2 Precontractual liability

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1. Introduction

Precontractual liability is not one of the most popular topics among Law and Economics scholars and the conspicuous absence, from the major Law and Economics textbooks, of precontractual liability as an independent field of analysis might indicate that the topic was traditionally considered to be non-problematic. However, as we will see, the issues relating to the precontractual stage are not trivial and deserve a careful treatment. The fact that, at first, mainstream Law and Economics scholarship failed to address the particular precontractual issues resulting from problems otherwise addressed in relation to the contractual stage, can be more properly explained by considering the evolution of Law and Economics as a discipline stemming essentially from the Anglo-American theory of contract law.

Law and Economics in its modern form has been developed by American scholars trying to reach new insights into American common law. The common law has traditionally refused to attach legal consequences to acts performed by the parties before the formation of a contract and has subscribed to what has been called the ‘aleatory view’ of negotiations (Farnsworth, 1987). The classic bargain theory of contract law has endorsed this view. It is not surprising, then, that Law and Economics scholars might at first have disregarded the precontractual stage as an autonomous field of inquiry and analysis. The general view was that precontractual liability simply did not exist in the common law. It is true that the economic theory of contracts presents itself as a (better) alternative to classic bargain theory, which is criticized for its excessive dogmatism in defining what an enforceable contract is and for its inability to foster efficient exchanges. But the generally accepted and established economic models of contract law still focus exclusively on rules regulating the enforcement of contracts and on liability arising from a breach of contract.

The common law, however, is full of hidden surprises. A famous commentator repeatedly used the doctrine of promissory estoppel as an example supporting his contention that classic bargain theory had been overtaken and that the traditional distinction between torts and contracts had to be revised (Gilmore, 1974). The inclusion of what has since been known as
‘promissory estoppel’ in the Restatement (First) of Contracts dates back to the 1930s, and this inclusion was soon followed by a new academic interest in reassessing the basics of contract law in light of the new development, especially with regard to the recognition of the importance of protecting the reliance interest (Fuller and Perdue, 1937). However, the wide influence that Gilmore’s book had on the legal environment had a major part in stimulating a greater attention to promissory estoppel and to the realization that courts were applying promissory estoppel to achieve a variety of goals in a variety of settings: not just to overcome the obstacle of lack of consideration in the context of gratuitous promises, but also to enforce promises made during precontractual negotiations even when a contract was not ultimately formed. This realization made some legal scholars wonder whether a new form of liability had been born (Knapp, 1997–98).

Law and Economics scholars did not fail to accept the challenge. During the last 30 years, a number of authors addressed problems related to the precontractual stage. Even though the number of papers in this field certainly cannot be compared with the extensive literature that has been devoted to other key problems in contract law, it nonetheless indicates that the Law and Economics world was indeed well aware of the issues surrounding the precontractual interaction between parties of a prospective contract. However, none of the models developed during those years could form the basis of a consensus among Law and Economics scholars. The various works on the subject widely differ not just in methodology but also in the identification of the basic problem to be confronted when analyzing precontractual negotiations.

This lack of a generally accepted framework of analysis is probably what ultimately prevented precontractual liability from obtaining the place it deserved in comprehensive treatises on the economics of the law. Also, because of the lack of a generally accepted framework of analysis, a uniform ‘label’ for the problems related to the precontractual stage is absent in the literature. The expression ‘precontractual liability’ appears in some of the titles (Farnsworth, 1987; Kostritsky, 1997; Schwartz and Scott, 2007). Other authors address the problem as a problem of reliance, referring to it as to a problem of ‘precontractual reliance’ (Bebchuk and Ben-Shahar, 2001; Grosskopf and Medina, 2007; Scott, 2007) or, more generally, of ‘efficient reliance’ (Craswell, 1989; Craswell, 1996). Another important line of works focuses on the opportunism perspective (Shell, 1991; Cohen, 1991–92). An alternative way of looking at the problem is from the point of view of ‘incomplete contracts’ (Kostritsky, 2004; Ben-Shahar, 2004). Some authors are mostly concerned with the informational side of the problem (Craswell, 1988; Johnston, 1999; Johnston, 2003–2004).
Since the confusion surrounding the problem of precontractual liability is not merely semantic, but rather a reflection of the fundamental lack of a commonly accepted framework of analysis, attempting to rationalize the various contributions on the topic is a particularly hard task. Though any such classification would necessarily be approximate, and unable to fully capture the complexity of each author’s legal and economic reasoning, I still believe that it is worth trying.

A common theoretical basis is indeed present in the scholarship on precontractual liability and it is represented by the explicit or implicit affirmation that the ultimate goal of the law, in contract situations as well as in precontractual settings, is the promotion of surplus-maximizing exchanges. Now, the law can attempt to do so in a number of different ways. The classification I propose distinguishes the models of precontractual liability on the basis of the incentives on which the parties focus in order to promote surplus-maximizing exchanges. I have identified three basic categories of models: first, those emphasizing the need to protect the precontractual (efficient) reliance of the promisee; second, those focusing more on the prevention of opportunistic behavior by the promisor; and third, those advocating the necessity of fostering efficient information exchange or efficient information gathering.

Although these three approaches may occasionally overlap, most of the works on precontractual liability can find a more or less precise collocation in one of the three categories identified above. In addition, from a normative perspective, Law and Economics contributions on precontractual liability can further be subdivided into two groups: those arguing for the necessity of a new liability regime; and those describing the legal status quo as already adequate to achieve efficiency. Common issues, such as the effects of precontractual liability on the incentive to enter negotiations, the appropriate damage measure for precontractual misconduct and the problem of over-investment that may derive from a liability regime, are also discussed toward the end of the chapter.

2. Protecting Precontractual Reliance

When two parties decide to engage in a transaction they usually have some informal interaction which necessarily precedes the formation of a formal binding contract. They speak with each other, they manifest in some way their intention to negotiate, and they communicate their respective interests and expectations regarding the potential transaction. One of the main purposes of the exchanges occurring in this early stage of negotiation is to enable the parties to ‘test’ the actual feasibility of a mutually beneficial transaction. During negotiations, an initially hypothetical contract begins to take shape and, at a certain point in the process, it is not irrational for
the parties to begin to rely on the expectation of the successful formation of a contract. Reliance may indeed be beneficial (for one party or for both) because it can increase the size of the ‘pie’ (Craswell, 1996). Parties may be in a position to make investments that will increase the net private surplus of the transaction in the event of a negotiation successfully leading to a binding contract, for example by reorganizing their business in order to more fully and more promptly exploit the opportunities created by the deal, once the deal is entered into. These investments are usually ‘relation-specific’: they are going to be wasted if the negotiations fail and a binding contract is not formed.

According to the traditional ‘aleatory view’ of negotiations, the parties are free to retreat from the initiated negotiations at any time, for any reason, and without legal consequences, so that each party bears the risk that her investment will be wasted (Farnsworth, 1987). A common statement in law and economics analysis on this point is that, in this contest, the risk of losing the investment may lead to an incentive to under-invest, thereby foregoing the opportunity to maximize the surplus obtainable from the transaction. The under-investment problem has a far greater impact than legal scholars and earlier law and economics works generally believed. Early scholarship on the subject pointed out that the incentive to under-invest created by the traditional common law rule of no liability existed only when just one party had invested in reliance. Instead, as shown by successive analysis, under-investment can still occur even if both parties rely on the successful formation of the contract (and make ‘relation-specific investments’ based on that reliance) (Bebchuk and Ben-Shahar, 2001). On the other hand, imposing liability in any case on a party who retreats from an initiated negotiation (through, for example, a rule of ‘strict precontractual liability’), besides having a deterrent effect on the willingness to enter into negotiations in the first place, will probably lead to over-investment because the other party will be fully protected against the risk of unsuccessful bargaining and will not have any incentive to restrain her investment effort (Bebchuk and Ben-Shahar, 2001). This distortion will occur regardless of the magnitude of the damages imposed by the rule. In fact, both expectation damages and reliance damages will create suboptimal incentives for investment, because the party will internalize the benefits of the investment but not the costs, which are fully borne by the retreating party.

An efficient legal rule should instead stimulate optimal investment. From an economic perspective, the investment decision has the nature of a cost-benefit analysis and the level of optimal investment can be determined through the application of a test analogous to the ‘Learned Hand’ test used for defining the efficient level of precautions in a negligence contest.
Briefly, investing is efficient whenever the potential benefit (weighted by the probability that the contract will be formed) exceeds the potential loss (weighted by the probability that the contract will not be formed) (Goetz and Scott, 1980) (Craswell, 1996) (Katz, 1995–96). More explicitly, the surplus increase that would be gained by investing in precontractual reliance if the deal is ultimately closed must be weighed against the fact that, if negotiations fail, the costs incurred for actions taken in order to increase the surplus are lost and, in some cases, additional expenditures may even be needed to undo any actions that are no longer desirable because of the failure of negotiations.

In order to stimulate efficient investment decisions, the law may be called on to supply some kind of protection for efficient reliance. Indeed, the evolution of the doctrine of promissory estoppel may seem to demonstrate that common law courts were not unaware of this problem, and tried to provide some degree of protection for promisees whose precontractual reliance was frustrated because of the ultimate failure of negotiations.

The legal instruments currently made available by American courts may be sufficient to create optimal reliance investments. Farnsworth, for instance, contends that the existing contract doctrines of promissory estoppel, unjust enrichment and misrepresentation, particularly if considered together with the trend of modern courts to include lost opportunities in the recovery measure, provide sufficient protection for the parties in the case of failed negotiations, while an extension of the general obligation of ‘fair dealing’ in the context of precontractual negotiations is unnecessary, if not harmful (Farnsworth, 1987). However, the exact scope of application of those contract doctrines, and of promissory estoppel in particular, is uncertain. Professors Schwartz and Scott show through case analysis that courts are actually unwilling to attach liability for representation made during negotiations, whether on the basis of promissory estoppel or of any other doctrine. However, they find that liability is sometimes efficiently imposed by courts to protect reliance investments made after a ‘preliminary agreement’ has been reached (Schwartz and Scott, 2007; Scott, 2007). The term ‘preliminary agreement’ is defined broadly to include informal and even oral agreements from which it is possible to identify an intention to pursue a profitable project, a division of investment tasks, and an agreement on an investment sequence. Parties create preliminary agreements rather than complete contracts when their project can take a number of forms and the parties are unsure which form will maximize profits. Preliminary agreements are desirable because often they are necessary condition to the realization of a socially efficient opportunity. By developing a bilateral investment model encompassing both simultaneous and sequential investments settings, Schwartz and Scott
show that law can improve efficiency by awarding the promisee his verifiable reliance if the promisor has strategically deviated from the investment sequence agreed upon in the preliminary agreement. Without this protection, the parties are discouraged from entering into beneficial preliminary agreements and from engaging in relation-specific investments. On the other hand, attaching liability in cases in which no agreement has been reached will inefficiently and unnecessarily chill the parties’ incentive to enter into negotiations. Case law analysis evidences an emerging legal rule requiring parties to a preliminary agreement to bargain in good faith over open terms. This new legal rule is regarded by the authors as a positive step toward the efficient policy recommendation derived from the model. However, requiring parties to bargain in good faith is unnecessary: in order to enhance efficiency it is simply necessary to protect the promisee’s reliance interest.

Another author finds that a review of case law shows, instead, that courts do in fact grant recovery of precontractual expenditures even when a ‘preliminary agreement’ is absent (Kostritsky, 2008). Kostritsky argues that the problems characterizing precontractual negotiations without an agreement and those present in the ‘preliminary agreement’ framework identified by Schwartz and Scott are substantially the same: ex post hold-up and the related under-investment problem. Thus, a liability default rule providing for recovery of reliance expenditures is desirable in both contexts. In particular, legal protection may be necessary to curb the moral hazard problem in situations of sequential investments, where the first party to make an investment may be forced to accept less favorable terms under the threat of losing what she had paid in reliance if the other party breaks off the negotiations. According to Kostritsky, the courts’ willingness to grant recovery even in the absence of an explicit agreement on the investment sequence, evidence by case-law analysis, is therefore in line with economic efficiency.

Along the same lines, Richard Craswell, linking his analysis to the theory of incomplete contracts, focuses basically on the selection of an appropriate default rule to be applied when parties have not explicitly said whether they intended to be committed by their preliminary exchanges (Craswell, 1996). Craswell considers the case of unilateral reliance. Since optimal investments increase the size of the expected value of the transaction, the non-relying party also benefits from the investment made by the relying party because, depending on her bargaining power, she may be able to appropriate some of the surplus created by investing in preparation of the prospective conclusion of the deal. Hence, the non-relying party would want to commit herself in some way or the other in order to induce the other party to rely. Building on this intuition, Craswell concludes that the
optimal default rule would be a rule that recognizes the implied existence of a commitment in those cases in which, ex ante, even for the party who now seeks to withdraw, it would have been desirable to be committed in order to induce efficient reliance. In other words, courts should impose liability only when an enforceable commitment would have been necessary to induce an efficient level of reliance (found by applying a Learned Hand formula-style text). In addition, Craswell proposes the adoption of a ‘penalty default’ (Ayres and Gerlner, 1989), imposing a form of strict liability, in all those cases in which a party with superior information about the probability of performance explicitly recommends that the other party makes some kind of reliance investment. This penalty default will assure that the party with superior information would recommend that the other invest only when relying is efficient. The conclusions reached in the paper are supported by case analysis: Craswell finds that, in most instances, courts do in fact recognize the existence of a commitment when reliance was efficient.

These attempts to reconcile case law with a law and economics perspective on precontractual liability have produced mixed results. Courts have not always been consistent in the application of legal doctrines, such as promissory estoppel, to precontractual claims, so that even those scholars more convincingly campaigning for the overall efficiency of current judicial approaches cannot help but wonder whether a greater degree of definition would be helpful to reduce the uncertainty surrounding the precontractual stage. Departing from case law analysis, some law and economics scholars have searched for models able to provide clearer normative recommendations.

Avery Katz also considers the doctrine of promissory estoppel. In addition, he develops some normative suggestions on how the doctrine should better be applied (Katz, 1995–96). An important assumption of Katz’s model is that judges (and juries) are not in a position to make a substantive determination regarding optimal reliance. Accordingly, the Learned Hand test is inapplicable (as is any rule that makes liability depend upon a court finding of whether reliance was efficient) and the optimal rule should rather assign liability by following the ‘least-cost-avoider’ paradigm. The least-cost-avoider, in the traditional tort law scenario, is the party able to take precautions to avoid the occurrence of an accident at the least cost. In Katz’s unilateral investment model, the ‘least-cost-avoider’ is usually the party with the greater bargaining power ex post: the party who has the power to modify the terms of preliminary understandings once the reliance investments have occurred. (A typical example of bargaining power ex post is the position of the parties in the famous and groundbreaking case Hoffman v. Red Owl Stores: Red Owl Stores, a supermarket franchisor, promised that if Hoffman, a prospective franchisee, took certain steps
and raised a certain amount of capital, he would be granted a franchise. Hoffman did what he was told but then the franchisor refused to close the deal.)

An element that differentiates Katz’s analysis from most other models of precontractual liability is the relevance given to the ‘time dimension’ of the decision to invest in reliance. Katz interestingly notes that the balance between the benefit of the investment and the risk that the investment will be wasted if no contract is formed changes over time. At the beginning of the negotiation process, the risk of waste is high. Later on, once the parties have had the opportunity to better delineate the elements of the possible transaction, the risk decreases. However, the benefit generated by the investment also decreases in time: presumably, the sooner the investment, the larger the profit. The optimization problem, therefore, should focus on the identification of the optimal moment to begin investing in order to maximize the expected benefit of the transaction. Building on this intuition, Katz concludes that it is optimal to apply promissory estoppel when the non-relying party has the greater bargaining power, \textit{ex post}, so that she will have an incentive to make an offer to stimulate investments when it is optimal to rely. Conversely, if the relying party has the greater bargaining power \textit{ex post} promissory estoppel should not apply. In this situation, the relying party is able to capture the full benefit of the investment, so that incentives to rely at the optimal moment are only attainable by making her also internalize the risk of wasted reliance. (This would be the case if, for example, Red Owl had built a new supermarket in view of the prospective deal. The franchisor would still have the power to dictate the conditions of the deal because the investment made would not be wasted if the parties do not ultimately agree: Red Owl owns a building that can be leased to another franchisee willing to accept Red Owl’s conditions.)

This general unilateral investment model holds under the assumption that both parties are risk neutral and that there is no information asymmetry concerning the cost and the benefit of reliance and the risk of waste. Relaxing these assumptions, efficiency may require different solutions. In particular, risk aversion may lead the parties to rely too late, waiting until they can be almost sure about the successful conclusion of the deal, in order to minimize the risk of waste. Katz argues that the solution suggested by the general model is still valid in this case, but risk aversion can influence the view of who is the ‘least-cost-avoider’: it is efficient in this case to place the risk of wasted reliance on the party that can bear that risk more cheaply. When the parties have different attitudes toward risk, the ‘least-cost-avoider’ may not be the party detaining the bargaining power \textit{ex post}. In the case of asymmetric and imperfect information, moreover, Katz proposes a solution similar to the one individuated by Craswell: the
party with superior information should be held liable for wasted reliance by application of a ‘penalty default’.

One of the most recent law and economics works on precontractual liability is a paper by Lucian Bebchuk and Omri Ben-Shahar (Bebchuk and Ben-Shahar, 2001). They introduce a bilateral reliance model with a major focus on the efficiency of ‘intermediate’ liability rules. An important assumption of the model is that some relevant parameters, necessary for the application of the proposed rules, are judicially verifiable.

The structure of that paper is reminiscent of the structure used in the standard law and economics analysis of tort law. First, the two ‘polar’ regimes, no liability and strict liability, are considered. Under a regime of no liability, each party will under-invest in reliance, because the rule does not allow either of them to fully internalize the benefit of her investment. Conversely, under a regime of strict liability (defined as a rule requiring each party to fully compensate the other party’s reliance investment if a contract is not formed), each party will over-invest, because the cost of her reliance is shifted to the other party.

One of the principal contributions of the paper is the authors’ argument against the diffuse idea that under-investment only occurs when just one party makes precontractual investments. Intuitively, it may seem that when both parties invest in reliance, the problem of under-investment would diminish substantially: what causes under-investment is the risk that the other party will walk away from the negotiations, but if both parties rely, neither would want to walk away because both have something to lose (the precontractual investment that is wasted if the contract is not formed). Bebchuk and Ben-Shahar show that this intuition is incorrect: under-investment is more closely related to the existence of a positive surplus from the transaction than with the risk of a breakdown in negotiations. The surplus depends on the investment of both parties. When the parties’ investments are ‘strategic substitutes’ (the investment of one party reduces the marginal value of the other party’s investment), one party’s investment will be even lower when the other party also invests than when the other party’s investment is zero. Conversely, when the parties’ investments are ‘strategic complements’ (the investment of one party increases the marginal value of the other party’s investment), one party will invest more when the other party also invests. Finally, when the parties’ investments are independent, the investment of one party does not depend on whether or how much the other party invests.

After assessing these results, the authors propose and explore the implications of three different kinds of ‘intermediate’ liability regimes that could potentially produce optimal reliance decisions.

The first proposed rule imposes full liability for precontractual reliance
on a party that bargains in an *ex post* opportunistic manner (that is, by demanding a price that, taking into account the other party’s reliance expenditures, would leave the other party with an overall loss from the transaction). Under this regime, both parties make optimal investments because neither can totally shift her costs to the other, but must bear a fraction of the total cost that is equal to the fraction of the incremental surplus she extracts from the investment.

The second rule is a cost-sharing rule: each party bears part of the total reliance cost (that is, pays for part of the other party’s cost and recovers part of her own cost). In order to achieve efficiency, the sharing formula should be linked to the parties’ respective bargaining power. The rule, therefore, imposes a great informational burden on courts. While conceding that it is not plausible to assume that courts will be able to evaluate the parties’ bargaining power accurately, the authors suggest that a sharing formula that requires the parties to share reliance expenditures evenly could nonetheless reduce distortions produced by polar regimes.

The third and final rule combines a strict liability standard with a ‘capped’ measure of damages. When negotiations break down, each party will be liable regardless of her conduct, but recovery is limited to the part of the reliance cost which does not exceed the hypothetical cost of optimal reliance. If courts can correctly infer the level of optimal reliance, this rule creates incentives for optimal reliance because each party must bear the cost of any further investment beyond the point of optimal reliance, therefore correcting the over-investment problem linked with an unmodified rule of strict precontractual liability.

Omri Ben-Shahar returned to the problem of precontractual liability, analyzed this time from a gap-filling perspective, in a subsequent paper (Ben-Shahar, 2003–2004). Ben-Shahar argues that the mutual assent doctrine, according to which a contract is formed only when the positions of the two parties meet and which creates an all-or-nothing separation between precontractual and contractual stage, no liability and full contractual liability may be too rigid to induce optimal reliance. Instead, the author proposes a ‘no-retraction’ principle, imposing liability as a process of ‘continuous convergence’ for obligations gradually emerging during the parties’ relationship. More precisely, according to the no-retraction principle, a party who manifests a willingness to enter into a contract at given terms should not be able to freely retract that manifestation. The opposing party should have the opportunity to bind the counterpart to her representations. The more innovative suggestion of Ben-Shahar’s article consists in the fact that enforcement of the retracting party’s precontractual representations should be made according to the meaning intended by the retracting party herself. Any gap should be filled with terms most favorable to
the retracting party. Following the economic analysis developed in his previous paper co-authored with Lucian Bebchuk, the author contends that this solution is superior to the traditional principle of mutual consent because it provides incentives for optimal reliance by solving the holdup problem. The most obvious objection to the proposed rule is that it may be suboptimal from the perspective of allocative efficiency: given the option to enforce precontractual representations, the parties may be locked into unwanted contractual relationships, therefore missing the opportunity to maximize the potential surplus. Ben-Shahar addresses this issue and concludes that the possibility that liability could induce an inefficient choice of partner, while real enough, will produce a fairly small expected loss, because the parties should be able to take into account in their reliance decisions the probability that a better partner will appear. According to Ben-Shahar, moreover, the no-retraction principle would produce the additional advantage of providing a more consistent treatment of precontractual agreements, by eliminating the need to draw a defined line between full liability and no liability and introducing instead a burden of liability that is proportional to the ‘intensity’ of the agreement.

Reactions to the novelty of Ben-Shahar’s perspective have been mixed. Ronald Mann expressed mixed appreciation and caution (Mann, 2003–2004), while Jason Johnston arrives at a different cost-benefit result and objects that the inefficiency potentially produced by the no-retraction principle outweighs the efficiency improvements advanced by Ben-Shahar, so that the current legal approach should still be considered superior (Johnston, 2003–2004).

The paper, in all its novelty, is particularly at odds with Wouter Wils’s widely cited contribution on precontractual liability (Wils, 1993). One of the most important conclusions of Wils’s article is that liability should not be attached to the act of breaking off the negotiations. The author delineates two situations in which the precontractual behavior of one or both parties creates inefficiency and/or unfairness and maintains that in those situations, and in those situations alone, the law should supply some kind of liability rule to correct the inefficiency. The first such situation is the one in which one party misleadingly induces the other to incur costs in relation to the prospective contract. When, for instance, one party has superior information on the probability that the deal will go through, she may use this superior information to misrepresent the likelihood of the deal and induce the other party to invest in reliance more than she would otherwise. The incentive to misrepresent comes from the fact that the reliance expenditures that one party incurs, as defined by Wils, increase the surplus of the deal and both parties will receive a fraction of this surplus. Since misrepresentation provokes inefficient reliance investments, the party with
superior information should be deterred by the prospect of liability. Wils is very careful in pointing out that liability for costs misleadingly induced should not be conditional on whether the liable party has broken off the negotiations, because otherwise the parties would have an incentive to wastefully drag out the negotiations to avoid liability. The second problematic situation is the one in which a party makes a costly but efficient investment in anticipation of the deal, from which the other party retains a benefit after the failure of the negotiations. In the absence of liability, the party would not incur such costs because, although the investments increase the final surplus from the deal, they are too expensive for the party to take at her own risk. Here, efficiency calls for a rule imposing restitution of the benefits obtained out of the failed negotiations, to encourage the party to make such efficient but costly investments. Again, liability for restitution should not be linked to the breaking off of the negotiations. Rather, it should be attached to whatever party received benefits from the other party’s action, irrespective of which party has broken off the negotiations. Wils concludes that the common law doctrine of promissory estoppel is able to solve efficiently the problem of misleadingly induced costs and that the doctrine of unjust enrichment efficiently serves the goal of encouraging efficient anticipatory expenditures. A more general rule of precontractual liability is not desirable and the general principle should be, as traditionally in the common law, that losses are left where they fall.

3. Preventing Opportunism

Preventing opportunism and protecting precontractual reliance are actually two sides of the same coin. Opportunism, also known as the hold-up problem, is viewed by most scholars as one of the main causes of the under-investment issue affecting the investment decisions of parties engaged in precontractual negotiations (Bebchuk and Ben-Shahar, 2001). The decision to devote a separate section to opportunism is based on organizational reasons rather than logical necessity. Logically, the issues of preventing opportunism and protecting precontractual reliance are inherently linked. However, the structure of papers focusing on opportunism differs strongly from that of works directly addressing the issue of the protection of reliance. The thread of references evidences that these models are built on the basis of partially different economic ‘fundamentals’.

The opportunism tradition owes much to Oliver Williamson’s delineation of the holdup problem (Williamson, 1979). According to Williamson’s analysis, opportunism is especially relevant in contexts involving relation-specific investments: by making investments which have the potential of increasing the surplus of the relationship but which are sunk if the relationship ends, the parties create a situation of bilateral monopoly, in
which both have incentives to appropriate the gains from contracting. From the new institutional economics perspective, governance structures attenuating opportunism and fostering trust are necessary to achieve economic efficiency. In particular, protection of trust helps to minimize transaction costs.

The necessity to legally protect trust is not unknown to American courts. Some legal scholars went as far as to argue that the true key to understand promissory estoppel case law is to move away from the common ‘reliance protection’ justification and to recognize that the real rationale of the use of promissory estoppel made by the courts is the protection of trust whenever that protection turns out to be socially beneficial (Farber and Matheson, 1985). Although it is probably untrue that the reliance element, as Faber and Matheson have elegantly argued, has become irrelevant in promissory estoppel cases, the emphasis placed on trust protection provides a different perspective on the precontractual liability problem and links the analysis with the economic theory of opportunism.

Opportunism is in fact a behavioral phenomenon of general relevance in contracting relationships. Economic theory traditionally studies opportunism in the context of long-term contracts, employment contracts in particular. However, law and economics scholars, from early on, became aware of the possibility of fruitfully exploiting the theory of opportunism to analyze the problems arising during the precontractual stage. The same mechanism that gives rise to the bilateral monopoly situation in relational contracts is present also in precontractual negotiations settings. From this perspective, regulation of the precontractual stage is appropriate because opportunism undermines trust and raises transaction costs, therefore preventing the formation of surplus-maximizing relationships. Following this line of reasoning, Richard Shell proposed the creation of a new liability rule dealing with opportunism in precontractual negotiations (Shell, 1991). Shell first exposes the ‘dilemma of trust’. Trust is beneficial because it lowers transaction costs, therefore increasing the payoff obtainable from the transaction. On the other hand, abuse of trust makes the trusting party worse off than if she had not trusted to begin with. The parties in precontractual negotiations are thus playing a prisoner’s dilemma game, in which the unique Nash equilibrium is for both to adopt a distrust strategy. This outcome is suboptimal because it limits the possible gains from the transaction for both parties. An optimal regulation should give incentives to adopt a trust strategy instead. Shell contends that non-legal mechanisms, such as damage to one’s reputation, are insufficient to foster trust and that in principle the costs of legal intervention are outweighed by its benefits. However, the legal doctrines currently available to protect trust in the precontractual stage are unnecessarily costly and complicated. Shell
explores possible alternatives. He concludes that imposition of a general duty of good faith in precontractual negotiations, parallel to the corresponding duty already existing for the contractual stage, is impractical: the vagueness of the standard would allow courts to go beyond the goal of punishing opportunism, succumbing to the temptation of punishing also any other conduct they consider unethical. A better alternative, according to Shell, would be the creation of a new liability regime designed specifically for the precontractual stage and allowing the victim of opportunistic behavior, even in the absence of a specific promise, to recover the costs of her relation-specific investments, with the exclusion of normal negotiation costs.

The distinct relevance of the theory of opportunism is well evidenced by Cohen (Cohen, 1991–92). Considering the question of which party should bear the sunk costs associated with contract breach, Cohen distinguishes two different traditions of contract law analysis: the ‘least-cost-avoider’ tradition and the opportunism tradition. The former tradition, first elaborated in the context of tort law, suggests assigning the costs to the party that can bear them more cheaply, because its principal goal is preventing negligent behavior. Contrarily, the opportunism tradition places the costs on the party that acts opportunistically, with the purpose of preventing opportunistic behavior. Analyzing this tradeoff, Cohen argues that the ‘least-cost-avoider’ paradigm does not work well in contract law. In contract contexts, the decision not to take precautions to minimize sunk costs in the event of a breach is in most cases intentional and strategic, not negligent. Therefore, at least when it is not possible to achieve both goals contemporaneously (that is, because the least-cost-avoider and the opportunistic party are not the same person), the goal of deterring opportunism should prevail. In line with the new institutional economics’ call for legal regulation of opportunistic behavior, Cohen concludes that contract law should grant a bigger role to the goal of deterring opportunism. Opportunism is costly for society because, by killing trust between the parties, it prompts them to spend more on precautions. Although the scope of Cohen’s analysis generally embraces the contractual stage, Cohen’s referring to Williamson’s description of the bilateral monopoly situation, in which parties find themselves after the decision to make relation-specific investments, acknowledges that the potential for opportunism may arise even before any commitment has been made. Indeed, in the precontractual stage, the parties are more vulnerable and opportunism is more profitable. Therefore, Cohen’s results can be considered to hold even in the context of precontractual negotiations.

Another model based on transaction costs economics and the opportunism tradition is the one elaborated by Kostritsky (Kostritsky, 1993).
Kostritsky first develops a bargain model: preliminary negotiations involve elements of uncertainty, moral hazard and sunk costs, which give rise to a potential for opportunistic behavior. Because of bounded rationality, which is inseparable from the uncertainty that characterizes the precontractual stage, opportunism cannot effectively be curbed by explicit contract clauses, so that a legally supplied default rule is justified. To solve the opportunism problem, Kostritsky proposes the adoption of new default rule for the precontractual stage. This default rule should recognize an ‘implicit bargain’ and impose an obligation to perform according to its terms. The form of this implicit bargain in the precontractual stage would essentially be a promise to keep the counterpart informed of any change in the willingness to reach a definitive agreement and an assumption of liability for any step adopted by the counterpart before that communication of change of heart. Kostritsky contends that this formulation is probably the most similar to the one the parties would have agreed on in the absence of the high transaction costs present in the precontractual stage. This approach attempts to efficiently deal with opportunism by promoting trust and stimulating reliance investments, while at the same time avoiding the disincentive to enter negotiations that would follow a rule mandating enforcement of the definitive promise to conclude the contract. In other words, the proposed rule can be characterized as an ‘interim liability rule’, not linked to the final transaction, but still able to capture the externalities problem (Kostritsky, 1997). The relevance of the opportunism problem is also evidenced by courts’ rulings on promissory estoppel cases, whose outcomes can be rationalized on the basis of opportunism deterrence (Kostritsky, 2002). Kostritsky’s approach is further refined in a subsequent paper, in which the author also introduces some behavioral economics insights (Kostritsky, 2004).

4. Fostering Efficient Information Exchange or Information Gathering
The law and economics literature usually attributes two basic functions to contract law: the optimization of the incentives to perform and the optimization of the incentives to rely. A third function of contract law, which has traditionally received less attention, is the optimization of incentives to gather information on the probability of performance and to disclose that information efficiently. The remedies for breach of contract can be calibrated in such a way as to address the informational issue (Craswell, 1988, 1989). Those remedies, however, are available only once a contract has been formed. To stimulate optimal information disclosure in the precontractual stage, an independent basis for liability might be necessary. During precontractual negotiations, the parties exchange information in order to determine the worthiness of the proposed deal. Although the
negotiation process is mostly conflictual, the parties have a common interest in a truthful exchange of information, because it allows them to save negotiation costs when a deal turns out not to be profitable for one or for both. The recognition of this mutual interest in information disclosure suggests that the information issue in the precontractual stage could also be analyzed from the point of view of cheap talk economics (Johnston, 1999). Johnston shows that the parties’ mutual interest in minimizing the cost of useless negotiation can generate private incentives for informative cheap talk, in the absence of liability. However, when the parties perceive their interests as strictly in conflict, a message that is costless to send is not credible. Thus, there are circumstances, that is, when a seller with relatively high costs deals with potential buyers who have relatively high costs of investigating and bargaining, in which potential legal liability for unfulfilled optimistic talk (which now is no longer ‘cheap’) may be necessary to create an incentive for informative precontractual communication. Applying his carefully developed model to existing legal doctrines, Johnston concludes in favor of the efficiency of the use the courts made of promissory estoppel. According to his case-law analysis, what triggers liability in promissory estoppel cases is not just reliance, as commonly believed, but performance: courts impose liability if and only if the speaker has made an optimistic statement, observed that performance follows, and remained silent, failing to discourage further performance. This approach provides efficient incentives to disclose one’s actual beliefs as to the probability of a deal. The prospect of liability for the partial performance forces a pessimistic party to engage in informative talks when she would not otherwise do so.

5. Other Issues Related to Precontractual Liability

5.1. Incentives to Enter Negotiations
As critics of precontractual liability have pointed out, the imposition of some kind of liability for conduct prior to the formation of a contract may have negative effects on another relevant category of incentives: the incentives for the parties to enter into negotiation in the first place. Potential liability may increase transaction costs and discourage people from negotiating, even when the transaction, if successful, would have created a positive surplus. As Farnsworth pointed out, the traditional common law’s aleatory view of negotiations ‘rests upon a concern that limiting the freedom of negotiation might discourage parties from entering negotiations’ (Farnsworth, 1987). To better support their call for a form of precontractual liability, various authors have put some effort into trying to rebut the reasoning behind this concern.
Bebchuk and Ben-Shahar dedicate the last part of their analysis to addressing the issue of whether precontractual liability (in any of the possible forms delineated in their paper) might discourage the parties from entering negotiations (Bebchuk and Ben-Shahar, 2001). Assuming that transaction costs are zero, a party will enter negotiations only if her expected gain from the transaction (that is, the expected contractual profit less the cost of reliance and the cost of precontractual liability) is positive. The two ‘polar regimes’ of no liability and strict precontractual liability may induce the parties not to enter negotiations even when the contract that such negotiations will produce has a positive surplus. The inefficient level of reliance that such regimes produce prevents the parties from achieving the potential surplus. From this perspective, therefore, it is impossible to say that a rule imposing liability for precontractual reliance will certainly lead to fewer negotiations. The rule of capped strict liability, proposed as an ‘intermediate’ rule by the authors, shares part of the inefficiency of the ‘pure’ strict liability rule: since a party bears a fraction of the total costs which differs from the fraction of the benefit she can extract, in some situations she may get a negative payoff even if the total net surplus is positive. In such cases, she will not enter negotiations. Conversely, the other two ‘intermediate’ rules described (the one imposing liability for \textit{ex post} opportunism and the cost-sharing rule) link the fraction of the total costs that a party must bear to the fraction of the benefit she is able to internalize. Consequently, under these rules, parties will enter negotiations whenever there is a potential surplus obtainable from the transaction. As long as the precontractual liability rule is carefully designed, therefore, the threat of a negative impact on the incentives to enter negotiations is not a concern.

Ben-Shahar further considered the issue and pointed out, first, that precontractual liability’s chilling effect on the incentive to enter negotiations may be desirable in all the cases in which the parties begin negotiating for reasons different than to transact (a situation which is not uncommon and which has traditionally been one of the main territories of application of promissory liability devices; Ben-Shahar, 2003–2004). But even if the parties negotiate with the intent to conclude a surplus-maximizing transaction, the proposed no-retraction principle will enhance, rather than diminish, their willingness to negotiate, because it provides the parties with some assurance that neither of them can exit unilaterally.

Schwartz and Scott openly admit that a chilling effect on the parties’ willingness to enter negotiations is present whenever the traditional rule of no precontractual liability is modified (Schwartz and Scott, 2007). However, they argue that this effect will not pose a serious danger as long as courts follow their suggestion to recognize a binding preliminary...
commitment only if three specific elements are present: an intention to pursue a profitable project, a division of investment tasks, and an agreement on an investment sequence. Both parties would want to commit in order to increase the surplus available from negotiations, which is fostered by efficient incentives to invest. Moreover, since the liability regime they advocate is a default, a party who is unwilling to commit can always contract out.

5.2. Selection of the Optimal Damage Measure
As is the case with contractual liability, the efficiency of any precontractual liability regime may be influenced by the measure of damages coupled with it. Some authors dismiss this issue as unimportant. Avery Katz, for instance, says that the dispute on whether the expectation or the reliance measure of damage should be applied in promissory estoppel cases can be regarded as a secondary issue, because both measures fully insure the promisee against wasted reliance (Katz, 1995–96).

Although many authors, following Fuller and Perdue's well-established principle that when liability is based on reliance, compensation should be based on reliance damages (Fuller and Perdue, 1937), seem to imply that compensation for reliance expenditures should follow a finding of precontractual liability, in some papers the issue is explored specifically and with more depth of analysis.

Farnsworth, to support his conclusion that the existing legal doctrines have the potential to efficiently protect parties in the precontractual stage, identifies a judicial trend to include compensation for ‘lost opportunity’ in the calculation of the generally applied reliance interest (Farnsworth, 1987). According to the author, this damage measure would be the key to a more extensive use of the doctrine of promissory estoppel in precontractual settings, because it would render precontractual claims substantial enough to justify litigation.

Craswell argues that there is no economic rationale to prefer compensation of the reliance interest to other damage measures (Craswell, 1996). Most damage measures, in fact, will give the parties incentives to rely too much, and the reliance measure could prove to be the worst of all in this respect. Instead, the proper damage measure should take into account all relevant economic variables that may be affected by the magnitude of compensation, in particular risk-bearing costs, incentives to search for contracting partners, and incentives to investigate the profitability of the proposed deal. The preference for the reliance measure identified in the literature is probably motivated by the fact that the reliance measure is the minimum measure necessary to give optimal incentives to rely. However, parties in some situations may be willing to commit themselves to a larger
Precontractual liability

damage measure, for example in order to give their partner a positive signal of their willingness to conclude the deal. These observations seem to suggest that the choice of the optimal damage measure is possible only by carefully considering each particular set of case facts, so that it is neither desirable nor feasible to formulate a single, general, solution.

A similar intuition, that the proper damage measure depends on the specific goals that need to be addressed in different contexts, can also be found at the basis of Ben-Shahar’s argument (Ben-Shahar, 2003–2004). The author presents his no-retraction principle as a liability rule that can be coupled with different damage measures ‘depending on the underlying objectives that the remedy seeks to promote’. In the context of precontractual liability, where the social objective is to induce efficient reliance despite the risk of holdup, however, Ben-Shahar specifically suggests that the reliance measure should apply.

5.3. The Over-investment Problem

If the most commonly highlighted drawback of the traditional principle of freedom of negotiation is the under-investment problem, its counterpart is an over-investment problem that would arise, according to some commentators, when precontractual liability is imposed.

Schwartz and Scott suggest that a partial solution to this problem is to allow the relying party to recover just its ‘verifiable’ reliance costs when the other party breaches the precontractual agreement (recall, in fact, that Schwartz and Scott justify precontractual liability only for breach of a precontractual agreement having some specified characteristics) (Schwartz and Scott, 2007). The solution is only partial, however, because, as proven in a formal appendix at the end of their paper, there is no analytical answer to the question of whether a party will over-invest under a regime of precontractual liability. The answer depends on the particular values assumed by the relevant variables. By allowing just recovery of verifiable costs, the problem is nonetheless limited. Schwartz and Scott conclude that the proposed liability rule will cause over-investment only if an improbably large fraction of the reliance costs is verifiable and the probability of breach is unrealistically high.

According to Craswell, the over-investment problem is eliminated if one accepts the possibility that courts can correctly assess the efficient level of reliance that a party should adopt in a specific case. Courts should refuse to impose liability whenever they find that the relying party had acted ‘unreasonably’ by relying too much (Craswell, 1996).

An original view on the over-investment problem, and on precontractual liability in general, is the one expressed in a recent paper by Grosskopf and Medina (Grosskopf and Medina, 2007). These authors challenge
the traditional idea that the absence of legal regulation would produce under-investment in the precontractual stage. Instead, they argue that, if the parties operate in a relatively competitive market, competition is often sufficient to stimulate optimal investment decisions. The analysis shows that the real problem affecting the precontractual stage is the fact that a party may have incentives to push the other to over-invest. This perspective, which demonstrates the importance of taking into account market structure, suggests that legal regulation may be necessary in some circumstances, not to prevent under-investment, but rather to deter over-investment.

6. Conclusion

The analysis of the mechanisms and of the behavioral aspects of parties engaged in precontractual negotiations can still be considered an underdeveloped field in law and economics. The issues related to precontractual liability are surrounded by a veil of confusion both in the case law and in the academic scholarship. However, law and economics scholars have made several important contributions over the years. By drawing upon a large array of different economic theories, these scholars have in various ways improved the understanding of the precontractual stage as well as of the functioning of a number of important contract law doctrines. Although the absence of a commonly accepted framework of analysis has probably prevented precontractual liability from claiming its deserved place in general law and economics treatises, the issue, if not popular, certainly has not failed to stimulate a productive debate.

The ambiguousness of American courts’ attitudes toward precontractual liability has substantially increased the difficulty of identifying a commonly accepted analytical perspective. To achieve a better understanding of the underlying economic issues, it would probably be necessary to sever the analysis from the outcomes of judicial decisions and to forget for the moment the idiosyncratic aspects of American common law. Comparative law could be of some use. Precontractual liability is in fact one of the legal issues on which, at least in principle, common law and civil law systems differ the most. The civil law tradition has long recognized liability for precontractual misconduct. A rigorous economic analysis of the rules developed in civil law jurisdictions to address precontractual negotiations’ problems could help to clarify the structure and advance general understanding of the issue.

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Contract law and economics

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