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WHO SHOULD BEAR THE COSTS OF FAILED NEGOTIATIONS? A FUNCTIONAL INQUIRY INTO PRECONTRACTUAL LIABILITY

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Abstract

The objective of this paper is to undertake a systematic, functional analysis of how the law should deal with unsuccesful negotiations. This is done by analysing how different possible liability rules affect the decision by negotiating parties to take costly actions in anticipation of the deal in negotiation, and how they affect the decision whether to strike the deal or to break off the negotiations. We conclude that two types of liability should be provided for: liability for the cost of actions misleadingly induced, and restitution of benefits retained after the failure of the negotiations. More general liability, or liability for breaking off the negotiations, are undesirable. These recommendations appear to correspond to a large degree with the existing case law in the United States and several Common Law and Civil Law jurisdictions.

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INTRODUCTION

When parties have been negotiating a contract or deal, and these negotiations collapse, the question often arises whether any of the parties should be held liable for the expenses made or losses incurred by the other side.

This question is of obvious practical importance, and has received increasing attention from legal scholars and practitioners.[1] So far, however, it has never been systematically analysed from a functional viewpoint.

The first part of the present paper purports to provide such analysis. We look at the incentives of negotiating parties to engage in costly action during the negotiations, and at their incentives to break off the negotiations or enter into the deal. We compare these incentives in the absence of any precontractual liability, and under the various possible liability regimes. Using well-defined normative criteria of wealth-maximization and fairness, we will be able to draw conclusions as to the desirable regime of precontractual liability.

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[1]In 1989, the International Chamber of Commerce hosted a colloquium on precontractual liability. In 1990, the XIIIth Congress of the International Academy of Comparative Law was devoted to the issue. The reports of these colloquia were respectively published in *Formation of contracts and precontractual liability*, I.C.C., Paris, 1990, and *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991.

In the second part of the paper, we summarize our conclusions, and compare them with the existing law in a number of countries. It will appear that the actual case law in most countries corresponds with the conclusions of our analysis, although the doctrinal justifications sometimes diverge. We will then be able to suggest some reformulations of legal doctrine, so as to bring it more in line with the case law and its underlying functional concerns.

Our topic does not cover the whole field of precontractual liability. We only deal with the situation where the negotiations have failed, and no contract has thus been formed. This situation raises the linked questions whether parties should be free to break off the negotiations, and who should bear the costs of failed negotiations. We do not discuss questions which relate to the precontractual phase, but which arise after the completion of the negotiations, i.e. when a contract has been entered into.[2]

[2]These other questions have been analysed from a functional viewpoint a.o. by A. KRONMAN, "Mistake, disclosure, information and the law of contracts", 7 *J. Legal Stud.* 1 (1978); R. CRASWELL, "Precontractual investigation as an optimal precaution problem", 17 *J. Legal Stud.* 401 (1988); and J. COLEMAN, D. HECKATHORN and S. MASER, "A bargaining theory approach to default provisions and disclosure rules in contract law", 12 *Harv. J. Law & Public Policy* 639 (1989).

In the Germanic legal systems, the heading of precontractual liability also covers a third type of questions, concerning accidents in a precontractual situation, e.g. a prospective customer being injured when walking around in a department store. In other legal systems, these questions are treated as ordinary tort questions. They have obviously no relation to our analysis.

PART ONE : ANALYSIS

A. PRELIMINARIES

The question we want to answer is how the law should deal with unsuccesful negotiations. Through rules of precontractual liability, the law is able to influence the behavior of negotiating parties, or to alter the outcome of their interactions, so as to achieve a result which is considered socially desirable. At the outset of our analysis we need thus first to determine by what normative criteria we will judge the results generated by the various possible rules of precontractual liability. We also have to find out which aspects of the parties' behavior are relevant in view of these normative criteria, and in what ways rules of precontractual liability can make a difference.

I. NORMATIVE CRITERIA

We will use two normative criteria: efficiency and fairness. We call *efficient*, whatever increases social welfare. Social welfare is defined as the sum of the welfare of everyone. For our purposes, it comes down to the joint welfare of the two negotiating parties. We call social optimum, whatever maximizes social welfare.

We consider as *unfair*, any situation resulting from the interaction between the negotiating parties, in which one of them has suffered a loss, this party has never (reasonably knowingly) taken or accepted the risk of this loss, and the other party could have reasonably prevented the loss occuring, or the risk being born by the first party. We do not think that the situations and problems we will analyse, present issues concerning other dimensions of fairness.

II. OUTLINE OF THE MODEL

We will consider two kinds of decisions which are taken by parties during precontractual negotiations: decisions whether to take some costly action in anticipation of the deal, and decisions whether to break off the negotiations or to strike the deal.

Our analysis will be structured around the decision whether to take some costly action in anticipation of the deal. We will distinguish hereafter three types of action: strategic action, reliance and anticipatory performance. For each type of action, we will determine when it is efficient for the action to be taken, and when we can expect the action to be taken, either by one party on her own motion, or as a result of the interaction between the negotiating parties. It will appear that in several instances the parties would not take efficient decisions. In some instances, unfairness may also result from the parties' interaction. We will then investigate whether a liability rule, and what type of liability rule could improve the situation.

The decision to take action in anticipation of the deal will be presented as a simple two-options decision: one of the negotiating parties (we will call her the acting party) has the opportunity, at a given moment during the negotiations, to take or not to take a given action, with given cost. Of course, in the real world, the actions taken by negotiating parties are a matter of degree, and of timing. Our analysis, however, is not restrictive in this respect. In fact, what we do, is break down these real world actions in their smallest (alternative) components, and analyse them at the margin. When we talk, for instance, about a given indivisible reliance decision, this stands for every marginal choice as to reliance, both in size (relying a bit more or not) and in time (relying a bit earlier or not).

Throughout our analysis, we will also consider the decision whether to break off the negotiations or to strike the deal. This decision will be described as a simple two-options decision, situated at the end-stage of the negotiations. Whether it is efficient to enter the deal or to break off the negotiations, depends on whether the deal generates a positive surplus or not. By surplus we mean an increase in the parties' joint welfare, as compared to their next best alternative. If the parties strike the deal, they have to divide this surplus, by determining a price or other contractual conditions. We will assume that they divide the surplus according to some fixed proportion, which reflects the balance of their respective bargaining powers.

Most of our analysis will be verbal. Some numerical examples will be added as illustration. In addition, we will sometimes refer to a more formal analysis, which can be found in the footnotes.[3]

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[3]The following **notations** will be used in the formal analysis: $\mathbf{t_1}$ is the time at which the action in anticipation of the deal is taken; $\mathbf{t_2}$ is the time at which the deal is struck or the negotiations are broken off; **V** is the surplus from the deal; $\boldsymbol{\alpha}$ is the fraction of the surplus which the acting party receives if the deal goes through: $0 < \alpha < 1$; the other party thus receives a fraction $1 - \alpha$; $\boldsymbol{\pi}$ is the probability at t_1 that the deal will be struck at t_2; **R** is the cost of the reliance action; **P** is the cost of the anticipatory performance action; $\boldsymbol{\Delta V}$ is the increase in the surplus from the deal which results from the reliance or anticipatory performance action; **W** is the scrap value of the reliance or anticipatory performance action, i.e. the remaining benefit if the negotiations fail; **L** is a contribution paid by the other party to the acting party at t_1; **D** are damages paid when the negotiations are broken off.

II. THREE TYPES OF ACTION

Parties involved in precontractual negotiations can have two reasons for taking costly actions during the negotiations: either the action may increase the surplus expected from the deal, or it may affect the division of this surplus between the parties.

We define *strategic actions* as being all actions which do not increase the expected surplus from the deal, but only change its division. For example, a contractor might make efforts to try and convince her prospective client that her production costs are higher than they actually are, so as to secure a larger part of the surplus for herself. Or a party might drag a negotiation session so as to exhaust the other party, and lead him thus to accept terms he would otherwise not accept.

The actions which increase the expected surplus from the deal can be distinguished in two types, depending on whether the positive effect of the action accrues to the party who makes the expense or undergoes the negative effect, or accrues to the other party. 'Accrues to' is meant in the rather physical sense of 'changing the situation of', without looking to the division of the surplus or to transfers which happen if the deal goes through.[4]

Consider, for instance, negotiations concerning the sale of a company. During the negotiations, the prospective buyer

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All these quantities could be considered as probabilistic. We will assume, however, that the parties are risk neutral, so that we can work with expected values.

[4]Whether the positive effect of an action accrues to one party or the other, it not only a physical reality, but also depends on the rules of property, which we consider as given.

already starts reorganizing her existing business in anticipation of the merger with the company to be acquired. The positive effect of this action, being the change in the organization of her existing business, accrues to the buyer, who also bears the costs. This kind of action, the costs and benefits of which fall on the same acting party, will be called *reliance*.

Consider, on the contrary, a building contract in negotiation. If the contractor already renders services to her client, the costs of this action fall on the acting party, whereas the benefit accrues to the other party. This kind of action, the costs and benefits of which do not fall on the same party, will be called *anticipatory performance*.

Conceptually, all actions taken by the negotiating parties in anticipation of the deal in negotiation, can be broken up and classified as strategic action, reliance or anticipatory performance. In practice, however, it might be difficult to identify the nature of an action or an expense made. This fact will be taken into account when we draw normative conclusions as to the desirability of different legal rules.

B. STRATEGIC ACTION

We start our analysis with the type of action which can most easily be analysed. By definition, strategic action does not increase the expected surplus from the deal, but only changes its division. Social welfare is thus not increased. On the contrary, the resources spent on strategic action (and counteraction) reduce social welfare. Strategic action is thus always inefficient. Nevertheless, a party will engage in strategic action if her expected private benefit, being the increased part of the surplus she expects to receive, multiplied by the probability of the deal, exceeds her costs.

As to the law, its only realistic ambition is to avoid encouraging strategic action. Legal rules which tend to shift (part of) the costs of strategic action to the other party, are undesirable in that they reinforce the already excessive incentive to take such action. This applies, for instance, to a general rule imposing liability on the party who breaks off the negotiations, for all the expenses made by the other side.

C. RELIANCE

We defined reliance actions as those actions taken by parties in anticipation of the deal in negotiation, which increase the expected surplus from the deal, and the costs and benefits of which fall on the same acting party. This means that, if the negotiations eventually collapse, the acting party retains the scrap value of the reliance action. If the negotiations succeed, and the deal is struck, the benefit of the reliance action will be part of the surplus from the deal, which will be divided between the parties according to their relative bargaining powers. An example of reliance would be a prospective buyer of a company already starting to reorganize her existing business in anticipation of the merger with the company the acquisition of which is being negotiated.

I. SOCIAL OPTIMUM

Reliance increases social welfare, and is thus efficient, if the cost of reliance is smaller than its total expected benefit, i.e. if the cost of reliance is smaller than the resulting increase in the surplus from the deal, multiplied by the probability that the deal goes through, plus the scrap value of the reliance, multiplied by the probability that the deal does not go through.[5]

> **Example I:** A buyer can take some reliance action, of which the cost is 15. The effect of the reliance action is to increase by 20 the value to the buyer of the good the sale of which is being negotiated. The probability that the deal will be struck eventually, is 0.6. If the deal does not go through, the buyer retains a scrap value 10 out of the reliance action. In this example, reliance is efficient: the total expected benefit $(0.6)\times 20 + (0.4)\times 10 = 16$ exceeds the cost 15.

II. CASE WHERE INFORMATION IS SYMMETRIC

The reliance decision is a function of a number of parameters: the cost of the reliance action, the resulting increase in the surplus from the deal, the probability that the deal will go through, the division of the surplus when the deal goes through, and the scrap value of the reliance action. In order to analyse the incentives of the parties to engage in reliance, and to draw conclusions as to the effects of different legal rules, we need to make some assumptions as to the information the parties have, at the time of the reliance decision, concerning the relevant parameters.

It appears that the symmetry or asymmetry of information constitutes an important dimension. By *symmetric information*, we mean that, at the time the reliance decision has to be taken, both parties have the same information on the relevant parameters. If the information is *asymmetric*, it makes a difference whether the better informed party is the party who has to take the reliance action (the acting party), or the other party.

[5] Reliance is efficient if and only if: $R < \pi.\Delta V + (1 - \pi).W$.

We first assume symmetric information. For simplicity, we may assume that the parties have full information about all relevant parameters. The analysis is equally valid if their information is not full, but symmetric, i.e. if they face the same uncertainties (and have the same attitude towards risk).

Spontaneously, the acting party will engage in reliance if the cost of reliance, which is born by her, is smaller than the part of the benefits which she expects to receive herself.[6]

> **Example I continued:** Let the relative bargaining power of the parties be such that they will divide the surplus in equal parts, if the deal goes through. In that case, the acting party (the buyer) will not spontaneously take the reliance action, although (as we showed before) reliance would be efficient. Indeed, if the buyer took the reliance action, she would bear the cost 15, whereas she would gain half of the increased surplus 20 if the deal goes through, or the entire scrap value 10 if the deal does not go through. Her expected gain $(0.6)\times\frac{1}{2}\times 20 + (0.4)\times 10 = 10$ would be less than her cost 15.

It appears that *a party's spontaneous incentive to engage in reliance is suboptimal*. From the perspective of social welfare, a party should engage in reliance whenever the increase in the surplus from the deal, and the scrap value, weighed by the probabilities that the deal will go through or not, exceed the cost of reliance. The acting party, however, only takes into account the part of the increased surplus which she expects to receive. Spontaneously, a party will thus rely less often than socially desirable.

The disparity between the social optimum and a party's spontaneous behavior depends on the bargaining strength of this party. If the acting party is so strong as to receive the

[6] The acting party will spontaneously engage in reliance if and only if $R < \pi.\alpha.\Delta V + (1 - \pi).W$.

entire surplus when the deal goes through, including the entire increase in the surplus caused by her reliance, her reliance decisions will be optimal. The weaker the bargaining position of a party, the more her spontaneous reliance decisions will be suboptimal.[7]

Given our assumption of symmetric information, however, it is highly unlikely that efficient reliance action will not be taken. If reliance is efficient, but the acting party lacks the incentive to rely spontaneously, it will always be *in the other party's interest to pay part of the reliance cost so as to induce the acting party to rely.*[8]

> **Example I continued:** We showed before that in our example reliance is efficient (the total expected benefit 16 exceeding the cost 15), but that the acting party lacks the incentive to take the reliance action spontaneously (her expected gain equaling only 10). If the acting party relied, and the deal were to go through, however, the other party would receive half of the increased surplus, i.e. 10. The other party's expected gain from reliance is $(0.6)\times 10 = 6$. He will thus be willing to pay the acting party up to 6 so as to induce her to rely. The latter only needs $15 - 10 = 5$ to be induced to rely. The parties can thus reach an agreement: the acting party will rely, and the

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[7]Depending on the value of α, there will be a range of situations in which reliance is efficient, but the acting party lacks the incentive to rely. This range is defined by the condition $\pi.\alpha.\Delta V + (1 - \pi).W < R < \pi.\Delta V + (1 - \pi).W$.

[8]The benefit which the other party obtains from reliance by the acting party always equals $\pi.(1 - \alpha).\Delta V$. If necessary to induce the other party to rely, the other party will be willing to pay her any amount $L < \pi.(1 - \alpha).\Delta V$. The acting party will only rely if she receives from the other party an amount $M > R - \pi.\alpha.\Delta V - (1 - \pi).W$. The parties will thus reach an agreement inducing the acting party to rely if and only if $R - \pi.\alpha.\Delta V - (1 - \pi).W < \pi.(1 - \alpha).\Delta V \leftrightarrow R < \pi.\Delta V + (1 - \pi).W$, i.e. if and only if reliance is efficient. Under the agreement, the other party pays the acting party an amount $L = M \in [R - \pi.\alpha.\Delta V - (1 - \pi).W, \pi.(1 - \alpha).\Delta V]$. Given our assumption that the relative bargaining powers of the parties are reflected by a fixed proportion α, this amount will equal $(1 - \alpha).[R - (1 - \pi).W]$.

other party will pay her, for instance, 5.5.

In the case of symmetric information, reliance will thus be socially optimal. This is not surprising indeed. As only the two negotiating parties are affected by the reliance decision, the social optimum coincides with their joint interest. In general, two parties will maximize their joint welfare, unless high transaction costs or asymmetric information prevents them from making agreements. We made the implicit assumption that transaction costs are not prohibitive, which seems realistic in a setting where the parties are already involved in negotiations with each other. We explicitly assumed symmetric information. This assumption is relaxed hereafter.

III. CASE WHERE THE ACTING PARTY HAS SUPERIOR INFORMATION

We now assume that, at the time of the reliance decision, the acting party has superior information. We assume, for instance, that only the acting party knows by how much this action increases the surplus from the deal. We could interchangeably assume that the buyer has superior information on the cost of reliance, the probability that the deal will go through, the parties' relative bargaining power, the scrap value of the reliance investment, or several of these relevant parameters.

1) Incentives

Under this assumption, *we cannot be as confident anymore that the parties will make the necessary agreements to induce the acting party to make optimal reliance decisions*.

Imagine that the contemplated reliance action will increase the surplus from the deal sufficiently so as to make reliance not only efficient, but also worthwile for the acting party to undertake on her own motion. The acting party will then have an incentive to pretend that the increased surplus is high enough for the reliance to be efficient, but not high enough to make it worthwile to undertake on her own motion. If the other party beliefs this lie, he will assume part of the reliance cost, which means a net gain for the acting party.

> **Example II:** Consider a reliance decision with the same parameters as in example I (reliance cost 15, probability of the deal 0.6, division of the surplus by halves, and scrap value of the reliance investment 10), but with the resulting increase in the surplus from the deal, if the deal goes through, equal to 40 instead of 20. It would obviously be efficient that this reliance action be taken, as its total expected benefit $(0.6)\times40 + (0.4)\times10 = 22$ clearly exceeds its cost 15. Moreover, the acting party would be willing to take the action on her own motion, as her own gain $(0.6)\times\frac{1}{2}\times40 + (0.4)\times10 = 16$ also exceeds her cost 15. The acting party has an incentive, however, to pretend that the expected increase in the surplus is lower, for instance only 20 (as in example I). If the other party believes this lie, he will be willing to pay the acting party part of the reliance cost (as we showed in example I).

The other party, however, will be aware of the fact that the acting party may use her superior information to obtain from him a contribution in her reliance cost in cases where this is not necessary for efficient reliance to be taken. This will affect the other party's willingness to make an agreement and bear part of the reliance cost, also in those cases were this would be necessary to induce reliance: he will weigh the risk of paying when the acting party would take the reliance action anyway (which is a pure loss for him) against the risk of not paying when a contribution is necessary to induce reliance (and thus loosing the benefit of reliance).[9]

> **Example II modified:** Consider a reliance decision with all the same parameters as in example I, thus with the increase in the surplus from the deal equal to 20. We showed in example I that reliance is efficient, but that a contribution by the other party is needed to induce the acting party to take the action. If the other party cannot himself ascertain the increase in the surplus, however, he may disbelieve that the increase is 20 (and not for instance 40), and thus refuse to contribute to the reliance costs.

In a situation where the acting party has superior information over the other party, we can thus not be sure that the other party will be willing to pay part of the reliance cost whenever this is necessary to induce efficient reliance. The actual level of reliance may thus be suboptimal.

2) Mandatory contribution to the acting party's reliance costs

We found that asymmetric information may prevent the negotiating parties from reaching the socially (and jointly) optimal reliance decisions. We will investigate now whether

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[9]For reliance to be efficient, a contribution by the other party to the reliance cost is required if and only if $[R - (1 - \pi).W]/\pi < \Delta V < [R - (1 - \pi).W]/(\pi.\alpha)$. Whenever $\Delta V > [R - (1 - \pi).W]/(\pi.\alpha)$, i.e. whenever the acting party would rely anyway, she will have an interest in pretending that the opposite inequality holds. On the contrary, under the assumptions made, the acting party has no incentive to lie if $\Delta V < [R - (1 - \pi).W]/\pi$, i.e. when reliance is inefficient. This may be different if she has superior information not only on ΔV, but also on one of the other parameters.

Under the current assumptions, when the acting party (honestly or not) pretends that she needs a contribution from the other party, the latter will be willing to pay if and only if $\sigma.\pi.(1 - \alpha).(\Delta V)_e > (1 - \alpha).[R - (1 - \pi).W]$, with σ defined as the other party's subjective probability that $[R - (1 - \pi).W]/\pi < \Delta V < [R - (1 - \pi).W]/(\pi.\alpha)$, given the knowledge that $[R - (1 - \pi).W]/\pi < \Delta V$, and $(\Delta V)_e$ defined as the other party's subjective expectation of ΔV, given the knowledge that $[R - (1 - \pi).W]/\pi < \Delta V < [R - (1 - \pi).W]/(\pi.\alpha)$.

any legal rule can improve the parties' incentives.

Consider first a *rule which imposes the obligation on parties engaged in precontractual negotiations, to contribute to the reliance costs made by each other.*

If such a rule of mandatory contribution is to lead to more efficient reliance, without causing inefficient reliance, it must fulfill two conditions: In those instances where reliance is efficient, but would not be undertaken by the acting party on her own motion, the other party should be forced to contribute an amount which is sufficient to induce the acting party to take the reliance action. And in those instances where reliance is inefficient, no contribution should be paid, or at least not a contribution which is so high as to induce reliance.[10]

To distinguish these two types of situations, and to determine the appropriate amount of compensation, however, the law enforcer (a court or third party) would need *an unrealistically high degree of information.* It would be necessary in particular to know by how much the reliance action will increase the surplus from the deal. But the only situation where the parties might not be able to reach optimal reliance decisions, and where a legal rule could thus constitute an improvement, is a situation where the acting party has superior information. We assumed specifically that

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[10]Formally, the mandatory contribution L must fulfill the following two conditions: $L > R - \pi.\alpha.\Delta V - (1 - \pi).W$ when $[R - (1 - \pi).W]/\pi < \Delta V < [R - (1 - \pi).W]/(\pi.\alpha)$, and $L < R - \pi.\alpha.\Delta V - (1 - \pi).W$ when $\Delta V < [R - (1 - \pi).W]/\pi$.

To fulfill both conditions, a rule either has to distinguish the situations where ΔV < or > $[R - (1 - \pi).W]/\pi$, or to devise a formula for L which guarantees efficient incentives in all situations. The former option requires knowledge of π, W and ΔV, whereas an efficient incentive formula for L cannot be devised without knowledge of at least three out of the four parameters α, π, W and ΔV (The two simplest efficient incentive formulae being: $L = (1 - \alpha).[R - (1 - \pi).W]$, and $L = \pi.(1 - \alpha).\Delta V$).

the other party is not able to predict the increase in the surplus from the deal. It is hard to imagine that a court or third party would be able to do better.

It appears thus that a legal rule which imposes the obligation on parties engaged in contract negotiations, to contribute to each other's reliance costs, is unable to improve the efficiency of the reliance decision. Such a rule will either have no efficiency effect at all (if it is visibly nonenforceable), or be more likely to increase inefficiency, by inducing reliance when inefficient.[11] Anyway, it risks imposing a substantial administrative burden. Finally, the increased inefficiency in reliance, and the administrative burden, will inefficiently[12] lower the incentives of parties to enter contract negotiations at the outset.

3) Liability when breaking off the negotiations

Consider a rule which makes the party who breaks off the contract negotiations liable for the reliance costs made by his counterpart during the negotiations.

It is readily understandable that such a rule would suffer from the *same defects as a mandatory contribution rule*,

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[11]In addition, the risk exists that strategic action will be encouraged; see section B above.

[12]In saying that the incentives to enter negotiations are *inefficiently* lowered, we assume that, in the absence of a mandatory contribution rule, these incentives are optimal. Even if, for some reason (such as the fact that part of the costs of the contractual process are born by the courts, and thus not by the decisionmaking parties), these incentives were excessive before, there is no reason to assume that the lowering of incentives by the mandatory contribution rule would match and redress the preexisting inefficiency.

and thus not lead to more efficient reliance decisions.[13] It appears again impossible to devise a rule which enhances the efficiency of the reliance decision, without requiring an unrealistically high degree of information for its enforcement.

A simple, enforceable liability rule will lead to excessive, inefficient reliance. Consider, for instance, the rule which imposes liability on the party who breaks off the negotiations, for his counterpart's reliance costs, minus scrap value, i.e. for *reliance damages*.[14] This rule tends to decrease the efficiency of the reliance decision, by insuring the acting party against the risk that the deal will not go through.[15]

> **Example III:** Consider a reliance decision with the following parameters: reliance cost 15, probability

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[13]If a rule which imposes liability D on the party who breaks off the negotiations, is to lead to more efficient reliance, without causing inefficient reliance, the damage measure D must fulfill the following conditions: $D/\alpha > R - \pi.\alpha.\Delta V - (1 - \pi).W$ when $[R - (1 - \pi).W]/\pi < \Delta V < [R - (1 - \pi).W]/(\pi.\alpha)$, and $D/\alpha < R - \pi.\alpha.\Delta V - (1 - \pi).W$ when $\Delta V < [R - (1 - \pi).W]/\pi$. In deriving these conditions, we made the simplifying assumption that the imposition of liability will not affect the decision to break off the negotiations. This decision is assumed to remain efficient (only depending on whether the surplus from the deal is positive). As explained below, this assumption is unrealistic. The imposition of liability will distort the break-off decision. As a result, it is even more difficult to devise a liability rule which enhances the efficiency of the reliance decision.

[14]In our model, this means $D = R - W$. Then the acting party will have an incentive to rely if and only if $R < \pi.\alpha.\Delta V + (1 - \pi).W + (1 - \pi).(R - W) \leftrightarrow R < \alpha.\Delta V$.

[15]In addition, if no distinction is made between reliance expenses and strategic expenses, the simple liability rule will encourage strategic action. One might also object to the distributive impact of this rule. As the expression in footnote 14 indicates, the most likely recipients of liability payments are those acting parties who have a high relative bargaining power α. Such parties would already rely often anyway.

> that the deal will be struck 0.1, increase in the surplus from the deal 40, division of the surplus by halves, and scrap value of the reliance investment 10. Given the low probability that the deal will be struck, reliance would be inefficient: the total expected benefit $(0.1)\times40 + (0.9)\times10 = 13$ is smaller than the reliance cost 15. In the absence of a liability rule, the acting party would not take the reliance action either, because her own expected gain $(0.1)\times\frac{1}{2}\times40 + (0.9)\times10 = 11$ is smaller than her cost 15. If the acting party were to receive reliance damages when the negotiations fail, however, she would have an incentive to take the (inefficient) reliance action: being insured against the risk of failing negotiations, it would be profitable to take the action, because her gain in case the deal is struck $\frac{1}{2}\times40 = 20$ exceeds her cost 15.

Apart from concerns about efficient reliance, *concerns about the efficiency of the decision whether to break off the negotiations militate against the kind of liability rules we have been discussing so far.*

Any rule attaching liability to the act of breaking off the contract negotiations, distorts the break-off decision, and thus causes inefficiencies. Imagine a situation where, at the final stage of the negotiations, it becomes clear that the deal is not profitable, and that it is thus in the parties' joint interest to break off the negotiations. If the law provides that the party who breaks off the negotiations is liable for the reliance costs born by his counterpart, both parties will avoid breaking up the negotiations themselves, while trying to induce their counterpart. The result is likely to be a whole lot of wasteful activities of mutual avoidance and blaming, and dragging of the negotiations.[16]

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[16]The likelihood that the negotiations will be dragged on, depends on the type of deal in negotiation, and on how the courts define 'breaking off'. If the negotiations concern a production contract, and 'breaking off' means to stop talking, the parties will continue talking. On the contrary, if the negotiations concern the transfer of an existing good, the contract has become unprofitable because of a higher third party bid, and accepting the third party bid amounts to a

All the inefficiencies mentioned also tend to lower inefficiently[17] the incentives of parties to enter contract negotiations at the outset.

Finally, there does not seem to exist fairness concerns favoring a rule imposing liability for the other side's reliance costs when negotiations are broken off. In the situations considered sofar, the party who takes the reliance decision, has the best information around. If she has decided to rely, she must have done so knowingly, i.e. taking the risk that the deal may not go through.

The preceding discussion allows us to conclude that **in general, it is undesirable to have a legal rule which obliges parties in precontractual negotiations to contribute to each other's reliance costs, or to compensate for the costs born by the other side, when breaking off the negotiations. Such rules lead to excessive, inefficient reliance, and may cause additional inefficiency by distorting the decision whether to break off the negotiations. They do not promote fairness either.**[18]

'break-off', the negotiations will be broken off.

In the latter situation, the damages effectively paid by the party who breaks off, may be lower than the amount D the courts would grant. As we have already mentioned in footnote 13, this phenomenon makes it even more difficult to devise an efficient reliance inducing liability rule.

Finally, in a setting with a finite time horizon, (unsuccesful) strategic moves during dragged negotiations, or breakdowns (possibly caused by asymmetric information) in bargaining over the effective severance payment, might lead to the formation of unprofitable contracts. The result is again waste, and increased unpredictability.

[17]See footnote 12 above.

[18]This conclusion is markedly different from what is generally understood to be the desirable liability system for breach of contract: as a general rule, a party who breaks a contract, is held liable for the other party's expectancy, i.e. for what the other party expected to gain from the performance of the contract. This liability sanctions the act of breach. Why is it that liability for breach of contract is

IV. CASE WHERE THE ACTING PARTY HAS INFERIOR INFORMATION

We now assume that, at the time of the reliance decision, the acting party is less well informed than the other party. We assume, for instance, that only the other party knows how likely it is that the negotiations will eventually succeed. We could interchangeably assume that the other party has superior information on any other parameter which enters the reliance calculus.

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desirable, whereas a corresponding general liability for breaking off precontractual negotiations is not?

Two efficiency concerns justify liability for breach of contract (see S. SHAVELL, "Damage measures for breach of contract", 11 *Bell J. of Econ.* 466 (1980), S. SHAVELL, "The design of contracts and remedies for breach", 99 *Quarterly J. of Econ.* 122 (1984), and W. ROGERSON, "Efficient reliance and damage measures for breach of contract", *Rand J. of Econ.* 39 (1984)): * First, liability for the other party's expectancy enhances the efficiency of the choice between performance and breach of contract, because the party contemplating breach is forced to take into account the effect of his decision on the other party. In the absence of such liability, breach will occur more often than efficient, causing the foregoing of beneficial exchanges and/or renegotiation costs being incurred (see SHAVELL (1980) at p. 480-481 and SHAVELL (1984) at 141-142). In the precontractual situation, using liability to avoid excessive break-off is unlikely to be practical, as it will often be prohibitively difficult to calculate the expectancy of the party challenging the break-off. * Second, liability for breach of contract encourages contractual reliance (i.e. actions by the contract parties in anticipation of performance), which is inefficiently low in the absence of liability (see ROGERSON at 46). This is also true in the precontractual situation. The difference is that when the parties have found each other and reached an agreement, there is a much stronger presumption that the transaction is beneficial, and thus more need to protect reliance, justifying the administrative cost of imposing liability, and the risk of inducing excessive reliance. The parties' decision to enter a binding contract, i.e. to enter the regime of liability for breach, reflects their judgment that the expected benefit of the transaction warrants the costs of the liability regime.

1) Incentives

Whenever the acting party engages in reliance, the other party expects to gain from this. Indeed, when the deal goes through, he obtains a fraction of the increase in the surplus. This expected gain is always positive, whether or not the net total expected benefit is positive, i.e. whether or not reliance is efficient.

Using his superior information on the probability that the deal will go through, the other party may try and succeed in making the acting party believe that this probability is higher than it really is. As a result, the acting party will engage in reliance more often than she would do otherwise.[19]

> **Example IV:** Consider again the reliance decision of example III. We showed that reliance is inefficient, and that (in the absence of liability) the acting party would not take the reliance decision either. The other party, however, would like the acting party to rely, as he would receive a fraction of the increased surplus if the deal were to go through. His expected gain from reliance is $(0.1)\times\frac{1}{2}\times 40 = 2$. If the other party is better informed as to the probability that the deal will go through, he could try and convince the acting party that this probability is higher than it really is (0.1). If he can make the buyer believe that the probability is, for instance, 0.6, the acting party will take the reliance action, because she will erroneously expect to gain $(0.6)\times\frac{1}{2}\times 40 + (0.4)\times 10 = 16$, which exceeds her cost 15.

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[19]If the other party makes the acting party belief that the probability that the deal will go through is not the real π, but some higher probability $\pi°$, she will engage in reliance whenever $R < \pi°.\alpha.\Delta V + (1 - \pi°).W$, which is more often than she would do otherwise, given that $\pi° > \pi$, and $\Delta V > W$. The latter assumption is not restrictive at all. Basically, it means that we are only considering as reliance actions those actions which are taken in view of the deal in negotiation. As R denotes the full opportunity cost of such actions, it must be that $\Delta V > W$.

If able to do so, the other party will make the acting party belief that the deal will go through for sure ($\pi° = 1$), causing her to rely whenever $R < \alpha.\Delta V$.

The *other party's ability to use his superior information to misrepresent*[20] the likelihood that the deal will go through[21] and induce the acting party to rely more than she would spontaneously do, is *worrysome in two respects*.

First, it may lead to *excessive, inefficient reliance* (as in example IV). This will not in all instances be the result, however. We know that the acting party's spontaneous incentive to engage in reliance is suboptimal. To a certain extent, the misrepresentation of the likelihood of the deal by the other party may induce the acting party to engage in more efficient reliance.[22] But it is in the other party's interest to misrepresent the likelihood of the deal as far as possible, and thus to induce inefficiently excessive reliance. Moreover, to the extent that the misrepresentation induces efficient reliance, the same effect can be reached by an agreement between the parties. If the other party is able to misrepresent the likelihood of the deal to the acting party, because of superior information, he is also able to induce the reliance by offering to share its cost. Such an agreement will

[20]At this point, we do not intend to use the words 'misrepresent' or 'misrepresentation' in a technical legal meaning. We mean, in the broadest possible sense, any action or abstention by the other party which makes the acting party believe that the probability that the deal will go through is not the true probability, but some higher probability. By 'true probability', we mean the probability which the other party assigns to the deal going through. As we assume that the other party has superior information, this is the best estimate around.

[21]The same applies to misrepresentation of any other parameter which is relevant for the reliance decision. An exception has to be made, however, for misrepresentation concerning the division of the surplus from the deal. This misrepresentation raises only fairness concerns, because it will never lead to inefficient reliance: when α is misrepresented as $\alpha° \to 1$, the acting party's reliance decision tends towards efficient reliance; compare expressions in footnotes 5 and 6.

[22]This will be the case as long as $\pi°$ remains smaller than $\pi.[\Delta V - W]/(\alpha.\Delta V - W)$.

only be made if reliance is efficient. It would also be preferable over misrepresentation, if its transaction cost were lower than the resources the other party would spend on misrepresentation. It is certainly preferable from a distribution or fairness viewpoint.

The second reason why the misrepresentation by the other party is worrysome, has to do with *fairness concerns* indeed. Imagine that, as a result of the other party misrepresenting the likelihood that the deal will go through, the acting party engages in reliance in which she would not have engaged, but for being misled. When the deal does not go through, the acting party bears ex post a loss, equal to the reliance cost minus its scrap value, the risk of which she has never knowingly accepted, but which has been imposed on her by the other party's behavior. This outcome appears unfair.

2) Liability in case of misrepresentation

Both the inefficiency and the unfairness resulting from the misrepresentation can be remedied by imposing liability on the party who has misrepresented the likelihood that the deal will go through, for the reliance cost born by the acting party, minus its scrap value, i.e. for reliance damages.

Liability for reliance damages redresses the unfairness resulting from reliance induced by misrepresentation. Moreover, it can be proven that liability for reliance damages *will deter all misrepresentation inducing inefficient reliance*. Not all misrepresentation is deterred, but the reliance still induced will be efficient.[23]

[23]This can be proven as follows: If misrepresentation makes the other party liable for reliance damages when the negotiations break off, he will only gain from inducing reliance by misrepresentation if $\pi.(1 - \alpha).\Delta V - (1 - \pi).(R - W) > 0$, with $\pi.(1 - \alpha).\Delta V$ the expected gain in the absence of

> **Example IV continued:** Under a rule which makes the other party liable for reliance damages if he has induced reliance by misrepresentation and the deal does not go through, he will abstain from misrepresenting the likelihood of the deal. His expected gain from reliance, which we showed to be 2, is exceeded by his expected liability $(0.9)\times(15 - 10) = 4.5$.

When we say that all misrepresentation causing inefficient reliance is deterred, we implicitly assume that the imposition of liability for reliance damages caused by misrepresentation, does not *distort the decision whether to break off the negotiations*. Whether this assumption is realistic indeed, *depends primarily on how the liability rule is devised.*

Consider the rule which imposes liability on the other party for the reliance damage suffered by the acting party as a result of misrepresentation by the other party, only when the latter breaks off the contract negotiations. Liability is thus triggered by the liable party breaking off the negotiations. We know from our previous analysis[24] that any rule attaching liability to the act of breaking off the contract negotiations, distorts the break-off decision, and thus causes inefficiencies. The negotiations are likely to be dragged, and, when they are broken off, the damages effectively paid may be lower than the full amount (reliance cost minus scrap value) which the courts would grant. As a result, we cannot be confident anymore that all misrepresentation causing inefficient reliance, is effectively

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liability, and R - W the damages for which he expects to be liable when the negotiations break off. This condition is equivalent to $(1 - \pi).R < \pi.(1 - \alpha).\Delta V + (1 - \pi).W$ **(*)**. As to the acting party, in the extreme case where she believes that the deal will go through for sure, she will only rely if $R < \alpha.\Delta V$ **(@)**. Multiplying expression **(@)** by π, and adding it to expression **(*)**, we obtain: $R < \pi.\Delta V + (1 - \pi).W$, which means that reliance is efficient.

[24]See above, text accompanying footnote 16.

deterred.[25]

On the contrary, consider the rule which imposes liability on the other party for the reliance damage suffered by the acting party as a result of misrepresentation by the other party, irrespective of who breaks off the negotiations.

Assume first that the acting party is always able, at the final stage of the negotiations, to observe, and prove in court, that the other party misrepresented the likelihood of the deal at the time of the reliance decision, and so induced her to rely. Then the decision whether to break off the negotiations will not be distorted, and there will be no wasteful dragging of the negotiations. Whenever it appears at the final stage of the negotiations that the deal is not profitable, the acting party will break off the negotiations, and collect the full amount of reliance damages. Even if the deal is profitable, and thus goes through, the acting party may be able to collect the damages.[26] As a result, we can be sure that all misrepresentation causing inefficient reliance, is effectively deterred.

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[25]The demonstration that all misrepresentation causing inefficient reliance, is deterred by the liability rule (see footnote 23 above), depends indeed on the assumption that the expected effective liability payment equals $(1 - \pi).(R - W)$. If the expected effective liability payment is lower, because of the distorted break-off decision, some misrepresentation causing inefficient reliance, might not be deterred.

[26]Whenever $\alpha.V < D = R - W$, i.e. whenever the damage amount exceeds the fraction of the surplus from the deal which the acting party expects to receive, she has a credible threat to break off the negotiations, and sue the other party for reliance damages caused by his misrepresentation. Under the current assumptions, the other party's best response to this threat is to pay the acting party immediately the full damage amount D, and let the profitable deal go through. The final result is thus that the break-off decision remains efficient, but the expected effective liability payment (at time t_1) exceeds $(1 - \pi).(R - W)$.

In reality, however, the acting party might have difficulty observing and, more likely, proving in court that the other party misrepresented the likelihood of the deal at the time of the reliance decision. To the extent that the acting party's ability to prove the misrepresentation depends on the other party breaking off the negotiations, some dragging of the negotiations may occur, and the expected effective liability payment may be lower than without this evidentiary difficulty. Unless the law is particularly restrictive as to what constitutes evidence of misrepresentation, this is unlikely, however, to affect the conclusion that all misrepresentation causing inefficient reliance, will effectively be deterred.[27]

We conclude from our discussion of the break-off decision, that a rule which imposes liability for the reliance damage suffered by the party who has relied as a result of misrepresentation, should not be made dependent on whether the liable party breaks off the negotiations.[28] Neither should the

[27]The evidentiary problem discussed here does not seem substantially different from what occurs in any situation where the law imposes liability. The impending liability will always lead to some (wasteful or distortive) activity by the parties involved in order to obstruct, and conversely facilitate, proof.

As to the conclusion here that all misrepresentation causing inefficient reliance, will effectively be deterred, it should be noted that, in the absence of the evidentiary problem, the expected effective liability payment exceeds $(1 - \pi).(R - W)$ (see footnote 26 above). Even if the evidentiary problem would decrease it below $(1 - \pi).(R - W)$, it might remain high enough to deter all misrepresentation inducing inefficient reliance. We demonstrated in footnote 23 above that an expected effective liability payment greater than or equal to $(1 - \pi).(R - W)$ is a sufficient condition for deterrence of all misrepresentation causing inefficient reliance, not a necessary condition.

[28]We retain, however, the condition that the negotiations have been broken off. One might alternatively consider a rule under which liability is triggered by the sole fact of misrepresentation, irrespective of whether the negotiations have been broken off at all. This latter rule may in practice come down to the same as the rule we propose (which requires

law be restrictive as to what constitutes evidence of misrepresentation.

Another question is whether liability should be conditioned on any proof of *bad faith or intention to mislead*. Two arguments militate against requiring evidence of intent. First, negligent misrepresentation of the likelihood or the benefits of the deal is just as harmful as intentional misrepresentation: it is not less likely to lead to excessive, inefficient reliance by the acting party. Second, to require evidence of intent may create a costly hurdle in litigation, undermining the deterrence effect of the liability rule. For the passive party to be held liable, it should be sufficient that he made or let the acting party have inflated expectations of the likelihood or the benefits of the deal, whereas he knew better himself.[29]

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that the negotiations have been broken off), if psychological reasons concerning the interacting parties, or reasons of evidentiary difficulty or delay in court, make it impossible as a matter of fact to sue for damages without breaking off the negotiations. If this is (sometimes) possible, however, the rules differ in their effects. First, the rule which does not require that the negotiations have been broken off, may more strongly deter misrepresentation, but this does not improve the reliance decision, which is efficient under both rules. Second, the rule which does not require that the negotiations have been broken off, may lead to more cases brought in court, and thus to more administrative costs. As the rules do not differ in their efficiency (nor fairness) effects, these extra administrative costs make this rule undesirable.

[29]One might raise two objections: First, if no evidence of intent is required, is there not a risk of imposing liability in situations where parties engage in 'normal' strategic behavior? We do not believe that such risk exists. If we can assume that each party is relatively better informed about the parameters at his side - for instance, producers being better informed about their costs, and buyers about their valuation, which seems likely -, the parties' normal strategic incentives are to *understate* the likelihood or the benefits of the deal, so as to obtain a bigger share of the surplus. We would then not need an inquiry into intent to distinguish normal strategic behavior from the kind of harmful misrepresentation we want to deter: the observation that a

We now turn our attention to the effect on *the acting party's incentives* of a rule which imposes liability for the reliance damage suffered as a result of misrepresentation. Imagine that the other party tries to misrepresent the likelihood of the deal to the acting party, but that the latter is somehow aware of this. Knowing that she will receive damages when the negotiations break off, pretending that her reliance was induced by misrepresentation, the acting party may engage in inefficient reliance.[30] This can be avoided by *only awarding damages if it was reasonable for the acting party to believe the other party's misrepresentation.*[31]

The requirement that it was reasonable to rely, is

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party *overstated* the likelihood or the benefits of the deal would be sufficient. One might argue, however, that repeat-players who want to develop a reputation of good faith bargainers, would not have the described normal tendency to understate the likelihood and benefits of the deal. But they would have no reason to overstate them either. On the contrary, they would want to avoid misleading overstatements, so as to avoid their harmful effects.

Second, if no intent has to be shown, abuse of the liability rule by the acting party is facilitated. Such abuse can be avoided, however, by requiring that it was reasonable for the acting party to believe the other party's misrepresentation; see below, text accompanying footnotes 30 and 31.

[30]The acting party will gain from relying whenever $R < \pi.\alpha.\Delta V + (1 - \pi).W + (1 - \pi).D$. With damages $D = R - W$, this condition is equivalent to: $R < \alpha.\Delta V$. There is only a risk of inefficient reliance if $\alpha > [\pi + (1 - \pi).\ W]/\Delta V$, i.e. if the acting party's relative bargaining power is high, the probability that the deal will go through is low, and/or the reliance investment is highly specific to the deal.

[31]Note that the test is not whether the amount of the reliance was reasonable, but whether it was reasonable for the acting party to believe the other party's misrepresentation. If it is found that it was reasonable for her to believe the misrepresentation, compensating the acting party for all his reliance expenses will not have any negative effect on her incentives to engage in reliance.

Whether it was reasonable for a party to rely, depends on the relative sophistication of the parties, and on their relative information in the particular setting of the case (the misleading party should have superior information).

conceptually unrelated to the *requirement that the reliance compensation for which is sought, be caused by ('but for') the misrepresentation*. One may want to adopt this latter requirement, be it for different reasons: it may keep out of the courts the cases where misrepresentation occurred, and where it would be found to have been reasonable for the acting party to believe the other party, but where she would also have relied in the absence of the misrepresentation. In such cases, liability only imposes administrative costs on the courts and the parties. There is no inefficiency nor unfairness to be redressed.

Finally, we consider in more detail the *optimal damage measure* for a liability rule designed to redress the inefficiency and unfairness effects of a party's ability to induce reliance through misrepresentation.

We have demonstrated that liability for *reliance damages* (equaling the reliance cost minus the scrap value) deters all misrepresentation leading to inefficient reliance, and also redresses the unfairness problem. Note that the reliance damages (as defined in this paper) not only include expenses actually made. The reliance cost stands for the full opportunity cost for the relying party: it includes thus the forgone next best alternative.[32]

We could imagine a whole variety of other damage measures, but most would require an unrealistically high degree of information for their enforcement. One fairly simple alternative damage measure, is the *expectation measure*, which equals the benefit which the acting party expected to obtain as a result of her reliance if the deal were to go through,

[32]On the concept of reliance damages, see: R. COOTER and M. EISENBERG, "Damages for breach of contract", 75 *Calif. L. Rev.* 1432, at 1435-1438 and 1444-1445.

minus the scrap value.[33] How does the expectation measure compare to the reliance measure?

In the cases we are concerned with, the expectation measure always exceeds or equals the reliance measure.[34] The expectation measure will thus more strongly deter misrepresentation, but this does not enhance efficiency, as the reliance measure also deters all misrepresentation causing inefficient reliance. A higher damage measure might lead to more distortion of the break-off decision, or increase the incentives for the acting party to rely, pretending that her reliance is induced by misrepresentation. Both effects are probably very small, however, if the liability is not conditioned on the liable party breaking off the negotiations, and if the relying party is only awarded damages if it was reasonable for her to believe the misrepresentation.

A more important difference between reliance damages and expectation damages concerns the *relative difficulty to assess them accurately, and the resulting administrative cost.* In most instances, it is probably easier to assess the reliance cost, than the benefit the relying party expected to obtain if the deal were to go through: the former refers to something which actually happened, whereas the latter refers to something the parties had in mind. One can, however, easily imagine the opposite situation. As the reliance cost includes the forgone next best alternative, it may also require some counterfactual assessment. Moreover, as part of his misrepresentation, the liable party may have explicitly

[33]Formally: $D = \alpha.\Delta V - W$.

[34]We are concerned with those cases where the acting party would not rely if she knew the probability that the deal will go through π, which means that $R > \pi.\alpha.\Delta V + (1 - \alpha).W$, but relies because the other party misrepresented $\pi° > \pi$, which means that $R < \pi°.\alpha.\Delta V + (1 - \pi°).W$. It follows from the three inequalities above that $R < \alpha.\Delta V \rightarrow R - W < \alpha.\Delta V - W$, which means that reliance damages are lower than expectation damages.

promised or pictured the expected benefit to the relying party. Finally, if the negotiations were already far advanced at the time of the break-off, the expected benefit may be more easy to assess than in an earlier stage of the negotiations.

Another difference between reliance damages and expectation damages relates to the *full redress of the unfairness* resulting from the misrepresentation. In general, a loss can only be perceived by reference to a baseline, i.e. a normal situation. In the case of reliance induced during precontractual negotiations, it seems obvious to take as baseline the situation in which the acting party would have been, if she had not relied. The loss is then the reliance cost minus the scrap value, and liability for reliance damages redresses the unfairness indeed. If, however, the misrepresentation was particularly far-reaching and convincing, and maybe more so if the negotiations are very far advanced, one might reasonably consider the acting party's baseline to be the formation of the contract. The loss is then the benefit the relying party expected to obtain, and expectation damages are necessary to fully redress the unfairness.

We conclude that, in general, reliance damages are the optimal damage measure for a liability rule designed to redress the inefficiency and unfairness effects of a party's ability to induce reliance through misrepresentation. Occasionally, expectation damages may be preferable, for reasons of administrative ease or fairness.

The preceding discussion allows us to conclude that **it is desirable to have a legal rule which imposes liability, when negotiations have been broken off, on the party which has misled his counterpart as to the likelihood or the benefits**[35] **of the deal, and so induced the latter to take reliance action. Such liability enhances the efficiency of the reliance decision, and promotes fairness. To avoid wasteful distortion of the decision whether to break off the negotiations, the liability should not be conditioned on which party breaks off. No damages should be awarded if it was not reasonable for the relying party to be misled by the other party. Otherwise, the liability rule might be abused. Administrative costs can be reduced by only awarding damages for those reliance actions which the relying party would not have taken but for the other party misleading. Finally, reliance damages (including the forgone next best alternatives) should constitute the damage measure, unless, occasionally, reasons of administrative ease or fairness command expectation damages.**[36]

[35]In most of our discussion we talked only about misrepresentation of the likelihood of the deal. The analysis and conclusions are also valid for misrepresentation of the benefits of the deal; see footnote 21 above.

[36]Courts could thus use the following check-list of conditions, when a plaintiff claims damages: 1° plaintiff and defendant were involved in precontractual negotiations which have failed - who broke off, and for what reason, is immaterial -, 2° at some time during the negotiations, defendant misled plaintiff as to the likelihood or the benefits of the deal, 3° it was reasonable for plaintiff to believe what he was led to believe, 4° plaintiff took some reliance action, 5° which he would not have taken, but for defendant having misled him. If these five conditions are fulfilled, plaintiff should be awarded reliance damages (including the forgone next best alternative), unless the court finds it easier to estimate the expectation loss, or considers expectation damages necessary to compensate for the injury suffered by plaintiff.

D. ANTICIPATORY PERFORMANCE

Anticipatory performance stands for all actions which are taken by negotiating parties in anticipation of the deal, which increase the surplus from the deal, and the cost and benefits of which do not fall on the same party. This last characteristic distinguishes anticipatory performance from reliance: if the negotiations fail, the scrap value is not received by the acting party, but by the other party. An example would be a contracter already rendering some building services to the prospective client during the negotiation of a building contract.

I. SOCIAL OPTIMUM

Anticipatory performance increases social welfare, and is thus efficient, if the cost of anticipatory performance is smaller than its total expected benefit, i.e. smaller than the resulting increase in the surplus from the deal, multiplied by the probability that the deal goes through, plus the scrap value of the anticipatory performance, multiplied by the probability that the deal does not go through.[37]

> **Example V:** Consider the following anticipatory performance decision: the cost of the anticipatory performance is 15, the probability that the deal will go through 0.6, the increase in the surplus from the deal if the deal goes through 20, the surplus is divided by halves,and the scrap value of the anticipatory performance is 10. In this example, anticipatory performance is efficient, because its total expected benefit $(0.6)\times 20 + (0.4)\times 10 = 16$ exceeds its cost 15.

[37]The formal condition for anticipatory performance to be efficient is: $P < \pi.\Delta V + (1 - \pi).W$.

II. CASE WHERE INFORMATION IS SYMMETRIC

As in our analysis of the reliance decision, we distinguish three cases: symmetric information, superior information by the acting party, and superior information by the other party. We first assume symmetric information on all relevant parameters.

Spontaneously, the acting party will only engage in anticipatory performance if the cost of anticipatory performance, which is born by her, is smaller than the part of the benefits which she expects to receive herself.[38] It so appears that the acting party's *spontaneous incentive to engage in anticipatory performance is suboptimal*, because she does not take into account the fraction of the increased surplus which will benefit to the other party, when the deal goes through, nor the scrap value, which entirely accrues to the other party when the deal does not go through.[39] In comparison with reliance the problem of suboptimal spontaneous incentives appears to be worse for anticipatory performance. The difference concerns the scrap value, which accrues to the acting party in the case of reliance, whereas it accrues to the other party, in the case of anticipatory performance.

As in the case of reliance, however, our assumption of symmetric information makes it highly unlikely that efficient anticipatory performance will not be engaged in. If anticipatory performance is efficient, but the acting party

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[38]The acting party will spontaneously engage in anticipatory performance if and only if $P < \pi.\alpha.\Delta V$.

[39]Depending on the values of α, π and W, there will be a range of situations in which anticipatory performance is efficient, but the acting party lacks the incentive to do so spontaneously. This range is defined by the condition $\pi.\alpha.\Delta V < P < \pi.\Delta V + (1 - \pi).W$.

lacks the incentive to engage in it spontaneously, it will always be in the other party's interest to pay part of the cost of anticipatory performance, so as to induce the acting party to engage in it.[40]

> **Example V continued:** Although, as we showed, anticipatory performance is efficient, the acting party will not engage in it spontaneously, because her own expected gain is lower than her cost 15. Her expected gain includes only her share of the increased surplus if the deal goes through, i.e. $(0.6)\times\frac{1}{2}\times 20 = 6$. But the other party would like the anticipatory performance to happen, because he has an expected net gain $(0.6)\times\frac{1}{2}\times 20 + (0.4)\times 10 = 10$, being his share of the increased surplus if the deal goes through, and the scrap value if the deal does not go through. He is thus willing to pay the acting party up to 10 to induce her to take the anticipatory performance action. The latter requires at least $15 - 6 = 9$ to do so. The parties will thus reach an agreement, under which the acting party engages in the anticipatory performance, and the other party pays her, for example, 9.5 .

As in the case of reliance, we can thus conclude, that, *in a situation of symmetric information, anticipatory performance will always be socially optimal.*

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[40]The benefit which the other party obtains from anticipatory performance equals $\pi.(1 - \alpha).\Delta V + (1 - \pi).W$. In order to induce the acting party to perform anticipatorily, the other party is willing to pay any smaller amount. The acting party requires at least $P - \pi.\alpha.\Delta V$. The parties will thus reach an agreement if and only if $\pi.(1 - \alpha).\Delta V + (1 - \pi).W > P - \pi.\alpha.\Delta V \leftrightarrow P < \pi.\Delta V + (1 - \alpha).W$, i.e. if and only if anticipatory performance is efficient. Given our assumption that α describes the parties' relative bargaining powers, under the agreement, the other party will pay the acting party the amount $(1 - \alpha).P + \alpha.(1 - \pi).W$.

III. CASE WHERE THE ACTING PARTY HAS SUPERIOR INFORMATION

1) *Incentives*

We now assume that the acting party has superior information on any parameter which is relevant for the anticipatory performance decision. As in the case of reliance, under this assumption, *we cannot be as confident anymore that the parties will make the necessary agreements to induce optimal anticipatory performance decisions.*

Imagine for instance that, at the time of the anticipatory performance decision, only the acting party knows how much this action costs. Then the other party is not able to observe whether anticipatory performance is efficient, and whether he needs to bear part of its cost to induce the acting party to engage in it. When such contribution is not necessary, it will be in the acting party's interest to lie and pretend otherwise. Being aware that the acting party may be lying, the other party will be less willing to make an agreement and bear part of the cost of the anticipated performance, weighing the risk of paying when unnecessary, against the risk of forgoing efficient anticipatory performance.

> **Example VI:** Consider the following anticipatory performance decision: As in example V, the probability that the deal will go through is 0.6, the increase in the surplus from the deal 20, the surplus is divided by halves, and the scrap value of the anticipatory performance is 10. But the cost of the anticipatory performance is now only 5. Moreover, only the acting party is able to assess this cost. The anticipatory performance is obviously efficient, the expected benefit $(0.6)\times 20 + (0.4)\times 10 = 16$ exceeding the cost 5. The acting party is also willing to take the action on her own motion, as her own expected gain $(0.6)\times\frac{1}{2}\times 20 = 6$ exceeds her cost 5. But she has an incentive to try and convince the other party that the cost is higher, for instance 15 as in example V, so as to

receive a contribution from him (see example V). Knowing that the acting party may be lying when she claims that the cost is 15, the other party may refuse to contribute. This may also happen in a case where the cost is 15 indeed, thus resulting in an efficient action not being taken (see again example V).

In a situation where the acting party has superior information, some efficient anticipatory performance may thus not be engaged in. The likelihood of this happening, depends on two factors. It depends first on the degree of informational asymmetry.[41] Second, it depends on how likely it is that an anticipatory performance action is efficient, but that the acting party will not spontaneously engage in it.[42] This appears more likely to be a problem for anticipatory performance than for reliance, because, in the case of anticipatory performance, the acting party not only fails to internalize spontaneously the fraction of the increased surplus which the other party will receive, but also the scrap value. We may thus conclude that, in the absence of any legal rule, the actual level of anticipatory performance is more likely to be suboptimal than the level of reliance.[43]

[41]The informational asymmetry can concern one, several, or all of the parameters which enter the anticipatory performance decision. The less well informed party can have a more or less precise estimate, leaving a narrower or broader range of distrust between the parties.

[42]This probability is a decreasing function of the acting party's relative bargaining power, and of the probability that the deal will go through, and an increasing function of the scrap value.

[43]An argument to the contrary could be based on a presumptively lower degree of informational asymmetry in the anticipatory performance situation, where the benefit of the action falls on the side of the other party than the party who takes the action. If we presume that the party on whose side the benefit will fall, has, as a general matter, some informational advantage as to the (full and scrap) value of this benefit, it follows that the acting party is less likely to have superior information in the case of anticipatory performance than in the case of reliance.

2) Mandatory contribution to the acting party's anticipatory performance costs

As we did in our discussion of reliance, we want to investigate whether any legal rule can improve the parties' incentives to take optimal anticipatory performance decisions.

A rule which imposes the obligation on parties engaged in contract negotiations, to contribute to each other's anticipatory performance costs, is again undesirable, and for basically the same reasons as in the reliance case: it is impossible to devise a rule which encourages efficient anticipatory performance, without inducing inefficient action too, and without requiring an unrealistically high degree of information for the enforcement of the rule.[44]

3) Liability or restitution when the negotiations fail

As to reliance, we found that it was impossible to find a simple, enforceable liability rule, which is not likely to lead to excessive, inefficient reliance.

As to anticipatory performance, the situation is quite different: Consider the rule which, in case the negotiations are broken off, imposes an obligation on the party which benefited from anticipatory performance, to restitute the benefit, i.e. to restitute the scrap value.

[44]To promote anticipatory performance where efficient but not spontaneously undertaken, the mandatory contribution L must be at least $P - \pi.\alpha.\Delta V$ when $P > \pi.\Delta V + (1 - \pi).W$. To avoid inducing inefficient anticipatory performance, L must not exceed $P - \pi.\alpha.\Delta V$ when $\pi.\alpha.\Delta V < P < \pi.\Delta V + (1 - \pi).W$. The two simplest damage formulae which satisfy both conditions, are $L = (1 - \alpha).P + \alpha.(1 - \pi).W$ and $L = \pi.(1 - \alpha).\Delta V + (1 - \pi).W$. They are clearly not simple enough to be practical.

This *restitution rule* will lead the acting party to engage in anticipatory performance more often when this is efficient, without inducing any inefficient action. The restitution rule improves her incentives, by internalizing the scrap value. Overall, her incentives remain suboptimal, however, because she does not take into account the fraction of the increased surplus from the deal which the other party receives. But there is thus certainly no risk of excessive, inefficient anticipatory performance.[45]

> **Example VII:** Consider an anticipatory performance decision with the following parameters: the cost is 9, the probability that the deal will go through 0.6, the increase in the surplus from the deal 20, the surplus is divided by halves, and the scrap value is 10. This anticipatory performance is efficient, because the total expected benefit $(0.6)\times20 + (0.4)\times10 = 16$ exceeds the cost 9. In the absence of any liability rule, the acting party will not engage in the anticipatory performance, because her own expected gain is only $(0.6)\times\frac{1}{2}\times20 = 6$. Under the restitution rule, however, the acting party will receive the scrap value of her anticipatory performance if the deal does not go through. As a result, she will take the action, as her expected gain $(0.6)\times\frac{1}{2}\times20 + (0.4)\times10 = 10$ now exceeds her cost 9. With different parameters (for instance those of example V), however, the restitution rule may be insufficient to induce efficient anticipatory performance.

The restitution rule will not lead to inefficient distortion of the decision whether to break off the negotiations, at least if the liability is not conditional on the liable party breaking off.[46]

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[45]Indeed, under this rule, the seller will engage in anticipatory performance if and only if $P < \pi.\alpha.\Delta V + (1 - \pi).W$, which is more often than without the restitution rule (see footnote 38), but still less often than optimal (see footnote 37).

[46]There seems not to be any evidentiary problem which might, as a practical matter, make the liability conditional on the liable party breaking off; compare discussion preceding footnote 27 above.

We now consider *other damage measures* than the restitution measure (damages equaling the scrap value of the anticipatory performance). The most obvious alternative would be to require the beneficiary of the anticipated performance to compensate the acting party for the *cost* of her anticipatory performance, when the negotiations are broken off. Such liability for anticipatory performance costs may induce excessive, inefficient anticipatory performance.[47] This risk of increased inefficiency, however, only exists if the cost of the anticipated performance exceeds its scrap value.[48] We can thus find a second damage measure which does not induce excessive, inefficient anticipatory performance: *the lesser of the cost of the anticipatory performance and its scrap value*. Under this damage measure, when the negotiations are broken off, the beneficiary of the anticipatory performance has to pay the acting party the costs which she has born, but never more than the scrap value, i.e. the lesser of these two amounts.[49]

The liability should, however, be conditional on the negotiations having been broken off, for the reasons explained in footnote 28 above.

[47]Under this liability rule, the acting party will engage in anticipatory performance if and only if $P < \pi.\alpha.\Delta V + (1 - \pi).P \leftrightarrow P < \alpha.\Delta V$. Excessive anticipatory performance will result if the acting party's relative bargaining power α is high, i.e. higher than $\pi + (1 - \pi).(W/\Delta V)$. The inefficiency is due to the fact that the acting party is insured against the risk that the deal will not go through. Note that, depending on α, there is no guarantee either that more anticipatory performance will be taken when this is efficient.

[48]If, on the contrary, $P < W$, it follows from $P < \alpha.\Delta V$ (see footnote 47) that $P < \pi.\alpha.\Delta V + (1 - \pi).W \rightarrow P < \pi.\Delta V + (1 - \pi).W$, which means that only efficient anticipatory performance takes place.

[49]Is there any reason to prefer one of the two damage measures: the scrap value, or the lesser of the scrap value and the anticipatory performance cost? The first has the advantage of inducing some more efficient anticipatory performance, in those instances where the cost is lower than the scrap value. Which of the rules is easier to administer, is not obvious. It depends on whether the cost or the scrap

The preceding discussion allows us to conclude that **it is desirable to have a legal rule which imposes on any party who benefited from anticipatory performance the obligation, when the negotiations are broken off, either to restitute the remaining benefit, or to pay the cost born by the party who acted, but limited to the remaining benefit. Such liability improves the incentives to engage in efficient anticipatory performance. To avoid distortion of the decision whether to break off the negotiations, liability should not be conditioned on the liable party breaking off.**

Our conclusion that a liability rule is desirable, is partly based on *factual conjectures*. We explained how asymmetric information could prevent the parties from reaching an agreement when necessary to engage in efficient anticipatory performance. We also proved that a liability rule can, at least partially, remove the need for such an agreement, without risking to induce inefficient anticipatory performance. We make the conjecture that the problem of asymmetric information, to the extent solved by liability, justifies the administrative burden of the liability rule. To be precise, the trade-off is slightly more complicated. For those instances where the parties would reach an agreement in the absence of liability, we have to compare the administrative cost of forming and enforcing these contracts, with the cost of imposing restitution or similar liability. We make the conjecture that the latter cost is lower.[50] Finally, in those instances where the party who has to perform anticipatorily, would do so spontaneously, a liability rule

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value can more easily be assessed fairly accurately.

[50]The idea is that is it less costly to observe that anticipatory performance has happened, and how high the scrap value is, than to find out whether the parties reached an agreement, and what the terms of this agreement were.

would cause administrative costs, without any efficiency gain. This problem can be reduced substantially, however, by refusing liability for 'normal' anticipatory performance, i.e. the kind of action a party would engage in anyway, irrespective of any payment by or liability of the other party.[51] We thus add to our conclusion that **no liability for restitution should lie if the anticipatory performance action is 'normal', i.e. the kind of action in which a negotiating party, in the factual situation, would normally be willing to engage at her own risk.**

We do not base our argument in favor of liability on any consideration of fairness. As we stated at the outset of this paper, we consider as unfair, any situation resulting from the interaction between the negotiating parties, in which one of them has suffered a loss, this party has never (reasonably knowingly) taken or accepted the risk of this loss, and the other party could have reasonably prevented the loss occuring, or the risk being born by the first party. If, as we assumed, the party who has to engage in anticipatory performance, is as well informed as the other party, or has even superior information on the parameters which enter into her decision, the risk that the negotiations will break off, is a risk which the acting party takes reasonably knowingly, when she decides to take the action.

[51]One may object that a court would thus have to make the whole anticipatory performance calculus to find out whether the acting party would have been willing to take the anticipatory performance action on her own motion. We interpret the 'normality' test, however, as refering to normal business practices, or some other 'Gestalt'-like concept which might in fact be fairly cheap to assess.

IV. CASE WHERE THE ACTING PARTY HAS INFERIOR INFORMATION

1) Incentives

We now assume that the acting party is less well informed than the other party. For instance, only the other party knows how likely it is that the deal will eventually go through.

Under this assumption, the situation is similar to what we discussed concerning reliance: the buyer may induce the seller to engage in inefficient anticipatory performance, and a well-designed liability rule can deter the buyer from doing so.

Whenever the acting party engages in anticipatory performance, the other party has an expected gain, consisting of his share of the increased surplus if the deal goes through, and the scrap value if the negotiations eventually fail. He has thus an interest in inducing the acting party to engage in anticipatory performance more than the latter would spontaneously do. Given his superior information on the likelihood of the deal, the other party can achieve this result by making the acting party believe that the probability that the deal will go through is higher than it really is. As in the case of reliance, the use of superior information to induce anticipatory performance by misrepresenting the likelihood (or the benefits) of the deal, is worrysome because it may lead to excessive, inefficient anticipatory performance, and because it leads to an unfair result, when the negotiations are later broken off.

Example VIII: Consider the following anticipatory performance decision: The cost of the anticipatory performance is 15, the probability that the deal will go through 0.1, the increase in the surplus from the deal 30, the surplus is divided by halves, and the scrap value is 10. In this example, anticipatory performance is inefficient: the total expected benefit $(0.1)\times40 + (0.9)\times10 = 13$ is smaller than the cost 15. If correctly informed, the acting party will not spontaneously take the action either, because her own expected gain is only $(0.1)\times\frac{1}{2}\times40 = 2$, compared with a cost 15. But the other party has an incentive to induce anticipatory performance, because he has a net expected gain $(0.1)\times\frac{1}{2}\times40 + (0.9)\times10 = 11$. If able to do so, he will convince the acting party that the probability of the deal is much higher than it really is, for instance 0.9 . The acting party will then take the action, erroneously believing that her expected gain is $(0.9)\times\frac{1}{2}\times40 = 18$, and thus exceeds her cost 15.

2) Liability in case of misrepresentation

We argued above that the law should in general provide for restitution of the scrap value, or liability for the lesser amount of the anticipatory performance cost and the scrap value, when the negotiations are broken off, and a party has benefited from anticipatory performance. The question now is whether such general liability is sufficient to remedy the inefficiency and unfairness resulting from misrepresentation, or whether a separate rule should be provided for.

It appears that both *restitution and liability for the lesser amount of the anticipatory performance cost and the scrap value* are *insufficient to remedy the misrepresentation problem*. Not all misrepresentation inducing inefficient anticipatory performance would be deterred.

Example VIII continued: In our example, liability for restitution of the scrap value, or liability for the lesser amount of the anticipatory performance cost and the scrap value, when the negotiations are broken off, would not deter the other party from misrepresenting the likelihood of the deal. The expected liability, which equals $(0.9)\times10 = 9$, is smaller than the gain he would obtain from the acting party's anticipatory performance, which we showed to be 11.

The only simple damage measure which guarantees deterrence of all misrepresentation inducing inefficient anticipatory performance, is the *cost measure* (damages equaling the cost of anticipatory performance).[52]

> **Example VIII continued:** Liability for the cost of anticipatory performance when the negotiations fail, will deter the other party from misrepresenting the likelihood of the deal, because his expected liability $(0.9)\times 15 = 13.5$ exceeds his gain from anticipatory performance 11.

Liability for the cost of the anticipatory performance also fully redresses the unfairness, because this cost is the size of the loss which the acting party bears ex post, if she has been misled to perform anticipatorily, and the deal does not go through. Liability for restitution, or for the lesser of the two amounts would not fully redress the unfairness.

We conclude thus that, **if anticipatory performance has been misleadingly induced, and the deal does not go through, the party which misled the acting party should be liable for the cost of the anticipatory performance.**

In fact, **we advocate thus a general rule of liability for the costs of all action in anticipation of the contract in negotiation (be it reliance or anticipatory performance) misleadingly induced, when the negotiations subsequently fail.** Indeed, liability for reliance damages, is the equivalent, in

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[52]If the other party expects to be liable for $D = P$, when the negotiations are broken off, he will only gain from inducing anticipatory performance by misrepresentation if $\pi.(1 - \alpha).\Delta V + (1 - \pi).W - (1 - \pi).D > 0 \leftrightarrow (1 - \pi).P < \pi.(1 - \alpha).\Delta V + (1 - \pi).W$ (▾). If the other party convinces the acting party that $\pi^{o} = 1$, the latter will engage in anticipatory performance whenever $P < \alpha.\Delta V$ (#). Multiplying expression (#) by π, and adding it to expression (▾), we obtain that $P < \pi.\Delta V + (1 - \pi).W$, which means that all anticipatory performance which takes place, is efficient.

the case of reliance, of liability for the cost, in the case of anticipatory performance. All the qualifications as to the optimal liability rule, which we stated in section C.IV.2) above, equally apply here.

PART TWO : CONCLUSIONS AND COMPARATIVE LAW

A. CONCLUSIONS FROM THE ANALYSIS

Our analysis has led to the following recommendations as to the desirable legal rules[53] determining who should bear the costs of failed negotiations:

* First, there should be **liability for costs misleadingly induced:** If, at some time during the negotiations, any party misled the other party as to the likelihood or the benefits of the deal, and so induced this other party to engage in some costly action in anticipation of the deal, the first party should be held liable for the costs of this action, when the negotiations fail.

Such liability enhances efficiency, by deterring any party in a position of superior information from inducing the other party to engage in excessive, inefficient action in anticipation of the deal. It also redresses unfairness.[54]

This liability rule should be designed as follows:

- Liability should not be conditional on whether the liable party has broken off the negotiations. The party who

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[53]All the proposed rules are default rules. The negotiating parties should always be allowed jointly to opt for other rules governing their precontractual relationship, and their liability for breach. As the situations which we analysed, do not show externalities affecting third parties, there is no reason not to allow this.

[54]See above, text accompanying footnotes 23 and 52.

claims damages, should be allowed to take the initiative to break off the negotiations.

If liability were conditional on having broken off the negotiations, the prospect of liability may lead to wasteful dragging of the negotiations, and a party in a position of superior information may not be fully deterred from inducing the other party to engage in excessive, inefficient action in anticipation of the deal.[55]

- No evidence of bad faith should be required. It should be sufficient that the liable party made or let the acting party have inflated expectations of the likelihood or the benefits of the deal, whereas he knew better himself.

Negligent misleading behavior is as harmful as intentional behavior, and to require evidence of intent may create a costly hurdle in litigation.[56]

- No damages should be awarded if it was not reasonable for the relying party to be misled by the other party.

The objective of the liability rule is to deter abuse of superior information on the likelihood or benefits of the deal being negotiated. This rationale is absent if the relying party knew better, or should have known better, than to be misled by the other party. To allow liability in such a situation, would encourage excessive, inefficient reliance, in the same way as under a general rule of liability for breaking off negotiations.[57]

- Damages should only be awarded for the costs of those

[55]See above, text accompanying footnotes 24 to 28.

[56]See above, footnote 29 and accompanying text.

[57]See above, text accompanying footnotes 30 and 31.

actions which the relying party would not have taken but for being misled by the other party.

This restriction allows the saving of administrative costs, by keeping out of the courts those cases where the action misleadingly induced would have been taken anyway. In such cases, there are no efficiency nor fairness concerns favoring liability.[58]

- The measure of damages should be the reliance measure, defined as the costs born by the relying party, minus the scrap value retained by this party. The costs should not only include the expenses made, but also the forgone next best alternatives.

A lower damage measure, for instance based only on the expenses made, would not fully deter abuse of superior information on the likelihood or benefits of the deal being negotiated. It would also fail to redress fully the resulting unfairness.

The expectation measure, defined as the benefit which the relying party expected to obtain from her action, if the deal were to go through, minus the scrap value retained by this party, would also lead to efficient deterrence. Most often, however, expectation damages will be more difficult to assess fairly accurately than reliance damages. If the opposite happens to be the case, expectation damages are to be preferred. Occasionally, expectation damages may also be considered necessary to redress fully the unfairness resulting from the misleadingly induced action.[59]

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[58]See above, text following footnote 31.

[59]See above, text accompanying footnotes 32 to 35.

* Second, there should be **restitution of benefits out of the failed negotiations:** If, at some time during the negotiations, any party engaged in an abnormal costly action in anticipation of the deal, from which the other party retains a benefit after the failure of the negotiations, the latter party should be held liable to restitute the benefit.

Such liability enhances efficiency, by encouraging efficient anticipatory performance, which might otherwise be difficult or costly for the negotiation parties to agree on.[60]

This restitution rule should be designed as follows:

- The liability should not be conditional on which party has broken off the negotiations.

If liability were conditional on having broken off the negotiations, the prospect of liability might lead to wasteful dragging of the negotiations, and efficient anticipatory performance would be encouraged less.[61]

- Restitution should only be awarded in case of abnormal action in anticipation of the deal. A costly action is normal, and thus not leading to restitution, if a negotiating party, in a similar situation, would presumably be willing to take that kind of action at her own risk.

This restriction allows the saving of administrative costs, by keeping out of the courts those cases where the prospect of restitution, or other compensation by the other party, is not necessary to induce the action. The rationale of the restitution rule is to encourage those actions which are

[60]See above, text accompanying footnote 45.

[61]See above, footnote 46 and accompanying text.

efficient (in the mutual interest of the parties), but too expensive for the acting party to take at her own risk. Restitution serves thus no function in those cases where the action is sufficiently cheap, given the situation of the parties and their negotiation, to be undertaken by the acting party at her own risk.[62]

- Restitution means that the liability is measured by the scrap value (after the failure of the negotiations) of the benefit to the enriched party. Alternatively, one could allow the enriched party the choice between restitution of the remaining benefit, and compensation of the costs born by the acting party. By costs, we mean full opportunity costs, thus including forgone alternatives.

These two liability measures (the value of the benefit, or the lesser of benefit and costs) are equivalent.[63] Other damage measures, such as the costs born by the acting party (even if greater than the remaining benefit), would lead to excessive, inefficient action in anticipation of the deal.[64]

* Third, there should **not** be **a more general rule of liability for the other party's costs, nor any liability attached to the act of breaking off the negotiations.** As a general rule, losses should be left where they have fallen.

Such liability would lead to excessive costs being made during the negotiations, to wasteful distortions of the decision to break off the negotiations, and would undesirably deter parties from entering into negotiations at the outset.[65]

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[62]See above, text accompanying footnote 51.

[63]See above, footnote 49 and accompanying text.

[64]See above, footnote 47 and accompanying text.

[65]See above, text accompanying footnotes 13 to 18.

* These recommendations imply the following answers to some commonly asked questions concerning precontractual liability:[66]

- Should the law require that a party who enters into negotiations, has a *serious intent* to reach a deal? As such, the intent of the parties should not be investigated into. What matters is the impression parties give each other. If a party gives the impression of being more likely to enter into a deal than he really is, and the other party is not in a position to know better, there is cause for liability for the costs so induced, when the negotiations subsequently fail (see first recommendation).

- Is a negotiating party allowed to conduct *parallel negotiations* with a third party? Nothing is wrong with parallel negotiations as such. Again, what matters is the impression given to the other party. If the other party is made or let to believe that no parallel negotiations are taking place, and it is reasonable for the other party to believe so, there is cause for liability for costs thus induced, when the negotiations subsequently fail (see first recommendation).

- Should the law condemn certain types of *negotiating behavior*, such as raising new and unreasonable demands during negotiations, rejecting reasonable offers put forward by the other party, revoking offers previously made, extending negotiations sine die by continual modification of the initial position, or requesting further benefits or imposing new obligations on the other party? These practices should not be

[66]We took the list of questions from E. HONDIUS, "General report", in *Precontractual liability*, Kluwer, Deventer, 1991, p. 15-20.

condemned as such. They may, however, very well constitute evidence that the party who now behaves in this fashion, has previously misled the other party as to the likelihood and the benefits of the deal.[67] If so, the party who is the victim of this behavior, should be allowed to break off the negotiations and sue for compensation of the costs it was misleadingly induced to make (see first recommendation).

- What is the relevance of the fact that the negotiations were conducted by a person who does not have the *legal capacity* to conclude the envisaged contract? Only if the other side was made or let to believe that the negotiator did have the necessary capacity, and it was reasonable for the other side to believe so, is there cause for liability for the costs so induced, when the contract is subsequently not formed (see first recommendation).

- Is it relevant which party took the *initiative* to enter into the negotiations? This is not relevant as such. One could imagine some situations, however, where this would constitute part of the evidence that one party misled the other as to the likelihood or profitability of the envisaged deal (see first recommendation).

- Is it relevant *which party broke off* the negotiations? No. Liability should not depend on who breaks off the negotiations. The wider circumstances of the collapse of the negotiations may, however, constitute evidence of previous misleading behavior (see third and first recommendations).[68]

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[67]An example is the Hoffman v. Red Owl Stores case, the facts of which are mentioned below after footnote 73. The defendant was not held liable because he changed his conditions, but because it became thus apparent that he had previously misled the plaintiff as to the conditions of the deal.

[68]See also below, section D. 3).

- Is it relevant *for what reason* the negotiations failed? Not as such. But again, the reasons why the negotiations collapsed, may constitute evidence of previous misleading behavior, which can justify liability (see first and third recommendations).

- Finally, what importance should be attached to *preliminary agreements, letters of intent and other interim documents*? They play an important role in creating an impression as to the likelihood and benefits of the envisaged deal. If these instruments are used by a party to make or let the other party have an unrealistically optimistic impression, and it was reasonable for the other party to have this impression, there is cause for liability for the costs so induced, when the negotiations subsequently fail (see first recommendation).

We will now investigate to what extent the existing law in the United States and other countries corresponds to our recommendations.

B. LIABILITY FOR COSTS MISLEADINGLY INDUCED

1) *American law*[69]

We concluded from our analysis that if, at some time during the negotiations, any party misled the other party as to the likelihood or the benefits of the deal, and so induced this other party to engage in some costly action in anticipation of the deal, the first party should be held liable for the costs of this action, when the negotiations fail.

American law provides for such liability under the tort doctrine of misrepresentation and under the doctrine of promissory estoppel.

Restatement (Second) of Torts § 525 states that "one who fraudulently makes a *misrepresentation* of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation". 'Misrepresentation' means any conduct that amounts to an assertion not in accordance with the truth. A specific fraudulous intent has to be proven.[70] In the case of

[69]The most systematic discussion of precontractual liability under American law can be found in E. FARNSWORTH, "Precontractual liability and preliminary agreements: fair dealing and failed negotiations", 87 *Colum. L. Rev.* 217 (1987); see also E. FARNSWORTH, "General report", in *Formation of contract and precontractual liability*, I.C.C., Paris, 1990, p. 15-34, and D. TURACK, "United States of America", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, p. 333-349.

[70]Fraudulous intent is not required for the tort of negligent misrepresentation, which concerns 'false information''supplied for the guidance of others'; Restatement (Second) Torts § 552.

unfulfilled promises, courts have required evidence that the promisor possessed the present intent not to perform.[71] Not surprisingly, very few cases can be found where liability for costs misleadingly induced during precontractual negotiations has been held on the basis of the tort of fraudulent misrepresentation.[72]

No evidence of intent is required under the doctrine of *promissory estoppel*. The leading case here is *Hoffman v. Red Owl Stores*.[73] A supermarket franchisor, Red Owl Stores, was held liable to Hoffman, a prospective franchisee, as a result of a promise that if Hoffman took certain steps and raised $ 18,000 worth of capital he would be granted a franchise. Hoffman sold his bakery, purchased a small grocery store to gain experience, resold it, moved to another town, and acquired an option on land, all approved by the defendant's agent. Finally, the negotiations were broken off when Red Owl demanded a substantially larger investment and Hoffman refused. The Supreme Court of Wisconsin ruled for the plaintiff on the theory of promissory estoppel. It applied the test of Restatement (now Second) of Contracts § 90 (1), which

[71] See, for instance, Suskey v. Davidoff, 2 Wis2d 503, 507, 87 N.W.2d 306.

[72] One of the exceptions is Markov v. ABC Transfer & Storage Company, 76 Wash.2d 388, 457 P.2d 535 (Washington 1969). A lessor of a warehouse intentionally misrepresented to the lessee his intention to renew the existing lease, and to negotiate the amount of rentals in good faith. In reality, the lessor was busy negotiating the sale of the premises to a third party. Shortly before the lease expired, the lessor informed the lessee that he had to vacate the premises. The Supreme Court of Washington relaxed the requirement of absence of intention to perform, by declaring equivalent the making of a promise 'without care or concern whether it will be kept' (at 539). This somewhat more lenient test has again been interpreted strictly in Zeman v. Lufthansa German Airlines, 699 P.2d 1274 (Alaska 1985), requiring 'reckless indifference' (at 1285). Another case, where *negligent* misrepresentation was found, is Guilbert v. Phillips Petroleum Co., 503 F.2d 587 (6th Cir. 1974).

[73] 26 Wis.2d 683, 133 N.W.2d 267 (Wisconsin 1965).

reads: "A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise."

In the case of Hoffman v. Red Owl Stores, the misleading impression created or entertained, consisted in a 'promise' (as § 90 requires), viz. that for the sum of $ 18,000 Red Owl would establish Hoffman in a store. The range of factual situations where liability is desirable, however, goes far beyond what one would commonly call promises: a misleading impression as to the likelihood or benefits of the deal in negotiation, can obviously be created or entertained without real promises. Fortunately, it appears that the courts do not strictly apply the § 90 test. In *Werner v. Xerox,*[74] the U.S. Court of Appeals (7th Cir.) affirmed a judgment which based liability on the fact that the defendant had *'painted a rosy picture'*, a test which describes quite well the desirable liability test.[75] It would be desirable indeed to use such a test, specifically matching the underlying functional concerns, instead of using the general test for promissory estoppel.[76]

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[74]732 F.2d 580 (7th Cir. 1984).

[75]Apparently, some other cases apply the 'promise' test strictly. In Bender v. The Design Store, 404 A.2d 194 (D.C. 1979), liability was denied because 'in the final analysis there must be a promise' (at 196). But the case was rightly decided anyway, because the facts clearly indicate that there was no situation of informational asymmetry, and that it was (thus) not reasonable for the plaintiff to have been misled. Similarly, a rather strict 'promise' test was applied in Gruen Industries v. Biller, 608 F.2d 274 (7th Cir.), but the judgment is also explicitly based on the absence of informational asymmetry, and the unreasonableness of the reliance.

[76]In its origin, promissory estoppel is a substitute for consideration, as a basis for contract. The problem with which we are dealing here, is entirely unrelated to this. We are concerned with deterrence of harmful behavior, basically thus

We concluded from our analysis that liability should *not* be *conditional on whether the liable party has broken off the negotiations*. That this is indeed not required under Hoffman v. Red Owl Stores, is illustrated by the facts of this case: the negotiations were broken off by the plaintiff, Hoffman.[77]

We also concluded that no damages should be awarded if it was not *reasonable for the relying party to be misled by the other party*. A related, but different test is contained in Restatement (Second) of Contracts § 90 (1): the promisor should reasonably expect his promise to induce reliance.[78] It appears, however, that the courts do not really apply the test of § 90, but instead analyse whether it was reasonable for the plaintiff to be misled, and thus whether the plaintiff was in a situation of inferior information. In *Gruen Industries v. Biller*, for instance, liability was denied because "the plaintiffs were represented (in the precontractual negotiations) by sophisticated businessmen, and therefore this is not a situation of an individual taken advantage of by a corporation or individual with superior knowledge of legal and business practices".[79]

Also in conformance with our analysis, damages are only

with a tort-like situation.

[77]Hoffman v. Red Owl Stores, 26 Wis.2d 683, 133 N.W. 2d 267 (Wisconsin 1965), at 271. Contra R. SUMMERS, "'Good faith' in general contract law and the sales provisions of the Uniform Commercial Code", 54 *Va. L. Rev.* 195 (1968), who uses Hoffman v. Red Owl Stores to argue for liability because of breaking off negotiations (at 220 and 225).

[78]This latter test bears some resemblance to the requirement of intent under the doctrine of (fraudulent) misrepresentation, and is, as to the problem we are dealing with, inappropriate for the reasons explained in the text accompanying footnote 29 above.

[79]608 F.2d 274 (7th Cir. 1979), at 281. See also J. KOSTRITSKY, "A new theory of assent-based liability emerging under the guise of promissory estoppel: an explanation and defense", 33 *Wayne L. Rev.* 895 (1987), at 920.

awarded for the costs of those actions which the relying party would not have taken but for being misled by the other party.[80]

Finally, the damage measures which the courts actually use, correspond with our prescriptions. Restatement (Second) on Contracts § 90 (1) provides that 'the remedy granted for breach may be limited (short of enforcement of the promise) as justice requires'.[81] In practice, the courts most often award reliance damages, which include lost alternative opportunities.[82] In some cases, where the expectancy can more easily be assessed than the reliance interest (including lost alternatives), expectation damages are awarded.[83]

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[80]In combination with the reasonableness requirement, this is illustrated by Werner v. Xerox, 732 F.2d 580 (7th Cir. 1984), at 583.

[81]See Comment, "Once more into the breach: promissory estoppel and traditional damage doctrine", 37 *Un. of Chicago L. Rev.* 559 (1970), at 588.

As to the tort of misrepresentation, its normal remedy is also liability for reliance damages; see Restatement (Second) of Torts § 549, comment *g*.

[82]For instance: Goodman v. Dicker, 169 F.2d 684, 83 U.S.App.D.C. 353 (1948); Hoffman v. Red Owl Stores, 26 Wis.2d 683, 133 N.W.2d 267 (1965), at 277 and Werner v. Xerox Corporation, 732 F.2d 580 (7th Cir. 1984), at 584. See also E. FARNSWORTH, "Precontractual liability and preliminary agreements: fair dealing and failed negotiations", 87 *Colum. L. Rev.* 217 (1987), at 225-228.

[83]For instance: Walters v. Marathon Oil Co., 642 F.2d 1098 (7th Cir. 1981), at 1100-1101 and St. Germain v. Boshouwers, 646 P.2d 952 (Colo. Ct. App. 1982), at 954-955; see also FEINMAN, "Promissory estoppel and judicial method", 97 *Harv. L. Rev.* 678 (1984), fn 53 at 688.

2) Other Common Law jurisdictions

The *Australian law* as to liability for costs misleadingly induced, is similar to the American law. Liability can be based on misrepresentation. In addition to the Common Law tort of misrepresentation, a statutory provision controls misleading or deceptive conduct in commercial relations.[84] Liability can also be based on promissory estoppel. In *Walton Stores (Interstate) Ltd. v. Maher,*[85] the High Court of Australia broadened the doctrine of promissory estoppel along American lines, and adopted a test, as to precontractual liability, which requires 'the creation or encouragement by the party estopped in the other party of an assumption that a contract will come into existence'.[86]

In *New Zealand*, misrepresentation is a basis for both Common Law and statutory remedies, as in Australia.[87] It has

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[84]Section 52 of the Trade Practices Act 1974 (Cth), and similar Statutes in other States; see J. CARTER, "Australia", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 34.

[85](1988) 164 C.L.R. 387. The case concerned negotiations for the lease by Waltons of a property owned by Maher. On the basis of the assumption entertained by Waltons, that the deal would go through, Mahor demolished an old building, and started erecting a new building according to approved specifications. The building was forty percent complete when Waltons informed Mahor that the deal would not go through.

[86]Walton Stores (Interstate) Ltd. v. Maher (1988) 164 C.L.R. 387, at 406. The American Restatement (Second) on Contracts § 90 is discussed at 401-402.

In Walton Stores, expectation damages were awarded, apparently because this was judged necessary to redress the unfairness in the case. Reliance damages are presumably the norm; see W. CARTER, *l.c.*, at 37. This corresponds with the recommendation from our analysis; see above, text accompanying footnote 59.

[87]The New Zealand Fair Trading Act contains provisions on misleading or deceptive conduct similar to those on the Australian Trade Practices Act 1974; see S. TODD, "New Zealand", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 254-258.

not yet been accepted that estoppel can create a positive cause of action. The development of the case law makes it plausible, however, that the Australian *Walton Stores* holding will also be followed by the New Zealand courts.[88]

Under *English law*, liability for costs misleadingly induced during precontractual negotiations can practically only be based on the tort of fraudulent or negligent misrepresentation.[89] The doctrine of promissory estoppel is not very useful, because it requires under English law that the promisor intended his promise to be binding, and it does not support a positive cause of action.[90] It follows thus that in a case like *Red Owl* or *Walton Stores*, the plaintiff could not make a successful estoppel claim under English law.[91] If this meant that no damages could be obtained in such a case, we would have to conclude that liability for costs misleadingly induced during precontractual negotiations is too narrowly defined, in comparison with what our functional analysis recommends. We have reason to believe, however, that an English plaintiff could obtain damages in a case like *Red Owl* or *Walton Stores*, not on the basis of estoppel, but on the basis of tortious misrepresentation. It appears indeed that

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[88]See S. TODD, *l.c.*, at 265. A recent lower court decision (*Dickson Elliott Lonergan Ltd. v. Plumbing World Ltd.*, (1988) 2 N.Z.L.R. 608), however, held the defendant liable in a case which was factually very similar to *Walton Stores*. The judgment was based on unjust enrichment, although no benefit remained. The judgment also points to representations by the defendant that the deal would go through. It appears thus that the judgment applied de facto a test similar to *Walton Stores* or *Red Owl*, but with a confusing doctrinal justification; see S. TODD, *l.c.*, at 265-266. A similar confusion can be found in the Australian case *Sabemo Pty Ltd. v. North Sydney Municipal Council*, (1977) 2 N.S.W.L.R. 880; see J. CARTER, *l.c.*, at 38.

[89]See R. GOODE, "England", in *Formation of contracts and precontractual liability*, I.C.C., Paris , 1990, at 57.

[90]D. ALLEN, "England", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 132.

[91]D. ALLEN, *l.c.*, at 133.

this liability ground is interpreted sufficiently liberally, as exemplified by the *Box v. Midland Bank* judgment. In this case, a loan applicant was given 'the impression' by a local bank manager that the granting of a loan facility up to £ 45,000 would be 'a mere formality', whereas there was in fact only a bleak prospect of the facility being made available. The bank was held liable for the overdraft which the applicant had run up, relying on the created impression.[92]

We conclude thus that, nonwithstanding doctrinal differences, the actual law as to liability for costs misleadingly induced during precontractual negotiations is similar in all Common Law jurisdictions considered, and corresponds with the recommendations from our analysis.

3) Civil Law jurisdictions

In all the Civil Law jurisdictions we have studied, a party who, during the negotiations, misled the other party as to the likelihood or the benefits of the deal, and so induced this other party to engage in some costly action in anticipation of the deal, will be held liable for the costs of this action, when the negotiations fail.

In *German law*, precontractual liability ('culpa in contrahendo') is a well-developed concept, separate from both contractual and tortuous liability. According to the case law of the Bundesgerichtshof, precontractual liability lies if a

[92]Box v. Midland Bank Ltd., (1979) 2 Lloyds Rep. 391. The judgment is also interesting in that it clearly states that damages should only be awarded for those costs which the plaintiff would not have incurred but for being misled (at 400). Finally, it is stated that the reliance interest is the appropriate damage measure (at 399).

Reliance damages are also the normal remedy under Australian and New Zealand law, both for liability based on tortuous misrepresentation, as on promissory estoppel; see J. CARTER, *l.c.*, at 34 (fn 17) and 37, and S. TODD, *l.c.*, at 259.

party has 'created or enhanced the expectation of the other side that the contract will be formed', and the other side has actually and reasonably relied on this.[93] The damages awarded are measured by the reliance interest.[94] German law corresponds thus entirely to our recommendations.[95]

In *France* and *Belgium*, liability for costs misleadingly induced during precontractual negotiations is seen as an application of general tort liability.[96] The Paris Court of Appeals already held in 1883 that 'the false promise to enter into a contract can constitute a tort-like fault'.[97] Later French judgments held the defendant liable because he had 'lured the plaintiff with the expectation of a contract',[98] or

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[93]BGH, 10 July 1970, NJW 1970, 1840. Similarly: BGH, 5 May 1989, cited by W. EBKE, "Germany", in *Formation of contracts and precontractual liability*, I.C.C., Paris, 1990, at 43. See also W. LORENZ, "Germany", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 161-163, and D. MEDICUS, "Verschulden bei Vertragsverhandlungen", in *Gutachten und Vorschläge zur Ueberarbeitung des Schuldrechts*, BUNDESMINISTER DER JUSTIZ (ed.), Köln, 1981, 495-496.

[94]D. MEDICUS, *l.c.*, at 496-497.
German law makes the same distinction between the reliance interest ('negatives Interesse' or 'Vertrauensinteresse') and the expectation interest ('positives Interesse' or 'Erfüllungsinteresse') as American law.

[95]The same can be said about *Austrian law*; see W. POSCH, "Austria", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 48-49.

[96]Article 1382 of both countries' Civil Code provides that whoever causes injury by his fault, is liable.
In *Italy*, a specific provision in the Civil Code requires good faith in precontractual negotiations. This provision only repetes the general tort provision; see G. ALPA, "Italy", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 199.

[97]Paris, 13 Feb. 1883, *Gaz. Pal.*, 1883.2.414.

[98]Rennes, 8 July 1929, D.H., 1929.548.

'kept him voluntarily in a protracted uncertainty'.[99] In several Belgian cases, the defendant was held liable for 'having created a false impression likely to mislead the justified expectations of the plaintiff'.[100] For damages to be awarded, it is required that the misleadingly created expectations of the plaintiff were 'serious' and 'justified'.[101] French and Belgian courts appear thus to impose liability precisely in those situations were our analysis recommended to do so.[102]

As to the measure of damages, French and Belgian law are doctrinally quite different from American or German law. We have the firm impression, however, that this does not lead to different outcomes. In French and Belgian law, the concepts of reliance interest and expectation interest are not used.[103] A distinction is made, however, between out-of-pocket losses (damnum emergens) and lost profits (lucrum cessans). In case of contractual liability, compensation for both components is awarded. Because the lost profits are measured on the broken

[99]Cass.com., 20 March 1972, Bull. IV, nr.93.

[100]Comm. Bruxelles, 24 June 1985, J.T., 1986, 236 and Comm. Bruxelles, 3 Feb. 1988, J.T., 1988, 516; similarly Bruxelles, 28 Sept. 1980, Entr. et Dr., 1980, 220; Comm. Bruxelles, 30 June 1983, R.D.C. 1984, 458 and Comm. Liège, 20 Dec. 1984, Jur. Liège, 1985, 149.

[101]J. SCHMIDT, *Négociation et conclusion de contrats*, Paris, Dalloz, 1982, nr.214. French cases where this condition was not fulfilled, include: Cass. com., 15 Feb. 1965, Bull. IV, nr.123 and Pau, 14 Jan. 1969, D. 1969.716.

[102]It should be noted, however, that several French judgments are cast in a somewhat confusing language, focusing on the right to break off the negotiations, as a function of how far the negotiations are advanced. We discuss this doctrinal confusion below, in section D.3).

[103]In Italian law, the distinction is known (under German influence). As to precontractual liability, reliance damages are the appropriate damage measure; Cass. 20.8.1980, No. 4942, cited in G. ALPA, "Italy", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 202.

contract, this comes down to expectation damages. In case of precontractual liability, the lost profits are deemed too uncertain to assess. Instead, compensation is awarded for a lost opportunity ('perte d'une chance').[104] It is left open, however, whether this lost opportunity refers to the deal which was being negotiated (in which case the damage measure would come down to probabilistically calculated expectation damages) or to the lost alternative opportunities (in which case it would come down to reliance damages).[105] This question is left open - never asked indeed -, because the assesment of damages is considered to be a factual issue, decided by the lower judges. These judges take a pragmatic approach, presumably based on administrative ease and fairness.[106] This is not incompatible with our analysis. We recommended that, as to precontractual liability, the choice between reliance and expectation damages should be based on these two factors indeed.[107]

Finally, there is no doubt that *Dutch law* would also impose liability in those cases were we recommended so. It seems, however, that recent Dutch case law has broadened liability, or at least changed the liability test, focusing more on the act of breaking off the negotiations. We will discuss this under section D. 3) below.

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[104]On precontractual liability, see: J. SCHMIDT, *Négociation et conclusion de contrats*, Dalloz, Paris, 1982, nr. 210, or -, "France", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 149. On the 'lost opportunity' concept in general, see Ph. le TOURNEAU, *La responsabilité civile*, Dalloz, Paris, 1982, nr. 512.

[105]We remind that we define the reliance interest as including not only actual expenses, but also the forgone next best alternative; see footnote 32 above.

[106]See, for instance: Comm. Bruxelles, 3 Feb. 1988, J.T., 1988, 517.

[107]See above, text accompanying footnotes 32 to 35.

C. RESTITUTION OF BENEFITS OUT OF THE FAILED NEGOTIATIONS

1) American law

We concluded from our analysis that if, at some time during the negotiations, any party engaged in an abnormal costly action in anticipation of the deal, from which the other party retains a benefit after the failure of the negotiations, the latter party should be held liable to restitute this benefit.

American law provides for such a rule of restitution under the doctrine of *unjust enrichment*. Similarly to what we saw before as to liability for misleadingly induced costs, the doctrine on restitution is somewhat confusing, but the actual case law corresponds well to our recommendations.

The elements necessary to support a claim based upon unjust enrichment are: '1) Valuable services were rendered, or materials furnished, 2) to the party to be charged, 3) which services or materials were accepted, used and enjoyed by the party, and 4) under such circumstances which reasonably notified the party to be charged that the plaintiff, in rendering such services or furnishing such materials, expected to be paid by the party to be charged. Without such payment, the party would be unjustly enriched.'[109] The conditions 3) and 4) are sometimes interpreted as meaning that the services must have been furnished at the other party's request.[110] In

[109]Pancratz Company v. Kloefkorn-Ballard Construction and Development, 720 P.2d 906 (Wyo. 1986), at 908-909.

[110]E. FARNSWORTH, "Precontractual liability and preliminary agreements: fair dealing and failed negotiations", 87 *Colum. L. Rev.* 217 (1987), at 232, citing as authority Gould v. American Water Works, 52 N.J. 226, 245 A.2d 14 (1968), where restitution was denied to a 'volunteer'. It appears, however, that the case was rather decided on another ground, viz. that the benefit conferred had in fact fallen in the public domain,

the light of our analysis, this interpretation seems undesirable. The objective of the restitution rule is to encourage efficient anticipatory performance, precisely in those instances where asymmetric information makes it costly or impossible for the negotiating parties to make an agreement inducing the action.[111] Requiring that the action took place 'at the other party's request' comes close to requiring an agreement, which makes the whole restitution rule pointless.[112]

In the light of our analysis, a more appropriate way to interpret conditions 3) and 4) would be to consider them as *distinguishing between normal and abnormal actions*, i.e. between actions which the acting party would supposedly also be willing to take at her own risk, and other actions.[113]

It appears that the actual case law centers around risk-taking indeed:[114] restitution can be obtained for 'extensive developmental work',[115] but not when the plaintiff 'admits

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so that no 'unjust' enrichment had occured (condition 4)); see G. PALMER, *The law of restitution*, Little Brown, Boston, 1978, at 462-463.

[111]See above, text accompanying footnotes 41 to 47.

[112]The exclusion of 'volunteers' in the law of unjust enrichment is based on a policy concern against 'officious intermeddling', i.e. a person unjustifiedly intervening in someone else's affairs; see G. PALMER, *The law of restitution*, Little Brown, Boston, 1978, at 359. The relevance of this policy concern obviously depends on the type of situation. As to anticipatory performance during precontractual negotiations, the concern seems of no importance.

[113]See above, text accompanying footnotes 51 and 62.

[114]D. TURACK, "United States of America", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, p. 348.

[115]Comm v. Goodman, 6 Ill. App.3d 847, 286 N.E.2d 758 (1972). In Hill v. Waxberg, 237 F.2d 936 (9th Cir. 1956), the 'request' language is used, but the Court also refers to (the action going beyond) 'the ordinary course of business affairs'.

that those services were rendered with the expectation that the subject deal would go through and he would be rewarded through the profits generated',[116] or when 'those activities are not uncommon and are regularly engaged in by parties endeavoring to reach a mutual accomodation', and 'each side's efforts where for the purpose of advancing its own interests.'[117]

We concluded from our analysis that restitution should *not* be *conditional on whether the enriched party has broken off the negotiations*. That this is indeed not required by the courts, is illustrated by Hill v. Waxberg, where the Court notes that both parties claimed that the other caused the termination of their relationship, but does not attach any importance to this issue.[118]

There seems to be no discussion that the proper measure of damages for unjust enrichment is the value of the remaining benefit: 'In the absence of fraud or other tortious conduct on the part of the person enriched, restitution is properly limited to the value of the benefit which was acquired.'[119] The exception of tortious behavior corresponds with the liability rule for misleadingly induced action, which we discussed above. As to the damage measure, the law thus again corresponds with the conclusions from our analysis.

[116]Cherokee Oil Company v. Union Oil Company of California, 706 F.Supp. 826 (M.D.Fla. 1989), at 830. Similarly, Jako v. Pilling Company, 848 F.2d 318 (1st Cir. 1988), at 320.

[117]Songbird Jet Ltd. v. Amax, 518 F.Supp. 912 (S.D.N.Y. 1984), at 926. Restitution was granted in Precision Testing Laboratories v. Kenyon Corporation, 644 F.Supp. 1327 (S.D.N.Y. 1986), where the situation was the opposite.

[118]Hill v. Waxberg, 237 F.2d 936 (9th Cir. 1956), at 938.

[119]Idem, at 939.

2) Other Common Law jurisdictions

The law on restitution of benefits out of failed negotiations appears to be similar in all Common Law jurisdictions. The leading case in England is *William Lacey (Hounslow) Ltd. v. Davis*. During the negotiations for a building contract, the plaintiff builders produced various estimates and calculations concerning the reconstruction of the defendant's premises. Restitution was granted because the work done fell 'outside the work which a builder, by custom or usage, normally performs gratuitously, when invited to tender for the erection of a building'.[120] This test corresponds with the 'abnormality' test we proposed on the basis of our analysis.[121]

3) Civil Law jurisdictions

In *Germany*, the principle of restitution for unjust enrichment, is laid down in § 812 of the Civil Code, and applies to benefits retained out of failed precontractual negotiations.[122]

In *France*, the question of restitution or compensation for benefits obtained out of failed negotiations, has only been dealt with in the specific context of building

[120]William Lacey (Hounslow) Ltd. v. Davis, (1957) 2 All E. R. 712, at 716.

[121]As to the law in Australia and New Zealand, see *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 37-38 and 265-266.

[122]G. HEIMANN-TROSIEN, in *BGB-RGRK*, de Gruyter, Berlin, 1989, § 812, Rdn. 50 and 93, and Vorbem.Rdn. 20.

contracts.[123] French law recognizes a general principle of liability for unjust enrichment. An enrichment is 'unjust' if is lacks a (legal) justification, such as a contract. But no compensation is awarded if the impoverished person acted on his own risk.[124] As to restitution after failed negotiations, French (and Belgian) case law generally awards compensation for services by architects or engineering consultants,[125] and not for studies by construction firms, unless these constitute an abnormal service.[126] This case law is arguably not inconsistent with the 'abnormality' test we proposed on the basis of our analysis.

Under French law, the compensation awarded in case of unjust enrichment, is limited by both the benefit retained by the enriched party, and the loss suffered by the impoverished party.[127] The lowest of the two amounts is thus awarded. We

[123]Most of the cases we have found in other jurisdictions also concern building contracts. What is different in France, is that both courts and commentators have only formulated legal rules specifically for (types of) building situations. The literature on precontractual liability does not discuss unjust enrichment; see, for instance, J. SCHMIDT, *Négociation et formation de contrats*, Dalloz, Paris, 1982 and -, "France", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, p.145-158. General discussions of unjust enrichment do not mention the case of failed negotiations either; see, for instance, MAZEAUD, *Leçons de droit civil*, II.1, *Obligations*, Monchrestien, Paris, 1991, p. 831-847, and F. GORE and C. SAUJOT, "Enrichissement sans cause", in *Encyclopédie Dalloz*, Dalloz, Paris, updated 1991.

[124]Cass. civ. (1st chamber), 7 June 1974, Bull. III, nr. 240; see also J. MESTRE, *R.T.D.C.*, 1988, p. 132.

[125]Cass. civ. (1st chamber), 7 Feb. 1966, Bull. I, nr.89; Cass. com., 25 June 1973, Bull. IV, nr.217; Aix, 15 Jan. 1985, *Rev. Dr. Imm.*, 1986, 465; Paris, 30 April 1985, *Rev. Dr. Imm.*, 1986, 71 and (Belgium) Bruxelles, 8 June 1989, *Entr. et dr.*, 1990, 420.

[126]See FLAMME, *Le contrat d'entreprise - Quinze ans de jurisprudence*, Larcier, Bruxelles, 1991, nr.35.

[127]Cass. civ. (1rd chamber), 19 Jan. 1953, D.1953.294 and Cass. civ. (1rd chamber), 15 Dec. 1976, Bull. I, nr.408.

demonstrated above that this damage measure leads to efficient and fair results.[128]

Of all the countries we have studied, the *Netherlands* appears to be the only one where the law does not provide for restitution of benefits out of failed precontractual negotiations. In a 1969 judgment, the Supreme Court of the Netherlands rejected the use of the doctrine of unjust enrichment as a basis for the recovery of expenses made during precontractual negotiations.[129] This holding has been strongly critisized, however, and may be no longer good law.[130]

D. NO GENERAL LIABILITY FOR BREAK-OFF

1) American law

Our analysis led to the recommendation that there should not be a more general rule of liability for the other party's costs, nor any liability attached to the act of breaking off the negotiations. As a general rule, losses should be left where they have fallen.

This is also the existing American law: there exists no liability beyond misrepresentation or promissory estoppel, and unjust enrichment. Parties are free to break off negotiations,

[128] See above, footnote 48 and following text.

[129] Hoge Raad, 18 April 1969, N.J. 336.

[130] J. VAN DUNNE, "Netherlands", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 227-228; and -, *Verbintenissenrecht in ontwikkeling*, Suppl. 1986, Kluwer, Deventer, 1986, at 33-34.

and each party bears his own costs.[131]

2) Other Common Law jurisdictions

The general principle of freedom to break off precontractual negotiations, is repeated in all Common Law jurisdictions, most vocally in England.[132]

3) Civil Law jurisdictions

At the most general level, all Civil law jurisdictions also accept the principle of freedom to break off precontractual obligations. But as to the relevance of the fact of breaking off the negotiations, as a condition for liability, some differences appear.

Under *German law*, breaking off precontractual negotiations, even though unsupported by a good reason, does

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[131] E. FARNSWORTH, "Precontractual liability and preliminary agreements: fair dealing and failed negotiations", 87 *Colum. L. Rev.* 217 (1987), at 221 and 285.

Contrary to what Farnsworth suggests at 239, fn 82, the Werner v. Xerox judgment (see above, footnote 102) does not imply anything to the contrary. The 'painted-a-rosy-picture' test in Werner v. Xerox provides a single test, replacing the tests of tortuous misrepresentation and of promissory estoppel, for liability for costs misleadingly induced. This liability is not a general liability, and is not conditional on the liable party having broken off the negotiations. Under Werner v. Xerox, parties remain free to break off the negotiations. They are only sanctioned for 'painting a rosy picture'.

[132] See R. GOODE, "England", in *Formation of contracts and precontractual liability*, I.C.C., Paris, 1990, at 58; D. ALLEN, "England", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 135 and 143; and also P. ATIYAH, *An introduction to the law of contracts*, Clarendon, Oxford, 1989, at 108-110.

not as such lead to liability.[133]

Some *French* judgments have held a defendant liable because he had "broken off advanced negotiations without justified reasons, abruptly and unilaterally".[134] This language suggests that one could be held liable for the fact of breaking off the negotiations, at least without good reasons. A closer analysis of French case law reveals however that the French courts only conclude for liability if the defendant has misled the plaintiff as to the likelihood or the benefits of the deal, and so induced the plaintiff to engage in some costly action. The liability is thus not for breaking off the negotiations, but for misleadingly inducing costs.[135] The investigation into the reasons why the negotiations fail, makes sense to the extent that it may reveal evidence about the defendant previously having misled the plaintiff.[136] If, for instance, the defendant had assured the plaintiff that no parallel negotiations with a third party were going on, and he then breaks off the negotiations because he has reached a better agreement with a third party, the reason why he breaks off reveals that he previously misled the other party. On the contrary, if he had made no secret of the parallel negotiations, there is no reason for liability.

This confusion as to the proper liability test, and the relevance of the act of breaking off the negotiations in particular, is even stronger in the recent *Dutch* case law.

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[133]W. LORENZ, "Germany", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 165.

[134]Cass. com., 20 March 1972, Bull. IV, nr.93; similarly Cass. com., 15 Feb. 1965, Bull. III, nr.123.

[135]See J. SCHMIDT, *Négociation et conclusion de contrats*, Dalloz, Paris, 1982, nr. 213, 219 and 221.

[136]See above, text accompanying footnote 67.

In a 1982 judgment, *Plas v. Valburg*,[137] the Dutch Supreme Court distinguished several stages in precontractual negotiations. These stages are a function of how far advanced the negotiations are. In the first stage, negotiations can be broken off without liability. In the second stage, i.e. when the negotiations are further advanced, a party who breaks off the negotiations, is liable for the expenses made by the other side.[138]

From a functional point of view, it is, as such, *immaterial for the imposition of precontractual liability whether the negotiations are further advanced or not*. Both fairness and efficiency justify liability if, and only if, a party has misled the other party as to the likelihood or the benefits of the deal. This could happen at a very early stage in the negotiations, and liability should then lie. On the contrary, if both parties have the same information, or have fully informed each other as to when they might break off the negotiations, why should any liability be imposed? Relevant is not how far the negotiations are advanced, but whether one party has misled the other.[139] Maybe this is what the Court

[137]Hoge Raad, 18 June 1982, N.J. 1983, 723.

[138]In the third and final stage, the negotiations cannot be broken off anymore; break-off will be sanctioned similarly to breach of contract. In *Plas v. Valburg*, expectation damages were awarded. In some later cases, specific performance has been granted: Hoge Raad, 11 March 1983, N.J. 585 and Amsterdam Court of Appeals, 7 May 1987, N.J. 1988, 430. The third stage is defined as the situation where both parties could reasonably assume that the negotiations would result in 'a contract of some kind' (see J. VAN DUNNE, "Netherlands", in *Precontractual liability*, E. HONDIUS (ed.), Kluwer, Deventer, 1991, at 230). It seems odd to define a precontractual stage in which contractual-type liability lies. Liability for breach is exactly what 'contract' means. If the point is reached where such liability is desirable (see footnote 18 above), why not simply say that there is a contract?

[139]Compare Advocate-General Biegman-Hartogh in Plas v. Valburg, N.J. 1983, 723, at 2304: 'in my opinion are nor the duration of the negotiations, nor the resulting expectations sufficient to cause liability for the costs made'...'there

meant with its distinction between the first and second stages, but it would then better have said so.

Finally, the most worrying aspect of the Plas v. Valburg test is that liability appears to be made dependent on the defendant having broken off the negotiations. As we explained in our analysis above, this condition causes inefficiency in the form of wasteful dragging of negotiations and maybe formation of unprofitable contracts. In the absence of a requirement of misleading behavior, this liability for break-off will also lead to excessive, inefficient reliance action by all parties in precontractual negotiations.[140]

should be additional circumstances'... .

[140]See above, text accompanying footnotes 24 to 28.