PRE-CONTRACTUAL RELIANCE

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**ABSTRACT**

During contractual negotiations, parties often make (reliance) expenditures that would increase the surplus should a contract be made. This paper analyzes decisions to invest in pre-contractual reliance under alternative legal regimes. Investments in reliance will be socially suboptimal in the absence of any pre-contractual liability -- and will be socially excessive under strict liability for all reliance expenditures. Given the results for these polar cases, we focus on exploring how "intermediate" liability rules could be best designed to induce efficient reliance decisions. One of our results indicates that the case for liability is shown to be stronger when a party retracts from terms that it has proposed or from preliminary understandings reached by the parties. Our results have implications, which we discuss, for various contract doctrines and debates. Finally, we show that pre-contractual liability does not necessarily have an overall adverse effect on parties' decisions to enter into contractual negotiations.

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## I.  INTRODUCTION

Before a contract is made, there is generally a period (sometimes a long one) in which the parties negotiate the contract's terms. During this period, the parties might make reliance expenditures — investments that will raise the value of performance if the contract is formed but will have a lesser value otherwise. For example, in negotiating an employment contract, the employee may quit other jobs, acquire knowledge about the new task, or turn down competing offers,[1] while the employer may prepare tasks and facilities for the potential employee. Similarly, in negotiations of a financial loan, the borrower may invest in expanding its business and the creditor may devote effort to monitoring the borrower's business. Such investments increase the value of the completed transaction, but are fully or partially squandered if the transaction does not go through.

If the contract is entered into, it will stipulate how to divide the surplus that will be generated in part by the reliance investments. If negotiations break down, however, and the contract is not entered into, the law must explicitly or implicitly determine who will bear the cost of the reliance expenditures. Under current U.S. law, the traditional rule assigns no pre-contractual liability. Parties are free to break off negotiations at any time, in which case each party bears the sunk cost of its reliance investments.[2] In recent decades, however, some grounds for liability have been recognized. A party may be liable for the other party's reliance costs on three possible grounds: if it induced this reliance through misrepresentation; if it benefited from the reliance; or if it made a specific promise during

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[1] This was the situation in Grouse v. Group Health Plan, Inc., 306 N.W.2d 114 (Minn. 1981) and Hunter v. Hayes, 533 P.2d 952 (Colo. 1975).

[2] See E. Allan Farnsworth, Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations, 87 Colum. L. Rev. 217, 221 (1987).

negotiations.[3] Most European jurisdictions share the basic no-liability approach, restricting it mainly by the duty to negotiate in good faith. In several countries, however, liability may arise once negotiations reach advanced stages.[4]

This paper seeks to present a systematic analysis of pre-contractual reliance decisions under alternative legal rules. Applying the insights of the economic literature on the ex ante effects of ex post hold-up problems,[5] we start by highlighting the potential problem of under-investment in pre-contractual reliance under the prevailing regime of no liability for pre-contractual expenses. Our analysis then focuses on comparing reliance decisions under alternative legal rules. Our aim is to explore which rule would perform best in providing incentives for pre-contractual reliance decisions. It also analyzes the effect of

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[3] For the first ground, see Restatement (Second) of Torts, §§ 525,530 and Markov v. ABC Transfer & Storage Co., 457 P.2d 535 (Wash. 1969). The second ground for imposing pre-contractual liability under the doctrine of unjust enrichment is exemplified in Hill v. Waxberg, 237 F.2d 936 (9th Cir. 1956), and Pancratz Co. v. Kloefkorn-Ballard Construction and Development, 720 P.2d 906 (Wyo. 1986). Finally, for the third ground, see Hoffman v. Red Owl Stores, 133 N.W.2d 265 (Wis. 1965), and Drennan v. Star Paving Co., 333 P.2d 757 (Cal. 1958).

[4] For a survey of civil law jurisdictions, see Wouter P.J. Wils, Who Should Bear the Costs of Failed Negotiations? A Functional Inquiry Into Pre-Contractual Liability, 4 J. des Economistes et des Etudes Humaines 93 (1992). Wils points out that under Dutch law, for example, a party who breaks off advanced negotiations is liable for expenses made by the other party. See also E. Hondius, Pre-contractual Liability (1991).

[5] A large economic literature, following the pioneering work by Williamson, has studied the incentives to make specific post-contractual investment in incomplete contract settings. See Oliver Williamson, Markets and Hierarchies: Analysis and Anti-Trust Implications (1975); Williamson, The Transaction Cost Economics: The Governance of Contractual Relations, 22 J. Law & Econ. 235 (1979); Klein, Crawford and Alchian, Vertical Integration, Appropriable Rents and the Competitive Contracting Process, 21 J. Law & Econ. 297 (1978). See, generally, Oliver Hart, Firms, Contracts, and Financial Structure (1995). We apply the analytical approach of this literature to the context of pre-contractual reliance. It is worth noting that much of the focus of the economic literature is on the parties' ability to induce optimal investment through carefully designed contractual terms when the actual levels of investment are non-verifiable in court. In contrast, the focus of our analysis is on the ability of background legal rules to induce optimal investment in those cases in which the actual levels of investment are verifiable in court. The reason for the focus on observable investments, which we discuss in detail in Section II.D of the paper, is to contribute to the legal debate on whether, when pre-contractual investments are verifiable, they should give rise to liability and to what extent.

alternative rules on the ex ante decisions of whether to enter into contractual negotiations.[6]

After Section II presents the framework of analysis, Section III.A begins by examining reliance in the absence of any pre-contractual liability, that is, under a regime in which a party cannot get any recovery for its reliance expenditures if no contract is formed. In this case, as should be clear to those familiar with the economic theory of hold-up problems, there will be a problem of under-invest in reliance. Whereas a party that relies will bear the full cost of the reliance, this party will not capture the full benefit of the reliance, because the other party will be able to capture some fraction of the increase in surplus due to the reliance investment.

It is worth noting that this under-investment in reliance expenses under a no-liability regime also exists in the presence of bilateral reliance – that is, in the case in which both

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[6] Our paper builds on earlier work on the subject in the law and economics literature. The first treatment of pre-contractual reliance in this literature is by Wils, *supra* note 4. The most important articles on the subject in this literature are Richard Craswell, Offer, Acceptance, and Efficient Reliance, 48 Stan. L. Rev. 481 (1996) and Avery W. Katz, When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations, 105 Yale L.J. 1249 (1996). These articles have pointed out that the absence of any pre-contractual liability might lead a party to under-investment in reliance. In addition to offering a formal model of the subject, the analysis in our paper differs from that of Craswell and Katz in several significant respects. First, our analysis is not limited to the case in which one of the parties relies; it covers the general case in which both sides might expend reliance investments. Second, a major focus of our analysis is on "intermediate" liability rules, how they could be best designed to improve reliance decisions, and what information would be required to implement them. Accordingly, the conclusions reached in this paper with respect to the optimal magnitude of liability differ significantly from those reached by Craswell and Katz. Third, our paper examines the case for liability following a retraction of preliminary understanding or communication. Finally, our paper incorporates into its analysis the ex ante decisions of parties as to whether or not to enter into contractual negotiations.

Related to our project is also the work in the law and economics literature on the effects of alternative remedies for breach on *post-contractual* reliance. See Steven Shavell, Damage Measures for Breach of Contract, 11 Bell J. Econ. 466 (1980); William P. Rogerson, Efficient Reliance and Damage Measures for Breach of Contract, 15 Rand J. Econ. 39 (1984). Like this literature, our analysis focuses on reliance expenses that are verifiable in courts and thus can be the subject of a liability rules. We compare our results regarding the polar regimes of no-liability and strict liability for pre-contractual reliance with the results obtained in this literature in footnotes 14, 20, *infra*. This literature, however, did not analyze rules that are analogous to the intermediate liability rules and that are the main focus of our analysis.

sides invest in reliance. One might conjecture that mutual reliance will produce a "hostage taking" balance, through which the under-investment problem will be eliminated.[7] The analysis shows, however, that this conjecture is not valid. Indeed, the fact that one side relies not only fails to ensure that the other side's investment will be optimal but might even lead to a further decline in that level.

Section III.B analyzes reliance decisions under the other polar regime, of "strict" pre-contractual liability. Under this regime, whenever a party makes reliance expenditures and the negotiations break down, he will be eligible for full reimbursement of those reliance expenditures. In this case, we show, there will be systematic over-investment in reliance. Due to his ability to impose liability on the other party, the relying party does not effectively bear any of the cost of reliance but captures some of its benefits. Consequently, as long as reliance raises the ex post surplus in the event of a contract, the party will make the reliance investment.

The above results concerning the no-liability and the strict liability regimes prepare the way for the subsequent analysis in Section IV of "intermediate" liability regimes. Here, the analysis explores how such rules could be designed to induce socially optimal levels of reliance. The analysis identifies three rules that could – if courts always had the relevant information – be depended on to induce such levels. Under one rule, liability is imposed only on a party that bargains in an ex-post opportunistic manner by proposing terms that leave the other party with a net negative payoff. Such an aggressive tactic can be regarded as the cause for the failure of the negotiations to reach a contract and can, ex ante, deter the other party from expending reliance costs. Liability for this kind of "obstructionist"

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[7] We thank Richard Craswell and Christine Jolls for suggesting that this conjecture be examined.

bargaining ensures that the relying party will be able to secure more favorable terms, and –
as the analysis will show – provides optimal incentives to rely.

Under a second intermediate rule, a sharing rule, each party is required to
compensate the other for a fraction of its reliance costs, regardless of their respective fault
in the negotiation failure. Under the third intermediate rule, liability is strict but capped:
each party is required to reimburse the other party, but only up to the amount of the socially
optimal level of reliance. We demonstrate that, if courts had the required information, each
of these three rules would induce optimal reliance decisions. The analysis then compares the
three rules in terms of both their informational requirements and their pricing effects. As
will be discussed, each of the rules requires certain (different) information that courts might
lack.

Section V then identifies an important difference between cases in which parties did
and did not reach a "preliminary" understanding on the contract's basic terms. When such a
preliminary understanding is reached, and later one of the parties wishes to reopen the issue
and refuses to enter into a binding contract based on the terms of that understanding, that
party can be regarded as being responsible for the failure to enter a contract. We show that
there is a strong case for making that party liable for reliance expenses made following the
preliminary understanding. Our conclusions in this section have implications for an
important line of cases. The traditional approach pursued by courts and contracts scholars is
a dichotomous one: communications between the parties either create a binding contract,
with its substantial legal consequences, or have no legal consequences whatsoever. Our
results suggest that a more graduated approach might be warranted. Certain communications
might be insufficient to create a binding contract but still have some legal consequences –

imposing certain liability for reliance expenses incurred after them in the event that a binding contract is not subsequently made.

Finally, following the analysis in preceding sections of the effects of alternative liability regimes on reliance decisions made during contractual negotiations, Section VI moves back one step in time to consider parties' incentives to enter into contractual negotiations. For the different regimes, the analysis considers (i) the set of cases in which entrance into negotiations would produce a surplus, and (ii) the incentives of parties to enter into negotiations whenever such negotiations would produce a surplus. In contrast to what some commentators have conjectured, the analysis demonstrates that a regime of no-contractual liability would not necessarily lead to the greatest incidence of parties' entering into contractual negotiations, and that some intermediate liability regimes will unambiguously increase the incidence of contractual negotiations.

Before proceeding, it might be worthwhile to emphasize two points. First, it should be noted that prior to entering contractual negotiations, parties might elect to adopt a private arrangement concerning the allocation of pre-contractual reliance expenses in case a contract in not reached. For the purposes of our analysis, it is plausible to assume that if the parties were to adopt such an arrangement, that arrangement would govern. Thus, for example, under the traditional Common Law regime in which each party bears its own reliance expenditures in the event that a contract is not reached, parties often opt for different arrangements. For example, an investment bank that enters into negotiations with an M.B.A. student will often agree to reimburse the travel expenses that the student – a potential employee – will incur. Or, when companies enter negotiations for one to acquire the other, there is often a preliminary agreement that the target corporation will reimburse

some or all of the buyer's information acquisition expenses in case the contemplated sale does not take place. Conversely, if the law were to adopt a regime with some pre-contractual liability, it is likely that parties would sometimes precede negotiations with an agreement exempting each other from liability for the other's reliance expenses.

In light of the possibility of individually tailored reliance agreements, the analysis in the paper can be regarded as an exploration of the optimal *default* rule for pre-contractual expenses. Given that the law must provide a default arrangement for the numerous instances in which parties entering contractual negotiations do not adopt a private arrangement, the question is which default arrangement will be best.[8]

The second point to emphasize is that this paper focuses on one justification for imposing pre-contractual liability—to induce optimal reliance decisions—and it ignores other reasons for imposing pre-contractual liability. In particular, it may be desirable to impose liability in order to discourage certain undesirable behavior in the course of the negotiations, such as misrepresentation or bad faith bargaining. This issue is different from the one on which we focus and deserves a separate treatment.[9]
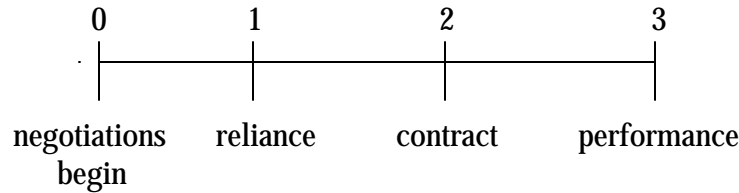
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[8] Private agreements or norms that provide reimbursement for pre-contractual investment can also be used for signaling purposes. For example, a firm that is offering to reimburse the other party for pre-contractual reliance costs is signaling its confidence that a deal will be struck (that the surplus is large), thereby raising the likelihood that the other party will make the investment. For a discussion of commercial practices that can be explained as signaling devices, see Eric Posner, Law and Social Norms, Ch. 9 (2000). The analysis in this paper does not consider problems that arise from asymmetric information and focuses instead on issues that arise even when information is symmetric.

[9] See, generally, Farnsworth, *supra* note 2, at 234-9. For example, society may wish to deter parties from seeking negotiation partners if they do not seriously intend to enter agreement. See, for example, Markov v. ABC Transfer & Storage Co., 76 Wash. 2d 388, 457 P.2d 535 (1969) (lessor misrepresented intention to renew existing lease); Restatement (Second) of Contract § 161 (the duty to disclose intent); Restatement (Second) of Torts, §§ 525, 530 (fraudulent misrepresentation actionable in tort). Or, society may wish to deter bargaining tactics that manipulate the cost and information available to counterparts. For an excellent survey of the economic analysis of this issue,

# II. THE FRAMEWORK OF ANALYSIS

*A. The Sequence of Events*

Two risk-neutral parties – to which we refer as the buyer and the seller – meet. Initially, it will be assumed that the parties enter into contractual negotiations. In Section VI this assumption will be relaxed, and we will consider the parties' decision of whether or not to enter into contractual negotiations. The timing of the parties' interaction is as follows:

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0            1            2            3
|------------|------------|------------|
|            |            |            |

negotiations  reliance     contract    performance
  begin
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At time 0 the parties begin to negotiate a contract. At time 1, while negotiation takes place over a possible transaction, reliance investments might be made. Such investments include any costs incurred by either party – including costs of foregone opportunities—that reduce the seller's cost in providing the goods or services that are the subject of the transaction, or that enhance the value of these goods or services to the buyer. At time 2 the parties either succeed or fail to enter into a legally binding contract. If the contract is entered into, it will be performed at time 3.

We assume that performance will provide the buyer with a value $V$ and will cost the seller an amount $C$. Let $G = V - C$ denote the gain from the transaction after time 2. It is assumed that $G > 0$, that is, that the potential transaction between the parties is certain to

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see Avery W. Katz, Contract Formation and Interpretation, 1 The New Palgrave Dictionary of Economics and the Law 425-432 (1998).

yield a positive value.[10] Subsequently, in Section VI we will allow for the possibility that $G$ < 0.

The reliance investments the parties can make at time 1 will generate value only if a contract is reached. In this case, the invested reliance may raise $G$, either by raising $V$ or by reducing $C$. Let $R_b$ and $R_s$ denote the cost of reliance investments for the buyer and the seller, respectively. For reasons discussed in the introduction, it will be assumed that at time 0, when negotiation begin, the parties do not make any agreement concerning liability for reliance expenses. Thus, the allocation of reliance expenses will be determined by the legal rule which, by default, will govern.

*B. The Optimal Level of Reliance*

It is assumed that both sides can rely and affect the surplus from the transaction. If the transaction goes through, the surplus from it will be $G(R_b,R_s) = V(R_b,R_s) - C(R_b,R_s)$. It is assumed that $R_b$ and $R_s$ yield positive returns throughout the intervals $(0, R_b^{max}(R_s))$ and $(0, R_s^{max}(R_b))$. That is, given the seller's investment $R_s$, any investment by the buyer of less than $R_b^{max}(R_s)$ yields positive returns and any investment beyond that level has zero return, and conversely for the seller. In addition, we employ the usual assumption that the marginal return to investment is declining, that is, $G_{11}(R_b,R_s) < 0$ and $G_{22}(R_b,R_s) < 0$ wherever the first derivatives are strictly positive. The efficient reliance investments are the levels of $R_b$

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[10] We have also considered the possibility that whether or not $G > 0$ depends on factors that are uncertain and that are to be realized between time 0 and 2. Specifically, we considered a situation in which $G$ will be positive with some probability $q$ and negative with probability $1-q$ (for example, the probability that the parties will determine, in the course of the negotiations, whether or not the good that can be produced by the seller fits the buyer's needs.) In this more complex scenario, the results to be presented will generally hold.

and $R_s$ that maximize $G(R_b, R_s) - R_b - R_s$. Denote the efficient reliance levels by $R_b^*$, $R_s^*$ They satisfy the first order conditions:[11]

$$G_1(R_b^*, R_s^*) = 1$$

$$G_2(R_b^*, R_s^*) = 1 \tag{1}$$

*C. Bargaining*

It is assumed that if the contract is formed at time 2, it divides the surplus between the parties. The division of bargaining power between the parties is such that if they have to reach an agreement to create a surplus, they will divide it so that the buyer is expected to get a fraction *2* of the surplus (0 *# 2 #* 1) and the seller is expected to get a fraction 1-*2* of the surplus. One interpretation of this formulation is a bargaining procedure in which one of the parties, whose identity is determined randomly, makes a take-it-or-leave-it offer, after which the bargaining ends. In this case, *2* can stand for the likelihood of the buyer being the offeror and 1-*2* is the likelihood of the seller being the offeror. For parts of the analysis below, it will be assumed that *2 = ½*, which is the case of equal bargaining power, but the general case will also be considered.

*D. Information*

It is assumed that the parties have perfect information. That is, the structure of the interaction, including the functional form of *V(.)* and *C(.)* and the value of *2*, as well as the levels of *R* actually chosen, are common knowledge. Regarding the information that courts have, it will initially be assumed that courts can observe the levels of $R_b$ and $R_s$ that the

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[11] Our assumptions guarantee that the optimal solution is unique.

parties pick – namely, that the investment levels are ex post not only observable by the parties but also verifiable in courts.

To be sure, there might be many cases in which investments are non-verifiable, and the economic literature on incomplete contracting and hold-up problems has focuses on these cases. But there are also many cases in which such investments are verifiable and these cases are the focus of our analysis. We have sought to focus on these cases because of our interest to contributing to the legal debates on liability for pre-contractual reliance. When pre-contractual reliance is non-verifiable, liability for such reliance is not an option. The legal debate is thus relevant to those cases in which liability could be imposed in principle by courts and the question is whether it should be imposed and to what extent.

While we assume that courts can verify the parties' reliance expenditures $R_b$ and $R_s$, we will assume initially that this is all that courts can verify. In particular, we will assume that they cannot verify $V$ or $C$ or the way in which these values are influenced by the reliance expenditures, nor $2$, the relative bargaining powers. As we will see, verifiability of $R$ alone is not sufficient to produce an efficient outcome. For each liability regime examined we will explore what extra information courts would need in order to induce optimal reliance expenditures.

## III. THE POLAR REGIMES OF NO LIABILITY AND STRICT LIABILITY FOR PRE-CONTRACTUAL RELIANCE

This Section analyzes the reliance incentives under the two polar regimes of no liability and strict liability. The results established in this Section will provide a useful baseline for the analysis in Sections IV and V of intermediate liability regimes.

*A. Reliance in the Absence of Pre-Contractual Liability*

Under a regime of no liability for pre-contractual reliance, a party cannot recover any of its reliance expenditures in the event that a contract is not formed. As the analysis below demonstrates, in the absence of liability parties will under-invest in reliance.[12]

To understand the parties' incentives to make pre-contractual investments when there is no liability for reliance costs, consider the expected outcome of the bargaining, given the choices of $R_b$, $R_s$ by the parties. The upper bound of the bargaining range is $V(R_b, R_s)$ -- the highest price the buyer might agree to pay (as $R_b$ is already sunk and the buyer bears no liability for $R_s$); and the lower bound of the bargaining range is $C(R_b, R_s)$ -- the lowest price the seller might be willing to accept (as $R_s$ is already sunk and the seller bears no liability over $R_b$). Assuming that the parties' agreement reflects their relative bargaining power, the expected price will be

$$p = 2C(R_b, R_s) + (1-2)V(R_b, R_s), \tag{2}$$

The buyer's expected profit at time 2 will be $V(R_b, R_s) - p - R_b = 2G(R_b, R_s) - R_b$ and the seller's expected profit at time 2 will be $(1-2)G(R_b, R_s) - R_s$. Expecting this time-2 payoff, the parties will set $R_b$ and $R_s$ at time 1 to maximize their respective profits. Solving their maximization problems simultaneously, we arrive at the result that the actual levels of reliance chosen, $(R_b^N, R_s^N)$, must satisfy:

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[12] This result mirrors the well-known hold-up problem in the contract theory literature, and readers familiar with this literature might consider skipping to Section III.B. We present this result here as a baseline for the analysis that follows.

$$2G_1(R_b^N, R_s^N) = 1 \quad \forall \; 2 > 0$$

$$(1 - 2)G_2(R_b^N, R_s^N) = 1 \quad \forall \; 2 < 1^{13}$$

(3)

Comparing (1) and (3) we can establish the following Proposition (the "hold-up" problem):

*PROPOSITION 1.* (a) Under a regime of no pre-contractual liability, both parties will under-invest in reliance. (b) The investment of each party may be either higher or lower than the investment it would make if the reliance of the other party were fixed at zero.

*Remarks.* (i) *Divergence between Private and Social Gain.* The distorted investment result arises from the divergence between a party's private gain and the social benefit from reliance. From the social point of view, the buyer should raise $R_b$ as long as the benefit, in terms of increased surplus, exceeds the marginal cost of 1. From the buyer's private point of view, however, it pays to raise $R_b$ as long as her private benefit, in terms of the fraction of the surplus she can extract, exceeds her marginal cost of 1. Since the buyer expects to be "held-up", namely, he does not capture the full benefit of her reliance, but only a fraction *2* of it, the buyer is led to strike a sub-optimal balance, and similarly for the seller.[14]

    (ii) *Under-reliance When Both Parties Rely.* It might intuitively seem that, with bilateral reliance, the under-investment problem would diminish and may even disappear. This conjecture would be based on the following logic. When only one party relies, the

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[13] When $2 = 0$, the first expression in (3) is not well-defined. By assumption, the limit of $R_b^N(2)$ as $2$ approached 0 is 0. Similarly, When $2 = 1$, the second expression in (3) is not well-defined. By assumption, the limit of $R_s^N(2)$ as approached 1 is 0.

[14] This type of distortion is well-recognized in the incomplete contracts literature. See, for example, Hart, *supra* note 5, at 26-28. It is similar, for example, to the distortion in the level of

other party may walk away from negotiations without having incurred any cost. The risk of this occurrence is what drives the relying party to under-invest. When both parties rely, however, neither is inclined to walk away, both having invested in the relationship. When the threat of such negotiation breakdown diminishes and each party is confident that the surplus will not be wasted, they will be more ready to invest and the under-investment problem will diminish.[15] Part (b) of the Proposition addresses this conjecture. It suggests that the fact that the other party is also expected to rely does not necessarily raise each party's reliance investment, relative to the case in which the other party invests zero.

To see how one party's investment depends on the investment of the other, compare the investment levels of the buyer in two situations. In the first situation, when the seller invests 0 (only the buyer relies), the buyer sets $R_b^N$ that solves $2G_1(R_b^N, 0) = 1$. In the second situation, when the seller invests $R_s^N$, the buyer sets $R_b^N$ that solves $2G_1(R_b^N, R_s^N) = 1$. The point at which the level of $R_b$ is greater depends on the cross-derivative, $G_{12}$. If $G_{12} < 0$, the buyer's investment will be even lower when the seller also invests. This is a situation in which the parties' decisions are "strategic substitutes."[16] The positive level of reliance by the seller reduces the marginal value of the buyer's investment and, in equilibrium, leads the buyer to reduce her reliance investment. Conversely, if $G_{12} > 0$, the buyer's under-investment problem will become less severe the more the seller invests. Here, the reliance investment by the seller increases the marginal value of the buyer's investment and leads the buyer to raise her reliance investment (a case of "strategic complements").

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post-contractual reliance that arises in the absence of liability for breach of contract. See, for example, Rogerson, *supra* note 6, at 47.

[15] See Craswell, *supra* note 6, at 492, for the claim that the under-investment result arises from the credibility of the non-relying party's threat to walk away from the deal.

[16] See J. Bulow, J. Geanakoplos and P. Klemperer, Multimarket Oligopoly: Strategic Substitutes

Lastly, if $G_{12} = 0$, which is the case where the marginal value of one party's investment is independent of what the other party does, the levels of under-investment are independent of whether and how much the other party invests.

*B. Reliance Under a Strict Liability Regime*

The In the opposite side of the spectrum from the no-liability regime stands the regime of "strict liability" for pre-contractual reliance. Under this regime, any party that makes reliance investments is entitled to fully recover from the other party if no contract is ever signed. This is an extreme rule—a party may be required to pay for the other party's reliance even if the other party was "responsible" for the negotiation breakdown or if the other party relied excessively—but it will also provide a useful baseline for the analysis in subsequent parts. Given our initial assumption that courts can observe only the parties' reliance investments and cannot observe other parameters regarding the bargaining environment, the only rule of pre-contractual liability that can be imposed is one of strict liability. When parties fail to reach a contract, the mere knowledge of $R_b$ or $R_s$ does not enable courts to judge which party was responsible for the negotiation breakdown or whether reliance was excessive and to condition liability on such factors.

Under the strict liability regime, if a contract is not formed, each party must fully compensate the other party for its reliance investment.[17] The effect of this rule is to shift the boundaries of the bargaining range. Here, the highest price the buyer might agree to is

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and Complements, 93 J. Pol. Econ. 488 (1985).

[17] The damages are assumed to be equal to $R_b$ because this is the measure applied in most American cases. See Farnsworth, *supra* note 2, at 223-5. The expectation measure of damages cannot be an applicable measure in most situations since, at the pre-contractual stage, the parties have not yet set a price. The special set of cases in which a preliminary understanding over the price

$V(R_b, R_s) - R_b + R_s$, as she no longer considers $R_b$ to be sunk, but considers the cost of

liability for $R_s$ in case the contract is not reached.[18] Similarly, the lowest price the seller

might agree to is $C(R_b, R_s) - R_b + R_s$. The bargaining range lies within $[C(R_b, R_s) - R_b + R_s,$

$V(R_b, R_s) - R_b + R_s]$. Assuming the parties split the bargaining range at a point that reflects

their relative bargaining power, the expected price will be

$$p = 2C(R_b, R_s) + (1-2)V(R_b, R_s) - R_b + R_s. \qquad (4)$$

The buyer's expected gain from the transaction, net of investment, will be $2G(R_b, R_s) - R_s$,

and the seller's expected gain from the transaction, net of investment, will be $(1-2)G(R_b, R_s)$

$- R_b$. Notice that each party's expected gain does not include the cost of its own investment.

Expecting these gains at time 2, the parties will choose $R_b^L$ and $R_s^{\ L}$ that maximize their

expected gains, and satisfy the first order conditions:

$$G_1(R_b^L, R_s^{\ L}) = 0$$

$$\qquad (5)$$

$$G_2(R_b^L, R_s^{\ L}) = 0,$$

which implies that $R_b^L = R_b(R_s)$ and $R_s^{\ L} = R_s(R_b)$.[19] Comparing conditions (1) and (5), we

can establish:

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[18] To see that $p = V(R_b, R_s) - R_b + R_s$ is the highest price the buyer will agree to, compare her payoff when accepting or rejecting a take-it-or-leave-it offer at this level. If she accepts the offer, her payoff is $V(R_b, R_s) - R_b - p = - R_s$, and if she rejects the offer she is reimbursed for her investment $R_b$ but must pay the seller $R_s$, ending up with a payoff $- R_s$.

[19] In principle, the parties may raise their investments beyond the levels identified, even when such additional investment yields zero private returns. If, however, we assume that a party will raise its investments in reliance only as long as the marginal private value is positive, and will not raise its investments if the marginal private value is zero, then the identified levels of investments are unique.

*PROPOSITION 2.* Under a rule of strict pre-contractual liability, each party chooses a level of reliance investment that is excessive, given the other party's investment.

*Remarks.* (i) *Intuition.* The intuition underlying this result can be explained as follows. The over-investment result arises from the fact that each party captures some of the gains from its reliance investment without effectively bearing any of its cost. Each party's ability to recover all of its expenditures if a contract is not formed is translated into the contractual price in a way that shifts the entire cost of its own reliance to the other party. Consequently, no matter how small a fraction of the created surplus the party can capture, that party will invest in reliance as long as such investment increases the total surplus.[20]

## IV. INTERMEDIATE REGIMES OF PRE-CONTRACTUAL LIABILITY

The previous Sections examined two polar regimes, no-liability and strict liability, and demonstrated that neither can lead parties to make efficient pre-contractual reliance investments. With no liability, there will too little reliance; under strict liability—which is available when courts observe only $R_b$ and $R_s$ —reliance will be excessive. We therefore turn in this Section to explore what kind of "intermediate" liability regimes could potentially produce optimal reliance decisions. We will identify three rules that could do so and determine the additional information (different in each regime) that courts would be

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[20] Notice, that this distortion is different from the one associated with the reliance measure of damages for breach contract. Under reliance damages, the investing party can only shift the cost of reliance to other party in the event that the contract is breached, but not when it is performed, thus—unlike the situation of pre-contractual liability—he bears some fraction of the cost of reliance. At the same time, under reliance damages the benefit to the investing party from increasing its investment is greater than merely the incremental value created; the benefit also includes the increased likelihood that the contract will be performed rather than breached. See Shavell, *supra* note 6. Thus, while both pre-contractual strict liability and post-contractual reliance damages lead to excessive levels of investment, they do so for different reasons and to different extents.

required to know in order to apply these rules.[21]

*A. Liability For Ex post Opportunism*

In analyzing the strict liability regime in Section IV, we noted that one of the features that makes it extreme is the fact that a party could be held liable for the other's reliance expenditures even if the party was in no way the one responsible for the negotiation breakdown. Conversely, a party may recover even if its bargaining conduct clearly led to the breakdown. Thus, under the strict liability rule, a buyer who demands a price that is very low (even lower than the seller's cost *C*), which leads to the negotiation breakdown, would still be reimbursed for its $R_b$; similarly, a seller who demands a price that is very high (even higher than *V*), which clearly leads to the breakdown, would still be reimbursed for $R_s$.

We have also seen that in the absence of liability, bargaining between the parties focuses on the *ex post bargaining range*, $[C(R_b, R_s), V(R_b, R_s)]$. Within this bargaining range, each party bargains as if the reservation value of the other side is net of its sunk investment. This form of ex post opportunism (or hold-up) reduces the payoff an investing party expects to reap from its investment and consequently weakens the ex ante investment incentive. Thus, in order to induce parties to invest optimally ex ante, the bargaining strategy of each party must be (legally) constrained in such a manner that will force this

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[21] The results we derive in this Section might be contrasted with the long line of inquiry in the economic literature on incomplete contracting that has highlighted the difficulties in inducing optimal ex ante investments when investment levels are not verifiable by courts. The reason that our analysis is able to identify rules that induce optimal investments is our focus on cases in which the levels of reliance investment and some additional parameters are judicially verifiable. This is also the reason why our results are not sensitive to factors that play an important role in the incomplete contracting literature, such as whether the investment generates a direct benefit to only one or to both parties.

party to take into account the other party's sunk investment. The legal rule should effectively prevent the Seller from trying to push the price above $V(R_b,R_s)$- $R_b$ (toward $V(R_b,R_s)$) and prevent the Buyer from trying to push the price below $C(R_b,R_s)$+ $R_s$ (toward $C(R_b,R_s)$). If the parties expect that bargaining over price will be conducted within this *ex ante bargaining range,* $[C(R_b, R_s)$+ $R_s, V(R_b, R_s) - R_b]$, which accounts for sunk investments, the distortions will be resolved. Each party will be immune from the hold-up problem (and the under-investment problem will be resolved), and at the same time each party will be barred from laying its entire investment cost on the other party (and the over-investment problem will be resolved.)

If courts have information only regarding $R_b$ and $R_s$, which was our assumption in examining the strict liability regime, they cannot in any way determine which party was taking "unreasonable" bargaining positions and should be regarded as responsible for the breakdown. Let us assume, however, that courts can observe not only the reliance expenditures $R_b$ and $R_s$, but also the resulting ex post cost and valuation—$V(R_b, R_s)$ and $C(R_b, R_s)$—that the parties face when they bargain over the contractual price.

In this case, we could explore the possibility of rules that would shrink the bargaining range in the desired manner. One possible method of obtaining this result is to impose full liability for pre-contractual reliance on a party that bargains in an ex post opportunistic manner. Specifically, under the rule to be considered, a party would be regarded at fault, rendering it liable for the other party's costs as well as losing its own chance for reimbursement, if it demands a price that, taking into account the other party's reliance expenditures, would leave the other party with an overall loss from the transaction.

Thus, the buyer will be liable if she offers to pay a price below $C(R_b, R_s) + R_s$ and the seller will be liable if he demands a price greater than $V(R_b, R_s) - R_b$.[22]

An alternative, or complementary, way to curtail ex post opportunistic bargaining is to make it (legally) impossible for parties to obtain prices outside the ex ante bargaining range. If, say, the parties agreed on a price exceeding $V(R_b, R_s) - R_b$, the buyer would be able to seek recovery for the excess between the actual price and the maximal price permitted, $V(R_b, R_s) - R_b$, which is exactly the amount that would make the buyer end up with a non-negative payoff. Similarly, if the parties agreed on a price below $C(R_b, R_s) + R_s$, the seller would be able to seek recovery for the excess between the actual price and the minimal price permitted, $C(R_b, R_s) + R_s$. With this rule in place, neither party would benefit from making offers outside the ex ante bargaining range, and the source of the distorted investment would be eliminated.

To see how this liability approach works, consider the first formulation (of full liability on a party who bargains opportunistically). Under this rule, the bargaining range is determined as follows. The lowest price the buyer can effectively bargain for is $C(R_b, R_s) + R_s$. If she offers to pay less, the seller will reject her offer and receive full reimbursement.

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[22] Under this rule, a party who offers a price that leaves the other party with an overall loss will *not* be inflicted with liability if he is doing so legitimately, namely to avert his own loss. It might be argued that in order to properly implement the rule courts would need information about bargaining motivations to ascertain whether a price offer is opportunistic or legitimate and that this added informational requirement would make the rule less applicable. However, under the assumptions stated above, that courts are able to verify $V(R_b, R_s)$ and $C(R_b, R_s)$, they can also verify whether a party who offers to leave the other party with a negative payoff could have offered a better price without suffering losses. Thus, courts would be able to restrict liability to opportunistic parties. Notice, that this selective liability would allow parties to break down negotiations whenever the ex-post surplus is negative ($G < 0$) which is optimal both ex post (avoidance of a negative-surplus transaction) and ex ante (reduction of the incentive to invest, in proportion to the risk that the surplus will be negative.)

Similarly, the highest price the seller can bargain for is $V(R_b, R_s) - R_b$. Thus, the bargaining range in this case lies between $C(R_b, R_s) + R_s$ at the bottom and $V(R_b, R_s) - R_b$ at the top. Given the parties' relative bargaining power, the expected price will be

$$p = 2[C(R_b, R_s) + R_s] + (1-2)[V(R_b, R_s) - R_b]. \qquad (6)$$

The buyer will choose a level of $R_b$ to maximize her net expected gain $V(R_b, R_s) - R_b - p = 2[G(R_b, R_s) - R_b - R_s]$ and the seller will choose a level of $R_s$ to maximize his net expected gain $p - C(R_b, R_s) - R_s = (1-2)[G(R_b, R_s) - R_b - R_s]$. The first order conditions of these maximization problems are identical to conditions characterizing the socially optimal levels of reliance. Thus, we can state:

PROPOSITION 3. Under a rule that assigns liability only to a party that bargains in an ex post opportunistic manner, both parties make optimal reliance investment.

Remarks: (i) Intuition. The reason that this rule leads to optimal reliance is that neither party shifts the entire cost of its reliance to the other party, nor bears it alone. By effectively eliminating the possibility that the parties will end up as overall losers from the transaction, the bargaining range shrinks. Thus, no party can fully capture the fruit of the other party's reliance (since it must make a price concession, to account for the other party's sunk reliance); and no party has to bear alone the cost of its own reliance (since this cost improves the offer that other party must now make). Put differently, unlike the case of strict liability, under the present rule parties will not rely excessively, because they may bear some of the cost of their own reliance -- the buyer with probability 2, and the seller with

probability $1$-$2$.[23] Consequently, each party in effect bears only a fraction of the cost of its own reliance investment, equal to the fraction of the incremental surplus it extracts. The positive and the negative externalities balance off.

(ii) *Alternative Liability Formulation.* Under the alternative formulation, which makes the party who offered the price liable for the excess between the agreed price and the most favorable price permitted, the analysis and the result would be the same. The Seller will have no incentive to offer price above $V(R_b, R_s) - R_b$ and the Buyer will have no incentive to offer a price below $C(R_b, R_s) + R_s$. Once the bargaining range diminishes in this fashion, the analysis is identical to the one conducted above. Note, though, that under the second formulation, if an opportunistic price is actually offered, it must be accepted by the offeree. Unlike the first formulation, where such offers could be readily rejected, here the offeree must accept the aggressive offer and seek reimbursement by turning to courts at the following stage. Since the offeror has nothing to lose by this reimbursement method, it is less likely to deter aggressive bargaining in equilibrium.

*B. Sharing of Reliance Expenditures*

Under a no-liability regime, in the event of no-contract a relying party would not recover any of its reliance costs. Under strict liability, in such an event the relying party will fully recover from the other party. Given that the first regime leads to under-investment and the second to over-investment, it is natural to explore the possibility of a sharing rule.

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[23] If $q$ denotes the probability that the buyer makes the take-it-or-leave-it offer, then the buyer must bear the cost of the seller's reliance whenever she is the one that makes the offer; that is, she bears an expected fraction $q$ of the seller's reliance costs. Similarly, the seller cannot offer the buyer a price that will leave the buyer with a negative net payoff, thus the seller must bear the buyer's cost of reliance whenever he is the one making the offer -- with probability $1$-$q$.

Under a sharing rule, in the event of no-contract the relying party will be able to get *partial* recovery; that is, the parties will in effect share the cost of the reliance expenditures. When both parties rely, each party bears part of the total reliance cost -- pays for part of other party's reliance cost and recovers part of its own cost. The question is what sharing formula would lead to optimal reliance decisions.

Let us begin by considering the case in which the parties have equal bargaining power ($2 = \frac{1}{2}$). In this case, a rule that specifies that in the event that there is no contract, each party must pay half of the other party's expenditures, would produce the efficient levels of $R_b$ and $R_s$. To see why this sharing rule works, consider the bargaining outcome under this rule. The highest price the buyer can agree to pay is $V(R_b, R_s) + \frac{1}{2}(R_s - R_b)$, a price that reflects the fact that she can recover for $\frac{1}{2} R_b$, and can expect the seller to recover $\frac{1}{2} R_s$. Similarly, the lowest price the seller can agree to is $C(R_b, R_s) + \frac{1}{2}(R_s - R_b)$, again reflecting the seller's potential share of liability. Given their relative bargaining power, the expected price will be

$$p = \frac{1}{2}C(R_b, R_s) + \frac{1}{2}V(R_b, R_s) + \frac{1}{2}(R_s - R_b). \tag{7}$$

The buyer's expected gain, net of investment, will be $\frac{1}{2}[G(R_b, R_s) - R_s - R_b]$ and the seller's expected gain, net of investment, will be $\frac{1}{2}[G(R_b, R_s) - R_s - R_b]$. The resulting levels of $R_b$ and $R_s$ that maximize the respective expected gains are ones that satisfy the first order conditions that are identical to conditions characterizing the socially optimal levels of reliance, $R_b^*, R_s^*$.

In cases in which parties have unequal bargaining power ($2 \ldots \frac{1}{2}$), the equal sharing

rule does not lead to efficient reliance. In such cases, we need a rule that equates the buyer's share of the surplus with her share of the reliance cost. Under such a rule, the net reimbursement that the buyer receives is $(1-2)R_b - 2R_s$, and thus the highest price the buyer will agree to is $V(R_b, R_s) - (1-2)R_b + 2R_s$, and the lowest price the seller will agree to is $C(R_b, R_s) + (1-2)R_b - 2R_s$. The price that would split this bargaining range would leave the buyer with a net payoff of $2[V(R_b, R_s) - R_b - R_s]$ and the seller with a net payoff of $(1-2)[V(R_b, R_s) - R_b - R_s]$. Thus, the following proposition states:

*PROPOSITION 4:* Under a sharing rule that assigns the total reliance cost between the buyer and the seller at a fraction *2* to the buyer and 1-*2* to the seller, the efficient level of reliance arises.

*Remarks.* (i) *Intuition.* This sharing rule works because it equates the fraction of the cost that a party bears with the fraction of the surplus that it can capture via bargaining. The buyer captures a *2*-fraction of the incremental surplus that is created when $R_b$ is raised, and through the partial reimbursement, bears a fraction *2* of the incremental cost of $R_b$. Similarly, the seller captures a fraction of 1-*2* of the incremental surplus created by $R_s$ and bears only a 1-*2* fraction of the cost of $R_s$. Thus, the two externalities—the uncaptured surplus and the "free" reliance expenditures—balance out.

(ii) *Information Needed.* The problem with a sharing rule that is dependent on *2* is in the informational requirement it places on courts to evaluate *2.* Since the parties' relative bargaining power, as measured by *2*, depends on a multitude of factors, many of which are not verifiable in court, it is not plausible to assume that courts will be able to evaluate *2*

accurately. The informational problem is particularly acute in light of the contra-factual nature of the evaluation of *2*, as liability arises in cases in which the negotiated contract was *not* formed.

(iii) *Splitting Expenditures.* When courts lack accurate information about *2*, and when parties do not appear to have significantly unequal bargaining powers, a plausible rule-of-thumb would be to share reliance expenditures evenly, that is, each party would reimburse the other for half of its costs. This may not lead to optimal incentives (unless *2* = ½), but it may reduce the magnitude of the distortion relative to the strict liability rule.

## C. Strict Liability Capped by the Level of Optimal Reliance

Suppose that in addition to the actual levels of reliance invested by the parties, $R_b$ and $R_s$, the court can establish the optimal levels of reliance, $R_b^*$ and $R_s^*$.[24] The rule we consider here imposes liability regardless of the conduct that led to the negotiation breakdown, but limits the magnitude of the liability. The amount of reimbursement a party may get would equal its full reliance costs, unless the reliance exceeded the optimal level. At that point, liability is capped and the relying party will only recover for the hypothetical cost of its optimal reliance.

The bargaining range under this rule lies between $C(R_b, R_s) - R_b + R_s$ at the bottom

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[24] Note that to establish this the courts needs to know something different than the information requirement in Section IV.A. In Section IV.A, the court needed to know the *absolute* levels of *V* and *C*, given the actual reliance invested by the parties. Now the court is required to know the optimal levels of reliance, and to this end the court needs to know the first derivative of *V* and *C* throughout the interval between actual reliance and optimal reliance. Craswell, *supra* note 6, at 501-3, examines a version of the capped liability rule and whether the information burden it places on courts is reasonable. Charles J. Goetz and Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 Yale L.J. 1261, 1279-1280, 1289-1290 (1995), examine a similarly capped damage

and $V(R_b, R_s) - R_b + R_s$ at the top, with $R_s$ and $R_b$ restricted not to exceed $R_s^*$ and $R_b^*$. That is, $C(R_b, R_s) - min(R_b, R_b^*) + min(R_s, R_s^*)$ is the lowest price the buyer may offer, reflecting the fact that she can impose liability of $R_b$ but no greater than $R_b^*$ on the seller, and may bear liability of $R_s$, but not greater than $R_s^*$. And $V(R_b, R_s) - min(R_b, R_b^*) + min(R_s, R_s^*)$ is the highest price the seller may demand, reflecting his actual liability $R_b$ which cannot exceed $R_b^*$, and the fact that he can impose liability of $R_s$, but not greater than $R_s^*$, on the buyer. Thus, the price agreed upon is expected to be

$2[C(R_b, R_s) - min(R_b, R_b^*) + min(R_s, R_s^*)] + (1-2)[V(R_b, R_s) - min(R_b, R_b^*) + min(R_s, R_s^*)].$ (8)

The buyer's net gain will have the following discontinuous form:

$$2G(R_b, R_s) - min(R_s, R_s^*) \qquad if \qquad R_b \# R_b^*$$

$$2G(R_b, R_s) - min(R_s, R_s^*) - (R_b - R_b^*) \qquad if \qquad R_b \, {}^3 R_b^*$$

The buyer's optimal level of reliance within the lower range $(R_b \# R_b^*)$ is $R_b^*$. In that range, in effect, strict liability applies, and the buyer has no incentive to restrain her investment, regardless of how much the seller invests. Further, the buyer's optimal level of investment within the upper range $(R_b \$ R_b^*)$ solves the first order condition $2G_1(R_b, R_s) \# 1$, which, when solved at $R_s^*$, implies a corner solution at $R_b^*$. Thus, if the seller sets $R_s^*$, the buyer will choose the optimal level of reliance, $R_b^*$. Similarly, if the buyer chooses $R_b^*$, the seller will choose the optimal level of seller's reliance, $R_s^{*}.$[25] Hence, we can state:

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measure for breach of contract and identify the informational burden it places on courts.
 [25] $(R_b^*, R_s^*)$ is the unique Nash equilibrium. There cannot be an equilibrium in which $R_b^* > R_b$

*PROPOSITION* 5: Under a rule that caps liability at the socially optimal reliance levels, the parties invest optimally in reliance.

*Remark.* (i) *Intuition.* This rule works because it makes each party bear the full cost of any added reliance investment beyond the point of optimal reliance. Up to that point, each party counts reliance expenditures as "free", as it is fully reimbursed for the investment, which also translates into a more favorable contractual price. Above the optimal level of investment, the party bears the full cost of its incremental reliance, and since it can never get more than the full added surplus this extra investment produces, it will not invest.

(ii) If courts have the information to correctly infer the optimal levels of reliance investment, the rule that caps liability is not the unique rule that can induce optimal investment. Any rule that penalizes an upward deviation from the optimal investment with a sufficiently harsh sanction can successfully deter parties from relying excessively. (For example, a rule that sets the overall, not only the marginal, reimbursement at zero whenever a party over-invests.)

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and $R_s^* > R_s$, because the increase in total surplus relative to one of the parties remaining at the optimal level is less than the cost of the extra investment, and given that the party bears the entire incremental cost above the optimal level, it cannot benefit from such an increase. Also, there cannot be an equilibrium in which either $R_b^* < R_b$ or $R_s^* < R_s$, because the party who invests less than the optimal level will unambiguously benefit from increasing its investment, effectively imposing the cost of this investment on the other party.

*D. Comparing the Rules*

### 1. Information

We have examined three rules that in theory could lead the parties to invest optimally during the pre-contractual stage. Each of the three rules poses different problems of implementation. All rules require courts to know the actual levels of investment, $R_b$ and $R_s$, that parties picked. But each rule requires different additional information regarding other characteristics of the case. To apply the rule of liability for ex post opportunism, courts need information about $V(R_b, R_s)$ and $C(R_b, R_s)$—the hypothetical values that the parties accord to a performed contract—in order to determine if any party's bargaining conduct was overly aggressive. To apply the sharing rule, courts have to be able determine $\lambda$, the division of bargaining power between the parties (or, at the very least, the fractions of the "new" surplus – the incremental surplus due to the parties' reliance—that each party captures). And to apply the capped liability rule, the courts need to be able to ascertain $R_b^{*}$ and $R_s^{*}$, to which end they need to have information about the first derivatives of the functions $V(R_b, R_s)$ and $C(R_b, R_s)$ throughout the interval between actual and optimal reliance.

### 2. Distribution

In addition to the different information requirement that the three rules impose, they also produce different contractual prices. The price differences are important because they produce different divisions of the surplus, which have implications for the parties' decisions

to enter contractual negotiations. While all three rules could—if courts have the relevant information—induce optimal reliance decisions, they do not, as we will see, provide the same incentives to enter contractual negotiations.

Under the rule of liability for ex post opportunism and under the sharing rule, the contractual price will equal $2C(R_b^*, R_s^*) + (1-2)V(R_b^*, R_s^*) + [2R_s^* - (1-2) R_b^*]$ (expression (6)), and the division of surplus is such that the parties will split the ex ante bargaining surplus according to their respective bargaining power. The buyer expects to get $2[G(R_b^*, R_s^*) - R_b^* - R_s^*]$ and the seller expects to get $(1-2)[G(R_b^*, R_s^*) - R_b^* - R_s^*]$. Under the rule that caps liability at the optimal reliance cost, the expected price will be $2C(R_b^*, R_s^*) + (1-2)V(R_b^*, R_s^*) + [R_s^* - R_b^*]$, and thus each party gets a share of the ex post bargaining surplus minus *the other party's* capped reliance cost. The buyer expects to get $2G(R_b^*, R_s^*) - R_s^*$ and the seller expects to get $(1-2)G(R_b^*, R_s^*) - R_b^*$.

Thus, the parties will be indifferent only between the rule against opportunism and the sharing rule. The buyer will prefer the capped liability rule if her expected gain will be greater under this rule, which will be the case if and only if $2 R_b^* > (1-2) R_s^*$. That is, under the rule against opportunism and the sharing rule, the buyer bears a *2*-fraction of the total reliance expenditure, whereas under the capped liability rule she bears none of her actual, and all of the seller's actual, expenditures. Specifically, $2 R_b^*$ is the fraction of the buyer's reliance costs that she bears under the rule against opportunism and the sharing rule, but not under the capped liability rule. $(1-2) R_s^*$ is the fraction of the seller's costs that the buyer bears under the capped-liability rule, but not under the rule against opportunism or the sharing rule. These two fractions of costs are the only differences between the rules.

Thus, the buyer will prefer the capped liability rule if the latter fraction is smaller.

Intuitively, the conclusions concerning the price differences under the rules imply that under the rule against opportunism and the sharing rule, parties always end up with a share of the ex ante surplus, and thus, when the surplus is positive, no party will ever end up with a net loss (taking reliance expenses into account). In contrast, under the capped liability rule, parties end up with a share of the ex post surplus minus the cost of the other party's reliance, and thus, even if the surplus is positive, one of the parties might end up with a net loss. The difference between the prices and the expected distributions of the surplus are significant in shaping the parties incentives to enter negotiations. This aspect will be explored in Section VI below.

## V. CASES WITH PRELIMINARY REPRESENTATIONS OF TERMS

### A. The Situation

The rules examined in Section IV above place significant informational requirements on courts and thus are limited in their practical application. In this Section, we examine a particular situation in which another rule can be implemented -- one that places a weaker informational requirement on courts.

In many pre-contractual situations, negotiations develop up to a point in which one or both parties put forth an interim representation of the basic features under which it will agree to contract. Often, only one party makes such a representation, whereby it is either formally regarded as an offer[26] or an invitation for the other party to make an offer based on

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[26] See Restatement of Contracts (Second) §24. An offer need not include all the terms of the proposed agreement, as long as there is a rational basis to supplement the missing terms. See UCC §2-204(3).

the communicated terms. Other times, both parties may represent their intentions and a preliminary understanding thus emerges about some basic features of the contract. Nevertheless, in either case the parties may not yet manifest assent to enter into a binding agreement.
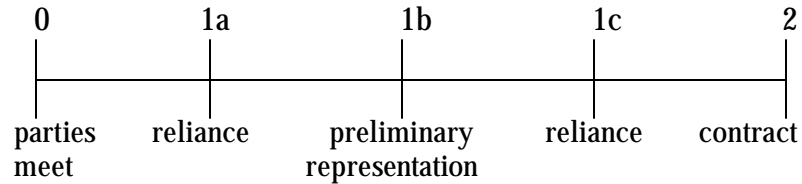
Several reasons may delay the agreement. First, an offeree may inquire about more favorable terms or make a counter-offer. Second, even if the offeree plans to accept the offer and enter into a contract based on its terms, the offeree may want to delay the acceptance notice.[27] The offeree, or for that matter either one of the parties, may wish to prepare formal documents for the "closing"; to further negotiate in order to reach understanding over some elements of the agreement that are still missing; to confirm profit values or acquire additional information about the desirability of contracting[28]; or to get formal approval from their principals.[29] Thus, in many cases one or both parties may delay the final manifestation of assent to avoid the legal consequence of a fully binding contract.

When either one or both parties have represented the terms under which they are willing to enter an agreement, but a formal contract has not yet been entered into, we can introduce a distinction between two stages of reliance -- reliance made prior to said representation and reliance made after it. Thus, the sequence of events can now be depicted as the following:

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[27] See, generally, Farnsworth, *supra* note 2, at 249; Teachers Insurance and Annuity Assoc. v. Tribune Co., 670 F. Supp. 491 (1987).

[28] This is the standard situation in negotiations between general contractors and sub-contractors. A sub-contractor ordinarily makes an offer – a "bid" – that the general contractor responds to only after the general contractor is notified regarding his own bid. Compare Baird v. Gimbel Bros., 64 F.2d 344 (2d Cir. 1933) with Drennan v. Star Paving, 333 P.2d 755 (Cal. 1958).

[29] For example, parties negotiating the sale of a company may reach an understanding over the price and other significant elements of the transaction, but may delay the entry into an agreement until consulting their bankers or board of directors. See, for example, Arcadian Phosphates v. Arcadian Corp., 884 F.2d 69 (1989).

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0              1a             1b             1c             2
|              |              |              |              |
parties        reliance       preliminary    reliance       contract
meet                          representation
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## B. The Rule

This Section focuses on the reliance decision made *after* the preliminary representation, at time 1c. We analyze a rule that imposes liability for the reliance costs incurred at time 1c on a party who can be regarded at fault for the negotiation breakdown -- a party who retracts from the terms it had previously communicated, or, if a mutual preliminary understanding was achieved, a party who retracts from the terms included in this preliminary understanding.[30]

Suppose that at time 1b, one or both of the parties communicated an understanding that trade can take place on the basis of a price term *p.* Suppose, further, that after additional reliance expenditures were spent at time 1c, and before the parties entered into a binding agreement, one party behaves opportunistically and seeks to retract from its previous representation and reopen the negotiations in order to extract a more favorable price term (the buyer seeking a price lower than *p* or the seller seeking a price greater than

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[30] Variants of this rule were applied in several famous cases. In Hoffman v. Red Owl Stores, 26 Wis. 2d 683, 133 N.W.2d 267 (1965), a prospective franchisee recovered reliance damages incurred after the contractual price and other financial terms were communicated by the franchisor and before the franchisor reneged. In Grouse v. Group Health Plan, Inc., 306 N.W. 2d. 114 (Minn. 1981), a prospective employee recovered reliance damages from the employer who revoked his employment offer. In addition, applications of this rule can be found within the doctrine of "good faith." See, for example, Itek Corp. v. Chicago Aerial Industries, 248 A. 2d 625 (1968). Farnsworth, *supra* note 2, at 280-281, proposes a similar rule, in which liability arises if a party reneges on terms on which agreement has already been reached. This rule should be distinguished from the rule based on "promissory estoppel", which holds the preliminary agreement to be a legally binding contract and awards the expectation measure of damages (which extend beyond the promisee's reliance costs, to also cover its expected profit from the transaction). See Walters v. Marathon Oil Co., 642 F.2d 1098 (7th Cir. 1981); Craswell, *supra* note 6, at 531.

*p.*). Then, if negotiations fail and the parties do not enter an agreement, the party who retracted from its previous representation will be required to reimburse the other party's subsequent reliance expenditures. Thus, in the case in which only one party makes a representation (an offer or a solicitation), he alone could be liable; in the case in which both parties arrived at a preliminary understanding, the one who retracts could be liable.

Notice that the rule we are examining is different than other contractual or legal arrangements that have been proposed. To start with, this rule is *not* equivalent to a rule that regards an offer as irrevocable, or the preliminary understanding reached at time 1b as binding. If the representation were taken to be binding and irrevocable, the other party—by accepting the communicated terms—could impose the legal consequence of a fully binding contract (with liability equal to the expectation interest), not merely the more moderate consequence of reliance liability, and the court would need to supplement all the missing terms. Such a rule would also discourage the making of offers. Furthermore, this rule is *not* equivalent to a rule that effectively prohibits renegotiation of agreed-upon terms. Under the rule considered here, a party can, at time 2, revoke its proposed terms and refuse to have a contract for *p*—and will only have to compensate for the reliance expenditures made at time 1c after the representation, and only if negotiations break down. As we will see below, this rule does not block renegotiation but merely affects the bargaining range in the renegotiation stage by restricting the parties' choice of the ultimate price.[31]

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[31] This rule also differs from contractual schemes proposed in the economics literature, which manipulate the incentives at the renegotiation phase in a way that could prevent the hold-up problem See, for example, Georg Nöldeke and Klaus Schmidt, Option Contracts and Renegotiation: A Solution to the Hold-Up Problem, 26 Rand J. Econ. 163 (1995); Aaron S. Edlin and Stefan Reichelstein, Holdups, Standard Breach Remedies, and Optimal Investment, 86 Am. Econ. Rev. 478 (1996). These schemes are contractual provisions that are designed by the parties as part of the final agreement over all the other elements of the transaction. In contrast, the rule we analyze assumes that the representations that lead to liability if retracted from are more preliminary than the

To focus on the incentives to rely at time 1c, let $R_b$ and $R_s$ denote the reliance expenditures made at this stage alone. If, following these investments, a party is unwilling to enter a contract at the price $p$ which at time 1b it represented as agreeable, this party will be held liable for the other party's reliance expenditures.

## C. The Effect of the Rule

Let us examine first the case in which both parties communicated the understanding over $p$. The case in which there is only one-sided representation will be considered below. Begin by looking at the final bargaining stage (time 2), after reliance expenditures have been incurred by both parties. At this stage, the parties may potentially agree on a new price, different from the original $p$. In the absence of liability, the parties may simply ignore the original understanding and negotiate a price within the ex post bargaining range, $[C(R_b, R_s), V(R_b, R_s)]$. However, with the potential liability, the ability of each party to propose a new price is curtailed. Thus, the bargaining range at this stage shrinks and lies between $C(R_b, R_s) + R_s$ at the bottom and $V(R_b, R_s) - R_b$ at the top. As long as the original agreed-upon price lied in the range between $C(R_b, R_s) + R_s$ and $V(R_b, R_s) - R_b$, the lowest price the buyer may offer is $C(R_b, R_s) + R_s$. If she goes lower, the seller would prefer to reject the offer since he will not have to bear liability and would recover $R_s$. The highest price the seller may demand is $V(R_b, R_s) - R_b$; a higher demand would lead the buyer to reject it, as the buyer will expect to recover $R_b$. Thus, while the parties may renegotiate the original

complex communications and understandings that would self-enforce optimal investment. In particular, these representations might leave some important terms open, or might be mere proposals put forth by one of the parties.

price *p* and agree on a new price, the new price must lie within this restricted bargaining range. Assuming the parties set a price that splits the bargaining range according to their relative bargaining power, the expected price will be

$$2[C(R_b, R_s) + R_s] + (1-2)[V(R_b, R_s) - R_b]. \tag{9}$$

The buyer's expected gain, when choosing her reliance investment, is $2[G(R_b, R_s) - R_b - R_s]$. The seller's expected gain is $(1-2)[G(R_b, R_s) - R_s - R_b]$. The solutions to the two maximization problems yield the socially optimal levels of reliance, $R_b^*$ and $R_s^*$.

The analysis is similar for the case in which only one party, say, the seller, represents at time 1b his willingness to trade for the price *p,* and the other party relies before representing its own intention. A rule that would impose liability on the seller if he retracts from the representation would change the bargaining range. If, following the seller's representation, the buyer sinks reliance costs of $R_b$, the bargaining range would lie between $C(R_b, R_s)$ at the bottom and $V(R_b, R_s) - R_b$ at the top. (Notice that only the seller's ability to propose a new price is curtailed; the buyer, who made no preliminary representation, is not affected.) The eventual price will split this surplus, thus giving the buyer an expected gain of $2[G(R_b, R_s) - R_b]$, which, when maximized over $R_b$, yields the socially optimal level of investment. Note, that the seller can still effectively retract from his original offer of *p* and negotiate a higher price, but no higher than $V(R_b, R_s) - R_b$. As long as the original offer was not too high (no higher than $V(R_b, R_s) - R_b$), the buyer will have optimal incentives to rely at stage 1c.[32] And as long as the original offer did not mimic

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[32] If the original represented price exceeded $V(R_b, R_s) - R_b$, the buyer will not rely optimally.

this exact price that the seller will extract ex post, renegotiation will occur *without* liability being invoked. Hence, we can state:

*PROPOSITION 6*:   Under a rule that assigns liability to any party who retracts from a preliminary representation he has made during the negotiations for the reliance expenses incurred by the other party after that representation, the other party will make the optimal reliance investment during the pre-contractual stage that follows the preliminary representation.

*Remarks*. (i) *Intuition*. This rule succeeds in inducing efficient reliance because it shields an investing party from the hold-up problem. By formally sanctioning any retraction from the preliminary representation, the rule changes the incentives of the parties to retract and negotiate different terms. While renegotiation might still occur, the retracting party must restrain its claim so as to avoid negotiation breakdown. Like the rule against ex post opportunism of Section IV.A., a party that represented a price term is effectively limited to make offers that leave its counterpart with a non-negative payoff. Thus, because the negotiated price cannot ignore investments sunk subsequent to the representation, the investing party cannot be held up and his incentive to make investments in this interim stage is optimal.

(ii) *The Original Price p.* The final price the parties agree upon depends, in part, on the original *p* that was represented at time 1b, but need not be identical to it (which is why

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Although the buyer might expect to negotiate a better price following the reliance stage (such that might eventually leave her with a positive surplus), the seller is less constrained by the potential liability: he may extract a greater share of the ex post surplus from the buyer without invoking liability. Thus, in this case the buyer effectively operates under a no-liability regime, and the under-reliance result emerges.

this rule differs from a regime that would forbid any type of renegotiation or modification.) It is enough to assume that the preliminary representation or understanding named any $p$ in the region that subsequently became the bargaining range, that is, $C(R_b, R_s) + R_s \# p \# V(R_b, R_s) - R_b$. For one, it can be assumed that at the preliminary stage, the parties choose the same price that they rationally expected to arise in the subsequent agreement, $2[C(R_b, R_s) + R_s] + (1-2)[V(R_b) - R_b]$. Note that even if the parties reach understanding over a price $p$ that accurately reflects the price they expect to arise in the subsequent agreement, they at the same time recognize their ability to renegotiate it. Still, the reason that optimal reliance occurs is that the ability to rename a price is constrained by the potential liability.[33]

(iii) *Changed Circumstances.* One significant limitation of the rule discussed in this Section is that it must be limited to cases in which no change of circumstances can account for a party's retraction. If, say, a party retracts from the original represented understanding after it has become clear that the profitability of the intended trade is so low that trade is not desirable, no liability should be invoked. This restriction would leave the cost of reliance on the investing party, and would lead that party to take into account the uncertain nature of the deal and the true distribution of its prospects. However, such a restriction would require courts to be able to verify claims of changed circumstances and to distinguish between realizations that were or were not expected by the parties.

(iv) *What Amounts to a Retraction?* It might be argued that a party who wishes to retract from a preliminary representation and yet avoid liability will try to circumvent the rule by masquerading a retraction as a demand related to a missing term that does not

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[33] Note that if the buyer, for example, considers the preliminary price $p$ to be final, she chooses $R_b$ to maximize $V(R_b, R_s) - p - R_b$, and relies sub-optimally, as she does not take into account the

conflict with the original understanding but that is so unreasonable as to lead to the breakdown of negotiations.[34] For example, if the parties agreed upon a price $p$ to be paid in several deferred installments, a party suffering change of heart would effectively impose unconstrained renegotiation if he were able to demand an unreasonable interest rate.

In order to avoid this deception, courts would have to determine if the demands regarding the missing terms are unreasonable. A party would be held to retract when he is unwilling to enter the contract even under the specification of the missing term that, within the range that the parties could reasonably expect, is the most favorable to him. This judicial determination is administratively less exacting than filling all the missing terms in the agreement and enforcing it as a binding contract. The gap-filling approach requires the courts to determine not only the reasonable range of provisions, but also identify the single most reasonable term. It then requires the courts to assess the aggrieved party's expectation according to the imputed agreement and award this measure of damages. The rule here does not require such detailed determinations and restricts liability to the post-representation reliance costs.

(v) *Information Needed.* This regime places a more modest informational requirement on courts, relative to the intermediate liability regimes studied in Section IV. Courts need only observe a deviation between the originally manifested term and the subsequent offer made, both ordinarily documented by the parties, and any reliance expenditures actually invested after that initial agreement, as well as any changed circumstances.

(vi) *The Broad Applicability of the Rule.* Although this rule governs only the time

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"cooperative" effect of her reliance in reducing the seller's cost $C(R_b, R_s)$.

interval that follows the preliminary representation or understanding, many, if not most, pre-contractual reliance opportunities fall within its scope. The rule applies as soon as at least one of the parties makes a well-specified communication of the terms of trade it seeks, an event that often occurs early on in the negotiations stage. The discussed rule does not apply to any investment made prior to the preliminary understanding, nor to any investment made by one party prior to the preliminary representation made by the other party. Investments occurring at this early stage (time 1a) will be distorted, as there is no liability to monitor them. However, given that individuals are faced with numerous simultaneous trade opportunities, it is unlikely that they would invest any significant expenditure in reliance before receiving some—if only preliminary—articulation of the proposed terms of trade.

## D. Doctrinal Implications

Doctrinally, the law of pre-contractual negotiations aims to distinguish between situations in which parties mutually manifest their intent to be bound, in which case a fully binding contract is produced, and situations in which no such intent is mutually manifested, in which case there are at this stage no legal consequences. Inferring an intent to be bound from the parties pre-contractual representations has proven, however, a difficult judicial task, leading some commentators to critique the inconsistency arising from the body of case law.[35] Our analysis in this Section suggests that the law's dichotomous, all-or-nothing approach—viewing certain communications as either creating a fully binding contract or as

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[34] We are grateful to an anonymous referee for suggesting that this problem be addressed.

[35] See, for example, Farnsworth, *supra* note 2, at 255-263 ("it would be difficult to find a less predictable area of contract law"); Gerald Buechler, The Recognition of Preliminary Agreements in Negotiated Corporate Acquisitions: An Empirical Analysis of the Disagreement Process, 22 Creighton L. Rev. 573, 574 ("the decisions in this area continue to appear both confusing and

having no legal consequences—might not be optimal. It might be desirable to take a more "graduated" approach. Certain communications might be regarded as establishing some "intermediate" legal consequences – while not creating a binding contract, they might trigger liability for subsequent reliance expenses if a contract is not ultimately made. This view has implications for, and suggests a new approach to, several contract formation doctrines.

1. *Revocation of an Offer*

The analysis suggests that it might not be desirable to allow a party who made a full-blown offer to revoke its offer *costlessly* before an affirmative acceptance was communicated. Under current law, unless stated otherwise by the offeror, the offer can be withdrawn at no cost before the intent to be bound becomes mutual, namely, any time prior to acceptance.[36] Recognizing the chilling effect that the unconstrained revocation power has over the incentives to rely suggests that the current rule might not maximize the surplus available to *both parties.* A better result might be to require the offeror who revokes the offer to reimburse the offeree for reliance expenditures incurred after the offer was made.[37] Note that although the rule studied here is more "generous" to the relying party than the default doctrine, it does not go as far as some courts have gone in a prominent line of cases,

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inconsistent to the point where it is said to be virtually impossible to predict the outcome in a particular case.")

[36] UCC, § 2-205; Petterson v. Pattberg, 161 N.E. 428 (N.Y. 1928) (offer is revocable anytime before acceptance even though offeree incurs costs in reliance.)

[37] Doctrinally, this reliance measure of damages is available under §87(2) of the Restatement (Second) of Contracts ("An offer which the offeror should reasonably expect to induce action or forbearance of a substantial character on the part of the offeree before acceptance [...] is binding as an option contract to the extent necessary to avoid injustice.")

enforcing a binding contract on the offeror.[38] It also would not, as a general matter, reduce the incentives of parties to make offers. As will be shown in Section VI below, the cost the offeror bears from the surrendered freedom to freely revoke an offer is more than offset by the benefit the offeror derives from the increased reliance investment by its negotiation partner.

### 2. Solicitation of an offer

The analysis also questions whether a party who invites another party to make an offer of specified terms should be able costlessly to retract its invitation and refuse to enter a contract based on these terms. Under the basic principles of contract formation, a party whose representation merely invites the other party to make an offer is not bound and can walk away even if the other party has responded by making the solicited offer. Recognizing the effect that this retraction power might have on the incentives of invitees to rely and to respond by making the solicited offers suggests that the current rule might not maximize the surplus available to *both parties.* Although the representation did not amount to a full-blown legal offer, it might be desirable to impose some reliance liability on the party who solicited the offer and is now unwilling to contract upon its terms.[39]

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[38] Courts have limited the power of the offeror to revoke his offer in cases involving subcontractor bids; see cases cited *supra* note 28. According to the rule that has emerged from these cases, reliance by the offeree leads to full expectation liability.

[39] This was the situation in Kukuska v. Home Mutual Hail-Tornado Insurance Co., 235 N.E. 403 (Wis. 1931) (an insurer was liable after soliciting an insurance application, even though it never accepted the application once made); Cole-McIntyre-Norfleet v. Holloway, 214 S.W. 817 (Tenn. 1919) (seller who solicited a set-price offer from buyer is held liable since it did not respond – reject or accept – during the period in which market price increased). Since in these cases the reliance cost equaled the forgone opportunities to enter into substitute contracts, it was effectively identical to the lost expectation. Thus, these cases do not provide a clear indication as to the nature of the liability,

Notice, however, that this rule of liability would not apply to a situation in which the solicitation was addressed simultaneously to a number of invitees and only one of the relying invitees eventually entered a contract (as, for example, in a case where a seller invites offers to buy his house at a specified sum and potential buyers incur costs to make the requested bids which, all but one, are eventually be rejected.) While the invitees might have been led to make reliance investments, the seller's action is not a retraction and the invitees will not be reimbursed under the rule. The original invitation should be understood to include an implicit provision that only one of the invited offers would be accepted. A retraction might occur in this case if, say, the soliciting party insists on terms that are more aggressive than the ones included in the invitation, or rejects all the offers, or does not fairly consider one of the bids. But a retraction does not occur if the soliciting party is rejecting the invited offers after impartially accepting one of the bids.[40] Thus, in choosing their reliance levels the invitees will be shielded from opportunistic modification of the terms of the invitation, but will not be shielded from the risk that another invitee will be chosen. They will therefore likely reduce their reliance investment to account for this risk, which is the socially optimal outcome.

### 3. Counter-offer

The analysis suggests that when an offeree responds with a counter-offer, the

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whether it is full contractual liability or mere pre-contractual reliance liability.

[40] For a similar understanding of the no-retraction rule, see Heyer Products Co. v. United States, 140 F. Supp. 409 (Ct. Cl. 1956); Farnsworth, *supra* note 2, at 238-239.

original offer should not cease to have any legal consequences whatsoever. [41] Rather, it might be desirable to view this situation as creating some pre-contractual liability in the event that one of the parties withdraws its outstanding offer. Although there is neither a preliminary understanding over terms nor a mutual intent to be bound, there is a bilateral representation of terms, and either party should be liable when negotiations fail due to this party's retraction from the terms it previously communicated. Following the counter-offer, the offeror should be able to refine his offer and further negotiate the final terms, but cannot retract from his original offer and insist on more favorable terms, thereby leading to failure of the bargaining.

4. *Definiteness*

In common law, preliminary understandings or representations, even such that manifest an intent to be bound, often fail to be enforced due to their incompleteness or lack of sufficient definiteness. Courts are reluctant to make the contract for the parties and to provide remedies that have no basis in the actual agreement. [42] However, under the rule analyzed here, the absence of a complete and certain agreement does not require courts to heavily supplement the contract for the parties. Instead, courts can provide remedies even when the representation of terms is severely incomplete, by restricting recovery to sunk investments. This intermediate approach applies irrespective of whether the parties manifested intent to be bound and thus it renders unnecessary a judicial inquiry into the

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[41] Restatement (Second) of Contracts §36(1)(a) ("the offeree's power of acceptance may be terminated by rejection or counter-offer").

[42] Restatement (Second) of Contracts, §33. But see UCC §2-204(3) for a less rigid principle.

complex and unpredictable matter of intent.

### 5. Agreements to Agree

In many complex negotiations parties reach an agreement in principle over some fundamental terms and, while still not bound and still lacking the intent to be bound, agree to further negotiate the remaining issues. If one of the parties breaks off further negotiations in order to, say, deal with a third party who is offering better terms, the rule discussed suggests that the repudiating party be inflicted with reliance liability. Unlike the existing "all-or-nothing" position of the law, that either dismisses the preliminary agreement as unenforceable or fully enforces it and awards expectation remedies,[43] the analysis here supports an interim measure of liability, extending only to reliance investments. Again, by offering an intermediate solution that obviates a determination of the binding status of the preliminary agreement, this rule might simplify and make more predictable an area of contact law that is notorious for its inconsistency.

## VI. DECISIONS TO ENTER CONTRACTUAL NEGOTIATIONS

### A. Incorporating the Decision to Enter Negotiations

Thus far, it has been assumed that at time 0 the parties will always enter into

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[43] Compare R.G. Group, Inc. v. The Horn & Hardard Co., 751 F.2d 69 (2d Cir. 1984) ("handshake deal" not enforceable as there is intent not to be bound until the execution of a final agreement) with Texaco, Inc. v. Pennzoil, Co., 729 S.W.2d 768 (Tex. Ct. App. 1987) (agreement-in-principle enforceable when one party breaks off negotiations to accept better terms from another bidder).

contractual negotiations. In this Section, we examine the parties' decisions whether to enter negotiations and consider the effect of pre-contractual liability rules on these decisions. A common view held by legal scholars suggests that imposing liability for pre-contractual reliance will discourage parties from entering negotiations and making pretrade representations.[44] The analysis in this Section will demonstrate that this view may not be valid. We will show that the absence of liability may not necessarily lead to either more negotiations, or, more importantly, a greater joint surplus. The analysis we offer is exploratory in nature, and intended to highlight some of the ways in which the liability regimes affect the incentives to enter negotiations.

Several simplifying assumptions will be made in examining this issue. First, we will ignore any "transaction costs" parties may incur in entering negotiations. We will assume that these costs are zero. Second, we will assume that a party is not obligated to enter into contractual negotiations. A party will enter negotiations if and only if its expected gain, given the expected contractual profit less the cost of reliance and of pre-contractual liability, is positive. Additionally, given that we wish to focus on the decision of whether or not to enter into negotiations, we will no longer assume that a transaction between the parties is guaranteed to produce a surplus ($G > 0$). This assumption would have made the decision to enter negotiations a trivial one. Instead, we will assume that when two parties meet, a transaction between them may or may not be a surplus-producing one. As before, we will assume that all parameters are common knowledge throughout the interaction, including at time 1, when the parties decide whether to enter into negotiation.

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[44] See Farnsworth, *supra* note 2, at 221, 243; Jason S. Johnston, Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation, 85 Va. L. Rev. 385, 416-417 (1999).

*B. Comparing No Liability with Strict Liability*

Let us begin by comparing the set of cases in which contractual negotiations will emerge under the two "extreme" rules -- no liability and strict liability. As we will demonstrate, the rule of no liability does not necessarily lead to more contractual negotiations.

*1. No Liability*

*PROPOSITION 7.* (a) Under a regime of no pre-contractual liability, the parties will enter into contractual negotiations if and only if, given the anticipated inefficient levels of reliance, there will be a positive surplus;

(b) Under such a regime, the parties will not enter into negotiations in some cases in which there would be a positive potential surplus if reliance levels were set optimally.

*Proof.* (a) Given the inefficient levels of reliance under the no-liability rule, if there is a positive surplus, each party is guaranteed at worst a zero payoff (since it can always set $R = 0$ and reject the contract at time 2) and will enter negotiations. If, instead, given the anticipated levels of reliance there is a negative surplus, at least one of the parties expects a negative payoff and will not enter negotiations.

(b) In the absence of liability, the parties set reliance levels that deviate from the optimal levels, and thus the surplus from the transaction is necessarily smaller relative to the surplus resulting from efficient levels of reliance. If the distorted reliance shrinks the surplus sufficiently to make it negative, we know, given part (a) of the Proposition, that the

parties will not enter negotiations.

*Remark.* The key feature of the no-liability regime is that a party cannot be forced to enter into a negative-payoff contract. Since each party is guaranteed a positive payoff, every time the parties enter negotiations there is a positive surplus from the contract. But the parties may fail to realize every potential surplus because their "cautious" reliance may fail to produce the positive surplus that optimal reliance would have produced. In this case the parties will not enter negotiations.

### 2. Strict Liability

*PROPOSITION 8.* Under a regime of strict pre-contractual liability, parties might not enter into contractual negotiations even if the contract that such negotiations would produce has a positive surplus.

*Proof.* $G(R_s{}^L, R_b^L) - R_s{}^L - R_b^L$ denotes the contract's surplus given the levels of reliance that the parties privately choose under the strict liability rule. The parties expect to divide the surplus such that the buyer will get $2G(R_s{}^L, R_b^L) - R_s{}^L$ and the seller will get $(1\text{-}2)G(R_s{}^L, R_b^L) - R_b^L$. When either $2G(R_s{}^L, R_b^L) < R_s{}^L$ or $(1\text{-}2)G(R_s{}^L, R_b^L) < R_b^L$, one of the parties will expect a negative payoff and will not enter the negotiations. Either of these conditions may be satisfied even though $G(R_s{}^L, R_b^L) - R_s{}^L - R_b^L > 0,$ that is, the contract is a surplus-creating one.

*Remark.* *Why Parties May Not Enter Negotiations.* The rule of strict liability may fail to realize a potential positive surplus because the division of the surplus does not guarantee

each party a positive payoff. Once entering negotiations, a party is liable for the reliance expenditures of the other party, a quantity that it does not control. If it expects the other party's reliance expenditures to be high and its own share of the surplus to be small, it expects to enter a contract with a negative payoff, in which case the party will not enter negotiations. This will occur even if the other party (who stands to get the bulk of the surplus) has a positive gain, such that the total net surplus from the transaction is positive.

### 3. Comparison of the No-Liability and the Strict Liability Rules

The last two Propositions may seem to suggest, at first glance, that the set of circumstances in which parties will enter into contractual negotiations is wider under the no-liability rule than under the strict liability rule. Claims in this spirit have been previously made by scholars who have studied pre-contractual liability.[45] This impression, however, is not valid. A careful comparison of the two rules reveals that it is impossible to conclude that one of the rules will produce more entry into contractual negotiations than the other.

To understand the ambiguity of the comparison, consider two cases. The first case involves a transaction that would produce surplus under both regimes. From Proposition 7 we know that parties will enter contractual negotiations under the no-liability rule, and from Proposition 8 we know that the same parties may not enter negotiations under he strict

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[45] Notably, Johnston, id., argues that liability for pretrade representations in the event of negotiation breakdown would "cause the market to shrink" (p. 417) and would force parties to utilize more cautious bargaining strategies, wasting opportunities for efficient trade (p. 445-6). Johnston's analysis focuses on situations in which liability results from judicial misunderstanding of the information conveyed in the preliminary representation, but describes the intuitive conjecture that is widely held. See, for example, Wils, *supra* note 4, at p. 103 (pre-contractual liability "tends to lower inefficiently the incentives of parties to enter contract negotiations at the outset"); Farnsworth, *supra* note 2, at p. 221 (describing "a concern that limiting the freedom of [exiting]

liability rule. Thus, in this case more entry occurs under no-liability. There is another case, however, which involves a transaction that would produce surplus under the rule of strict liability but not under the rule of no-liability.[46] In such a case we know that there will certainly not be negotiations under no-liability (Proposition 7), but that there might be negotiations under strict liability (Proposition 8). Thus, the analysis suggests that the case for no pre-contractual liability is weaker than some commentators perceived. Even in comparison to a strict liability regime, the no-liability rule does not produce superior decisions to enter negotiations. We will now show that the no liability rule is strictly inferior to intermediate liability regimes.

## C. Intermediate Rules

### 1. Liability for Ex Post Opportunism and the Sharing of Costs Rule

*PROPOSITION 9.* Under the rule that assigns liability for ex post opportunism and under the sharing rule, the parties will enter negotiations if and only if there is a potential surplus from the transaction.

*Proof.* Under these rules, parties invest optimally in reliance (Proposition 3 and 4). Further, under either of these rules the contractual price is the same (expression (6)). Under either of these rules, the buyer's expected gain from entering negotiations is $2[G(R_b^*, R_s^*) - R_b^* - R_s^*]$, which will be positive if and only if the surplus $[G(R_b^*, R_s^*) - R_b^* - R_s^*]$ is positive. The seller's expected gain from entering negotiations is $(1-2)[G(R_b^*, R_s^*) - R_b^* - R_s^*]$, which will

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negotiations might discourage parties from entering negotiations.")

[46] The comparison between the no-liability and the strict liability regimes, in terms of the surplus they generate, is ambiguous. Under strict liability, there may be greater surplus if the welfare loss of the excessive reliance is smaller than the welfare loss of under-reliance which no-liability produces.

be positive if and only if the surplus is positive.

*Remark.* These rules guarantee that parties will make reliance investments that maximize the net surplus from the contract. Since each party bears a fraction of the total reliance costs that is equal to the fraction of the surplus it extracts (*2* for the buyer, 1-*2* for the seller), each is guaranteed a fraction of the total net surplus. Whenever the total maximal net surplus is positive, each party will get part of it; hence, each party will choose to enter negotiations. Accordingly, the rule against ex post opportunism and the sharing rule will produce the efficient outcome, not only with respect to reliance decisions, but also with respect to the prior decisions of whether to enter into negotiations.

### 2. Liability Capped by the Efficient Level of Reliance

*PROPOSITION 10.* Under a rule that caps liability at the cost of the efficient level of reliance, parties may not enter into contractual negotiations even if the contract such negotiations would produce has a positive surplus.

*Proof.* From Proposition 5, we know that if the parties enter negotiations, they invest optimally in reliance. Thus, the buyer expects a gain of $2G(R_b^*, R_s^*) - R_s^*$, and the seller expects a gain of $(1-2)G(R_b^*, R_s^*) - R_b^*$. Either of these payoffs may be negative even if the total surplus is positive, in which case the party with the negative payoff will not enter negotiations.

*Remark.* This rule guarantees that parties will make reliance investments that maximize the net surplus from the contract. Under this rule, however, a party may bear a fraction of the

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total reliance costs that differs from the fraction of the surplus it extracts (the buyer extracts a $\alpha$-fraction of the surplus, but bears none of her own and all of the seller's reliance costs; the seller extracts a 1-$\alpha$-fraction of the surplus, but bears none of his own and all of the buyer's reliance costs). Thus, even if the total net surplus is positive, one of the parties may get a negative payoff, in which case it will not enter negotiations.

Note that even if courts have the required information, such that all three intermediate rules can potentially lead to optimal reliance, the first two rules—the rule against opportunism and the sharing rule—are better than the capped liability rule. The first two rules also guarantee the efficient outcome with respect to the parties' prior decisions of whether to enter negotiations, whereas under the capped liability rule the parties may forego opportunities to create a positive surplus.

### 3. Liability for Retraction from a Preliminary Representation

*PROPOSITION 11.* Under a rule that assign liability to any party who retracts from a preliminary representation earlier made by this party for reliance investments made by the other party after that representation, the parties will enter negotiations in more cases in which there is a potential surplus than in the absence of liability.

*Proof.* From Proposition 6 we know that if the parties enter negotiations and a preliminary representation is made, they invest optimally in reliance in the period that follows the representation, period 1c. Since each party effectively bears a fraction of the reliance costs that is equal to the fraction of the surplus it extracts ($\alpha$ for the buyer, 1-$\alpha$ for the seller), each is guaranteed a fraction of the net surplus that is added by the induced reliance. Since

the net surplus can only increase under this rule, there are three cases to consider. First, if the increased net surplus is still negative even under this rule, parties would not enter negotiations, but in this case at least one of them would not have wanted to enter negotiations also in the absence of liability; thus, there would be no effect on the incidence of negotiations. Second, if the net surplus in the absence of liability were already positive, we know from Proposition 7 that the parties would have entered negotiations, but they will also enter negotiations under the liability rule as the net surplus is even higher and each gets a fraction of it; thus, here too there would be no effect on the incidence of negotiations. Third and last, if the surplus was negative in the absence of liability and became positive under the liability rule due to the more efficient reliance, the parties would not have entered negotiations in the absence of liability (Proposition 7) but will certainly enter negotiations under the liability rule as, again, each one of them gets a fraction of this positive net surplus.

*Remark.* What this proposition shows is that the existence of liability does not chill the parties' incentives to enter negotiation. In the contrary, this rule—by inducing efficient investment—makes negotiations more desirable. This proposition does *not* claim that both parties are better off under the liability rule. It might well be that the non-investing party, by effectively bearing some of the reliance costs of his counterpart, is worse off than he would have been in the absence of liability. However, the proposition does show that this distributive effect will not distort the incentives to enter negotiations. A party whose payoff was positive in the absence of liability will not experience a negative payoff under the liability rule.

## VII. CONCLUSION

This paper has analyzed decisions to invest in pre-contractual reliance under alternative legal regimes. The analysis has shown that extreme rules of pre-contractual liability—no liability or strict liability—lead to inefficient levels of pre-contractual investments. No-liability leads to under-investment, and strict liability leads to over-investment. In addition, both of these rules distort decisions of whether to enter negotiations. Which rule leads to more severe distortions is ambiguous; a widely held view that liability will deter negotiations and thus permit less frequent realizations of joint surplus has been shown to be incorrect.

A main contribution of this paper is in studying various "intermediate" liability rules. We have explored several rules that might potentially improve ex ante reliance decisions, and we have identified the type of information that courts would need for implementing each of these rules. Our analysis has also identified how the alternative intermediate regimes compare in terms of providing incentives to enter into contractual negotiations.

Various legal doctrines have been developed to govern conflicts arising at the pre-contractual stage. We have remarked throughout the analysis on ways in which these doctrines can be best applied to induce optimal pre-contractual reliance. Whereas much of the doctrinal and scholarly attention has focused on the comparison between no liability and full contractual (expectation) liability, our analysis suggests that the best way to regulate pre-contractual investment might be through an appropriately-tuned intermediate approach to reliance liability.