

# Law & Economics of Contract Law

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# Issues in Contracts

- Uncertainties and risks
- Bilateral monopoly and Opportunism
- Co-operation and Commitment
- Incentive alignment
- Transaction cost
- Asymmetric information and disclosures

# Economic Functions of Contract Law

1. Promote co-operation – co-operative games – agency game
2. Prevent opportunism
3. Encourage efficient disclosure
4. Prevent avoidable mistakes
5. Allocate risk to superior risk bearer
6. Minimize transaction cost

# Economic Functions of Contract Law

7. Optimal commitment to performance
8. Optimal reliance
9. Reduce cost of resolving dispute
10. Interpret efficient terms
11. Protect third parties from external efforts
12. Foster enduring relationship

# Agency Game With Contract & Without Contract

- Two players
- First player- investor/ principal/ promisee
- Second player- agent/ promisor
- First player- Two options – Invest or don't invest
- Agent – Two options – Co-operate or Appropriate

# Risk Allocation

- Uncertainty & risk
- Contracts for allocation of risk
- Allocate risk to superior risk bearer

# Risks

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- Opportunistic behaviour
- Uncertain events
- Change in anticipated scenario
- Change in circumstances
- Availability of resources
  - material & human
- Law & Regulations
- External effects
- Change in technology
- Change in purpose of project

# Transaction Costs in Contract

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## ➤ Pre Contract

- Cost of search – search and identify matching party
- Cost of collecting & assessing necessary information
- Cost for plan, prepare & request for proposal
- Cost of negotiation
- Cost of agreeing terms
- Cost of drafting effective contracts
- Cost of legal & other consultants
- Execution formalities – stamp fee, registration fee



# Transaction Costs in Contract

- ▶ Performance of contract
  - ▶ Monitoring resources
  - ▶ Monitoring quality
  - ▶ Monitoring time schedule
  - ▶ Monitoring other party performance stages
  - ▶ Coordinating during performance and maintaining cordial relationship and developing trust
  - ▶ Cost of delivery and acceptance material

# Transaction Costs in Breach

- ➔ Cost of enforcing contract by
  - Arbitration
  - Mediation
  - Court Proceedings
- ➔ Direct Costs for proceeding
- ➔ Error Costs and cost of uncertainty