

Economic Analysis of Contract Law

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Economic Analysis of Contract Law

Incomplete Contracts and Asymmetric
Information

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*To
My Family*

Preface

The economic analysis of Contract Law is a specialised branch of Law and Economics. It is essentially a synthesis of two distinct but well-established branches—Theories of Contract and Economics of Contract Law. Due to specialisation, these two fields have developed relatively independent from each other over the years, especially in that Contract Economics relies on a simplified notion of the role of law (both legislation and courts) and Law and Economics scholarship focuses on the role of courts and legal doctrine, sometimes at the expense of what parties do out of court. This book tries to make a meaningful contribution to both fields by reconnecting them.

Of late, most law schools and Economics departments offer courses in Law and Economics at both under-graduate and post-graduate level. Economic Analysis of Contract Law is taught as a small part of Law and Economics at a very rudimentary level. A stand-alone course on the Economics of Contract law is rare. The majority of the texts available for this purpose cover the entire gamut of Law and Economics. This book attempts to raise the level by bringing in the latest developments in the literature and specialised areas of contracts and Contract Law.

As a text on Economic Analysis of Contract Law, the book will appeal to scholars from both Economics and Law, particularly those who are interested in the economic foundation of law. However, there is a challenge to provide a unified analytical and pedagogical approach that

can serve these two different sets of readers, who are well-versed in their own fields. This book tries to strike a balance.

The major thrust of this book lies in its dealing with the assessment of effect of damage remedies of contract law on incomplete contracting under an asymmetric information scenario. The main purpose of this book is two-fold: (1) to convey the ability of economic theory to provide a unifying framework for understanding law from an economic perspective, and (2) to draw the attention of economists, as well as of quantitative-minded lawyers, towards the latest developments in the field, by incorporating the issues of asymmetric information in incomplete contracts. The available texts on Law and Economics, which might have more of a legal orientation, are systematically omitting these aspects. The book does not attempt to cover an exhaustive set of legal topics; rather, it tries to tell a brief but coherent story about the law and how economic analysis can be used to shed more light on the efficacy of various legal rules from both the Civil and the Common Laws of contracts. This book does not, however, require the reader to have any particular familiarity with Contract Law, nor is its objective to teach Contract Law comprehensively. Rather, the objective is to apprise readers from both sides of how they can apply the tools of economic analysis to understand the basic structure and function of the law.

Organisation of the Book

This book consists of six chapters. The introductory chapter discusses the basic premise of contracts and laws, discusses the issues of contractual incompleteness and asymmetric information, and sets out the research agenda for the remaining part of the book. Chapter 2, using a multi-task model, presents an overview of the nature and the extent of the canonical hold-up problem under different modes of incomplete contracting when the trade is always economically justified. The different issues surrounding contracting for procurement under the symmetrical but non-verifiable information set-up are also touched upon. Chapter 3 attempts to set the basic framework for the analysis of the effects of the different legal

rules and rank them when the parties write simple fixed-price contracts. It also searches for an optimal contract in a situation when only one party undertakes the non-observable reliance investment and the other party holds some ex post private information and contemplates contract-breach. In Chap. 4, the analysis from the previous chapter with a bilateral reliance and one-sided private information model is extended. The effects of the various court-imposed damage remedies are again assessed systematically. In Chap. 5, the analysis is taken further when either of the parties can breach irrespective of his holding private information against the backdrop of the expectation damage measure. Towards this end, extensive use is made of the mechanism design to show that assessing the correct ex post expectation damage by the court is not only flawed in the face of private information but also comes at a cost through a loss of efficiency. Chapter 6 deals with a situation when both the parties undertake reliance investments as well as holding ex post private information. This bi-dimensional information asymmetry poses great difficulties for the parties in writing a simple contract, and it creates problems for the courts in settling the expectation interest of the victim of contract-breach. Two methods of justifying the expectation interest by the courts, namely, the subjective method and objective method, are used. Finally, Chap. 7 presents the general conclusions and reflections of this study.

Instruction for Readers

Keeping the Economic Analysis of Contract Law simple and tractable for a reader who is not so mathematically oriented is a big challenge. It gets mathematically quite dense beyond a certain level; it is rather difficult to avoid the rigour from a modelling perspective. I have tried to adopt a graded approach in building the models in successive chapters so that the readers gradually get accustomed to the intricate mathematical terrain.

I would urge the reader to get themselves acquainted with the basics of optimisation procedure from any standard graduate-level mathematics text book, and economic concepts such as Consumer Theory and Game

Theory from any standard microeconomics textbook. For the sake of brevity, I had to drop the idea of having another chapter here.

Chapter 2 would be helpful for lawyers as it introduces the basics of Economic Theory of Contracts. This chapter would allow them to understand the approach of economists towards contracts and contract law. Chapters 3 and 4 introduce Economic Analysis of Contract Laws and its damage remedies in most pragmatic settings of one-sided asymmetric information. The first four chapters of the book are suitable for those who have opted for their first course on Economic Analysis of Contract Law at both undergraduate and graduate levels in Economics as well as Law. However, Chaps. 5 and 6 are directed to more advanced readers, who are familiar with advanced Game Theory and mechanism design.

Having said that, I would appeal to lawyers to go through the discussions and remarks in those chapters, which will reveal interesting and useful insights on how the trading environment coupled with laws shapes the behavioural and contracting aspects of the concerned parties.

Acknowledgements

This book traces its origin to my doctoral thesis at the Centre for Economic Studies and Planning of Jawaharlal Nehru University, India. The present version of this book is a fully revised, somewhat expanded, and hopefully improved version of my earlier works. The ideas for this book took shape over the years through the graduate-level course that I offered at Delhi School of Economics. It benefited a great deal from the classroom interactions and invaluable feedback from students of the course. I also thank two anonymous reviewers who read the manuscript. Their extensive comments have been very helpful, and many of their suggestions are incorporated into the current version.

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in a way my '*gurudakshina*' (token of respect) to them; they have made indelible impressions on my professional career.

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While work should always be fun, it is never complete without a fulfilling private life. I am indebted to my parents and sister for their sacrifice, love, and wholehearted support during this endeavour. Suja, my wife, has been equally generous in supporting me over these years.

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Needless to say, I am solely responsible for any errors or imperfections that may remain in the book.

Delhi, India
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