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Investments to Make Threats Credible, Rent-Seeking, and Duress

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Existing literature on the contract law doctrine of duress identifies a number of tests to determine conditions under which a contract can be voided. No article provides a specific and formal economic analysis on the link between rent-seeking and the conditions under which allowing a defense of duress is wealth enhancing. This article shows that commitments made as a result of ex ante investments by threatening parties made solely for the purpose of transferring, rather than creating wealth, ought to be voidable. We discuss cases in which a test based on rent-seeking enhances efficiency where previously proposed tests do not.

I. INTRODUCTION

In contract law, a party that breaches (or intends to breach) a contract may assert a duress defense to relieve himself from liability, if he can demonstrate that the non-breaching party induced him to enter the contract by a wrongful threat. Courts have allowed parties to assert the defense even absent a threat of tortious or criminal

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conduct. A wrongful economic threat is sufficient. Unfortunately, the cases do not develop a coherent concept of what constitutes a wrongful economic threat.[1]

Law and economics scholars have attempted to provide such a coherent concept,[2] but excluding some commentary,[3] we are unable to locate any game-theoretic analysis that formalizes the link between rent-seeking and the conditions under which allowing duress as a defense is socially desirable. However, as we have argued in a recent law review article, wrongful threats can be thought of as threats that are made as part of endeavors to transfer wealth, rather than generate wealth, through the formation of a contract.[4] Given recently asserted doubts regarding the value of economic reasoning in analyzing the contract law doctrine of duress,[5] we find it important to provide the link between rent-seeking and duress. In this article, we crystalize this link through a formal game-theoretical model.

In particular, we present a modified version of previously used models,[6] and show that allowing a duress defense to the threatened party when the threatening party's threat is motivated by rent-seeking is wealth enhancing. The intuition is the following: When a party can make investments that enable him to engage in acts that generate benefits exceeding the costs of such investments, he will make those investments regardless of whether or not such investments may harm another party. In these circumstances, if another

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[1] Here we are focusing on the simple breach case; the analysis extends identically to cases of contract modification. See generally Mark Seidenfeld and Murat C. Mungan, *Duress as Rent Seeking,* 99 Minn L Rev 1423 (2015) for a more detailed discussion of the doctrine of duress and its application to contract modification cases.

[2] See, for example, Oren Bar-Gill and Omri Ben-Shahar, *Threatening an "Irrational" Breach of Contract,* 11 S Ct Econ Rev 143 (2003); Oren Bar-Gill and Omri Ben-Shahar, *The Law of Duress and the Economics of Credible Threats,* 33 J Leg Stud 391 (2004); Oren Bar-Gill and Omri Ben-Shahar, *Credible Coercion,* 83 Tex L Rev 717 (2005); Steven Shavell, *Contractual Holdup and Legal Intervention,* 36 J Leg St 325 (2007). For a more detailed literature review, see Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1).

[3] See, for example, Robert Cooter and Thomas Ulen, *Law and Economics* (Pearson Addison Wesley 4th ed 2004); Benjamin Hermalin, Avery W. Katz, and Richard Craswell, *Contracts,* in 1 Handbook on Economics 3–128 (Elsevier 1st ed 2007), Todd Zywicki, *Libertarianism, Law and Economics, and the Common Law*, 16 Chapman L Rev 309–24 (2013); and Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1), discussed in section II.

[4] Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1).

[5] See Shawn Bayern, *The Limitations of Economic Reasoning in Analyzing Duress,* 99 Minn L Rev Headnotes 141–60 (2015).

[6] See, for example, Ben-Shahar and Bar-Gill, 33 J Leg Stud at 394-97 (cited in note 2) and Ben-Shahar and Bar-Gill, 83 Tex L Rev at 720–27 (cited in note 2).

party is in fact likely to be harmed by the first party's investment, the law ought to enable these two parties to enter into an enforceable contract where the first party refrains from engaging in the act that harms the second party, since they will exercise this option only if the harm to the second party is greater than the benefit to the investing party. In these circumstances, the investor is motivated by wealth generation, and a duress defense can only hinder wealth-improving arrangements. If, however, the investment is cost justified (for the first party) only by the prospect of a wealth transfer from a second party trying to avoid harm, then allowing the second party to assert a duress defense removes the first party's incentives to invest. Although the transfer of wealth itself does not reduce social wealth, the investment in making the threat credible reduces social wealth. Hence, it is optimal to allow a duress defense in these circumstances. Next, we briefly review the relevant law and economics literature on duress and the previous articles linking rent-seeking to the contract law doctrine of duress. In Section III, we describe our model, and use it to formalize this link. In Section IV we conclude.

II. PREVIOUS LITERATURE AND RENT-SEEKING

Bar-Gill and Omri Ben-Shahar's[7] and Steven Shavell's[8] articles are the most influential law and economics studies analyzing duress in the context of contract law. Bar-Gill and Ben-Shahar claim that "enforcement of an agreement, reached under a threat to refrain from dealing, should be conditioned solely on the threat's credibility."[9] The intuition behind their claim is the following: if courts void agreements that result from a credible threat, they run the risk of incentivizing the party that is in a position to threaten the second party to engage in the threatened activity without informing the second party of their intention to do so. This is bad for both parties in situations where the threatened activity reduces the surplus available to the two parties and, therefore, where the act could have been avoided with an enforceable contract.

Shavell, on the other hand, deals with contractual hold-ups more broadly, and suggests that contracts entered into as a result of engi-

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[7] Bar-Gill and Ben-Shahar, 11 S Ct Econ Rev 143 (cited in note 2); Bar-Gill and Ben-Shahar, 33 J Leg Stud 391 (cited in note 2); and Bar-Gill and Ben-Shahar, 83 Tex L Rev 717 (cited in note 2).

[8] Steven Shavell, 36 J Leg. St 325 (cited in note 2).

[9] Ben-Shahar and Bar-Gill, 33 J Leg Stud at 391 (cited at note 2).

neered hold-up situations ought to be voided.[10] This follows in Shavell's model, because the engineered hold-up situation is harmful to the second party, and can be avoided if the engineering party's incentives can be removed by preventing him from benefiting from an enforceable contract.

Both articles provide excellent insights regarding the welfare effects of enforcing contracts under various situations, but we believe that they do not consider some important cases where the proposed tests do not reach the efficient result. In particular, Bar-Gill and Ben-Shahar's model does not incorporate potential ex ante investments by the threatening party to make his threat credible ex post.[11] More specifically, a party's investment in putting himself in a situation to threaten another party plus the cost of carrying forward with the threatened conduct can exceed the benefits that party has to gain from executing his threat, even if just the cost of executing the threatened conduct (absent investment costs) is lower than these benefits. These investments are inefficient, because they result in benefits that are lower than the total costs that enable such benefits. Despite this, the threat is credible, because at the time the threat is made, it is in the threatening party's best interest to execute the threat if the second party refuses his demands. This is because ex ante investments are sunk, and therefore they do not affect the threatener's decision. In such situations, contrary to Bar-Gill and Ben-Shahar 's proposal, it is not desirable to enforce contracts: by making duress a defense, the law removes all potential gains that the threatener may obtain form the threatened party. Removing this incentive will induce him to not invest in making the threat in the first place, thereby preventing inefficient investments.

Shavell, on the other hand, excludes another case from his analysis, namely, what he terms "engineered situations"[12]—situations in which the benefit to the engineering party from executing his threat is greater than the total cost of engineering and carrying out his threat. In such situations, the law can reduce social welfare by not enforcing contracts negotiated between the engineering party and his intended victim. Allowing a defense of duress induces the engineering party to undertake the threatened action without informing the party who would be harmed. When this action causes more

[10] Shavell, 36 J Leg Stud 325 (cited in note 2).

[11] Although the authors briefly comment on ex ante investments in Bar-Gill and Ben-Shahar, 83 Tex L Rev 717 (cited in note 2), they do not formally study the effects of such investments and they do not relate them, as we do here, to the concept of rent-seeking.

[12] Shavell, 36 J Leg Stud at 325 (cited in note 2).

harm to the second party than the benefit the engineering party has to gain from exercising his threat, the two parties can generate a surplus by entering an enforceable contract. But the law, by allowing a defense of duress, does not permit the generation of such surplus, and thereby reduces social welfare.

As we demonstrate in this article, a test based on the concept of rent-seeking produces the efficient result in these two cases that are excluded in Bar-Gill and Ben-Shahar's 2004 article[13] and by Shavell[14]. Although previous commentary has correctly pointed out that the concept of rent-seeking can shed light on the conditions under which allowing a defense of duress is desirable, no study of which we are aware provides a game-theoretical framework in which this claim is formalized. Benjamin Hermalin, Avery Katz, and Richard Craswell, for instance, suggest that rent-seeking provides "[a] better justification of the doctrine" of duress than those justifications based on credible coercion as suggested by Bar-Gill and Ben-Shahar in 2004.[15] Similarly, Cooter and Ulen touch on the topic of rent-seeking by distinguishing between voluntary contracts that create wealth versus involuntary contracts that only transfer wealth.[16]

Lengthier and more systematic discussions that illustrate the relationship between duress and rent-seeking with reference to specific cases also exist. For instance, two recent articles one by Seidenfeld and Mungan[17] and one by Zywicki[18] link the concept of rent-seeking to contract enforceability issues encountered in a number of cases, including *Alaska Packers*[19] and *Austin v Loral*.[20] In reviewing the former case, Zywicki argues that a modification entered as a result of rent-seeking threats were held to be unenforceable by the court.[21] Seidenfeld and Mungan use the facts of the latter case to construct a hypothetical demonstrating "that allowing a defense of duress is not warranted, even if the threat-maker is responsible for the vulnerability of the target to the threat," when the threat is not motivated by rent-seeking behavior.[22] These two articles, and previous commentary, provide insights regarding the relationship between rent-

[13] Ben-Shahar and Bar-Gill, 33 J Leg Stud 391 (cited in note 2).

[14] Shavell, 36 J Leg Stud 325 (cited in note 2).

[15] Hermalin, Katz, and Craswell, *Contracts* at 49 (cited in note 3).

[16] Cooter and Ulen at 269-71 (cited in note 3).

[17] Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1).

[18] Zywicki, 16 Chapman L Rev 309 (cited in note 3).

[19] *Alaska Packers Association v Domenico*, 117 F 99 (9th Cir 1902).

[20] *Austin Instrument, Inc v Loral Corp*, 29 NY2d 124 (1971).

[21] Zywicki, 16 Chapman L Rev 309 (cited in note 3).

[22] Seidenfeld and Mungan, 99 Minn L Rev at 1440 (cited in note 1).

seeking and duress. Neither, however, provides a formal economic model to pinpoint this relationship.

In this article, we provide the simplest game-theoretical framework to formalize the link between rent-seeking and duress. In particular, we consider parties that can invest in order to put themselves in a position where they can extract a transfer from a targeted victim by putting him in a vulnerable position. However, these investments need not be completely wasteful, they can generate value to third parties. Therefore, the party investing need not necessarily be hoping for a wealth transfer from his potential victim; he may be investing simply to receive some payment from the third parties for whom he is generating benefits. Therefore, the inquiry that determines whether a contract between the threatener and the victim ought to be enforceable is whether the threatener is making the investment for purposes of transferring wealth beyond that which he is generating. This inquiry is equivalent to investigating whether the person is engaging in rent-seeking.

III. MODEL AND ANALYSIS

We consider an extended version of the complete information model of duress proposed in previous work.[23] Specifically, we consider a sequential move game where a potential plaintiff (P, female) moves first and a potential defendant (D, male), who, if approached moves second. P has the option of investing $I \geq 0$, which enables (but does not necessitate) her to interact with D.[24] If P does not invest, the game ends. If P invests, she has to decide whether to approach D and inform him that if he does not make a payment to P (which is to be determined through negotiation, later) she will perform an act, which we call act x, that causes damages of V to D and generates a benefit of B to P, or whether to perform x without approaching D.[25] If she chooses the latter option the game ends. But, if P chooses the former option, D must decide whether to refuse P's demands, or to negotiate on a price to avoid the (full) performance of x. The negotiations result in a benefit of ρ to P and a cost of ψ to D, absent the

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    [23] See above, Ben-Shahar and Bar-Gill, 33 J Leg Stud at 394–97 (cited in note 2) and Ben-Shahar and Bar-Gill, 83 Tex L Rev at 720–27 (cited in note 2).

    [24] For example, P might invest in getting "dirt" on a celebrity that P believes it can sell to a sensationalist media outlet. See Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1), for other examples.

    [25] For example, if P invests in getting the dirt, it will have to determine whether to simply sell the dirt, or instead whether to offer D the opportunity to pay P not to reveal it. See id for other examples.
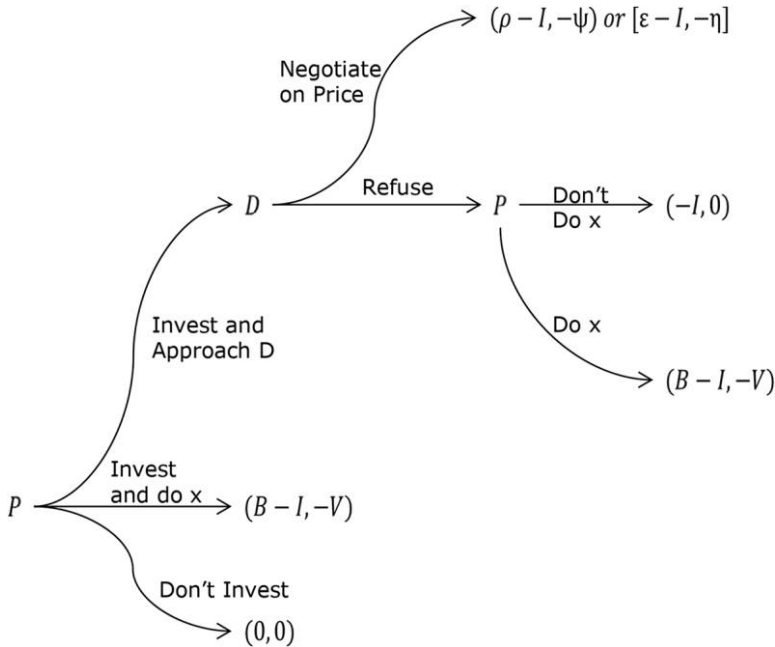
Figure 1.   Sequential game between P and D.
Note: Square brackets denote payoffs when there is a duress defense, and D invokes the defense.

duress defense.[26] ρ need not equal ψ, because it may be necessary for act x to be partially performed for P to make his demands in the first place. Hence, let $\rho = p + \varepsilon$ and $\psi = p + \eta$ where $\varepsilon \geq 0$ and $\eta \geq 0$ denote the partial benefit to P and partial harm to D, respectively. We assume that ε is relatively small, in particular that $\varepsilon \leq \min\{I, B\}$. If the duress defense is made available to D, however, it is assumed that P can be made to pay p back D. Finally, when D refuses P's demand, P decides whether or not to perform.[27] These interactions are summarized in Figure 1 below.

The subgame perfect Nash equilibrium (SPNE) of the game illustrated in Figure 1 can be obtained through backward induction.

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[26] Negotiations may reveal that the parties cannot reach a mutually agreeable outcome. In these cases, the parties receive their outside options, that is, $B - I$ for P and $-V$ for D. In these cases, the game is uninteresting, and the stable perfect Nash equilibrium is unaffected by whether there is a duress defense, because P has nothing to gain from threatening D, and therefore he always does x. Thus, we focus on the relevant case where $V + \rho > B + \psi$.

[27] Note that as long as $B > 0$, P always chooses to execute his threat when D refuses P's demands.

Table 1.   SPNE and Total Payoffs

		No Duress		Duress	
		SPNE	Total Payoff	SPNE	Total Payoff
I	$\rho > B > I$	Approach and negotiate	$\rho - I - \psi$	Do x	$B - I - V$
II	$\rho > I > B$	Approach and negotiate	$\rho - I - \psi$	Don't invest	0
III	$B > max\{I, \rho\}$	Do x	$B - I - V$	Do x	$B - I - V$
IV	$I > max\{\rho, B\}$	Don't invest	0	Don't invest	0

Table 1, below, lists the equilibria under various conditions and as a function of whether or not duress is a valid defense for D.[28] As the table illustrates, whether or not duress is a defense effects results when (and only when) $\rho > \max\{I, B\}$, that is, when P's payoff from threatening D and on negotiations transferring wealth from him to herself exceeds both the cost of investment and her external benefits from exercising the threat. On the one hand, when $B > \max\{I, \rho\}$ it is always in P's interest to invest in the first place because she can reap a benefit of B, which more than offsets the cost of investment I, simply by performing x. Furthermore, after she invests, she has nothing to gain from threatening D; she is always better off performing x because doing so provides him benefits (of B) that are greater than what she has to gain through a wealth transfer from B (that is, ρ). On the other hand, when $I > \max\{\rho, B\}$, the potential plaintiff knows that she will definitely be incurring losses through her investment; neither the gains from a transfer from D (that is, ρ), nor the benefit from performing x (that is, B), off sets the cost of investment.

For these reasons, whether or not duress is a valid defense is relevant for efficiency purposes only when $\rho > I$. Given this observation, the next proposition summarizes the conditions under which efficiency considerations require D to be allowed a valid defense of duress.[29]

[28] We are ignoring potential equalities and considering only strict inequalities in defining conditions I–IV in Table 1.

[29] Only for simplification purposes, we assume that if P is indifferent between investing and approaching and investing and performing x, that he chooses to invest and approach. This does not change any of the results, but simply eliminates some SPNE that generate results equivalent to what is presented here.

Proposition 1: *(i) Allowing a defense of duress is efficient when the cost of investment (I) exceeds the external benefits (B) to P from performing the threatened act. (ii) Conversely, allowing a defense of duress when B > I can cause inefficiencies.*

Proof: (i) When $I > \max\{\rho, B\}$ the defense has no effect on social welfare. When $\rho > I > B$, it follows that $\rho - I - \psi - 0$ since $\varepsilon - \eta < \varepsilon < I$. (ii) When $B > \max\{I, \rho\}$ the defense has no effect on social welfare. When $\rho > B > I$ it follows that $\rho - I - \psi > B - I - V$ since $V + \varepsilon > B + \eta$ is a necessary condition for negotiations to not breakdown. See note 15, above, for the irrelevance of the case where $V + \varepsilon < B + \eta$.

Proposition 1 formalizes the intuition that we conveyed in the introduction. In circumstances where P has an opportunity to make investments that lead to benefits greater than the investment, allowing a defense of duress incentivizes her to perform the act that is detrimental to D without giving him an opportunity to compensate P to refrain from harming D. Hence, the law ought to enforce contracts, and thereby give the two parties an opportunity to generate and share a surplus when P's external benefits are likely to offset her cost of investment. Conversely, when the cost of investment is greater than external benefits to P, the duress defense acts as a deterrent by informing P that she cannot profit through socially wasteful investment. Therefore the law ought to allow duress as a defense in this situation.

We turn now to discuss a few implications of our analysis. First, note that when $I = 0$, we revert to the complete information model in Bar-Gill and Ben-Shahar.[30] Given $B > 0$, as we have assumed, all threats by P to do x are credible, and according to the model, the defense of duress should not be available. This is precisely the implication of our analysis. When $I = 0$, rows II and IV in Table I refer to nonobservable cases, and hence, as Proposition 1 Part (ii) suggests, allowing a defense of duress causes inefficiencies. The implications of our analysis differ from those derived by Bar-Gill and Ben-Shahar[31] when $I > 0$. In particular, when $I > 0$, conditions that would fall under row II in table I are possible. In those cases, our analysis suggests that duress should be a viable defense, even though P has a credible threat ex post, and therefore Bar-Gill and Ben-Shahar's analysis would suggest enforcement.

[30] Bar-Gill and Ben-Shahar, 33 J Leg Stud 391 (cited in note 2).
[31] Id.

A second observation to be noted is that when $I > 0$, the potential plaintiff is "engineering," as in Shavell's work,[32] the circumstance which may causes D harm unless he subsequently meets P's demands. In contrast, our analysis suggests that efficiency is not necessarily enhanced by voiding all contracts in such situations. In particular, when $\rho > B > I$, as proposition 1 suggests, contracts should be enforced, because otherwise, P may be induced to perform x without notifying D of his intentions, and therefore giving him an opportunity to mitigate his losses. These two observations highlight how our test differs from those suggested by Bar-Gill and Ben-Shahar[33] and Shavell.[34] In particular, because our test includes potential ex ante investments and external benefits to P, it is able to identify potential inefficiencies that do not exist in previous analyses.

It is important to note that the same considerations allow us to identify the link between rent-seeking and conditions under which allowing duress as a defense enhances efficiency. The conditions that give rise to row-I type cases are those where P is investing for purposes of generating wealth (i.e. $B > I$) and hopes to capture some of the value generated through such wealth creation. Whether or not a third party is being harmed by P's investment is irrelevant to P for purposes of deciding on whether to invest I to generate wealth. In fact, P would invest, even if D did not exist. Conversely, row-II type cases arise when P's investment is motivated by a desire to transfer wealth (exceeding that which is created by his investment) from a person who is placed in a dire situation as a result of that investment. In fact, P would not invest, if he believed that he could not find a party, such as D, from whom she could extract wealth beyond the value generated by his investment. Hence, the latter situation corresponds to rent-seeking, and these are precisely the conditions under which we claim a defense of duress should exist.

Finally, we would like to highlight the simplicity of the model used to derive our results. The model abstracts from many issues, including; potential investment by D, in addition to investments by P; the potential for price caps as in Shavell's article,[35] the possibility of court error in the determination of the conditions under which the defense of duress ought to be made available; and the possibility

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[32] Shavell, 36 J Leg Stud 325 (cited in note 2).
[33] Ben-Shahar and Bar-Gill, 33 J Leg Stud 391 (cited at note 2).
[34] Shavell, 36 J Leg Stud 325 (cited in note 2).
[35] Id.

of parties having misperceptions about each other's characteristics. Needless to say these are extremely important considerations.[36]

III. CONCLUSION

The conditions under which it is socially desirable to allow a defendant to assert a defense of duress is closely related to whether the plaintiff has engaged in rent-seeking activity. In particular, the duress defense should be made available when the plaintiff's investments are motivated by the prospect of rent-seeking rather than wealth generation. Otherwise, the plaintiff can be incentivized to make investments whose primary objective is to redistribute wealth without generating much of value. We have used a very simple game-theoretical framework to derive this conclusion with the hope of highlighting the importance of rent-seeking for purposes of defining wrongful threats in the context of the contract law doctrine of duress.

[36] We may be too quick to suggest that this and similar statements need no mentioning. Although most law and economics scholars, perhaps because of commonalities in their education, feel no need to state that economic analyses proceed in steps by isolating various issues with hopes that future research will slowly build up on benchmark models, this implicit understanding may not be shared by some scholars. Many criticisms of Seidenfeld and Mungan, 99 Minn L Rev 1423 (cited in note 1), developed in Bayern, 99 Minn L Rev Headnotes 141 (cited in note 5), for instance, seem consistent with this type of miscommunication.