



# ECONOMIC ANALYSIS OF RESCISSION AS A REMEDY FOR PRE-CONTRACTUAL OPPORTUNISM

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# Objectives of the paper

- Explore the role of rescission as a remedy against certain forms of *ex ante* opportunism
  - Fraudulent misrepresentation : mistake as to whether to enter into a contract, difficult to verify information
  - Duress (imbalance of bargaining power) resulting in elimination of alternative options available (ex : threat to break a contract)
  - Undue influence due to bounded rationality (special relationship – trust)
- And examine under which conditions rescission should (or should not) be used (and in combination with which other instruments)

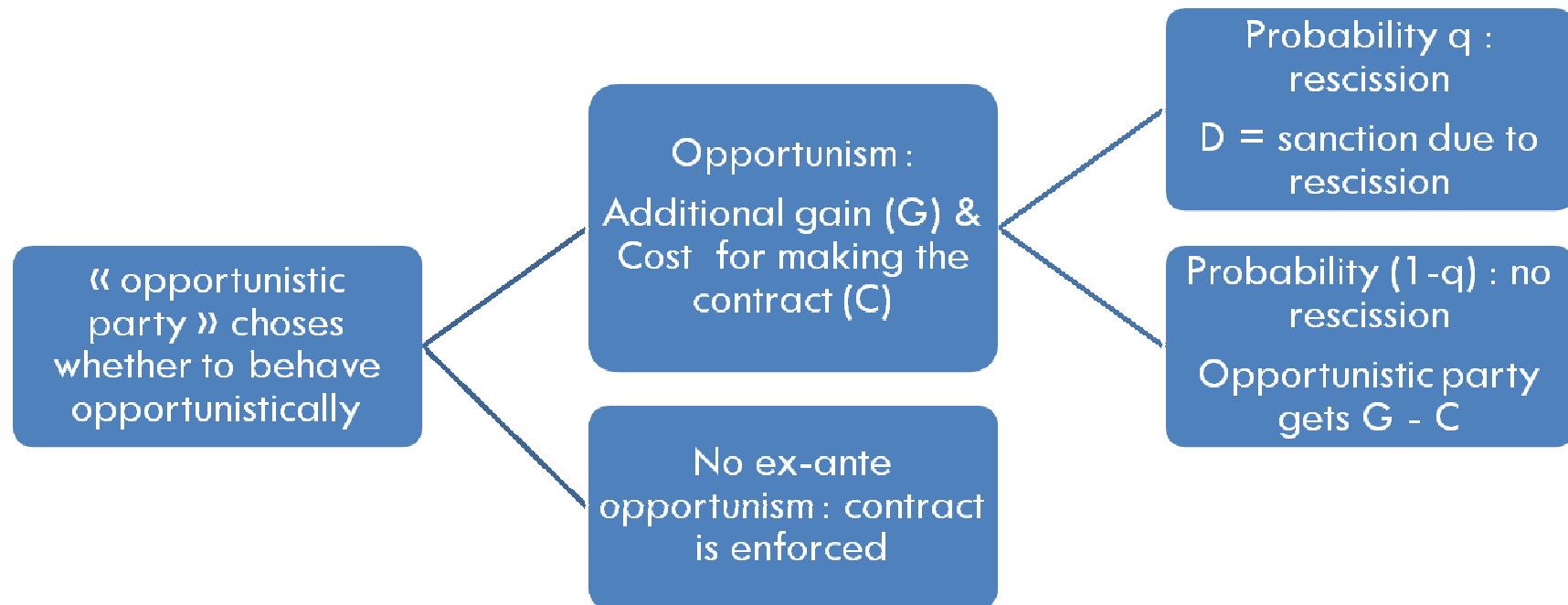
# Results

- The effectiveness of rescission as a « tool » to deter ex-ante opportunism can be analysed in terms of probability of enforcement ( $q$ )
  - $q \geq 1 - (C/G)$
  - Where
    - $C$  is the opportunistic party's cost of making the contract
    - $G$  is the opportunistic party's gain from opportunism
- But this result is amended by several factors
  - Legal restrictions on the use of rescission
  - Rescission does not solve all the problems raised by opportunistic behaviour (contract does not take place – i.e. an opportunity cost to the contractors)
- Other questions are discussed
  - The use of precautions by the aggrieved party (often difficult to implement + there could be an incentive problem)
  - How legal errors influence the incentives of parties (to sign the contract, to use precautions, to ask for rescission)

# General comments

- Very clear presentation of the topic, even for a reader who is not familiar with this literature
- Work in progress, therefore not yet a clear conclusion / synthesis on « when » rescission should (or should not) be used as a remedy to pre-contractual opportunism
- A discussion combining
  - an approach from « standard » L&E
  - elements of Transaction Cost Economics, which could be developed in more detail

# The choice of the opportunistic party



# Questions and suggestions (1)

- Discussion of rescission as a deterrence instrument
  - ▣ Why is  $D=G$  ?
    - If  $D$  is the loss from the rescission,  $D$  should include the opportunity cost, while  $G$  is here purely the gain from opportunistic behaviour (compared to the gain of a contract without this opportunism)
  - ▣ The signification of  $C$  is not so clear to me.
    - « expenses for making the contract » is maybe a bit vague. Is it only costs of writing the contract ? Or does it also include other costs (as you suggest, the costs of specific investments)
  - ▣ Conclusion : rescission as a superior deterrence instrument when the opportunistic party has made huge investments in specific assets (i.e. long-term relational contracts)
    - Anyway, if it makes huge investments, is it may be vulnerable to opportunistic behaviour by the other party ? So is the instrument of rescission really the main incentive element ?

# Questions and suggestions (2)

- The judge can make different types of errors (type 1 and type 2) but more generally, there is the problem of verifiability of the pre-contractual opportunism (even if a party to the contract knows about this opportunism, will the judge be able to verify it?)
- Is a further differentiation of the 3 types of ex ante opportunism useful (in terms of desirability of deterrence ? Or in terms of enforcement of rescission – maybe some types of opportunism are easier to detect for a third party?)
- What are the performances of rescission in comparison with other instruments ?
- Suggestion : what are the transaction costs incurred by the different parties (not only ex ante but also ex post) to explain the deterrence effects of rescission

# Transaction costs related to rescission

| « Ex ante » transaction costs   | « Ex post » transaction costs  |
|---|--|
| <p>Finding a partner<br/>Comparing alternative offers<br/>Writing the contract</p> <p><b>+ (for the opportunistic party)</b><br/><b>putting in place the ex ante opportunistic behaviour</b></p> <ul style="list-style-type: none"><li>• <b>Fraudulent misrepresentation</b></li><li>• <b>Duress</b></li><li>• <b>Undue influence</b></li></ul> <p><b>+ (for the other party)</b><br/><b>preventing ex ante opportunistic behaviour</b></p> | <p><b>Verification costs</b> (has one party behaved opportunistically ? How easily can it be detected, i.e. observability ?)</p> <p><b>Solving conflicts</b> (negotiating, going to court, giving proofs to a third party – judge - that there has been opportunism, i.e. verifiability)</p> <p><b>Breach of contract</b> (including loss of specific investment)</p> <p><i>(in addition, there is also an opportunity cost because the transaction is not taking place)</i></p> |