

The Economics of Contracts

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ABSTRACT

Economic analysis of law is an approach to legal theory that applies methods of economics to law. It includes the use of economic concepts to explain the effects of laws, to assess which legal rules are economically efficient, and to predict which legal rules will be promulgated. Earlier the use of economic analysis for the study of law and legal institutions focused primarily to the fields of anti-trust legislation etc. Today, however, it is common to delve with property law, crime and punishment, torts, and contracts with economic tools.

The economic basis for contract law is the creation of inducement for value maximizing behavior in the future; it encourages a process by which resources are efficiently stimulated through a series of exchange into successively more precious uses.

This paper demonstrates the usefulness of underlying economic principles for explaining the basic doctrines of contracts, enforcement of contracts, formation defenses and performance defenses. It further explores economically efficient breach also.

Key Words: *Contracts; Enforcements; Efficiency; Formation Defenses; Performance defenses; Value Maximization; Efficient Breach*

Introduction

Contract is the most exciting field of law in which economists are relaxed and feel at home. There are many excellent surveys which discuss economic analysis of contract law¹.

Scholars from economics discipline try to answer key issues related to contract law, such as; does our society really need contracts? If so, why and under what conditions? Should a contract always be performed, even if it causes an economic loss to one side or both of the contractors? What is the best solution when a party fails to perform his or her mandatory contractual obligations (Posner 2003)?²

In the traditional economist approach the law of the contract is viewed as a gadget for facilitating trade, passing on the risk between parties and economizing the cost of making transaction. By providing strategy for transaction it helps increase the wealth of nations.

Value maximization is the core of economic principles. The creation of incentives for value maximizing conduct in the future, encouraging a process

by which resources are smoothly moved through a series of exchange into successively more valuable uses forms a basis for contract law.

Basic Canons of Contract Law

A contract is a promissory agreement for a future exchange freely and voluntarily arrived at. The law of contract is designed to facilitate the process of exchange and to minimize the breakdowns and thus it contributes to transaction efficiencies.³

The basic doctrine of contract law is the presumption of voluntary action by both parties. Validity of contract depends on a clear sign of consent by both the parties and the presence of consideration. Duress or compulsion or other non-voluntary behavior is thus a defense to contract

enforcement.

An economically efficient contract maximizes net gains to both the parties. Hence we would expect rational bargainers and parties will enter into a contract which maximize the net gain.

In general it facilitates the voluntary (and well informed) exchange of well-defined and exclusive property rights:

In non-simultaneous exchanges, it checks and controls the opportunistic behavior of parties by ensuring that the first mover, in terms of performance, does not run the risk of defection rather than cooperation, by the second mover.

It reduces the transaction costs. The transaction costs is the cost of entering into and executing contracts. Transaction costs can be of various types. For example, the cost of negotiating, preparing and signing the contract court fee, attorney fee, time cost and psychic cost. It provides a set of default or breakdown rules where the terms of a contract are incomplete.⁴

It distinguishes welfare enhancing and welfare reducing exchanges.

The customary approach assumes that the parties enter into a contract to secure investment in a jointly beneficial project and maximize the net gain.⁵ Another common rationale for entering into contract is risk sharing. In a sale transaction, the contract provides gains from the investment that reduces the cost of production for seller or increase the value of the good for the buyer. It can be simple as the sale of a good or complex as the construction of a high rise building. If buyer can augment the value of good by making investment prior to delivery, buyer will want an assurance that seller will not raise the price after seller has observed buyer's reliance. A contract can sometimes prevent seller from holding up the buyer in this way, and thus permit buyer to invest with knowledge that he will enjoy the full return of his investment.⁶

In the contract, the parties incorporate terms describing the performance, goods to be delivered, the date of delivery, or the identity of party who bears the risk and contingencies influencing the value of performance. A completely specified contract lists all conditions explicitly on which the actions are based. One of the reasons for incomplete contract is higher transaction costs of foreseeing low-probability events and uncertainty turns into all contracts incomplete. In order to take advantage of superior bargaining power parties might choose some terms or avoid others for strategic reason depending on information they have. Thus contracts are usually quite incomplete. Parties rely on custom, trade, usage, and in the end, the courts to fill out the terms of the contract.

In contract law, remedies, incentives are provided to make good on promises. If the parties, to the contract agree, the terms of the contract, legal system provides enforcement remedies. What rules of contract law would best serve and maximize the welfare of parties, this question is asked in two different ways, depending on whether the scholar takes a descriptive or a normative approach.

Descriptive analysis provides a "prediction" of contract doctrine. In the descriptive approach the judges decide cases in a manner that maximizes efficiency⁷ and generate efficient law. A literature on these analyses is available and inconclusive.⁸

The contract is a meeting of minds intended to carry legal weight. Its binding force depends upon its compliance with the law. The parties would maximize their utility if they could enter into a best possible contract. The legal rules help the parties to enter into an optimal contract. The descriptive hypothesis is justified if the hypothetical legal rules are same as actual legal rules.

The normative approach of decision assumes that the contract law should be efficient. When the buyer's valuation exceeds the seller's cost and buyer and seller make efficient investments and then the

equilibrium outcomes under alternative legal rules is optimal outcome. Different rules are efficient under different assumptions. Contract as a societal institution facilitate efficient exchange by providing a social mechanism for enforcing those agreement where aggregate value between the parties can be presumed to have increased.

A mutually beneficial contract cannot be modified so as to raise the well being, i.e., expected utility of each of the parties to it in the sense of 'Pareto's Efficiency'. We would suppose that contracts would tend to be mutually beneficial, if a contract can be altered in a way that would raise the expected utility of each party. The first contract would not be considered mutually beneficial and would be modified.

Enforcement of Contracts

Contracts are assumed to be enforced by law, i.e. court. Sometimes an entity other than state authorized courts serve as a tribunal and enforce the contracts. Moreover reputation and related factors may also serve to some degree enforcement.

The question which bothers us that why do we need the contract law? The courts may read the contract and enforce the terms as read. This seems the obvious and perfect solution and would save the law students several semester hours. But this is not the way courts behave. There are at least four answers to the above question.

The courts may believe that they know better than the parties, hence may not wish to enforce the terms as mentioned in the contract. What the terms should have been and accordingly fill the gaps in contract and resolve ambiguities.

The courts may have questions on the validity of the contract even if parties accept the contract and enforce as they are written.

The problem of inability to foresee all the contingencies make the contracts incomplete most of the times and leave the gaps to be filled in by the

courts.

The courts may consider and take into account the not the well-being of the parties only but outsiders affected by the contract also. Thus the courts do maximize social welfare and welfare of the contracting parties. This means that court acts to further welfare of the parties to the contract.

Thus the contract law provides a carefully worked out body of information concerning certain contingencies that may defeat an exchange. This knowledge assists the parties in planning their exchanges. Uncertainty is decreased and efficiency is increased: this can reduce the complexity and thus the cost of transactions.

Formation Defenses

A contract, not binding in certain circumstances, is called formation defense. Contract law provides certain formation defenses. These formation defenses have economic rationale. There are certain formation defenses that allow a party to escape judicial enforcement of the court. One such defense is illusory promise, for example, "I will give you my house when I feel like it." This promise is illusory, subject to a condition that makes the value uncertain or possibly nonexistent. An exchange of such promise is not efficient since the deal is too vague. And a contract involving such vagueness defies enforcement. Similarly promissory exchange made within intimate relationships (*Balfour v. Balfour Case*)⁹ they are not legally binding.

Free consent of the parties and incapacity are the essentials of a valid contract. Contracts, made under the doctrine of duress/coercion, undue influence, are not binding because of not being voluntarily made. The defense of incapacity has a persuasive economic rationale. The essence of the defense is that true preferences are not revealed in the exchange. Thus the legal enforcement mechanism should not validate and enforce an exchange where there can be no presumption that value is increased.

A contract that is regarded as fraudulent generally will not be legally recognized even though it meets the usual requirement of validity.¹⁰ Fraud is socially undesirable for various reasons. Efforts taken out to carry it out are economically sterile. Firstly, the resources devoted to this task are a waste, as they do not produce anything of direct value to anyone. Secondly efforts made to detect fraud also constitute a waste. Thus constitute the social cost of fraud. Thirdly, to the extent if it is successful, it would result in inefficient action.

Contract Performance and Performance Defense

Society has an interest in seeing contracts enforced once they are formed. It provides parties to the contract a high degree of confidence in the sanctity of promise and in its being carried out. If performance is not ensured, few contracts would be entered into and the number of value increasing exchanges would be reduced. Therefore, the law provides incentives to ensure performance.

The law provides a social mechanism for its enforcement, a party to a contract who breaches his deal, will be required to provide the non-breaching party with compensation under specific damages rule. However, there are conditions under which the breaching party may be excused from performing or paying damages. Such conditions, which excuse performance, are known as performance defenses. A performance defense can only be raised where the contract does not explicitly assign the risk in question and the event responsible for claiming the performance defense could not have been avoided by cost-justified precautions.¹¹ Posner and Rosenfield suggest that, when *“these threshold condition have been satisfied, economic analysis suggests that the loss should be placed on the party who is the superior (that is lower-cost) risk bearer. To determine which party is the superior risk bearer three factors are relevant—knowledge of the magnitude of the loss, knowledge of the probability that it will occur, and (other) costs of self or market-*

*insurance.”*¹²

A number of performance defenses have been identified in the law. The risk of losses due to entirely unforeseen events that make delivery on a contract impossible can be assigned in various ways. If the seller assumes a risk, he will want to be compensated for it by including in the price a risk premium. And if the buyer assumes the risk, he will want to deduct the risk premium from the price he pays. There is an advantage in having a general risk assignment, as under the impossibility defenses, rather than writing special clauses into every contract. Such a rule will tend to reduce the litigation cost and transaction costs.

Similarly, if crucial assumption underlies the deal as a foundation to the performance agreed upon, then failure of the assumption is a defense to actual performance. Thus rule clearly has economic rationale, since the underlying assumptions to the deal have been destroyed, would cause inefficient exchange.

One example is the death of a contracting music performer. The performer's estate simply cannot provide performance of the terms of the contract between the decedent and another party. The law implies and provides legal recognition of the risk of nonperformance by death of the purchasing party, thus discouraging unnecessary suits when parties to the deal have not specifically made provisions for the contingency. Here the doctrine promotes efficiency by decreasing the incentives for additional lawsuits and providing incentives to the parties to specify and think out future contingencies to the deal.

The Theory of Efficient breach

The theory of efficient breach of contract¹³ permit unilateral breach to the party who has discovered more profitable opportunity for the resources dedicated to the performance. Suppose that the breaching party compensates the other for his full expectancy losses. This breach is Pareto superior

(nobody is worse off, someone better off). Robin West one of the critics of efficiency approach makes the objection that

It encourages uncivil, unilateral, uncooperative attitude towards contractual relationships.

It deprives the non-breaching party of the possibility of sharing in the gains of the new opportunity” Which a negotiable release from performance would engender.

I think this point needs some more elucidation. The thought behind efficient breach of contract is reflecting “bad man's” view of law, to use Oliver Wendell Holmes' famous phrase. In his view, “The only universal consequence of a legally binding promise is that the law makes the promisor pay damages if the promised event does not come to pass.”¹⁴ Beyond this question whether this perspective eliminates the moral dimensions of a legal contract, this choice between delivery and damages raises another question, whether and how the breach of the contract of one party may be efficient at all. In other words, which contract remedy leads to an outcome that maximizes the joint net gains of the parties? To demonstrate this point, it will help to be (slightly) more concrete.

Consider A seller, S can produce a good for Rs.150. The good is not generally available; therefore, a buyer B1 enters into a contract with S for future delivery. The contract price is paid in advance. B1 values the good at Rs.200. B1 makes an expenditure of Rs.10 prior to delivery (reliance investment, R1), which is necessary for him to use the purchased goods. If the contract is not completed, R1 has no value to B1. B1 has a choice: if he makes an additional investment (R2) of Rs.24 and the good is delivered, he gains a sum of Rs.30. (Else, R2 has no value.) For the moment it is assumed that both S and B1 are risk neutral, i.e. they care only about the expected value of the risky situation. (For example, both are indifferent between a gain and loss of Rs.100 for sure and a gain or loss of Rs.1000 with a

probability of 10 %.)¹⁵

Before delivery there is a chance that another buyer (B2) wants to purchase the same good and offers a sum of Rs. 0, Rs.180 or Rs.250. (For simplicity we assume that these values are equally likely and are the same as the amount B2 evaluates the good in each case.) Both S and B1 are aware of the possibility that B2 may offer more for the good than B1 does.

The case of fully specified contract

Economic theory assumes that if S and B1 could bargain costless and with full information, they would end up in an efficient situation. Let's see what it means in this case.

First we deal only with R1. The contract price must be between Rs.150 and

Rs. 190 (Rs. 200 – Rs. 10). The exact value is determined by the relative bargaining force of S and B1. Suppose that this price is Rs.175. It is easy to demonstrate that the efficient contract includes a provision that in the event that B2 values the good at Rs.0 or Rs.180, S has to sell the good to B1. If B2 values the good at Rs.250, S is to sell it to B2 and at the same time S has to pay damages (for breach of contract) to B1. Say, the amount S pays to B1 equals Rs.225. To prove the efficiency of the breach of contract, let's consider the joint profit of S and B1. (Given that B2 offers the same amount as he values the good, his profit is not affected so it is not to be taken into account in determining the efficient contract provision.) If S sells to B1 and B2 offers Rs.180, the joint profit is Rs.40 (Rs.175 – Rs.150 = Rs.25 for S + Rs.200 – Rs.175 – Rs.10 = Rs.15 for B1). If S sold the goods in this case to B2, the joint profit would fall to below to Rs.20 (Rs.180 revenue - Rs.150 production cost - Rs.10 of R1). When B2 offers Rs.250 there are also two cases. If S sells to B2, the joint profit is Rs.90 (Rs.175 + Rs.250 – Rs.150 – Rs.225 = Rs.50 for S + Rs.225 – Rs.175 – Rs.10 = Rs.40 for B1). If, however, S does not breach, the joint profit is only Rs.40, as we have

seen.

It is worth noting that there is a positive relation between the contract price and the 'damages' paid. If S had to pay more than Rs.225 in case of breach, he would only contract for a higher price. As we have seen, in the case of Rs.250, It offer, efficient breach.

All the above-mentioned provisions presuppose that bargaining and information is costless. For example it may be difficult for S to detect B1's gain from R2 or the parties may underestimate the probability that another purchaser, B2 offers more than B1. So, as is noted above it is reasonable to think, that legal rules are needed to regulate the issues raised by the breach of contract.

Holmes inspires the law and economics scholars. For example, Posner notes, "When a breach of contract is established, the issue becomes one of the proper remedy. A starting point for analysis is Holmes' view that is not the policy of law to compel adherence with the contract but only to require each party to choose between performing in accordance with the contract and compensation for the other party for any injury resulting from a failure to perform. This view contains an important economic insight."¹⁶

In accordance of above reasoning, Cooter and Ulen,¹⁷ state "We define an efficient breach as follows: a breach of contract is more efficient than performance of the contract when the cost of performance exceed the benefits to all the parties."

In other words, breach is efficient when as a result of windfall or an accident; the resources needed for the performance are more valuable in an alternative use. Incentives for breach are efficient when the transfer of resources to the highest valued use is accomplished at the lowest transaction costs in such a way that no one is made worse off by the transfer and at least one person is made better off.

Thus a breach of contract is the *rule of financial equivalent performance*. Under this rule, a breaching party must pay the financial equivalent of

his breach of the contract to the non-breacher. The objective is to put the innocent party in the position he would have been in if the contract had not been breached The financial equivalent performance of the deal from the buyer's perspective is the difference between the market price and the contract price.

The underlying economic rationale for this rule is that if one party determines the breach is in its self-interest, actual breach is efficient, as long as the other party is not harmed. The rule of financial equivalent performance ensures such an outcome by giving the non-breacher the value of his deal: it releases the breaching party from an actual performance that he believes would be more expensive for him than payment of damages. Thus, the party best able to evaluate the cost of actual performance versus the payment of financial equivalent damages is given power to decide. The non-breacher is given financial equivalent for performance of the deal and may purchase conforming performance on the market. Resources are saved, and the lowest cost performance is revealed to the contracting parties.

Efficient Breach: Posner Analysis

Assume that Seller agrees to sell Buyer 100 widgets for Rs.1000. These widgets are worth Rs.1500 to the buyer. Subsequently, seller is approached by a foreign consortium that offers him Rs.10,000 if, in lieu of manufacturing widgets, he will manufacture and sell them 100 gidgets. Assume that seller can produce either the widgets or gidgets (but not both) at a cost of Rs.500. The efficient breach argument is in terms of societal welfare, the optimal solution would be for the seller to breach, compensate the buyer for his contractual expectancy (Rs.1500), and devote his productive energies to manufacturing gidgets for the foreign consortium. Such a result is "efficient" in the sense that buyer receives the same benefits as performance would have provided, while the seller can do even better. Under these circumstances, the rule of compensatory damages is

contended to be preferable to any alternatives since it produces exactly this result.

If the law imposes penalty damages for breach of contract of 20 times the contract price. Here seller would owe damages for breach of Rs.20,000. Seller would choose the cheaper (for him) alternative, forego the Rs.10,000 gain obtainable by making gidgets, and instead perform his contract with the buyer. Under these circumstances, the rule of penalty damages would direct an inefficient outcome. While society as a whole would be better off if seller's productive resources were devoted to making gidgets, he will instead produce widgets in order to avoid the penalty.

Consider the effects of a rule that imposes damages for breach only equal to 20% of the contract price. In this case, seller would certainly breach his contract with buyer, pay him Rs.200 in damages and manufacture gidgets in exchange for the Rs.10,000. But in other circumstances, the rule too will result in a socially inefficient allocation of resources. Assume that the foreign buyers only offered seller Rs.1300 for the gidgets. Under the 20% damages rule, he would still have an incentive to breach, pay buyer Rs.200 in damages and manufacture gidgets, thus pocketing an additional Rs.100. (Rs.1300 – Rs.500 – Rs.200 = Rs.600 profit v. Rs.1000 – Rs.500 = Rs.500 profit.) Social welfare, however, would be improved if the widget contract were, in fact, performed because Buyer values widgets Rs. 1500, which is more than the Rs.1300 value the foreign buyers attach to gidgets. Under a rule of compensatory damages, the widget contract would still be performed in this case since seller would have to pay buyer Rs.500 in damages (Rs.1500 value – Rs.1000 contract price), thus making the gidget contract less profitable than his existing obligation to the buyer. In sum, the argument is that only one legal rule, compensatory damages, appears to satisfy the social welfare criterion in every case by directing seller's productive energies to their most highly valued

uses.

In the absence of transaction costs, parties can and will negotiate around sub-optimal damages rules by stipulating damages at the time of contracting. Or, parties can costlessly negotiate optimal outcomes when the prospect of breach

presents itself. So, in the case where seller has contracted to manufacture widgets for buyer at a price of Rs.1000, is offered Rs.10,000 by another trading partner to make gidgets, and faces a twenty-times-contract –price legal remedy, the seller will be motivated by the opportunity to earn an additional Rs.9000. He will buy his way out of the contract with the buyer. The bargaining range will be between Rs.500 (the amount necessary to make buyer whole), Rs.9000 (seller's potential gain). Similarly where the law specifies 20% damages, and the gain to seller from making gidgets is less than the loss to buyer from losing widgets, buyer will “bribe” seller to perform the widget contract. Judge Posner disposes of this “answer” to the efficient breach hypothesis by extending that because it necessitates a further transaction (in the one case, negotiating out of the first contract; in the other case, bribing seller to perform the first contract) it is not the best solution. This is a clever move at first glance, but in fact the theory of efficient breach cannot survive the introduction of the transaction costs. What Posner has done to introduce some transaction costs but not all transaction costs? He uses to his advantage the cost of negotiating the optimal rule when the contract is formed and the costs of negotiating an optimal solution when the prospect of profitable breach occurs. He ignores the costs of enforcing his “efficient breach” remedy. In the real world, one suspect, breachers do not always send the damages check to the non-breacher along with a nice note.

Transaction Costs

Coase showed that traditional basic microeconomic theory was incomplete because it only included

production cost and transportation costs, whereas it neglected the costs of entering into and executing contracts and managing organizations. Such costs are commonly known as transaction costs and they account for a considerable share of the total use of resources in the economy. Transaction costs can be of various types. For example, the cost of negotiating, preparing and signing the contract court fee, attorney fee, time cost and psychic cost.

Contracts often involve risks. The contract allocates some of risks explicitly. On the other hand, the contract may remain silent about many risks. Real contract suffers from gaps. When a contract remains silent about a risk the contract has a 'gap'. Gaps are events not explicitly addressed in the contract that affect obligations created by it. Gaps may be inadvertent. Alternatively, gaps may be deliberate. Lets us consider the calculations that might lead the parties to leave the gaps deliberately in contracts. Negotiating the allocation of this risk imposes transaction costs with certainty when contract is made. Alternatively, the parties could leave a gap and wait to see whether the wrong event occurs. Leaving a gap in the contract will require the parties to allocate a loss if it materializes.

This trade-off continues. "Ex ante risks" refer to the risk of future losses faced by the parties when they negotiate a contract.. "Ex post losses" refer to losses that actually materialize after making the contract. In general, the parties to a contract must choose between allocating ex ante risks and allocating ex post losses. If the parties negotiate explicit terms to allocate risks, they will bear transaction costs for certain. If they leave a gap, they will bear transaction costs with positive probability. The expected transaction cost of a gap in the contract equals with probability that the loss materializes multiplied by the cost of allocating it.¹⁸ The parties expect to save transaction costs by leaving gaps in the contracts whenever the actual cost of negotiating explicit terms exceeds the expected cost of filling a gap. The following rule summarizes

these facts:

**Cost of allocating a risk > cost of allocating a loss
* probability of a loss leave gap**

**Cost of allocating a risk < cost of allocating a loss
*Probability of a loss fill the gap**

The contract law can minimize transaction costs of negotiating contracts by supplying efficient defaults.

Strategies to Reduce Transaction Costs

A number of strategies can be identified in order to reduce transaction costs. Using standard form contracts can reduce them, often referred to as boilerplate forms. They make it unnecessary to draft a new contract from each time.

More interestingly the strategies that can be used, particularly by the seller- creditor, to improve his position during the performance stage should default be threatened or occur. Within our microeconomic framework the seller –creditor can, if the buyer -borrower defaults, take steps that will increase the latter's cost, thus reducing the likelihood of default. Interesting provisions such as , Add-on clause, Waiver-of-defense clauses, Due-on-sale clauses, Termination- at- will clauses have been incorporated into contracts in this connection.

CONCLUSION

Thus economics of contract provides the economic rationale for various issues related to contract law and give justification of particular act of the party or parties in a contract maximizing the welfare of both the parties and society as well.

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- 2 Posner, E. A. (2003), *Economic Analysis of Contract Law after Three Decades: Success or Failure?* *The Yale Law Journal*, 112(829), pp. 829-880.
- 3 In economics, the term economic efficiency refers to the use of resources so as to maximize the production of goods and services. An economic system is said to be more efficient than another (in relative terms) if it can provide more goods and services for society without using more resources.
- 4 The term incomplete suggests that a contract has gaps in its terms, which will leave its content undefined unless the law supplement it with some *gap-filling rule*, such as default rule or a maximum of interpretation.
- 5 See Polinsky A. Mitchell (1983), *Risk Sharing Through Breach of Contract Remedies*, 12, *Journal of Legal Studies*, 427.
- 6 Posner, E. A. (2003), *Economic Analysis of Contract Law after Three Decades: Success or Failure?* *The*

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- 7 The concept of efficiency being used is Pareto Efficient. The decision maker chooses the rule that maximizes the surplus from cooperation, and might involve the *Kaldor-Hicks idea* of transferring goods from the person who values them less to the person who values them more, all people who use contracts are better off with an efficient system.
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