
Incomplete Contract

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1. General Description: most contracts are incomplete. They are incomplete because there is uncertainty. As long as the contract is not instantaneous, there is an element of uncertainty involved in the processes of contract formation (before and during negotiation) and contract performance (after the agreement has reached). Assuming everyone is risk averse, everyone will try to cover uncertainty by specifying clauses for all possibilities in the contract. However, this is costly and time consuming. It may outweigh the benefits that may be realised in the contract. Therefore, contract law provides the set of provisions called *specific contract*.

2. Specific Contracts: they are default rules provided by contract law to govern frequently-used transactions. These transactions include purchasing (buying-selling), borrowing, leasing, and landlord-tenant agreement (renting), for instance.

Due to the fact that these transactions are frequently used, it is quite clear who is more prone to uncertainty in each transaction; the default rules will be designed in such a way that the least cost avoider of the particular uncertainty is responsible.

For example:

-The buyer is the owner of the bought item once the contract is formed. Any damage occurs to the bought item is not seller's responsibility. Hence, the buyer still has to pay for the price.

-If the borrower failed to pay back the borrowed money, the lender has the right to claim for that money from the borrower's property by using the court and the legal executor. An appointed legal executor will seize the borrower's property on the lender's behalf, resell it in the public auction, pay the lender in full, and if there is some money left, it will be returned to the borrower.

-If the mortgagor failed to pay back the borrowed money, the mortgagee has the right to claim the ownership over the mortgaged property.

****Compare between last two cases to see the reason why****

Important elements of each transaction are covered by each specific contract. Thus, everyone knows exactly what is the right and responsibility under such transaction including what to do in most likely contingencies. This reduces the transaction cost and negotiating time for contracting parties without wasting their time to negotiate for everything. If they do not like the default rules provided, they can negotiate for different terms/clauses in their agreement.

3. The Theory of Incomplete Contract: from the incompleteness, there is another branch of study called the theory of incomplete contract trying to explain that the incompleteness is not only resulted from uncertainty but also '*non-verifiability*.' Some contractual terms cannot be verified or very costly to do so by contracting parties and by the third party (the court or the police).

For example, by promising with you "if you are diligent, I will give you 'A'," but at the end, you did not get A. This is not a binding contract, not because of impossibility or duress but from disability to measure 'diligence.' Your definition of diligence is different from my version of it. Of course, the judge's version of diligence is different from yours and mine. Similarly, an employer may say 'if you work hard, I will give you 10-month bonus.' An employee may not receive the bonus since the employer may think what the employee has done is not qualified as 'hard-working.' Hard-working is difficult to define and difficult to verify.

This kind of contract may be unfavourable for contracting parties because shirking or breaching is attractive. But we can observe that in the real world, these contracts exist and working. The existence of incomplete contract, even it is non-binding, is a result from repeated transaction between contracting parties. If the contract is one off, contracting parties may dare not to engage in the contract. If it is repeated, they know they are depending on each other. Mutual benefits are realised. The breach will interrupt both parties and cooperation (perform the contract) is more valuable to them.

Even though they cannot sue each other in the court or the arbitrator, they can use the *stick-and-carrot* or *tit-for-tat* (“you did good, I will return you a favour; you did bad, I will give you the worst”) strategy to retaliate the breaching party. The fear or threat of retaliation will act as the enforcing instrument making the contract self-enforceable. Reputation is crucial for the relationship.

Not every relationship can use the incomplete, but self-enforcing, contract. It depends on many factors. How much they are depending on each other? How easy they can switch to other potential contracting parties to complete the same objective? How difficult it is for contracting parties and the third party to verify the crucial terms of contract?