THE LAW AND ECONOMICS OF FORCE MAJEURE LITIGATION: *THE CASE OF COVID-19*

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1. Introduction

In the aftermath of the Covid-19, the world is witnessing a flurry of disputes over contractual performances and compensation claims for injuries with India being no exception. The pandemic has forced companies and firms to suspend their promised supply of goods or services, triggering legal demands of compensation from the counterparties in the contract. Many employers have held back on the promised wages, debtors have suspended servicing their debts, and insurance companies have refused to compensate claimants for the business income losses. In many of the disputes triggered by Covid-19, one or the other contracting party has invoked the pandemic as 'force-majeure', or an event that has frustrated the contact. In many other disputes, the suppliers have argued that the disease has made contractual performance an economic impossibility. That is, the pandemic has increased the cost of contractual performance to a level that they cannot afford.

Covid-19 has triggered many claims for compensation for injuries as well. In the aftermath of Covid outbreak, many employees were able to work from home. However, for a large section of employees it was not possible to work remotely, especially those working in the essential services. These people faced an enhanced risk at the workplace. Indeed, many of these workers have been engaged in very high risk works with direct exposure to Covid-19. The degree of risk varies across activities. Therefore, it is very likely that the disease will take a higher toll on these people in terms of physical and mental health, leading to disputes over compensation. There are also reports of compensation claims arising from the injuries caused by safety products, like sanitizers, masks etc.

Indeed, the count of disputes triggered or caused by Covid-19 is large and is increasing by the day. In this paper, we examine these disputes from a law and economics perspective. We present a litigation model to analyze the effect of the pandemic on the probability of litigation

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and the subsequent trial outcomes. We examine how the predicted litigation outcomes have bearing on the likelihood and the terms of the 'out of court' settlements between the parties.

In several cases, disputant parties try to settle their dispute out of the court. The out of court settlement happens in the shadow of the litigation outcome.[2] In other words, during pretrial negotiations, the bargaining position of parties depend on what they can expect from the trial. A rational plaintiff will demand high compensation if he expects high compensation through trial and vice-versa. Covid related disputes are different on several counts. The pandemic has come as a macroeconomic shock for many workers, employers, traders, service sector firms and the industrial and service sector companies. The disease has adversely affected the financial position of many business entities and firms. Unsurprisingly, many find themselves unable to meet their contractual obligations; such as debtors are unable to service their debts, buyers are unable to make payment for goods delivered, etc. Numerous individuals and business entities have been left 'judgement proof' by the disease. In other words, these entities are not in a position to fulfill their obligations and hence their disputes cannot be resolved in pre-trial negotiations. However, the economic impact of the pandemic differs across sectors but more importantly across firms within a sector. This means that while buyers and the debtors know about their financial position, the other side (suppliers and creditors) does not.

Moreover, the Covid-19 has increased uncertainty about the litigation outcomes. As mentioned above, many parties have cited the pandemic as an force majeure event in an attempt to wriggle out of their contractual obligations. In numerous other cases, one or the other party has cited 'frustration of contract' as a ground for not making promised payments and/or for not fulfilling their other contractual obligations. During the lockdowns, many suppliers had refused supplies citing the high costs of production and transportation. Media reports also abound on these issues.

However, there is a lot of uncertainty around how the courts are going to adjudicate the disputes triggered by the pandemic. Therefore, how the courts adjudicate Covid related disputes will affect not only the distribution of losses among the litigants but more importantly it will affect the intensity of litigation as well as the success rate for the pre-trial negotiations.

[2] R.H. Mnookin & L. Kornhauser, *Bargaining in the shadow of the law: The case of divorce*, YALE L J 88, 950-997 (1979).

The legal uncertainty and asymmetric information about the case strength have direct consequences for the pre-trial negotiations. As such, many times the pre-trial negotiations fail because the disputants have very different beliefs about the court awards, or they have asymmetric information about the case strength, or both. As examined in the next section, the pandemic has exacerbated the problems of legal uncertainty and informational asymmetry, undermining the prospects of out of court settlements.

In Section 2, we discuss the Indian legal position on the force majeure, frustration of contract and cost of performance, and compensation for injuries. We also discuss how Covid-19 has increased legal uncertainty and informational asymmetry between the disputant parties. In Section 3, we present a model that serves as a basis for analysis in the next section. In Section 4, we examine the effect of uncertainty and informational asymmetry on the litigation outcomes and pretrial negotiations. Lastly, in Section 5, we offer our concluding remarks and suggestions for efficient adjudication of the disputes triggered by this pandemic.

2. The Law, Litigation and Uncertainty

The literature on litigation attributes the existence of, in equilibrium, litigation to different beliefs about litigation outcome or asymmetric information between the parties involved.[3]

In this paper, our focus is on examining the implication of Covid-19 pandemic on contractual disputes and litigation over them. A contract is a formal agreement between the contracting parties. However, for the purpose of this study, the contract can be 'implicit', or it could arise out of another formal agreement between the respective parties.

Consider an example of a derived contract: The case of Workplace Injuries. The Employees Compensation Act, 1923 in India provides compensation for workplace injuries based on the principle of no-fault liability. The victim of a workplace injury does not have to prove fault or negligence on the part of the employer. Rather, it is enough to show that an injury arose out of and in course of the employment. Similar is the case for occupational diseases. However, in case of Covid, the courts will have to ensure that the injury happened due to the Covid exposure

[3] *See* Kathryn Spier, *The dynamics of Pretrial Negotiation*, 59(1) THE REVIEW OF ECONOMIC STUDIES, 93-108 (1992); SHAVELL, STEVEN, FOUNDATIONS OF ECONOMIC ANALYSIS OF LAW (Belknap Press World 2004)

at the workplace and dealing with the issue of causation is not easy by any means, since most people are exposed to various different sources of exposure.[4] This mean that the worker plaintiff seeking compensation as well as the defendant employer cannot be certain about their victory in the trial.

Even if the causation can be established, enquiry into compensation for injury is equally difficult. It is difficult to quantify the cost of injury/disease in monetary terms, especially when the injury can take time to fully manifest all its symptoms and their consequences.

For a compensation suit to succeed, the court has to examine if there exists a causation between workplace conditions and the mental and physical health of the plaintiff/victim. However, in many cases, affected people face multiple exposure to the disease but the symptoms appear after a considerable time gap since the exposure. Therefore, it is difficult for the court and also for the parties to prove or rebut the claim that an injury arose in the course of employment. There is uncertainty about whether a compensation claim will be admitted by the court or not. Even if a claim is admitted, the court has to quantify the compensation based on its assessment of the severity of the injury which can be very subjective assessment of the court. In other words, the plaintiffs and defendants face uncertainty about the court awards.

A similar logic applies to suits for compensation for injuries caused by 'safety' products used in the aftermath of Covid-19; such as sanitizers, masks, air purifiers, etc. An example of an implicit contract is the relationship between manufactures of such risky products and their consumers. Even though there is no formal agreement between the two sides, the proof of a transaction between a manufacturer (seller) of a product can create entitlement for the consumer to sue the producer/seller in the event of consumer suffering from injury while using the product. In the context of Covid-19, disputes over the injuries caused by defective safety products can be a significant source of litigation. However, it is not clear whether and how courts will adjudicate such disputes. It seems plausible to assume that in the event of litigation, the producers will have an informational edge over the consumers, when it comes to establishing the manufacturing defects. The consumers will have better knowledge of the harm suffered by them.

[4] Ram Singh, *Causation-consistent' Liability, Economic Efficiency and the Law of Torts*, 27 INTL REV LAW & ECON, 179-203 (2007).

Most contractual disputes are likely between parties with explicit agreements. Media reports abound on how many promisors have suspended promised supply by arguing that the pandemic is a 'force majeure' (FM) event. During the lockdowns, the power producers had refused to accept supply of electricity arguing that the Covid was a FM event as per their power purchase agreements with the power producers. Similarly, the real-estate developers and contractors had cited the pandemic as an FM event to justify the delays on their part. Many employers have refused the promised wage payments, borrowers have defaulted on the debt contracts with lenders on similar grounds. Even insurance companies have refused claims for compensation for business income losses caused by Covid-19. In other words, one of the contracting parties has argued that the Covid-19 is an event that is beyond the control of the parties involved, and that the event has made it impossible for the party to perform its contractual duty.

As a matter of fact, most supply contracts contain a FM clause. The clause provides a list of events like strike, war, riot, etc., along with events called 'acts of god,' for example flood, cyclone, earthquake, hurricane, epidemic, among others. Several 'acts of government,' are also included in the FM clause; such as prohibitory lockdowns, travel bans, etc. The idea behind the clause is to allow the parties to either terminate the agreement or put it on hold (depending on the context), if an FM event listed in the clause happens. However, the problem is that most of the contracts provide an incomplete list of events that the parties would have liked to include under FM Clause. Even worse, the clause can contain ambiguous phrases like, 'events including but not limited to the ones listed herein'. This Incompleteness and vagueness of the FM clause offers an opportunity for exploitation by the self-interested parties to absolve themselves from contractual obligations.

The term force majeure is not defined in the Indian Contract Act, 1872 (ICA). In several landmark judgements, The Supreme Court (SC) has ruled that if a contract has FM clause, it will be governed under section *32* of the Act. In several important judgements, the higher judiciary has clarified several important issues related to the FM clause.[5] However, this does

[5] *See e.g.,* Edmund Bendit and Anr. vs Edgar Raphael Prudhomme, AIR 1925 Mad 626; Satyabrata Ghose v Mugneeram Bangur & Others, AIR 1954 SC 44; Energy Watchdog v Central Electricity Regulatory Commission, (2017) 14 SCC 80; *NAFED v Alimenta* (2020).

not detract from the fact that there are various kinds of uncertainty that still haunt the use of FM clause.

The Covid related disputes are especially vulnerable to different interpretations as the new virus does not find explicit mention in most of the contracts under dispute in the aftermath of the pandemic. Therefore, in each case, the court will have to check whether the promisor could not have fulfilled the promise under the circumstance. Moreover, it will have to ensure that the claimed impossibility of performance by the promisor is attributable to pandemic. For cases where the plaintiff is entitled to compensation, the court has to enquire if appropriate steps were taken to mitigate consequences of the pandemic. Judicial findings on all these matters can be a matter of guess for the disputants. Therefore, there is a lot of uncertainty about how the courts will deal with the disputes citing Covid as a force majeure event.

In other disputes, one of the parties has argued 'frustration of contract' to justify its failure to meet contract terms. For example, restaurant operators, retailers, occupants of multiplexes, and the commercial property premise owners have sought rental-waivers from the property owners, arguing that the Covid has caused frustration of the purpose with which they had signed the contract (i.e. lease agreements). Similar is the case with contracts in the hospitality sector and management services. Consider the clients of caterers, event-managers, venue-owners, wedding planners, and vendors for decor & entertainment companies. Their clients, who had provided security deposits/booking amounts, have now filed claims for refund citing frustration of contract by the government ordered lockdowns.

Frustration of a contract is said to have occurred if an unforeseen event happens after the contract has been signed. The event responsible for frustration should make performance impossible physically or commercially or illegal, and should be outside the control of the contracting parties.

Though the Indian contract law does not define the term 'frustration of contract', the SC has held that the doctrine of frustration of contract can be dealt with under *Section 56* of the ICA. This section of the ICA makes an agreement void if as a consequence of an ex-post event the promise is rendered impossible or an illegal act, after the contract is made.[6]

[6] *See* Boothalinga Agencies v V. T. C. Poriaswami, AIR 1969 SC 110; Satyabrata Ghose v Mugneeram Bangur & Others, AIR 1954 SC 44.

As far as Covid related disputes are concerned, to allow a party to use the claim of frustration of contract, the courts have to verify if the very purpose or basis of the contract has been upset by the pandemic. That is the court has to engage in a counterfactual enquiry. The litigation outcome will depend on which side can establish preponderance of its arguments. Again, the Judicial outcomes are highly unpredictable in such cases. Using a legal phrase, the jury is still out on how the courts will decide on Covid related disputes.

As mentioned in the introduction, in many instances the suppliers and producers have reneged on their promise citing high cost of production or transportation in the aftermath of the pandemic. Indeed, during lockdowns many contracting parties found the contractual performance economically ruinous and hence had breached the contractual promises. In other words, they had refused promised deliveries/supplies arguing that the cost of supply was beyond what they could afford.

In normal times, Indian courts do not allow a promisor to renege on their supply promises based on such ground. In several judgments the SC has held that an increase in production costs or cost of delivery is not an admissible ground for absolving a party of its contractual obligation. For instance, in *Alopi Parshad v Union of India* (1960)[7] , the Supreme Court (SC) held that the promisor (a supplier of ghee) cannot wriggle out of his contract merely because his cost had increased post signing of the contract, due to the war (World War II). The apex court held that commercial difficulty did not amount to impossibility to perform and was not an admissible ground for absolving a party of its contractual duties. This is true internationally as well – courts across jurisdictions do not permit non-performance on grounds of high costs. E.g, see Tsakiroglou & Co Ltd v Noblee Thorl GmbH [1962].[8] However, the situation created by Covid is unusual, and it is not clear if the courts will still take a similar view on the cost of compliance issue, leading to a feeling of uncertainty about judicial findings.

[7] Alopi Parshad v. Union of India, AIR 1960 SC 588; *See* Naihati Jute Mills Ltd. Vs. Khyaliram Jagannath, AIR 1968 SC 522.

[8] Tsakiroglou & Co Ltd v Noblee Thorl GmbH, [1962] AC 93; The appellants/seller had agreed to ship groundnuts by sea to Hamburg. The seller argued that he could not ensure supply as after signing of the contract, the Suez Canal was closed to navigation due to military operations by Great Britain and France against Egypt. The contract had a force majeure clause. However, the court held that closing of Suez Canal did not make the delivery impossible. Appellant goods could have shipped around the Cape of Good Hope, even though this route was almost twice as long and the freightage would have cost much more.

As to the compensation claims for the costs suffered by the promisee or profit lost by him on account of non-performance by the promisor, generally the compensation for the costs or losses arising on account of the breach of contract are restricted foreseeable costs/losses. First of all, it is difficult to establish what part of the loss was foreseeable. Even if foreseeability is established, a court may still deny compensation. In this regard Transfield *Shipping Inc. v. Mercator Shipping Inc.,* House of Lords [2008] UKHL 48, is an interesting judgment.[9] In the terminology of the law and economics, the foreseeability can be termed as the "expected damage". At the time when the hirer took the decision to return the ship too late the expected damage (on top of the lost rent for 11 days) was zero.

Summing up, the pandemic has not only caused a spate of disputes, it has created a lot of uncertainty about how the courts will adjudicate these disputes. In many cases, the pandemic has led to disputes where parties have asymmetric information or beliefs about their case strength and court awards.

In the next section, we model the litigation and settlement processes in the aftermath of Covid-19. Using the model, we show that the judicial uncertainty and informational asymmetry between the parties have implications for the trial outcomes as well as for the chances of out of court settlements.

3. The Model

Consider a dispute between a potential plaintiff, P, and a potential defendant, D. The plaintiff claims to have suffered a loss as a consequence of an act of the latter. The plaintiff can be a worker who has suffered physical or mental injuries at the workplace, or a buyer who has been denied contractually agreed delivery by the seller. In such contexts, the defendant can be thought of as the employer and the seller, respectively. In general terms, the plaintiff can be any person or entity that has suffered losses or incurred costs attributable to an act of the

[9] Transfield Shipping Inc. v. Mercator Shipping Inc, [2008] UKHL 48; In this case, the hirer of a ship returned it to the ship-owner after a gap of 11 days after expiry of the contract, leading to a suit for damage compensation. The ship-owner claimed damages for the lost rent of 11 days. In addition, he argued that during this delay period the charter prices had dropped so he was forced to make a new contract for renting the ship at a reduced price. Hence, he also claimed compensation for the lost profits for this period. The British court argued that the second part of the damage was foreseeable and neither unlikely nor remote and still denied compensation.

defendant.[10] The former may have a legal claim to demand compensation from the latter. Both parties are rational and risk neutral individuals. Simply put, they care only about their own expected gains or losses. Let,

π denote the probability that the plaintiff will win the trial.

A denote the award of damages (compensation) by the court.

Informally put, π represents the likelihood of the plaintiff winning a claim of compensation against the defendant; with probability $1 - \pi$, the defendant expects to win the case. If the plaintiff wins the trial, the court will ask the defendant to pay an amount A to the plaintiff. Therefore, for the plaintiff the expected value of the gains from trial is equal to $\pi \times A$. Let

$$E = \pi \times A$$

Trial is costly for both sides – parties have to spend time, money and other necessary resources during the trial. Let,

T_p and T_d denote the trial cost for the plaintiff and the defendant, respectively.

Therefore, the net trial gains for the plaintiff will be:

$$\pi A - T_p = E - T_p$$

On the other hand, the expected cost of the total trial for the defendant will be the expected damages that he will have to pay to the plaintiff plus the trial cost. That is, the total trial cost for D is given by

$$\pi A + T_d = E + T_d$$

Now, consider a litigation context where parties have symmetric beliefs about the litigation outcome. An example of this is a situation where both sides have an objective and therefore undertake a similar assessment of their case strength and the quantum of court award. Specifically, assume that both parties believe that the probability of the plaintiff winning the case is π and the value of court award is A. Under such a scenario, both sides are better off settling their dispute out of court, rather than going for a litigation. To see this, let

[10] The act can be an inaction on the part of the promisor. E.g., failure of the employer to provide adequate safety measures at the workplace.

S denote the settlement offer by the defendant to the plaintiff.

Note that if there is litigation, for P the net expected gains from the trial are: $E - T_p$. So, the plaintiff will be willing to accept a settlement offer if $S \geq E - T_p$. By a similar logic, the defendant will be willing to make a settlement offer that is less than or equal to their own total cost of litigation, i.e., the defendant will be willing to offer $S \leq E + T_d$.[11] However, $E - T_p < E + T_d$. That is, the net trial gains for the plaintiff are less than the total trial cost for the defendant, due to litigation costs. Therefore, when parties have symmetric belief about the litigation outcome, a mutually beneficial offer always exists for the parties. Actually, any settlement offer S is mutually beneficial for the parties as long as S lies in the following range:

$$E - T_p \leq S \leq E + T_d \qquad (1)$$

The range of mutually acceptable settlement offers is $[E - T_p; E + T_d]$

Next, suppose that both parties believe that the probability of win for the plaintiff is $\underline{\pi}$ and the court award is going to be $\underline{A}$. Even if $\underline{\pi} \neq \pi$ and/or $\underline{A} \neq A$, it can be checked that the parties are better off settling their dispute out of court, rather than going for a litigation. In other words, as long as parties have symmetric beliefs about the probability of winning, the trial and the court awards, they will prefer to settle their dispute out of court rather than going for costly litigation. Using terminology of law and economics, the Coase Theorem will hold as long as parties have symmetric information or beliefs about the trial outcome.[12]

Therefore, we have the following result:

Result 1: *If parties have similar expectation about the court outcome, they are more likely to settle rather than litigate*

4. Settlement in the Shadow of Uncertainty

As discussed in the previous section, Covid-19 has aggravated the problem of uncertainty for disputants and litigants. The parties at dispute face increased uncertainty not only with respect

[11] Note the defendant is indifferent between going for litigation and paying a settlement amount equal to E+Td. Without any loss of generality, we assume that the defendant will choose to pay S=E+Td, rather than going for litigation.

[12] The basic claim behind this 'informal' theorem is the following: If there are no transaction costs, the price mechanism will lead to efficient outcome regardless of the legal entitlements of the parties involved.

to their own case strength but also with respect to the court awards. In many cases, the pandemic has resulted in informational asymmetry between the parties involved in the disputes. The informational asymmetry can be unilateral or it can be bilateral.

Asymmetric Beliefs: Unilateral case

In many disputes one of the parties has better information about the strength of the case and/or the quantum of the loss under dispute. For instance, P may know the level of harm suffered by him but D may not have a good sense of the harm and hence the quantum of his obligation towards the plaintiff. In such contexts, the informational asymmetric is unilateral. That is, under unilateral asymmetry one of the parties has a better assessment of the strength of the case or the court award or both.

For example, consider the case of workplace injuries. It is plausible to argue that compared to the defendant, the victim of an injury (the plaintiff) has better information about the strength of his case. While the plaintiff would know whether he has had exposure to the disease at places other than at the workplace, but the defendant may be completely unaware of their whereabouts after working hours. Moreover, the plaintiff victim has better information about his health condition and also the associated costs. This means that when the parties litigate or bargain over the compensation for injury, there is an informational asymmetry between them; the victim has better information about the strength of his case as well as the quantum of loss to his health. In many other contexts, a promisee who has relied on performance by the promisor is likely to have a better idea of the losses that can be caused to him due to the non-performance by the promisor.

This kind of information asymmetry means that the plaintiffs have a better idea about the probability of their winning the suit before a court of law. The other side, the defendant, has only a partial knowledge of the case strength. Such contexts can be modeled as follows.

Assume there are two types of plaintiffs - Low and High types. Low types can be thought of as plaintiffs with a weak case strength, and hence has a low probability of win. High types can be thought of as plaintiffs with a strong case strength. Let

π_l denote the probability of win for low types of plaintiffs.

π_h denote the probability of win for high types of plaintiffs.

$0 < \pi_l < \pi_h < 1.$

This implies that the defendant has better chance of winning against a low type of plaintiff, compared to the high type.

Following the literature, assume that if the trial takes place, during cross examination the case strength, i.e., the type of the plaintiff will become clear to both sides as well as the court. To keep things simple, assume that both sides know the value of court award A . Moreover, the litigation cost of plaintiff is T_p, for both types of plaintiffs. These assumptions are made only to keep the exposition simple. All our arguments will hold even if we allow the possibility that the parties might have different beliefs about the value court award A or their litigation costs might be different.

If the trial takes place, a high type of P will end up with $\pi_h A - T_p = E_h - T_p$ as net gains. On the other hand, the low type will end up only with $\pi_l A - T_p = E_l - T_p$ as their net gains. Before the trial, however, the plaintiff's type is a private information for P. That is, D does not observe the plaintiff's type directly, i.e., it does not know whether he is up against a low or high type of plaintiff he is faced with. Therefore, D does not know whether $\pi = \pi_l$ or $\pi = \pi_h$. However, D knows the proportion of high types in the population of potential victims/plaintiffs. Let,

λ be the proportion of High type Plaintiffs

$1 - \lambda$ be the proportion of Low type Plaintiffs

This means that if there is no settlement and a trial takes place, the total expected costs for D is

$$\lambda[E_h + T_d] + (1 - \lambda)[E_l + T_d] = \lambda E_h + (1 - \lambda)E_l + T_d$$

Following the standard practice, assume that the uninformed party, D, makes a 'take it or leave it' (TIOLI) settlement offer to the plaintiff. In view of the above, it is clear that if the defendant's offer is greater than $E_h - T_p$ then all types of plaintiff will accept the offer and there will be no litigation. However, it is easy to see that a choice of settlement offer that is greater than $E_h - T_p$ can never be in the interest of the defendant. On other hand, if defendant's offer is less than $E_l - T_p$ then all types of plaintiff will reject the offer and there will be litigation for sure. Again, the defendant's interests are not served by a choice of settlement offer that is

less than $E_l - T_p$. The next question is whether a settlement offers of $E_h - T_p$ or $E_l - T_p$ are in the interest of the defendant. Let,

$$S_l = E_l - T_p \; and \; S_h = E_h - T_p$$

If D makes a TIOLI offer equal to $S_l = E_l - T_p$, then only the low type will accept the offer. If D makes a TIOLI offer equal to $S_h = E_h - T_p$, then both types will accept the offer. [13] However, when the settlement offer S is equal to or greater than S_l but less than S_h, the high type will reject the settlement and will go for litigation. Recall, that from the perspective of D, the probability that he is litigating with a low type of plaintiff is $1 - \lambda$. So, if the defendant makes a TIOLI offer of $S_l \leq S < S_h$, while the low type will accept his offer, the high type will not. Therefore, the expected cost of the defendant will be

$$\lambda[E_h + T_d] + (1 - \lambda)S$$

It can easily be seen that a choice of S such that $S_l < S < S_h$ is not a cost minimizing choice for D. A settlement offer S such that $S_l < S < S_h$, will be accepted only by the low type. However, the low type will accept the offer even if $S = S_l$. Therefore, it is not in the best interest of the defendant to make an offer more than $S_l = E_l - T_p$. If the defendant chooses $S = S_l$, his expected costs can be expressed as

$$\lambda[E_h + T_d] + (1 - \lambda)\big[E_l - T_p\big] = \lambda E_h + (1 - \lambda)E_l + \lambda T_d - (1 - \lambda)T_p$$

In view of the above, the defendant will choose $S = S_l$ over $S = S_h$, if and only if $\lambda E_h + (1 - \lambda)E_l + \lambda T_d - (1 - \lambda)T_p < E_h - T_p$ iff $\lambda\big[T_p + T_d\big] < (1 - \lambda)\,[E_h - E_l]$, i.e., if and only if

$$E_h - E_l \; > \frac{\lambda}{1 - \lambda}\big[T_d + T_p\big] \qquad (2)$$

Replacing E_l and $E_h$respectively with $\pi_l A$ and $\pi_h A$, gives us

$$(\pi_h - \pi_l)A \; > \frac{\lambda}{1 - \lambda}\big[T_d + T_p\big] \qquad (3)$$

[13] Even though the low type plaintiff is indifferent between accepting a settlement offer equal to El-Tp or going for litigation, without affecting the results we can assume that he will choose for the former. A similar assumption is made about the high type and the offer Eh-Tp.

Therefore, when stakes are high or the difference between the case strengths of low and high types is large, the defendant is more likely to make a low settlement offer. Similarly, as the fraction of the high types, λ becomes low, the defendant is more likely to make a low settlement offer, and vice-versa. However, a low offer means that the trial will take place between the defendant and the high type of plaintiffs. Therefore, we get the following result.

Result 2**:** *The probability of litigation increases with: the amount under dispute, the difference between beliefs case strength and the proportion of low types of plaintiffs.*

We can draw some inferences immediately. As informational asymmetry between the parties reduces, their beliefs about the court outcomes will converge. This in turn will reduce the conditions needed for litigation. In other words, if judiciary can reduce the uncertainty and asymmetry between the parties, it will encourage out of court settlements.

Asymmetric Beliefs: *Bilateral case*

As discussed above, many parties have terminated or suspended the performance of their contractual obligations citing Covid-19 as a force-majeure. However, there is uncertainty about whether the courts are going to treat this pandemic as a case of force-majeure or not. In other words, there is uncertainty about whether a claim will be admitted by the court or not. Even if a court is going to admit a case, its assessment of the harms suffered by the plaintiff and hence the compensation award is a matter of uncertainty. In the context of sales contracts, the seller knows better whether the pandemic and the subsequent lockdown really made it impossible for him to supply, however, the buyer has advantage with respect to the losses caused by this non-performance. Simply put, the informational asymmetry can be bilateral.[14]

Similar is the case with respect to tenability of the economic impossibility and frustration of the contract as grounds for contractual non-performance. In many cases, the parties at dispute may have distinct informational advantages. In such a scenario, the litigants can have very different beliefs about the tenability of their claims as well as the court awards. To formalize, these let

π_p denote the subjective probability of the plaintiff that he will win the trial.

π_d denote the subjective probability of the defendant that he will lose the trial.

[14] *See* Andrew F Dauchety & Jennifer F Reinganum, *Settlement Negotiations with Two-Sided Asymmetric Information: Model Duality, Information Distribution, and Efficiency*, 14 INTERNATIONAL REVIEW OF LAW AND ECONOMICS, 283-298 (1994).

In other words, the plaintiff believes that his chances of winning are given by π_p. On the other hand, defendant believes that the plaintiffs chance of winning is given by π_d; i.e., the defend expects to win and pay nothing with probability $1 - \pi_d$. Let

A_p denote the plaintiff's belief about the damages (compensation) from trial;
A_d denote the defendant's belief about the court award of damages (compensation).

That is, the plaintiff believes that in case of his winning the case, the value of compensation is A_p. However, the defendant thinks that in case he ends up losing the case, the amount he will end up paying to the plaintiff is A_d. This means that for P the net expected gain from trial is $E_p = \pi_p \times A_p$. For D, the expected payment to the plaintiff is $E_d = \pi_d \times A_d$.

An over confident or supper optimistic plaintiff will over-estimate either his chances of winning the case or the compensation award, or both. Formally, he will overestimate π or A or both, leading to an overestimation of the expected award E. On the other hand, an unreasonably optimistic defendant will under-estimate either the plaintiff's chance of winning the case or the damages compensation he will have to pay to P, or both. Formally, he will underestimate π or A or both, leading to an underestimation of the expected award E. To keep things simple, we assume that the parties do not suffer from optimum bias with respect to the trial costs, i.e., T_p and T_d.

Summing up, for P, the net expected gains from trial is$E_p - T_p$. The total cost of trial for D is given by $E_d + T_d$. An excessive optimism on part of P means that $E_p - T_p$ is an overestimate of the net gains from the trial. Due to excessive optimism on the part of D, the amount $E_d + T_d$ is an under-estimate by the defendant.

Arguing as in the case of symmetric uncertainty, it can be seen that a settlement offer S by the defendant is mutually beneficial as long as S lies within the following range:

$$E_p - T_p \leq S \leq E_d + T_d$$

However, under asymmetric beliefs about the trial outcome, it is possible that this condition is not met. When both the parties are over confident about the strength of their claims, they will fail to find a meeting ground. For example, suppose the trial costs are $T_p = T_d = 10$. Now, if

$E_p = 100$ and $E_d = 50$, the minimum amount acceptable to the plaintiff is 90 but the defendant would refuse to pay more than 60. Formally, there will not be any meeting ground for the parties, if $E_d + T_d < E_p - T_p$. That is, if $T_d + T_p < E_p - E_d$. This can be written as

$$\pi_p A_p - \pi_d A_d > T_d + T_p \qquad (4)$$

In view of the above, it is clear that the informational asymmetry between the parties has implications for their expectations from the trial and hence for the settlement offers. Our analysis leads to the following conclusion.

***Result 3*:** The litigation will happen only if $E_p > E_d$. In that case, the probability of litigation increases with the difference between beliefs about the expected court awards by the plaintiff and defendant, as well as the amount under dispute.

The pandemic has caused widespread financial distress. It has left many defendants as judgment proof. This essentially means that the effectively A_d has come become very low. As a result the condition (3) is more likely to be satisfied. Therefore, Covid has increased probability of litigation. Also note that as the gap between E_p and $E_d$comes down the litigation becomes less likely. Therefore, as the informational asymmetry comes down it will encourage out of court settlements.

5. Conclusions and Recommendations

As argued above, Covid-19 and the attendant lockdowns have either increased the cost of contractual performance for many promisors and/or have reduced contractual gains for many promisees (people who were to receive of goods and services as a part of contractual transactions), leading to termination or suspension of deals by one or the other side of contracts. Consequently, there is a surge in contractual disputes over performance or the compensation for the losses caused by non-performance. Moreover, the pandemic has triggered many claims for compensation for injuries at the workplace or the ones caused by safety products.

Our analysis shows that the pandemic has reduced the chances of out or court settlement and, hence, has increased probability of litigation for the following reasons. One, it has weakened the financial condition of the defendants, i.e., the suppliers of goods and services who have failed to fulfil their promise, the debtors who have failed to service their debts, etc. Second, it

has increased asymmetry of information among the disputants. Third, it has increased uncertainty about the litigation outcomes.

First consider the effect of economic costs of the pandemic. In terms of our terminology of our model, since the pandemic has weakened the financial condition of the defendants, it means that the probability of low types of defendant has increased. From our Result 2, this means that Covid has increased probability of litigation and reduced chances of pre-trial settlements.

Due to the financial distress caused by the pandemic, many defendants will not be able to pay for the court awarded damages. In other words, the effective payment made by them will be far less than the expectations of the plaintiffs. In such a situation, from our Result 3 it follows that the probability of out of court settlement for pandemic related disputes is going to be very low; by implication, the probability of litigation is very high.[15]

Courts cannot do much about the financial positions of the defendants. However, they can encourage pre-trial settlements and thereby reduce probability of costly litigation by reducing the informational asymmetry between the litigants. The most effective way of doing so is for the courts to make the litigation outcome clear and predictable. When litigation is consistent and predictable, it reduces the scope of unfounded optimism among the litigants. In terms of our terminology, it reduces the divergence between the expectation of the parties from litigation. As is shown in Section 4 greater the convergence between expectation of the parties from litigation, higher is the probability of out of court settlement. See the discussion related to our Result 3.

In other words, clear and consistent judgments are a public good in that they discourage socially wasteful litigation and encourage pre-trial negotiations. In the process, they reduce the social costs of litigation and induce parties to take efficient decisions. In contrast, delayed or ambiguous rulings encourage litigation thereby aggravating the economic cost of the pandemic and the lockdowns.[16]

[15] The plaintiff can still sue to extract maximum settlement. See L.A. Bebchuk, *Suing solely to extract a settlement offer*, JOURNAL OF LEGAL STUDIES 17, 437–450 (1998).

[16] On efficiency implications of legal errors *see* Ram Singh, *Efficiency of 'simple' liability rules when courts make erroneous estimation of the damage*, 16 EUROPEAN JOURNAL OF LAW AND ECONOMICS, 39-58 (2003); Ram Singh, *Economics of Judicial Decision Making, Indian Tort Law: Motor Accident Cases (special article)*, 39(25) ECONOMIC AND POLITICAL WEEKLY, 2613-2616 (2004).

Economic analysis in this paper, offers the following suggestions for judicial decision making. First, the courts should adopt clear and consistent rules for allowing claims using the pandemic as a force majeure or a ground for frustration of the contract. For instance, the Covid-19 and the ensuing lockdowns should be treated as a force majeure only if it had become impossible for the promiser to perform contractual duty.[17] While interpreting ambiguous and catch all terms in the FM clause, courts can apply the principle of '*ejusdem generis'* . The principle says that 'where general words follow an enumeration of particular things, those general words are construed of the nature or class as those specifically mentioned'.

As to the disputes over the claims of compensation, it is difficult for a court to correctly assess the quantum of harm suffered by the promisee. Therefore, courts stick to the contractually specified damages to the extent possible. In other words, the courts should interpret the contract narrowly by applying the *'Four Corners Rule'* (Posner 2004). In the context of business income losses, the rule implies that the compensation should be granted only if the contract explicitly provides for compensation in events like epidemic and lockdown. Moreover, the compensation should not be full expectation compensation.[18] Instead, the courts should restrict the scope of compensation to the foreseeable damages in the context of pandemic.[19] In terms of legal terminology, the compensation should be restricted to the consequential damages that can be proven to have occurred because of the failure of one party to meet a contractual obligation or breach of contract terms.

If the contract under dispute has gaps, courts can use clearly defined default and penalty default rules.[20] A default rule is a rule applied by courts to interpret a contract. A penalty default rule is a rule which will be applied by courts, if the promisee does not inform the promisor about the extraordinary harm that can result from breach by the promisor. Therefore, a penalty default rule penalizes the promisee by disallowing recovery of unforeseeable harms.

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[17] *See* Richard Posner & Andrew Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6(1) THE JOURNAL OF LEGAL STUDIES, 90-117 (1977).

[18] For merits and demerits of full compensation *see* Ram Singh, *'Full' Compensation Criteria: An Enquiry into Relative Merits*, 18 EUROPEAN JOURNAL OF LAW AND ECONOMICS, 223-237 (2004).

[19] *See* McDowell Banks, *Foreseeability in Contract and Tort: The Problems of Responsibility and Remoteness*, 36 CASE W. LAW. REV., 286 (1985)

[20] *See* Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 87 YALE L J, (1989).

A narrow interpretation of contracts along with clearly defined default rules can go a long way in reducing the costly litigation. Moreover, this combination promotes efficiency by reducing the possibility of error by courts in assigning risk.

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