Economic analysis of rescission as a remedy for pre-contractual opportunism

Introduction

Precontractual opportunism is characterised as fraud, duress, exploitation of bargaining power, the party's unilateral mistake or incompetence by which the actor intends to induce another party to make a contract, or to force him agreeing on unconscionable terms. Along with moral, justice and other non-economic justifications, the legal prohibition against precontractual opportunism is also justified on economic rationales that not only can opportunistic behaviours lead to misallocation of resources, but also generate real social costs in forms of time, effort, and resources wasted on such behaviours.

In contract law, a contract induced by an opportunistic behaviour is either entirely or partially unenforceable. In brief, three legal outcomes ensues that I call in this paper as invalidity of contracts: (a) void contract - no valid contract ever exists; (b) voidable contract – the contract is valid until rescinded by the aggrieved party; (c) void term – except for the unfair term, the rest of the contract is still enforced.

In this paper, I apply a law-and-economics analytical framework to examine invalidity of contracts as a legal instrument to regulate precontractual opportunism. The objectives of the paper are twofold. Firstly, it is intended to identify economic features of invalidity of contracts, e.g. efficiency characteristics, economic costs, and impact on the incentive structure of

contracting parities. And then some normative implications will be drawn of how the optimal regulation of precontractual opportunism can be achieved by the use of invalidity of contracts alone and in combination with other legal instruments such as damages in tort law or public law sanctions, e.g. financial penalty or imprisonment.

Both contractual opportunism and contract law remedies have already attracted a great deal of academic discussions; nonetheless, this paper is different from the existing literature in two ways.

Firstly, it studies the problem of precontractual opportunism. In contrast, the current literature predominately focuses on a post-contractual problem, hold-up where one party demands a modification of the contract in his favour after the investment by another party in the transaction becomes sunk costs. The problem of holdup undermines the incentive to make *ex ante* investment that increases the value of the transaction. Academic attentions were given to answers to the question of how legal or non-legal instruments can be used to create right incentives for both parties. This paper has different and broader focuses than the existing literature.

Secondly, it investigates economic questions with regard to the use of the 'remedy' of invalidity to achieve the optimal regulation of precontractual opportunism. Conversely, most studies of contract law remedies in the

existing literature concentrate on relations between damages and specific performances, and efficient breach and optimal precontractual investments. There is little discussion on either invalidity of contracts as a remedy or its use for regulatory purposes.

This paper fills the gap in the literature and proceeds as follows. After outlining the features of the problem of precontractual opportunism and the current legal responses, I will develop a theoretical framework and an economic model for choosing the efficient legal instrument, and then drawing upon them, answers will be offered for three questions: (a) when the 'remedy' of validity should be used to regulate pre-contractual opportunism; (b) when it should be used in combination with other legal instruments, and when it must not be used.

Three pre-contractual opportunistic behaviours

The term "opportunism" is defined in the economic literature as 'self-interest seeking with guile'.[1] By this definition, opportunism is a type of intentionally rational behaviour by which the actor intends to maximize

[1] O. Williamson, *The Economic Institutions of Capitalism* (New York, The Free Press, 1984), 47.

his or her self-interest. In the pre-contractual context, opportunism is characterised by one party exploiting the weakness of another party with the purpose of inducing the latter to make a contract or to agree on unconscionable terms.

A pre-contractual opportunistic behaviour normally takes three forms. The first is fraudulent misrepresentation, which is more or less attributable to the information asymmetry between the parties. The lack of information could lead the party to make a mistake as to whether to enter into a contract, or render him difficult to verify the information provided by another party. Therefore, information asymmetry creates an incentive for the party with information advantage to present a false statement to induce the information disadvantage party to enter into an unfair contract.

The second form of precontractual opportunism is duress, which is resulted from an imbalance of bargaining power between the parties. The imbalance of bargaining power can create a permanent or temporary monopoly, which enables the party in the strong bargaining position to eliminate all or most alternative options available to another party. Consequently, the latter party is left no choice, but contracting with the former party under substantially unfair terms. For example, a party with a gun threats to kill another party, unless the latter agrees to make the contract. The gun creates a temporary monopoly, which leaves the latter party no alternatives, but accepting the contract. A more subtle form of duress is economic duress. The most common type of economic

duress is the threat by one party to break a contract, unless the other party agrees to its modification or comprise. For example, in *B&S Contracts and Designs Ltd v Victor Green Publications Ltd*,[2] a contractor who had agreed in the contract to erect stands for an exhibition told his client, less than a week before the exhibition was due to open, that the contract would be cancelled unless the client paid an additional sum.

The third form of pre-contractual opportunism is undue influence, which is caused by the party's bounded rationality. Where two parties are in a special relationship so that a less sophisticated party places trust and confidence on the more sophisticated party, there would be a risk that the more sophisticated party would take the advantage of the weak party to maximise his or her self-interests. A typical example is a guarantee given by a wife for her husband's debt. The husband intends to arise a loan from the bank for his personal business, and then the bank approaches to his wife to ask her to provide the co-owned property as a security for the loan. Normally in such a case, the wife is less educated and unable to appreciate the prospective legal consequence of her behaviour. The husband takes advantage of her ignorance to maximise his own self-interests.

From an economic perspective, pre-contractual opportunism is undesirable, because not only does it lead to misallocation of resource, but also generates a waste of resources. A contract is a device for resource

[2] [1984] I.C.R. 419.

allocation. It can achieve allocative efficiency to move the goods to their highest value user, as well as ensuring that each step in the allocation process is a Pareto improvement. However, this argument depends upon two prerequisites that (a) the market is competitive thereby the party is free to decide whether to make a contract and with whom to contract; (b) when facing a range of behavioural options, the party can always choose correctly the one which can maximise his self-interests. Pre-contractual opportunism can either create a monopoly between the parties (duress) or induces the party to make an incorrect decision as to whether to make the contract. Therefore, it is a cause for misallocation of resources.

In addition, pre-contractual opportunism can generates two types of real social costs. The first is precautionary costs, which can be defined as the money, efforts and time used by the party for preventing pre-contractual opportunism. For instances, to prevent a fraudulent misrepresentation, the party may devote more time and effort to searching for the relevant information, or to prevent economic duress, the party will be more careful in choosing the partner, in some extreme circumstances, he may forgo the potential transaction.

The second type of cost is the cost of making pre-contractual opportunistic behaviours. The resources devoted to this kind of behaviour are dissipated, because an opportunistic behaviour does not increase social welfare, but merely transferring existing wealth between the parties. Thus, the more the parties invested, the

less trade surplus will remain for the parties. Any resource used in this way is totally wasted from a social standpoint.

Rescission: the remedy for pre-contractual opportunism

In English contract law, the contract concluded as a result of a fraudulent misrepresentation[3], duress[4] or undue influence[5] is voidable, the aggrieved party is entitled to rescind the contract. The legal consequence of rescission is normally restitution; the parties must return each other the benefit which he received. For instance, where a contract for the sale of goods is rescinded, the seller should return the buyer the contract price, and the buyer should return the goods back to the seller.

However, rescission is subject to four bars. When any of the bars occurs, the party's right of rescission is lost. The first bar is impossibility of restitution. A party who wish to rescind the contract should restore the other party any benefits which he has obtained under the contract. If it is impossible to restore the benefit, e.g. the buyer had consumed the goods which he purchased, the contract cannot be rescinded.[6] But this bar is not strictly applied by courts. Normally, if the party can restore substantial benefits, the court may allow the rescission in equity and order him to make an allowance

[3] *Redgrave v Hurd* (1881) 20 Ch. D. 1.
[4] *Barton v Armstrong* [1976] A.C. 104; *The Evia Luck* [1992] 2 A.C. 152.
[5] *Royal Bank of Scotland v Etridge (No.2)* [2001] UKHL 44.
[6] *Hunt v Silk* (1804) 5 East 449; *Blackburn v Smith* (1848) 2 Ex. 783.

or remuneration for the benefits which cannot be restored.[7] The second bar is lapse of time. The right of rescission should be exercised within a reasonable time, what constitutes the reasonable time is a matter of fact, and will be determined on a case by case basis.[8] The third bar is affirmation. A contract cannot be rescinded, if the aggrieved party expressly or by conduct affirms it after discovering the truth.[9] And finally, the right of rescission will be barred by the intervention of third party rights. For example, a person who was induced to sell goods by a fraudulent misrepresentation cannot rescind the contract after the goods have been purchased by a third party without notice of the fraud.

Rescission as a deterrence instrument

It has been generally accepted that the analysis of deterrence draws upon the well-known assumption of rational choice, which sees human behaviour as the result of a cost-benefit calculation.[10] A person will abstain from choosing the given behavioural option, if the cost of doing so exceeds the benefit. And then, the legal sanction is simply seen as an instrument by which the behavioural cost for the person can be increased.[11] Therefore, the deterrence of rescission is dependent upon the liability cost which it imposes upon the contracting

[7] *Redgrave v Hurd* (1881) 2 Ch. D. 1.
[8] *Leaf v International Galleries* [1950] 2 K.B. 86.
[9] *Habib bank Ltd v Tufail* [2006] EWCA Civ 374, [20].
[10] G. Becker, "Crime and Punishment: An Economic Approach" (1968) 76 *Journal of Political Economy* 168.
[11] Q. Zhou, Q. (2007), "A Deterrence Perspective on Damages for Fraudulent Misrepresentation" (2007) 19(1) *Journal of Interdisciplinary Economics* 83, 88.

party. If the *ex ante* liability cost of rescission for a given behaviour exceeds the party's expected profit from doing so, the rescission will create an effective deterrence; otherwise, the deterrence is ineffective. Based upon this assumption, we can create a simple deterrence model of rescission for pre-contractual opportunism.

$$Dq \geq G - C \quad (1)$$

G, is the party's gain derived from the opportunistic behaviour. Because the purpose for a precontractual opportunism is to induce the other party to enter into the contract, ***G*** can be measures as the party's expectation interest from the transaction. For example, if the opportunistic party is the seller, ***G*** will be measured as the difference between the contract price and the minimum amount of money which he is willing to accept for the goods; on the other hand, if the opportunistic party is the buyer, ***G*** is assessed as the difference between the contract price and the maximum amount of money which he is willing to offer.

C represents the expenses for making the contract. It includes all of the resources, efforts, times and money spent on making and performing the contract before the rescission, therefore, ***C***>0.

D presents the sanction magnitude of rescission, it is the loss on the party resulted from the rescission. It can be assumed that ***D***=***G***. because once the contract is rescinded, the restitution follows; the parties should return each other the benefit received under the

contract. Neither party can realise his expectation interest from the transaction. Thus, the rescission deprived the party of his expectation interest, which can be seen as the liability cost imposed by the remedy of rescission.

q is the probability of private legal enforcement. The rescission is a private law remedy. Its enforcement entirely relies on the aggrieved party to bring a legal action against the opportunistic party. In realty, there are many factors which will undermine or overcome the party's incentive to litigate, such high litigation cost, uncertainty on the judgement, information asymmetry, the risk of judicial error. Therefore, it is appropriate to assumed that in reality $\mathbf{q}<1$.

In brief, ***Dq***, can be seen as the *ex ante* liability cost for an opportunistic behaviour, and G-C is the party's net gain from the opportunistic behaviour. Rescission can effectively deter pre-contractual opportunism if inequality (1) is held.

Inequality offers the following implications. Firstly, if the private legal enforcement were perfect, $\boldsymbol{q}=1$, the remedy of rescission would be an effective deterrence for pre-contractual opportunism. Because, $\mathbf{D}=\mathbf{G}$ and $\mathbf{C}>0$, if $\boldsymbol{q}=1$, $\mathbf{Dq+C>G}$. Hence, the party's gain from the opportunistic behaviour is outweighed by the costs. As a consequence, the party's opportunistic incentive is overcome.

Secondly, if $q<1$ legal enforcement is imperfect like in reality, the deterrence of rescission may be ineffective. Because $D=G$, We can replace D with G in inequality (1) and rearrange it in terms of q as follows:

$$q \geq 1-\frac{C}{G} \quad (2).$$

It is a threshold for an effective deterrence. Two implications are offered by inequality (2). In the first place, as long as inequality (2) is held, the deterrence of rescission is effective. therefore, the perfect private enforcement of rescission, $q=1$, is not a prerequisite for the effective deterrence. Furthermore, q, the enforcement rate for an effective deterrence depends upon $\frac{C}{G}$ the opportunistic party's ratio of the cost of making the contract and the expectation interests from the contract. There is a inverse correlation between q and $\frac{C}{G}$. The higher the ratio is, the lower the enforcement rate is required. To illustrate, assume that C=£10 and G=£100, to satisfy inequality (2), q should equal or exceed 0.9 or 90%. However, if C=£50, and G=£100, q will be 0.5 or 50%. Therefore, other thing being equal, the higher the cost of making the contract, the lower the enforcement rate is needed.

This provides an important insight into the deterrence feature of rescission. The remedy of rescission can be a powerful deterrence instrument, when the opportunistic party had make a huge investment in the transaction, which become sunk costs, e.g. construction contracts, production contracts, and employment contracts, all of these contracts requires one party to make the specific

investment. Once the contract is rescinded, the investment cannot be retracted in full value or be put for alternative uses. For example, in the case of employment contract, the employee spent a huge amount of time and effort to master a special skill which is only useful for the current employer. Once the contract is rescinded, the employee's skill adds no competitive advantage for him to compete in the labour market. In the situation like this, the party is rather like to pay damages instead of the rescission. So, rescission may be a superior deterrence instrument to damages in the case of long-term relational contract or where the party's investments in the contract becomes sunk costs.

Thirdly, if the deterrence of rescission is ineffective, there is only one way to improve arising ***q***. unlike other monetary penalty, such as damages, we cannot increase ***D***. in the case of rescission, ***D*** is constant rather than variable. However, in reality there are many factors which can undermine or overcome the aggrieved party's incentive to enforce the remedy of rescission. The first factor is legal restrictions on the remedy of rescission. Each of the four legal bars to the right of rescission noted above is a disincentive to the private legal enforcement by the aggrieved party. Two of them, impossibility of restitution and the bona fide third party's right, are worth more discussions here.

The bar of impossibility of restitution is a more discouraging factor in consumer transactions than in commercial transactions. Unlike the commercial transaction, which is intended to contract for profits

via future resale, the consumer transaction is intended to contract for use. It is more often that the consumption of the goods immediately follows the completion of the transaction thereby the consumer cannot rescind the contract anymore. Although the court may grant the remedy of rescission in equality when the consumer can return the substantial benefits received under the contract, what constitutes a substantial benefit is unclear. Furthermore, as such a remedy is an equitable redress, the court may refuse to order the rescission at its discretion. This adds another layer of uncertainty to the consumer. The bar of impossibility of restitution definitely makes the rescission of contracts more difficult for consumers. While in the case of commercial transaction, the party intends to resell rather than consuming the goods, so the bar of impossibility of restitution rarely occurs. For the same reason, the bar of bona fide third party's right is a greater disincentive in commercial transactions than in consumer transactions.

The second disincentive is the cost of private legal enforcement. Although the judicial intervention is not always necessary for the rescission of a contract, once both parties have a dispute as to the right of rescission, the parties have to resort to the court. Litigations are costly activities. The aggrieved party will not initiate the litigation, if the expected return from the litigation is outweighed by litigation costs.

The third disincentive is the remedy of rescission itself. From the aggrieved party's standpoint, rescission

may be an unsatisfactory remedy. Where the contract is rescinded, the restitution follows. Both the opportunistic party and the aggrieved party cannot realise their expectation interests. In other words, even if the aggrieved party successfully rescinds the contract, he will still be worse off than the situation where the contract had been fulfilled. If the aggrieved party's expectation interests from the transaction is great, or the loss incurred by the opportunistic behaviour is not too high, the aggrieved party may prefer to enforce the contract and claim tortious damages if there would be one available. Particularly, in the case of commercial transactions, the aims of both parties are the profit maximization. Thus, given the high litigation costs, it can be assumed that the commercial party will be reluctant to rescind the contract, as long as the goods can be resold for profits. Moreover, it is also reasonable to say that where the investment in the transaction by the aggrieved party has become sunk costs, the party will be also reluctant to rescind the contract, such as in construction contract where the building process had commenced.

The fourth disincentive is the information asymmetry between the opportunistic party and the aggrieved party. As a private legal instrument, the enforcement of rescission depends on that the aggrieved party to sue. However, if the aggrieved party is not aware of that he is the victim of opportunistic behaviour. No legal action will be brought.

Rescission and the incentive for precaution

In his seminal paper,[12] Cooter correctly identifies the fundamental problem with perfect compensation, the paradox of compensation. In many cases apart from adjusting the injurer's incentive to commit a wrong, it is also socially desirable for the victim to take more care against his own private losses. This may be because that the contributory precaution by the victim may improve the legal deterrence or that it is more efficient or cost-effective for the victim to prevent the wrong because he has information advantages. But other things being equal, there is an inverse correlation between the amount of compensation recovered by the victim and the level of care taken by him. Thus, the more the compensation recoverable the victim, the lower the level of care will he take. If the law awards the perfect compensation which makes him no difference from the position where he would have been, had no injury been inflicted, the victim will take no care *ex ante*. Cooter calls this problem as the paradox of compensation.

In application of his theory to the analysis of rescission, the question is, to what extent does the award of rescission as a remedy for pre-contractual opportunism undermines the aggrieved party's incentive to take precautions? Other thing being equal, it is fair to say that the remedy of rescission does weaken the party's incentive to take cares, but the problem of compensation paradox must not be exaggerated. Rescission is not a perfectly compensatory remedy for the aggrieved party. As noted repeatedly in this paper, the remedy of rescission does not protect the party's expectation interests from

[12] R. Cooter, "Unity in Tort, Contract and Property: The Model of Precaution" (1985) 73 *California Law review* 1.

the contract. The rescission will put the party into the position where he would have been, had no contract been made rather than the position where had the contract been perfectly performed. So, it can be assumed that the party still have sufficient incentives to take precaution against his expectation loss. Drawing upon the traditional economic analysis of incentive, we could make two predictions: (a) the rational party will have the incentive to take care, if he believes that the precautionary cost is lower than the expectation loss and his precaution can effectively avoid his expectation loss; (b) he will take the private optimal precaution at the level where the marginal precautionary cost equals to the marginal expectation loss.

The above predications more or less reflect reality. In most cases, the person who is about to make a transaction will take some level of care; even consumers who generally are considered bounded-rational are often very cautious before making a purchase. Nonetheless, it is by no mean to say that the level of care taken by the party is sufficient to prevent his expectation losses. It could be argued that the party's precaution is useful in the case of fraudulent misrepresentation, but less effective in the case of duress and undue influence. A fraudulent misrepresentation occurs when there is an information asymmetry between the parties. If the information problem did not exist, there would be no room for an effectively misled misrepresentation. To prevent a fraudulent misrepresentation, the party can verify the statement by seeking more information or consulting with an expert. Therefore, the more careful verification by the

represented of a statement can reduce the probability of being misled by a misrepresentation.

Compared with fraudulent misrepresentation, it is more difficult to take effective precautions against duress or undue influence. There is no feasible way for the party to take precaution ex ante against duress. Perhaps the only way to prevent duress is to abstain from making the contract. It is reasonable to assume that once there is an imbalance in the bargaining power, the strong party will exploits the weak party. But the bargaining position between the parties will inevitably alter through the different stages of the contract. For example, two parties may be at equal position at the time of entering into the contract, but when stepping into the stage of performance, the party who made a specific investment in the performance will be in the weak position to be exposed to exploitation, like in in *B&S Contracts and Designs Ltd v Victor Green Publications Ltd*,[13] a contractor who had agreed in the contract to erect stands for an exhibition told his client, less than a week before the exhibition was due to open, that the contract would be cancelled unless the client paid an additional sum. For the client, economic duress is a risk which he has to bear unless he decides not to make the contract in the first place.

In the case of physical duress, the party is frequently unable to predict whether the other party will use physical threat and when the threat will materialise. Once the physical duress happens, it is too late for the

[13] [1984] I.C.R. 419.

party to take precautions. The weak party is left without any alternatives except for agreeing the request by the strong party. His freedom is significantly constrained.

Turning to the case of undue influence, it seems that aggrieved parties do not usually have sufficient incentives to take precautions. This is not because the problem of compensation paradox, but the special relationship between the parties. Normally, in the case of undue influence, the aggrieved party and the opportunistic party are in some kind of special relationship, such as husband and wife, children and parent thereby the aggrieved party place over confidence and trust on the opportunistic party. As a consequence, it may be the belief of the aggrieved party that there is no need to take precautions. Apparently, this problem is mitigated by the incentive of the third party. As noted above, the undue influence normally involves three parties where the husband persuades the wife to provide their co-owned property as a security for the husband personal loan given by the bank. If the charge is void, the bank will suffer a loss, this creates an incentive for the bank to prevent the undue influences of the husband on the wife.

Legal errors

Legal errors in relation to awarding the rescission can be divided into types. The first type is the error which the judge misperceives an opportunistic party as an innocent party, and then enforce the contract which should be rescinded. The second type of error is that the judge misperceives an innocent party as an opportunistic

party, and then rescinds the contract which should be enforced.

If the court systematically makes the first type of error, three possible outcomes can be predicted. Firstly, this error reduces the probability of enforcement thereby undermining the legal deterrence of rescission. If the court enforced the contract which should be rescinded on the grounds of opportunism, the aggrieved party would be left without the legal remedy, this, in turn discourages him to sue the opportunistic party in the first place. As the effective deterrence of rescission is dependent upon private legal enforcement, the decrease in the number of litigations against opportunistic parties lowers the probability of legal enforcement. Other thing being equal, the fall in the probability of legal enforcement weakens the legal deterrence of rescission.

Secondly, it undermines the incentive for trade. Compared with the case where the court does not make the error, now the party has to take the extra risk that he may be left without a remedy if he is induced to contract by an opportunistic behaviour. Accordingly the party may responds to this risk in two ways. In the extreme case, he may entirely lose the incentive to trade, or in the moderate case, he may transfer the risk to another party via the contract price. If he is the seller, he will increase the price to cover this risk. If he is the buyer, he will reduce the price which he is willing to offer. Regardless of the status of the party, this type of legal error clearly is a disincentive for trade.

Thirdly, it induces the party to take more care when entering into a contract. As the party might be left without a remedy, if becoming the victim of opportunistic behaviour, he will be more careful when making the contract in order to reduce the chance of being misled.

On the other hand, if courts systematically make the second type of legal error, still three predications can be made. First, it weakens the incentive for trade. Obliviously, if the court frequently misperceives an innocent party as an opportunistic party and rescinds the contract which should be enforced, it inevitably discourages the party from making the contract in the first place. It is simply because that the legal error may deprive him of the expectation interest from the contract which he should realise.

Secondly, it gives rise to the risk of frivolous litigation. Where the court frequently misjudges an innocent party as an opportunistic party, it will create an incentive for the party to rescind the contract when he made a bad bargain, even if there is no opportunistic behaviour.

Thirdly, it will have an uncertain effect on the legal deterrence. On the one hand, it can be argued that as this type of legal error encourages frivolous litigations, as a result, the probability of legal enforcement increases. Other thing being equal, the deterrence of rescission will be improved. On the other hand, the legal error of this kind encourages pre-

contractual opportunism. If the court often misjudges an innocent party as an opportunistic party, it reduces the gain of being an innocent party that will motivate the party to behave opportunistically.