillblaine family with "just compensation"? Briefly explain.

- d. Would any of your answers in parts a.-c. above change if the citizens of Los Peros were willing to pay \$2.5 million instead of just \$2 million for the new gallery? Briefly explain.
11. The majority opinion in *Mahon v. Pennsylvania Coal* established the precedent for determining when a regulatory taking has occurred and compensation must be paid.
- What is that precedent? On what grounds can that precedent be criticized?
 - The dissenting opinion in that same case argued that the determination of a regulatory taking should depend upon whether the regulation appears to stem from the government's *police power* or its *power of eminent domain*. Briefly state this argument.
 - Apply the argument in to the following: The city council passes a rent control ordinance intended to provide "affordable housing". The ordinance reduces the value of the apartment buildings subject to rent control. Should the owners of those buildings receive compensation?

CONTRACT

12. In the case of *Rexite Casting v. Midwest Mower*, Rexite found itself in a position where it could opportunistically raise the price of the castings it was selling Midwest. In the case of *Lake River Corporation v. Carborundum Co.*, Lake River insisted on a penalty clause to protect itself against possible opportunistic behavior on the part of Carborundum. What common characteristic of these exchanges raises the danger of opportunistic behavior?
13. In the cases of *Stelmack v. Glen Alden Coal Co.* and *Mills v. Wyman* promises were held to be unenforceable because of lack of consideration. In the former, it was Glen Alden's promise to repair Stelmack's buildings if they were damaged by Glen Alden's mining operations; in the latter it was Wyman's promise to reimburse Mills for caring for Wyman's sick son.
- How should Stelmack have responded to Glen Alden's promise to repair his buildings if he wanted that promise to be legally enforceable?
 - What would be the *economic* significance of such a response on the part of Stelmack?
 - In *Mills v. Wyman*, the court suggested that, although there are no *legal* grounds to force Wyman to honor his promise, there might be *moral* grounds. Might there also be *economic* grounds? Briefly explain.
14. In the case of *Sherwood v. Walker*, the court voided the contract for the purchase of a cow by Sherwood on the grounds of "mutual mistake," apparently believing that Sherwood and Walker assumed they were negotiating over a barren cow when in fact the cow was pregnant and therefore a breeder. However, there are at least two other ways to think about this case: (a) in terms of differential information, and (b) in terms of efficient risk allocation.
- In terms of differential information, suppose that Sherwood knew, or strongly suspected, that the cow would breed but withheld this information so that he could purchase her at a much lower price as a barren cow. (The dissenting opinion indeed suggests that this may have been the case.) Should this change the court's decision? Briefly explain.
 - In terms of efficient risk allocation, who should bear responsibility for the unforeseen contingency that the cow turns out to be a breeder, Sherwood (the buyer) or Walker (the breeder), and why? Would this approach change the court's decision?
15. In *Wilkin v. 1st Source Bank*, the Wilkins agreed to clean out the house they were about to buy from the bank on the condition they could keep any personal property they found. However, when the bank learned that the Wilkins had found valuable art work in the house, it sued to void the agreement.
- The court ruled for the bank, voiding the agreement on the formation defense of *mutual mistake*. What is the economic rationale for voiding contracts based on mutual mistake?
 - Suppose that the Wilkins had agreed to clean the house only after they hired an appraiser whose

preliminary inspection suggested that it might contain valuable artwork. (They did not share the appraiser's report with the bank.) Should that change the court's decision? Briefly explain.

16. In some of the contract cases we read (e.g., *Canadian Industrial Alcohol v. Dunbar Molasses, Transatlantic Financing Corp. v. U.S.*) a change in conditions made it much more costly, sometimes even literally impossible, for the promisor to complete his contractual obligations. What issues should the court examine to determine whether the promisor should be held liable for damages in such cases? Briefly explain.
17. In the case of *Lake River v. Carborundum*, Lake River insisted on a liquidated damages clause specifying that Carborundum pay Lake River \$533,000 in the event of breach by Carborundum. Carborundum breached after paying all but \$240,000 so Lake River sued for that amount, even though its actual damages were only \$83,000. Carborundum's breach save it \$150,000.
 - a. Is Carborundum's breach economically efficient? Briefly explain.
 - b. What would have happened if the court had enforced the liquidated damages clause? Briefly explain.
18. "I believe that there is value as well as an element of real nobility in the judicial decision to throw out, every time the opportunity arises, consumer contracts designed to perpetuate the exploitation of the poorest class of buyers on credit." The author of this statement, a famous lawyer, apparently has in mind the type of installment contract that the court threw out as unconscionable in the case of *Williams v. Walker-Thomas* furniture.
 - a. Did the add-on clause in her contract with Walker-Thomas necessarily "exploit" poor consumers like Williams?
 - b. Does striking down the clause as unconscionable necessarily benefit the "poorest class of buyers on credit"?
19. Suppose that Rexite Casting agrees to supply Midwest Mower with 1000 custom castings. To make these castings Rexite must invest \$25,000 in specialized dies and molds designed to Midwest's particular specifications. Rexite estimates that the variable costs of materials and labor add another \$40,000 so total costs will be \$65,000. Having agreed to a price of \$70 per casting, Rexite expects to make a profit of \$5,000 (= \$70,000 - \$65,000) on the deal.
 - a. What is it about this deal that makes Rexite vulnerable to opportunistic behavior by Midwest?
 - b. At what point does Rexite become vulnerable? At the moment it signs the contract? After it begins production? At the conclusion of the contract? Briefly explain.
 - c. What is the most that Midwest can hope to save by unilaterally and opportunistically lowering the price it will pay Rexite? How do you arrive at your answer?
20. Willy Wonka has insured his chocolate factory against fire. If Willy takes no precautions, the probability of a fire is 0.01 and the potential fire loss is \$100,000. If Willy were to monitor his employees more closely, at a cost of \$300, the probability of a fire would be reduced to = 0.005. If Willy were to install an indoor sprinkling system at a cost of \$250, the probability of a fire would not be affected, but the potential loss would be reduced by \$20,000 (i.e., from \$100,000 to \$80,000).
 - a. Are either or both precautions economically justified? Briefly explain.
 - b. If Willy is fully insured against fire, and if his insurance company can adjust premiums to reflect changes in risk, does Willy have any incentive to undertake either or both precautions? Briefly explain.
 - c. What problem arises, and why, to prevent real world insurance markets from working like the ideal you described in part b? Do you think this would be more of a problem with respect to precautions like Willy's monitoring his employees or precautions like his installing a sprinkling system.
21. Mrs. Fields is considering purchasing fire insurance for her cookie factory. The probability of a fire is 0.003 (i.e., 3/1000) and the fire loss would be \$500,000.
 - a. What would be the certain, insured wealth of Mrs. Fields if she can insure at a fair premium?
 - b. Suppose that the probability of a fire could be reduced by 0.002 to 0.001 if Mrs. Fields were to reduce the temperature in her baking ovens. If she did so, however, it would reduce her profits by \$750 because it

- would take longer to bake her cookies. Assuming that she is insured, under what conditions would there be an incentive for Mrs. Fields to take this precaution? Briefly explain.
- c. What problem arises in insurance markets, and why, that reduces the likelihood that precautions such as that in part b. will actually be undertaken.
22. Wally Welldigger drills water wells. This is a risky business because only 4 wells in 5 strike water; one in 5 comes up empty. It costs Wally \$100 to drill each well but, because he does not get paid for dry wells, he charges his customers \$125 per well to make up for the wasted costs of drilling dry wells. Thus, on average, for every 5 wells he drills, his costs are \$500 ($= 5 \times 100$) and his revenues are also \$500 ($= 4 \times 125$).
- a. Interpret Wally's pricing policy as a system of insurance. Specifically:
- What risk is being insured against?
 - What is the premium, who pays it, and what do they get in return?
 - Who pools the risks and how?
- b. How would things differ--i.e., What would the price be? What would happen when a well comes up dry? Who would bear that risk?--if there were no insurance?
23. Dunbar and Canadian Industrial Alcohol (CIA) enter a contract which calls for Dunbar to deliver a ton of molasses to CIA. Dunbar, a middleman, has only one source of molasses supply and if that supplier shuts down Dunbar will be unable to deliver. This problem could be avoided if the parties had an alternative source of supply. Either Dunbar could arrange for an alternative source at a cost of \$300 or CIA could at a cost of \$500. The expected benefits of their contract being successfully completed are \$250 to Dunbar and \$400 to CIA.
- a. Is this an economically preventable loss for Dunbar? For CIA? For both? Why or why not? Be specific.
- b. Would is the economically efficient way to deal with the shut-down contingency? Briefly explain.
- c. Suppose that Dunbar and CIA had originally agreed on a contract price of \$10,000 but had not considered the possibility of supplier shut-down. How would they renegotiate the price in light of the shut-down contingency?
24. In the case of *Hadley v. Baxendale*, Hadley suffered lost profits when Baxendale failed to return Hadley's repaired mill shaft on time. For the sake of this question assume that: (i) the reason Baxendale was late in repairing Hadley's mill shaft was because he decided to accept a rush order to first repair Smith's mill shaft; (ii) Baxendale made a \$50 profit from his deal with Smith; (iii) Hadley lost \$75 of profit as a result. Use this information to analyze the economic rationale for the court's decision to absolve Baxendale of liability on the grounds that Hadley's lost profits were not *foreseeable* to Baxendale, who didn't know Hadley didn't have a spare mill shaft.
25. What are *performance excuses* in the law of contract? In what general circumstances should the law not allow such excuses to eliminate liability for damages caused by a breach of contract? Is the economic rationale denying performance excuses stronger when viewed in the context of an individual contract dispute or when viewed as legal precedent? Briefly explain.
26. Below I have added hypothetical additional information to the actual facts of two of the cases we discussed.. Based on that information, answer the questions accompanying each case.
- a. Having agreed to pay Vanessa Redgrave \$50,000 to star a performance of *Oedipus Rex*, Boston Symphony Orchestra (BSO) cancels the play when it learns that security to control protests against her unpopular political views would cost \$5,000. Freed from her obligation to BSO, Redgrave agrees to star in the SCU performance of *Mary Poppins* for \$40,000.
- Is BSO's breach economically efficient? Briefly explain.
 - Would BSO breach if it knew it would be responsible for expectation damages? Briefly explain.
- b. The Peeveyhouses value restoration of their property at \$10,000. The court allows Garland Coal to breach because restoration would cost Garland \$29,000 and only increase the market value of the Peeveyhouse property by \$300.
- Is Garland's breach economically efficient? Briefly explain.

- ii. What would have happened if the court had ordered specific performance by Garland? Briefly explain.
27. The decision in *Redgrave v. Boston Symphony Orchestra* clearly states the law's position on the standard remedy for breach of contract: "One who is willing to pay the penalty of such damages as the law assesses is free to break the contract and pay. As to contracts not specifically enforceable in equity, the law provides no other remedy." Following this rule, courts typically use monetary damages as the remedy for breach even in cases where specific performance is still possible.
 - a. In general, when are monetary damages inadequate as an expectations remedy?
 - b. In what sense does specific performance protect the rights of a potential victim of breach with a property rule?
 - c. What general economic advantages of property rules are shared by specific performance? Briefly explain.
 - d. What economic argument can be made against the more frequent use of specific performance?
28. Dick enters a contract with Jane, a famed portrait artist, to paint his portrait for a price of \$2000, of which Dick has paid \$500 in advance. The cost of Jane's materials and painting time is \$1800 and Dick values the proposed portrait at \$3000. Dick also takes two days off work for his sitting and, as a result, loses \$400 (\$200 per day) in wages. Jane completes the painting on a Friday and calls Dick to come and pick it up, but Dick is reluctant to take another day off work so he tells Jane he will pick it up on Saturday. Unfortunately, Jane's studio catches fire Friday night and burns to the ground destroying the completed portrait. Dick sues Jane for breach of contract, arguing that the loss could have been prevented if Jane had installed a \$100 fire alarm. Jane countersues, claiming that Dick still owes her \$1500 because he could have prevented the loss by picking up his portrait on Friday when it was complete. The court rules in favor of Dick.
 - a. From an economic standpoint, is the court's ruling the correct one? Briefly explain.
 - b. If Dick's remedy is to be monetary damages, how much should he receive based on each of the following principles? Briefly tell how you arrive at each amount.
 - i. restitution
 - ii. reliance
 - iii. expectations
 - d. On what grounds might Dick argue that monetary damages are inappropriate, and request that the court order *specific performance* by Jane to repaint the portrait? Can you see a potential problem with using specific performance in cases like this?
29. Polly Patentholder, who invented and patented SuperDuper Glue, has licensed Manny Manufacturer to produce and market the new product for one year in return for \$100,000 in royalties. Manny expects his revenues from the sale of the new product to be \$800,000 and production and marketing costs to be \$650,000, of which he has already spent \$40,000 modifying his factory to produce the glue and \$80,000 on a pre-production advertising campaign. Seeing the enthusiasm that his advertising has generated for SuperDuper Glue, Polly decides to revoke Manny's license and produce the product herself. Manny successfully sues for breach of contract and the court must choose an appropriate remedy.
 - a. If the remedy is monetary damages, how much money would Polly pay Manny under each of the following principles? Briefly tell how you arrive at each.
 - i. Expectations
 - ii. Reliance
 - iii. Restitution
 - b. On what grounds might Polly argue that damages be reduced?
 - c. What arguments might Manny make to claim that specific performance is more appropriate than monetary damages in this case?