PRECONTRACTUAL LIABILITY

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For decades, there has been substantial uncertainty as to the circumstances under which the law will impose liability when the parties have had some negotiations, but had not reached agreement on a fully binding contract, and one of the parties refuses to go further. The law’s confusion is partly due to the scholars’ failure to recover the law in action governing precontractual liability issues. We show first that no liability attaches for representations made during preliminary negotiations. There is uncertainty when the parties make reliance investments following a “preliminary agreement”: that is, they sink costs in the pursuit of a project under an agreement that is too incomplete to enforce, and one of the parties later prefers to exit rather than pursue the contemplated project. Courts have been divided over the question of liability for breach of these preliminary agreements, but a number of modern courts impose on the party wishing to exit a duty to bargain in good faith. Substantial uncertainty remains, however, as to when this duty attaches and what the duty entails. The judicial uncertainty arises, we claim, because key questions have not been satisfactorily answered: Why do parties make such incomplete contracts, then rely before uncertainty is resolved and finally disagree over cost reimbursement when both recognize that their project would be unprofitable? We develop a model which shows that parties create “preliminary agreements” rather than complete contracts when the project they explore could take a number of forms, and the parties are unsure at the outset which form would maximize profits. A preliminary agreement roughly allocates investment tasks between the parties, specifies investment timing and commits the parties only to pursue a profitable project. Parties sink costs in a project because investment accelerates the realization of returns and illuminates whether any of the possible project types would be profitable. A party to a preliminary agreement “breaches” when it delays its investment beyond the time the agreement specifies. Delay will save costs for this party if no project turns out to be profitable and improves this party’s bargaining power in the renegotiation to a complete contract if a project would succeed. Delay often disadvantages the promisee, but the main inefficiency is ex ante: When parties anticipate such strategic behavior, the likelihood that they will make preliminary agreements is materially reduced. This is unfortunate because the performance of a preliminary agreement often is a necessary condition to the creation of a complete contract and the subsequent realization of a socially efficient opportunity. Thus, contract law should encourage relation-specific investment by awarding verifiable reliance costs to a party to a preliminary agreement if its partner has strategically delayed investment. We study a large sample of appellate cases that deal with reliance prior to the signing of a complete contract. This study reveals that (a) parties appear to make the preliminary agreements we describe and breach for the reasons our model identifies; and (b) courts sometimes protect the disappointed party’s reliance interest when they should, but the courts’ imperfect understanding of the parties’ behavior leads them to err.

I. INTRODUCTION

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For at least 50 years, a particular pattern of commercial behavior has engendered considerable litigation and substantial scholarly commentary. Two commercial parties agree to attempt a transaction, and agree also on the nature of their respective contributions, but neither the transaction nor what the parties are to do are precisely described, and may not be written down. The parties do not agree (they may not attempt to agree) on important terms such as the price. After the parties agree upon what they can agree upon and *before* uncertainty is resolved, one or both of them make a sunk cost investment.¹ This pattern of commercial behavior suggests that the parties have made a “preliminary agreement” that has two legally salient understandings: First, if a transaction turns out to be profitable after uncertainty is resolved, the parties will make their agreement more concrete, and then conduct the transaction. Second, if a transaction turns out to be unprofitable, the parties will abandon the project. Disputes sometimes arise under these preliminary agreements, however, when, after investment, the parties observe the actual ex post state of the world. Then one party may abandon the project though the other party protests the fact or the circumstances of the first party’s exit. In particular, the disappointed party believes that he is entitled to compensation for acquiescing in exit while the other party believes that she is entitled to exit without liability. Courts must then decide whether to protect the promisee’s² expectation, or to reimburse the promisee’s sunk costs (to protect his reliance interest), or to award him nothing.

The outcomes in these cases have been poorly understood by legal scholars and practicing lawyers. This is partly because the legal doctrines that address issues in the preliminary agreement cases are also invoked to support unrelated claims for the recovery of precontractual reliance damages.³ As a consequence, the governing criteria when reliance on a

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¹A sunk cost or relation specific investment is partly or totally nonredeployable. For example, steel rods ordered for a project are redeployable because a party can sell them on the market; rods that are fabricated into particular shapes would not be redeployable if the shapes were specific to the contract parties’ needs.

²For convenience, we refer to the party who seeks damages or to continue the deal as the promisee.

³The legal rules that have evolved to treat claims of precontractual liability travel under a confusing array of legal doctrines. Courts are typically asked to protect the promisee’s reliance on the enforceability of an incomplete bargain against the alleged promisor’s insistence that no contract had been made. The promisee typically alleges multiple grounds for relief including misrepresentation, unjust enrichment, promissory estoppel, implied contract
preliminary agreement is an issue have been obscured. The first task, therefore, is to categorize more precisely the commercial patterns and the associated legal rules that control precontractual liability.

Parties will have made a “fully binding contract” when they have agreed on all material terms and realized their agreement in a final written document. If the parties have not yet reached a fully binding contract, their negotiations will fall into one of three categories: (1) The parties have not agreed to a deal, but have only discussed a deal. In this event, the disappointed party can recover nothing.4 (2) The parties have agreed on all material terms, and intended to memorialize this agreement in a formal document. In the interval between agreement and memorialization, the promisor has had a change of heart. Courts treat this type of agreement as a fully binding contract when the evidence supports a finding that the parties did not intend the formalization of their agreement to be essential.5 As is usual with binding contracts, courts protect the promisee’s expectation interest. (3) The parties have made a preliminary agreement as defined above; that is, they have agreed on certain terms but left other terms open, so that the best inference from their negotiations is that they have made a “binding preliminary commitment” to pursue a profitable transaction. Here the emerging legal rule requires parties to
such preliminary agreements to bargain in good faith over open terms. Should the promisor – the party who prefers to exit – fail to bargain in good faith, she will be liable for the promisee’s reliance expenditures. The parties are not required to agree to a deal, however, because their preliminary agreement does not commit them to pursue an unprofitable project. In this article, we ask whether the new rule governing these binding preliminary commitments is justifiable.

This normative question is unresolved because the positive question – why parties engage in these transactions – also is unresolved. A decision maker cannot regulate a transaction intelligently without understanding why parties engage in the transaction. The behavioral pattern that is reflected in these preliminary agreements has never been plausibly explained. There are three open questions: First, parties often write complete contracts, or as complete contracts as they can, before they make relation specific investments. Why do parties in this context make preliminary agreements? Second, while it sometimes is infeasible for parties to write a complete contract at the beginning of their relationship, it does not follow that they must sink costs in what may turn out to be an unprofitable venture. A common alternative is to delay contracting until the ex post state of the world becomes clear. Why did these parties invest in the interval between making the preliminary agreement and when uncertainty was resolved? Third, parties would not invest in this interval unless the expected value of investment was positive. Investments are sunk when uncertainty dissipates, however, so the fact of investment will not cause the parties to pursue a deal that would lose money. How then, if both parties realize that exit is best, could one of them have a plausible expectation that the other would reimburse his

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6This rule originated with the opinion by Judge Leval in Teachers Ins. & Annuity Assoc. v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987). Currently, the Leval framework has been followed in at least thirteen states, sixteen federal district courts and seven federal circuits. See TAN infra. Regarding other countries, England does not award any remedy before a complete contract has been made. It is more common to impose a duty of good faith in conducting negotiations or, as in France, to regulate precontractual behavior under the law of tort. Liability for costs incurred is sometimes awarded under these rules but, apart from easy and unusual cases such as a party entering into negotiations when he has no intention of making a contract, foreign law seems as uncertain and in need of guidance as the law here. For sources, see Paula Gilker, A Role for Tort in Pre-Contractual Negotiations? An Examination of English, French and Canadian Law, 52 Int. & Comp. Law Quarterly 969 (2003); PRECONTRACTUAL LIABILITY: Reports to the XIIIth Congress International Academy of Comparative Law (Ewoud H. Hondius, ed. 1990).
sunk costs in the absence of a specific promise?\footnote{Litigated preliminary agreements do not settle the issue of reimbursement for sunk costs when deals are abandoned.}

Our article is the first to address these three questions as a set.\footnote{In Avery Katz’s interesting article, a party relies early because the value of the contemplated project declines over time but the parties do not contract because an exogenous event – an embargo, for example – made contracting infeasible. See Avery Katz, \textit{When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations}, 105 Yale L. J. 1249 (1996). The parties, however, could have written a force majure clause, which would have regulated their affairs if the event occurred. Also, Katz implicitly assumes that reliance is verifiable to a court; otherwise, a court could not protect the promisee’s reliance interest. If parties expect that reliance is verifiable, however, they can contract on reliance initially: that is, the promisor can purchase the promisee’s investment by agreeing to compensate him if a deal turned out to be impossible. In Lucian Bebchuk and Omri Ben-Shahar’s model, reliance also is verifiable and thus the parties could have contracted on reliance directly. Moreover, there is no explanation as to why the parties in their model relied before uncertainty was resolved. See Bebchuk and Shahar, supra note 3.}

In the model we analyze, the parties make a preliminary agreement because they cannot write a complete contract at the outset: They function in a complex environment in which a profitable project can take a number of forms, and just which form will work, if any, is unknown at the start. Parties invest in the interim period because early investment accelerates the realization of returns. The sooner the factory is built, the earlier profits will be realized. More importantly, investment clarifies what type of project could succeed. For example, an investment in learning market conditions may reveal which type of widget is likely to sell. The combination of increased knowledge about a project’s prospects that investment yields, and knowledge of the state of the world in which any project must be pursued that time reveals, makes a profitable project sufficiently tangible to support a complete contract.\footnote{The model we analyze thus attempts to answer, in the preliminary agreement context, an important contract theory question: “What can contracts achieve when actions are contractible ex post but not ex ante, especially in ‘complex’ environments?” PATRICK BOLTON & MATHIAS DEWATRIPONT, \textit{CONTRACT THEORY} 572 (2005).}

To see how a promisee can have a justifiable grievance, we later show that in some deals expected surplus would be maximized if the parties invested sequentially while in other deals
surplus would be maximized if the parties invested simultaneously. An efficient preliminary agreement to invest simultaneously may be unstable, however. The promisor has an incentive to defect from any such agreement by delaying her decision whether to invest until after the promisee has invested. The promisor benefits from defection if the project turns out to be unprofitable because she will not have sunk costs in a losing deal. Alternatively, if the project turns out to be profitable, the parties’ complete contract will compensate the promisor for the investment costs the project requires her to make, but that contract will not reimburse the promisee for costs he already had incurred. Defection from a preliminary agreement to invest simultaneously thus materially disadvantages the promisee. We therefore characterize a promisor’s defection as a breach. Promisees can reasonably expect their promisors not to breach.

It is efficient for contract law to protect the promisee’s reliance interest if his promisor deviated from an agreed investment sequence. A reliance recovery will encourage parties to make preliminary agreements and deter some strategic behavior. Therefore, the new rule governing preliminary agreements – awarding the promisee reliance if the promisor fails to bargain in good faith but not requiring the parties to agree – is a step in the right direction. The law cannot protect the promisee’s expectation interest because, in the contexts under study, there is no complete contract to enforce.

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10 The phrases simultaneous and sequential investment are partly metaphoric. The model below applies whenever both parties’ investments are needed to make a project successful but one of them has a greater ability than the other to delay a material portion of her work.

11 After the promisee’s investment is sunk, and the parties learn that the project will be successful, they will bargain to divide the expected gains from a successful project. At this point, the promisee cannot credibly threaten to exit unless his investment costs are reimbursed. If the promisor refuses to pay for those costs, the promisee’s options are to exit and receive no contribution toward his costs, or to accept a share of the expected gain and thus to recover some or all of them. The promisor will recognize that it would be irrational of the promisee to exit and so she will refuse to pay. In contrast, the promisor has a credible threat to exit unless the bargain compensates her for costs she has yet to incur. Her payoff would be zero if she exits rather than the negative sum of uncompensated costs. Thus, the ex post bargain, when the promisee invests first, will reimburse only the promisor’s costs. We develop the implications of this conclusion in the model below.

12 Sunk costs, we argue below, often become more tangible as projects proceed.

13 Complete contracts do not exist in the appellate cases.
The new legal rule is deficient, however, because it is unnecessary to require parties to bargain in good faith. As we show, efficiency would be sufficiently enhanced were the law simply to protect the promisee’s reliance interest. Further, if the duty to bargain is thought justifiable, the cases do not indicate what the parties should bargain about. Rational parties will pursue efficient projects and abandon inefficient projects. They will disagree, if at all, over whether a party should be compensated for a reliance expense. The parties thus should bargain over whether a timing promise had been breached, and if so what fraction of the injured party’s reliance should be reimbursed.\footnote{A promisor’s refusal to discuss whether or not the parties should transact should not be a violation of the duty to bargain in good faith because the parties will transact when they ought to (and not otherwise). Further, as we discuss in Part IIB, the cases are unclear as to when parties have made a preliminary agreement. We argue in Part IID3 that a binding preliminary commitment should be found when the parties have agreed in broad terms on engaging in a joint project; divided the investment tasks, although on a high level of abstraction (John is to prepare a construction site and Mary is to solve the supplier problem); and, most importantly, have agreed on the rough order in which their investments are to be made. This third requirement serves two functions. First, the promisor should not be held liable for delaying her investment unless the parties had agreed to invest simultaneously. Hence, a court must be able to recover the parties’ agreement as to the timing of planned investments. Second, an agreement on the timing of investment is a good proxy for an intention to be legally bound; parties are unlikely to have gone so far had they no such intention.}

The Article proceeds as follows. In Part II, we examine a sample of cases involving early reliance investments in order to recover the law in action regarding precontractual liability. This Part shows that courts require some joint intent to be bound before awarding any damages. Part III presents a model of the commercial pattern described above. We show how the model answers the three positive questions, and formally derive the normative implications just summarized. Part IV compares the model to a sample of the leading cases, in order to evaluate the fit between our results and the commercial patterns revealed in court opinions and to consider how our normative recommendations were (and should have been) applied. Part V is a conclusion that briefly highlights our principal result: Courts can facilitate commercial behavior not only by enforcing complete contracts, but also by attaching legal weight to preliminary agreements. These agreements commonly are exploratory: that is, the performance of a preliminary agreement sometimes is a necessary condition for parties later to pursue an efficient project.
II. RECOVERING THE LAW OF PRELIMINARY AGREEMENTS

A. Rethinking the Conventional Understanding of Precontractual Liability

The conventional wisdom among contemporary scholars is that courts will sometimes impose liability for reliance investments undertaken prior to any agreement between the parties.15 Treatise writers identify as grounds for such enforcement the existence of unjust enrichment, a specific promise made and relied upon during the negotiation process, and a “general obligation arising out of the negotiations themselves.”16 But even a casual survey of contemporary case law casts significant doubt on the accuracy of that conventional view. Courts actually make some form of agreement a necessary condition to promisee recovery. The real issues are when an agreement will be found and how the nature of the agreement will determine the type of damages a promisee can recover.

Much of the confusion can be traced to the frequently taught case of Hoffman v. Red Owl Stores.17 Hoffman and Red Owl engaged in extensive negotiations and preparations aimed at Hoffman opening a Red Owl franchise. In the course of these negotiations, Red Owl officials recommended that Hoffman take numerous financial and nonfinancial actions. He followed these recommendations because the officials also assured him that $18,000 would be a sufficient capital investment. Thereafter, Red Owl developed several financing proposals, the last of which required Hoffman to contribute $34,000 of debt and equity. In response, Hoffman broke off negotiations and sued Red Owl to recover his sunk costs. The court found as a fact that the parties never

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15 See e.g., E. Allan Farnsworth, Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations, 87 Colum. L. Rev. 217 (1987). (“In recent decades, courts have shown increasing willingness to impose precontractual liability... unjust enrichment resulting from the negotiations, misrepresentations made during the negotiations, and specific promises during the negotiations, have been recognized by courts in the United States....”); Michael B. Metzger & Michael J. Phillips, The Emergence of Promissory Estoppel as an Independent Theory of Recovery, 35 Rutgers L. Rev. 472, 496-97 (1983) (“It is clear that promissory estoppel has been used to enforce promises too indefinite or incomplete to constitute valid offers.”); RALPH B. LAKE & UGO DRAETTA, LETTERS OF INTENT AND OTHER PRECONTRACTUAL DOCUMENTS 177 (“Liability for action during the precontractual stage of a transaction may be based on the obligation to bargain and to negotiate in good faith.”); Restatement (Second) of Contracts §205, comment c (1981) (“Bad faith in negotiations ... may be subject to sanctions.”).

16 Farnsworth, Precontractual Liability, supra note 15, at 229-243.

17 133 N.W. 2d 267 (1965).
reached agreement on essential factors necessary to establish a contract. As examples, they had yet to agree on any of the details concerning Red Owl’s investment, such as the size, cost, design and layout of the store, nor had the parties agreed on the terms of the lease, including rent, maintenance, renewal and franchisee purchase options. Indeed, the parties never agreed on just what was meant by the statement that $18,000 of capital would be sufficient investment to sustain a franchise. Thus, the court held, there could not be basis of the bargain liability. Nevertheless, the court permitted Hoffman to recover sunk costs based on the doctrine of promissory estoppel, as expressed in §90 of the Restatement of Contracts. The court held that under this doctrine, a “promise” – here Red Owl’s assurances that $18,000 was a sufficient investment – need not be as definite in its terms as a promise that is the basis of a traditional bargain contract.

Nothing in the law of contracts supports this legal analysis. To the contrary, the Restatement has only one definition of a promise, and that definition applies equally to a promise that is the product of a bargained for exchange and a promise for which enforcement is sought on the grounds of induced reliance. Hoffman thus is wrong as a matter of doctrine. More
importantly, it is an outlier; the case has not been followed in its own or other jurisdictions.\textsuperscript{23} Thus, a recent case applying the Wisconsin law that governed Hoffman refused to award reliance damages on a promissory estoppel claim under similar facts; rather, the court required evidence that the defendant had induced a benefit by trick.\textsuperscript{24} Courts in other jurisdictions have established similarly strict limitations for imposing promissory liability based on representations made during

\textsuperscript{22}Commentators have offered alternative theories of liability that would support the Hoffman result. Some have argued that the decision can be grounded in a new duty to bargain in good faith. See, e.g., Duhl, supra note __, at 315-21; PATRICK ATIYAH, PROMISES, MORALS, AND LAW 80-92 (1981); Charles Knapp, Enforcing the Contract to Bargain, 44 N.Y.U. L. Rev. 673, 686-90; Robert Summers, Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 225 (1968). This theory is embarrassed by the absence of any evidence of bad faith by Red Owl officers. At most, Red Owl’s agent was careless in not inquiring further as to what Hoffman meant when he said he could contribute about $18,000. Hoffman, however, was much more careless than this because every Red Owl financial proposal listed Hoffman’s $18,000 equity contribution as exclusive of any additional debt needed to sustain the franchise. The proposed cash requirements for the franchise increased over time, but the equity requirements remained largely fixed; the additional proposals that required cash were loans that Hoffman could repay if the larger estimated cash flow turned out not to be necessary to run the grocery business.

A more plausible doctrinal claim for Hoffman might have been either for negligent misrepresentation (based on the claim that authorized Red Owl officials carelessly represented that $18,000 of capital would be adequate to support a franchise) or for unjust enrichment based on quasi-contract since by his actions Hoffman gave Red Owl valuable information regarding his future prospects as a franchisee. There are many problems applying either of these theories in arms length bargaining contexts, however. Imposing liability for the casual statements and contacts that are prevalent in business could chill contracting. Hence, the majority rule imposes liability for negligent misrepresentation in commercial contexts only where the party making the statement possess unique or specialized expertise or is in a special relationship of trust and confidence with the injured party such that this party could justifiably rely on the misstatement. See, e.g., Eternity Global Master Fund, Ltd. v. Morgan Guar. Trust Co. Of N.Y., 375 F. 3.d 168 (2d Cir. 2004). Similarly, unjust enrichment claims rarely succeed unless the defendant specifically and wrongfully induced the benefit. A claim for unjust enrichment does not lie simply because one party benefits from the efforts or obligations of others, but instead “it must be shown that a party was unjustly enriched in the sense that the term ‘unjustly’ could mean illegally or unlawfully.” See e.g., First National Bank of St. Paul v. Ramier, 311 N.W. 502, 504 (Minn., 1981); Greg Fimon v. Kenroc Drywall Supplies, Inc., 203 Minn. App. Lexis 311 (Minn 2003). Scott, Myth, supra note 18, at 23-27.

\textsuperscript{23}Farnsworth, supra note 16.

\textsuperscript{24} Beer Capitol Distributing, Inc. v. Guinness Bass Import Co., 290 F.3d 877 (7th Cir. 2002) (denying both promissory estoppel and unjust enrichment claims based on reliance during negotiations on defendant’s representation that he would recommend that plaintiff be chosen as the exclusive distributor for southeastern Wisconsin). See also Lake Michigan Contractors, Inc. v. The Minioowoc Company, Inc., 2002 U.S. Dist. Lexis 9547 ( W.D. Mich 2002) (plaintiff’s promissory estoppel claim fails because the evidence regarding the parties objective manifestations demonstrates that there was no meeting of the minds between the parties on a “not to exceed” agreement).
the negotiation process.\textsuperscript{25}

In order systematically to evaluate how contemporary American courts actually treat reliance investments made before the parties have written a complete contract, we analyzed a sample of 108 cases litigated between 1999 and 2003 that directly presented the issue of recovery for precontractual reliance.\textsuperscript{26} Our goal was to disaggregate the precontractual reliance cases by uncovering the commercial patterns that generated litigation and identifying the legal consequences courts attached to those patterns.

The cases in our sample fell into four patterns, each of which produced a different judicial outcome. (1) Thirty cases raised the issue of reliance in the context of ongoing negotiations. These cases thus posed the question whether the plaintiff could recover reliance costs even when the parties had not reached any agreement. The courts denied liability, whether based on promissory estoppel or quantum meruit, in 87\% of these preliminary negotiation cases.\textsuperscript{27} The case

\textsuperscript{25}In R.G. Group v. Horn & Hardart Co., 751 F.2d 69, 71 (2d Cir. 1984), the court underscored the baseline requirement that a claim for promissory estoppel for early reliance requires a “clear and unambiguous promise; a reasonable and foreseeable reliance by the party to whom the promise is made; and an injury sustained by the party who has relied.” In denying liability, the court found that the entire history of the parties’ negotiations made it plain that any promise or agreement at that time was conditional upon the signing of a written contract. Plaintiff manifestly cannot make an end run around the defendant’s reservations against undertaking a legal obligation absent a signed contract by recharacterizing the claim as one of promissory estoppel.

\textsuperscript{26}We began the project in the spring of 2004 by examining all public data bases for preliminary negotiation and preliminary agreement cases proceeding under the following theories of liability: promissory estoppel, quantum meruit, implied contract, indefiniteness and intent to be bound. This initial search returned 280 cases. We then selected every other case to produce a sample of 140 cases. In thirty-two of these cases, precontractual reliance was only peripherally relevant to the outcome. Eliminating these cases produced the final sample of 108 cases. The sample represented 29 state jurisdictions, 19 federal district courts and seven federal courts of appeal.

data thus show that, absent misrepresentation or deceit, there generally is no liability for reliance investments made during the negotiation process.  In twenty-nine cases, the parties had agreed on some material terms, but the court nonetheless denied recovery because the parties had also indicated, either expressly or by implication, that they did not intended to be legally bound.  Thirty-seven cases involved preliminary agreements that were sufficiently complete to be binding contracts, even though they contemplated a further memorialization of terms, because the evidence showed that the formal writing was not essential. The courts treated these agreements as fully

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It is noteworthy that, of the twenty-nine cases denying enforcement because the agreement was too indefinite or the parties had expressed an intention not to be bound, only two authorized restitutionary relief for the plaintiff. The conventional view has been that a promisee can recover in restitution for partial performance of an indefinite agreement. Teachers Insurance and Annuity Association of America v. Tribune, 670 F. Supp. 491, -- (S.D.N.Y. 1987); See also, Reprostream, BV v. SCM Corp., 727 F. 3d 257 (2d Cir. 1984).

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28 “It is fundamental to contract law that mere participation in negotiations and discussions does not create a binding obligation, even if agreement is reached on all disputed terms. More is needed than agreement on each detail, which is over all agreement to enter into the binding contract.” Teachers Insurance and Annuity Association of America v. Tribune, 670 F. Supp. 491, -- (S.D.N.Y. 1987); See also, Reprostream, BV v. SCM Corp., 727 F. 3d 257 (2d Cir. 1984).


It is noteworthy that, of the twenty-nine cases denying enforcement because the agreement was too indefinite or the parties had expressed an intention not to be bound, only two authorized restitutionary relief for the plaintiff. The conventional view has been that a promisee can recover in restitution for partial performance of an indefinite agreement. E. Allan Farnsworth, Contracts §3.30 (3d ed. 1999) (citing Bragdon v. Shapiro, 77A.2d 598 (Me. 1951) in which the court permitted an employee to recover in quantum meruit for the value of extra efforts induced by his employer’s promise to share the resulting profits).
binding contracts.\textsuperscript{30} (4) Finally, and most interestingly, in twelve cases, the court found a preliminary agreement to negotiate further in good faith.\textsuperscript{31}

To summarize, the sample shows that courts will not grant recovery for precontractual reliance unless the parties, by agreeing on something significant, have indicated their intention to be bound.\textsuperscript{32} The key issues thus involve reliance behavior that follows the conclusion of an “agreement” that is incomplete in some respects. Litigation results because the agreement does not represent the final stage in the contracting process. Central to these cases, therefore, are the following questions: What criteria do courts use to decide whether or not parties have made an enforceable preliminary agreement? And what does enforcement entail? We turn in the next section to an examination of the evolving legal doctrines that affect these questions.

**B. The Enforcement of Preliminary Agreements**

The initial issue in these cases is whether the parties have manifested assent to an


\textsuperscript{32}Courts traditionally consider a variety of factors as proxies for the intent of the parties regarding when they have reached “agreement,” including the extent to which agreement had been reached on all or most of the terms, whether this type of contract typically is reduced to a formal writing, whether the contract has few or many details and whether the amount involved is large or small. Mississippi & Dominion S.S. Co. v. Swift, 29 A. 1063, 1067 (Me. 1894); Restatement(Second) §27, comment c.
exchange. If the parties have not made a sufficiently clear and definite assent to an exchange, their negotiations are treated as preliminary and reliance incurred in the course of those negotiations is not recoverable. The courts have had difficulty, however, with preliminary agreements that settle some major terms but leave significant additional terms open for further negotiation. These “agreements to agree” invoke a core principle of the common law of contract: An enforceable contract requires promises that are sufficiently certain and definite so that a court may ascertain the parties’ intentions with a reasonable degree of certainty. This principle rests on the understanding that parties write contracts in important part to enable a party who feels herself unjustifiably disappointed to invoke the law’s aid. It follows that parties did not intend to invoke the law – i.e., did not intend to be legally bound – when their agreement was so vague or lacked so many terms that a court could not know what remedy to award. On the other hand, a court can infer, from terms that are sufficiently complete and definite to ground a remedy, that the parties intended to make a legally enforceable contract. The focus on the parties’ intentions –

33 See Restatement (Second) of Contracts §§17 & 18 (1981) [hereinafter Restatement]. The manifestation of assent can be oral (unless the Statute of frauds is relevant) and it can be by conduct as well as by words. See Restatement §19.

34 The manifestation of assent must be such as to ground an objective belief by each party that the other has made a promise. Restatement §3. A promise, in turn, is determined by a party’s objective rather than her subjective belief. See, e.g., Hotchkiss v. National City Bank of New York, 200 F. 287, 293 (S.D.N.Y. 1911) (L. Hand J). By definition, therefore, a manifestation of intent that is uncertain or indefinite cannot qualify as a promise. Restatement §33. See, e.g., Pappas v. Brewer, 219 N.W. 2d 720 (Iowa 1974).

35 See e.g., Varney v. Ditmars, 217 N.Y. 223, 111 N.E. 822 (1916); Joseph Martin, Jr., Delicatessen, Inc. v. Schumacher, 52 N.Y. 2d 105, 417 N.E. 2d 541 (1981); WILLISTON ON CONTRACTS, VOL. I, §§ 37 et seq.

36 For example, in Petze v. Morse Dry Dock & Repair Co., 125 App.Div. 267, 109 N.Y.S. 328, 331, the New York court held that an agreement providing: “the method of accounting to determine the net distributable profits is to be agreed upon later” was unenforceable under the indefiniteness rule. Courts thereafter have held consistently that such “agreements to agree” are unenforceable so long as any essential term is open to negotiation. ROBERT E. SCOTT & JODY S. KRAUS, CONTRACT LAW AND THEORY 34-44, 322-325 (3d ed. 2002).

37 Courts will infer an intent to be bound although some terms in the agreement have been left open. For example, UCC §2-204(3) provides that an agreement is a fully binding contract even if the parties failed to agree on certain terms if the parties intended to be legally bound and if they had agreed on enough terms to permit the court to grant an appropriate remedy in case of breach. The Code also follows the common law cases holding that price terms in sales contracts can be supplied from evidence of market prices. Thus, UCC §2-305 permits parties to conclude a sales contract though they have not agreed on a price, or they agreed to agree on a price but subsequently could not do so. Under the UCC, a court is asked to focus on the underlying question of intent, and is encouraged to find an intention to contract despite the existence of open or indefinite terms. That is what many courts have done.
permitting parties to determine just when their agreement has become binding – permits parties to “negotiate candidly, secure in the knowledge that [they] will not be bound until execution of what both parties consider to be a [binding] document.”

Recently, in a major shift in doctrine, courts have relaxed the knife edge character of the common law by which parties are fully bound or not bound at all. Instead, a new default rule is emerging to govern cases where the parties contemplate further negotiations. The default starts with the presumption that “preliminary agreements” typically do not create binding contracts. This presumption follows the common law approach and, as said, rests on the view that courts should not hold parties to contracts unless the parties intended to make them. The new default requires parties to such a preliminary understanding to “accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement.” Neither party, however, has a right to demand performance of the transaction. If the parties cannot ultimately agree on a final contract, they may abandon the deal. A federal court recently referred to this way of enforcing preliminary agreements as “the modern trend in contract law.”

The doctrinal key to the enforcement of these agreements is the parties’ intent. Courts honor express reservations of intention as well as statements of an intention to be fully bound. The major doctrinal development is that modern courts have recognized a further obligation to implement parties’ expressed intent to bind themselves in preliminary agreements by creating a

38 Winston v. Mediafare Entertainment Corp., 777 F.2d 78, 80 (2d Cir. 1985).

39 As note 6, supra, indicates, this rule was developed by Judge Leval and has been followed extensively.

40 See also R.G Group Inc., supra note 24, at 74.

41 Teachers Insurance and Annuity Association of America v. Tribune Co., 670 F. Supp. 481, 488 (S.D.N.Y. 1987). When the parties have agreed upon everything important – when they have made what courts call a fully binding agreement – the courts will enforce the disappointed promisee’s expectation. See Adjustrite, supra note – at 548; Hyman Gorodensky, H&H Warehousing Co. v. Mitsubishi Pulp Sales (MC) Inc., 92 F. Supp. 2d 249, 254-55 (S.D.N.Y. 2000). We focus here on so-called “binding preliminary commitments” where the parties have left important matters for further negotiation.

duty to bargain in good faith when one of them prefers not to deal.

This modern approach provides too little normative guidance. The cases endorse a multi-factor analysis that invokes (1) the language of the agreement; (2) the existence and number of open terms; (3) the extent of any reliance investments; and (4) the customary practice regarding formalities.\(^{43}\) The court, in addition, is to consider the context of the negotiations resulting in the preliminary agreement.\(^{44}\) A list of relevant factors confines a court’s discretion to some extent, but leaves the decision process largely obscure when, as here, courts fail to attach weights to the factors or specify the relationship among them. For example, focusing on the number of terms that remain open is unhelpful; courts cannot easily determine whether many terms or only a few remain to be negotiated. Further, the cases do not indicate what the parties are supposed to bargain over, or when the refusal to agree constitutes bad faith, or just what should be the remedy for bad faith. These normative questions cannot be resolved until the relevant positive questions are answered.

III. A MODEL OF SIMULTANEOUS AND SEQUENTIAL INVESTMENT\(^{45}\)

**A. The Model’s Assumptions: Why Parties Write Preliminary Agreements**

Our model attempts to explain why parties make preliminary agreements, and how such agreements can break down. To introduce the analysis, suppose that two parties come together to explore whether to produce a grinding machine that can be used to reduce various metallic ores, and then to produce a machine if it turns out to be profitable. Grinding machines can take a number of forms, depending on cost and demand. One of these parties – the “seller” – invests in this project by researching the technical feasibility of producing various types of grinding

\(^{43}\) See e.g., Teachers, supra note 43, at —.

\(^{44}\) This final factor recognizes that preliminary agreements always have open terms; hence, open terms per se will not be fatal to the obligation to negotiate further in good faith.

\(^{45}\) We extend the model of Smirnov and Wait, *Hold-up and Sequential Specific Investments*, 35 Rand J. Econ. 386 (2004) to the preliminary agreement context. Their modeling strategy, in turn, is based on staged finance models used to explain venture capital investing.
Part IIIA is written in narrative form, but it contains the assumptions on which the model is based.

machines and their cost. The other party – the “buyer” – invests by exploring demand for grinding machines and possible financing options if the project would be successful. A “state of the world”, or “ex post state”, is constituted by the realized values of three economic parameters: the level of demand for various grinding machines types; the cost of producing each of these types; and the options for financing. At the start, the parties know the distributions from which the values of the relevant parameters will be drawn. The parties learn the true values after they invest. The parties then will continue their venture if the market turns out to want a particular type of grinding machine that they can produce at an appropriately low cost and finance. Otherwise, the parties will abandon this project.

To make this example formal, let two risk neutral parties, a seller and a buyer, meet at \( t_0 \) to consider a project.\(^46\) The project will fail unless both parties invest in it, but may still fail even if both invest. If the parties do not trade, the seller’s investment is wasted (her investment is fully relation-specific). The buyer’s investment may either be fully relation specific or may benefit the seller though there is no deal. For example, the seller may benefit by learning more about the nature of demand for capital inputs in mining industries, even if grinding machines will not sell.

The parties cannot contract on their project at \( t_0 \) because it is too complex. In particular, the project can take many forms, and there are a large number of possible states of the world. A project would be profitable to pursue, we assume, in only one of the possible ex post states: Given demand and the production and financing costs that constitute that state, the parties can profitably produce only one of the possible grinding machine types. In any other state of the world, it would be inefficient to go forward. When the set of possible project types and the set of possible ex post states both are large, and the parties do not know at the outset which of the possible project types, if any, they will later want to trade, it is not feasible for them to write an ex ante contract on the project. On the other hand, the parties can agree at \( t_0 \) on the nature of the project (they hope to build some type of grinding machine); what each, broadly speaking, is to do (be responsible for product design and costs, attempt to line up final users and financing); and on timing decisions

\(^{46}\)Part IIIA is written in narrative form, but it contains the assumptions on which the model is based.
(explore technical feasibility first, or explore technical feasibility and market opportunities at the same time). A project becomes “tangible” – it will support a complete contract – after the investment stage.

There are two investment “regimes.” In the first, the parties agree to invest simultaneously. In the other, the parties agree that one party will invest first and the other will wait a period and then invest. Each party knows the distribution of costs from which the other’s investment will be drawn, and can observe the results of investment, but the timing and level of actual investment is private information. For example, if the seller’s investment is creating a set of plans, the buyer ultimately can observe whether the seller created the plans or not. The buyer cannot know when the seller began to work or the level of the seller’s investment that creating the plans turned out to require. These assumptions are made for realism: When parties are in different industries or trades, it is difficult for each of them to observe the other’s cost function. Each party, however, believes that, if a dispute were to arise, it could verify to a court a fraction of the costs of her completed investment. For the reasons just given, this fraction also is private information, and so is noncontractible.

In both investment regimes, the parties learn which of the possible project types, if any, it would be profitable to produce after time has passed and at least one of them has invested. Returning to our introductory example, the seller’s research thus may reveal that no new grinding machine is technically feasible, or the buyer’s research may reveal that only one machine type could sell in the actual ex post state. Investment and the resolution of uncertainty thus play two roles: they reveal whether a project would be profitable and they make profitable projects sufficiently tangible to be realized in final contracts.

The parties cannot write a final contract before the state of nature is revealed. Though ex ante contracting has been shown to induce efficient investment in some asymmetric information environments, ex ante contracting cannot encourage efficient investment in our context. When parties cannot contract directly on investment behavior, the ex ante contract could induce efficient investment if it could appropriately allocate the expected surplus that a transaction would yield.
For example, if one party must incur the larger share of the investment cost to bring a project to fruition, the contract can award this party the larger share of the expected surplus. The preliminary agreements we study cannot affect investment behavior in this way, however. Consistent with the common view that it is difficult to contract directly on expected profits or costs, we assume that parties can observe but not verify to a court the expected surplus from the complex projects modeled below.\(^{47}\) When the court cannot observe a project’s surplus, it cannot enforce a contract that attempts to allocate that surplus in such fashion as to induce each party to choose the efficient investment level.

The inability to contract on surplus directly would not be fatal, however, if the parties either could commit not to renegotiate their ex ante contract or that contract could specify the project type the parties hoped later to trade.\(^{48}\) Regarding the possibility of renegotiation, suppose that only the seller is to invest. The ex ante contract could authorize the seller to make a take it or leave it offer to the buyer after the investment stage is over. The seller would then make an offer that would award to her the full surplus that trade would generate. Anticipating this payoff, the seller would invest efficiently; that is, she would invest to increase expected surplus until the marginal gain from further investment would equal the marginal cost. Contracts that allocate bargaining power to a seller in this way cannot work, however, if the buyer could refuse the seller’s take it or leave it offer and propose a new division of the surplus. Then, the seller’s choice

\(^{47}\)An economic variable is unverifiable if the costs to the parties of establishing the value of the variable in a legal proceeding would exceed the gains. While parties commonly can estimate the expected value of conducting a transaction, the expense and time requisite to proving the profit that a foregone transaction would have yielded often will exceed the share of that profit that a successful litigant would realize. Verifiability is not coextensive with, but is related to, the legal concepts of foreseeability and certainty. Thus, we assume here that the parties can observe the expected surplus from doing their project, so that surplus is foreseeable to them, but we also assume that the costs of establishing the surplus in court would exceed the gain. On the other hand, legal costs may be high in considerable part because a party would have to introduce a great deal of evidence to show that her contract partner should have known the expected gain that a completed deal between them would have yielded. For a discussion of how front-end investments by parties in stipulating evidentiary proxies and allocating burdens and standards of proof can lower these back end enforcement costs, see Robert E. Scott & George G. Triantis, *Anticipating litigation in Contract Design*, 115 Yale L. J. 814 (2006).

\(^{48}\)For a review of how renegotiation and describability affect contracting behavior, see Bolton and Dewatrapont, *supra* note 9, at 560-578. The principal paper showing how the parties’ inability to describe in the ex ante contract what is to be traded reduces the value of ex ante contracting to zero is Oliver Hart and John Moore, “Foundations of Incomplete Contracts”, 66 Rev. of Econ. Stud. 115 (1999).
would be to bargain over the division – i.e., to renegotiate the ex ante contract – or to forego gains. Since parties are reluctant to leave money on the table, the seller would renegotiate and it seldom could bargain to capture the entire gain. But any seller who anticipated not being able to appropriate the full value from her investment in a project would underinvest; that is, she would invest only until the marginal cost equaled her fraction of the expected gain. Since parties cannot commit to eschew renegotiation under current law, the proposed contract, or variants of it for cases when both parties must invest, cannot induce efficient investment.  

Regarding the possibility of specifying the project type, parties sometimes can write “specific performance contracts” that induce efficient investment even where renegotiation cannot be prevented. For example, if the parties could know in advance that they will either trade a particular grinding machine or not trade, their ex ante contract could require the seller to deliver that machine at a fixed price if the state of nature turned out to be favorable. If a court would enforce this contract specifically, and if the price were appropriately chosen, the contract could induce efficient investment. Specific performance contracts, however, also would be ineffective in the context we consider, even if the parties could verify to a court that the favorable ex post state had materialized. As said above, in our model the parties cannot specify in advance just what project type they would later want to trade because there are too many possible product types that may work and too many possible states of nature. A court could not specifically enforce a contract without a subject matter. As a consequence, it would be pointless for the parties to set a price. And without a price, the ex ante contract could not allocate a transaction’s expected surplus in such a way as to induce efficient investment. In our model, then, there is no gain from ex ante contracting so such contracting will not be seen. The model thus captures the decided cases: The parties in those cases either failed to agree on anything or had only made preliminary agreements that did not attempt to allocate surplus, set prices or specify the parties’ bargaining power in an ex post renegotiation.

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49For further analysis, see Alan Schwartz and Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L. J. 541, 611-614 (2003); Christine Jolls, Contracts as Bilateral Commitments: A New Perspective on Contract Modification, 26 J. Legal Studies 203 (1997).
B. The Model’s Technical Details

The nature of the project requires one of the parties, whom we let be the buyer, move first.\(^{50}\) If the parties make a preliminary agreement at \(t^0\), the buyer will invest the discrete sum \(x_b\) at \(t^1\). In the simultaneous investment regime, the seller invests the discrete sum \(x_s\) at \(t^1\) as well; in the sequential regime, the seller invests at \(t^2\). After a party completes its investment, the other party can observe \(\alpha_i x_i\) (\(i\) denotes seller or buyer) of the investment’s cost, where \(0 \leq \alpha_i < 1\), and the investing party can later verify \(\alpha_i x_i\) to a court. The sum \(\$x\) is composed of various elements: raw materials, salaries, the value of human capital. The cost of some of these elements – the raw materials a party ordered – likely will later become verifiable while the cost of other elements – time spent thinking – will not. The sum of the verifiable elements divided by the total investment cost \(\$x\) equals the verifiable fraction \(\alpha\). At \(t^0\), each party knows its own expected \(\alpha\), but does not know her partner’s expected \(\alpha\).\(^{51}\)

The party’s investments are assumed to be perfect complements in the sense that the project will fail unless both investments are made. If the parties both invest, however, the project nevertheless succeeds only with probability \(\pi < 1\) (the state of the world turns out to be favorable) and fails with probability \((1 - \pi)\). A successful project returns a surplus of \(S > 0\) that is net of production costs (i.e., the cost of making the grinding machine) but gross of investment cost. The expected surplus in any other ex post state would be \(S \leq 0\), so no project is pursued in those states.

If both parties invest at \(t^1\) and a project turns out to be profitable, they will write a final

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\(^{50}\)If the technology requires both to invest simultaneously, the problem is not normatively interesting. The most reasonable equilibrium has both investing when investment would be efficient. The parties will pursue an efficient project and abandon an unsuccessful project. In this world, there is no role for the law to play. If the technology instead permits either to invest first, the parties play a dynamic game in mixed strategies to determine who moves initially, but the qualitative results reached below will not change.

\(^{51}\)If \(\alpha\) were verifiable, the parties could induce optimal investment by requiring the party who failed to invest appropriately to pay \(1/\alpha\) of the other party’s reliance costs. On our assumptions, this contract cannot be written. The parties also cannot write a contract requiring each of them to invest up to the level \(x\). This is because, plausibly in our view, a party cannot know just what level of investment her potential partner must reach in order for the partner to perform his assigned task, and the party also would have difficulty knowing whether her partner actually invested up to the specified level.
Regarding the expected project value, the project succeeds with probability \( \pi \) and it will then return \( S \). In the simultaneous investment regime, the parties receive \( S \) two periods after they make the preliminary agreement so \( S \) must be discounted one period; in the sequential regime, the parties receive \( S \) after three periods so they discount \( S \) by two periods. Hence, the expected project value in the sequential regime is \( \pi \delta^2 S \). Our assumption that this value exceeds total investment costs implies that the simultaneous investment regime also is socially efficient; for returns are realized one period earlier in that regime. We assume that the project is efficient because we want to see when parties will pursue efficient projects.

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Regarding Nash bargaining, a party’s bargaining power in a negotiation is a function of the parties’
disagreement points and their relative patience (their discount rates). The party who has the best outside option – the
best disagreement point – has more power in the negotiation because he must receive a larger share to compensate
him for staying in. Similarly, the more patient party has more power because he can wait longer for a good offer.
Our assumption that both party’s outside options are zero implies that they have the same disagreement points. It
also is customary to assume that commercial parties are equally patient – they have the same discount rates –
because commercial parties usually can borrow or lend on the same competitive capital market. On these
assumptions, the parties have equal bargaining power so neither of them could credibly demand more than a
fifty/fifty split. The other would refuse, knowing that the demander will accept half the expected gain rather than
receive no gain at all. The qualitative results reached below will not change if the bargaining power assumption is
relaxed. Thus, if the seller is assumed to have more bargaining power than the buyer, she will invest a larger sum
because she will realize more than half the surplus, and the buyer will invest less, but the parties still would have
incentives to behave strategically that are normatively interesting to analyze.

The comparative welfare effects of these investment regimes are ambiguous a priori. On
the one hand, the simultaneous regime is best, all things equal, because it accelerates the
realization of returns (the parties capture profits earlier). On the other hand, if no successful
project is revealed, both parties’ investments would be wasted in the simultaneous regime, while
only the buyer’s investment is wasted in the sequential regime.

C. The Parties’ Behavior

We begin with the simultaneous investment regime and introduce the hold up problem that

\[
\begin{array}{cccc}
  t^0 & t^1 & t^2 & t^3 \\
  \text{Agree} & \text{Buyer} & \text{Observe state:} & \text{Realize} \\
  & \text{invests} & \text{Renegotiate; seller} & \text{returns} \\
  \end{array}
\]

If a project would be profitable to pursue, the parties will write a complete contract.

Recalling that their ex ante agreement did not describe or price the particular project they will
trade, the parties must bargain as if from scratch to divide a profitable project’s expected gains.

We assume Nash bargaining and normalize each party’s outside option to zero. This implies that
the price in the parties’ complete contract will divide equally the surplus that trade is expected to
create.\(^{53}\)

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relaxed. Thus, if the seller is assumed to have more bargaining power than the buyer, she will invest a larger sum
because she will realize more than half the surplus, and the buyer will invest less, but the parties still would have
incentives to behave strategically that are normatively interesting to analyze.

\(^{54}\)The analysis in Part IIIC assumes that the law does not award a remedy unless the parties have made a
complete contract. This assumption is made because the issue is whether a legal remedy would be useful in the
context under study.
exists when parties must invest before they have a fully binding contract. The buyer’s and seller’s expected returns from investment in this regime are, respectively,

1) \[ \pi\left[\frac{1}{2}(\delta S)\right] - x_b \]

2) \[ \pi\left[\frac{1}{2}(\delta S)\right] - x_s \]

The project succeeds with probability \( \pi \), each party will then receive one half the project’s surplus less its investment cost, and the gross return must be discounted one period. Since the parties’ costs may not be equal, the sum of Expressions (1) and (2) can be positive (the project has positive expected value) while one of the private returns is negative. The project requires the participation of both, however, so in this case it will not be done. This is the ex ante hold up problem: A party will not invest at all when he must share the expected gain with his partner, and as a consequence the party’s portion of the return would be below his cost. The problem would vanish if the parties could contract on investment at \( t^0 \): When a project would generate total expected gains in excess of costs, the party whose expected return is positive could guarantee its partner a non-negative return by agreeing to reimburse the partner for investment costs if the project is not pursued. Investments are noncontractible in this model, however.\(^{55}\)

In the sequential regime (see Figure 2), the buyer invests initially and then, if the project will be a success, the parties renegotiate. Going forward from \( t^2 \), the net gain from the seller’s investment is just the expected project surplus less the seller’s cost. The buyer’s costs are then sunk, and so will be ignored when the parties renegotiate. Hence, in this regime the parties expect that renegotiation to a complete contract for a successful project will award the buyer and seller, respectively,

3) \[ \pi\left[\frac{1}{2}(\delta^2 S - \delta x_s)\right] - x_b \]

4) \[ \pi\left[\frac{1}{2}(\delta^2 S - \delta x_s)\right] - x_s \]

In the success state, the buyer expects to receive half the surplus less his investment cost; the seller expects to receive half the surplus. Since returns in this regime are realized at \( t^3 \), they must be

\(^{55}\)Our ex ante holdup result is identical to the result described in Proposition One of Luca Anderlini and Leonardo Felli, *Transaction Costs and the Robustness of the Coase Theorem*, 116 The Economic Journal 223, 229 (2006), except that the costs there are transaction costs while the costs here are investment costs. In both models, the parties’ inability to contract in advance on costs precludes the formation of efficient agreements.
discounted two periods.

To compare the relative efficiency of these regimes, denote social welfare from the simultaneous and the sequential investment regimes, respectively, as $W_{\text{sim}}$ and $W_{\text{seq}}$. Then a social planner would prefer simultaneous investment ($W_{\text{sim}} > W_{\text{seq}}$) when (a) the project is likely to succeed, so the seller’s investment is unlikely to be wasted; (b) the parties’ discount rate is high (i.e., $\delta$ is low), so that delaying returns by a period would be costly; (c) the seller’s costs probably will turn out to be low, so that not much would be saved by letting the seller await events; and (d) the possible surplus is large. Formally, writing down social welfare for each regime, simplifying and comparing, the simultaneous regime is best if $S(1 - \delta) > x_s\left(\frac{1}{\delta\pi} - 1\right)$. This inequality is more likely to be satisfied when $\pi$ is high, $\delta$ is low, $x_s$ is expected to be small and $S$ is expected to be big.

The parties’ preferences sometimes will not correspond to society’s preference, however. Thus, the buyer always prefers simultaneous investment because he does not have to reimburse the seller’s cost in the simultaneous investment regime. To be precise, the buyer prefers simultaneous investment when Expression (1) exceeds Expression (3): $\pi(\frac{1}{2}(\delta S) - x_b) > \pi[\frac{1}{2}(\delta^2 S - \delta x_s)] - x_b$. This inequality reduces to $S > \frac{x_s}{\delta - 1}$. The right hand side of this inequality is negative because $\delta < 1$. Since $S$ is positive because the parties only pursue profitable projects, the inequality always is satisfied.

In contrast, the seller’s preferences are parameter specific. She prefers simultaneous investment when this would generate a greater private return; that is, when

56$W_{\text{sim}} = \pi\delta S - x_s - x_b$ and $W_{\text{seq}} = \pi\delta^2 S - \delta x_s - x_b$. 

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Expression (2) would exceed Expression (4):

\[
(5) \quad \pi \left( \frac{1}{2} (\delta S) - x_s \right) > \pi \left[ \frac{1}{2} (\delta^2 S - \delta x_s) \right]
\]

Assuming that the buyer will participate, sequential investment is efficient when the left hand side of Expression (5) is negative (the seller would reject the simultaneous regime) but the right hand side is positive. The seller could earn a positive return in the sequential regime because she is not subject to hold up there; she will invest only if the ex post bargain compensates her.\(^{57}\) The availability of the sequential regime thus permits some projects to be done that would otherwise be foregone.

The availability of the sequential regime, however, creates an opportunity for the seller to behave strategically. To see why, suppose that simultaneous investment is efficient relative to sequential investment and the parties agree to function in the simultaneous regime. Rewriting Expression (5) and simplifying, the seller has an incentive to comply with an agreement to invest simultaneously (i.e., her private return would be greater in the simultaneous regime) when

\[
(6) \quad S > \frac{x_s (2 - \pi \delta)}{\pi \delta (1 - \delta)}
\]

The larger the right hand side of Expression (6) is, the more difficult the Expression is to satisfy and so the stronger is the seller’s incentive to breach. The right hand side is increasing in \(x_s\) and \(\delta\) and is decreasing in \(\pi\). Intuitively, the seller is more likely to defect to sequential investment if her costs would be high because if there were no profitable project to pursue defection would permit her to save a substantial sum. She also is more likely to defect when she is more patient. The

\(^{57}\)The contract price to which the parties will agree in the renegotiation is \(k = x_s + \frac{1}{2}(\delta^2 S - \delta x_s)\), so the seller recovers her costs while the buyer does not.
seller trades off the value of the option to delay and see how things turn out against the cost of delaying a possibly positive return. The more patient the seller is, the more likely she is to make that tradeoff in favor of delay. Finally, the seller more likely to comply with her agreement if there is a high probability that she can recover her investment costs. The probability of cost recovery gets bigger as the parties’ project is more likely to succeed. To be sure, the seller’s incentive to breach an agreement to invest simultaneously could be overcome if a successful project would generate a large enough gain (S is big). Breach, however, is always a possibility, and it is inefficient when \( W_{\text{sim}} > W_{\text{seq}} \).

D. The Ex Post Holdup Problem and Our Solution

The seller’s incentive to breach may prevent some efficient projects from being pursued. The buyer’s expected return from sequential investment can be negative when his return from simultaneous investment would be positive. In such cases, the buyer would only participate if the seller agreed to simultaneous investment. Even if the seller did agree, however, a sophisticated buyer would still not participate if his costs would be high and the seller’s defection is a serious possibility. The seller would like to commit to simultaneous investment in this circumstance because her expected gain is (assumed to be) positive, but she cannot. As we have just shown, sellers sometimes have an incentive to wait and the parties cannot contract on the timing or level of investment. Hence, the seller’s promise to begin by a date certain and then to invest up to the optimal level would not be credible. As a consequence, efficient projects will sometimes be

\[58\] Formally, regarding the discount and success probability variables, the discount factor \( \delta \) becomes bigger (i.e., future returns are worth more to a party) as the party becomes more patient. Hence, that the right hand side of (6) is increasing in \( \delta \) means that patient sellers are more likely to defect from agreements to invest simultaneously. That the right hand side of (6) is decreasing in \( \pi \) means that sellers are more likely to defect when projects are only marginally successful (i.e., when \( \pi \) is low).

\[59\] The buyer cannot predict with certainty whether the seller would defect because he does not know \( x_i \). The buyer, however, does know \( \pi \) and \( \delta \). When the former is relatively low and the latter is relatively high, the prospect of seller breach could be sufficiently great as to deter the buyer from participating.
The model here has at most two investment stages: both parties invest at the same time or one invests and then the other does. The model generalizes to multistage projects in which either it is efficient for both parties to invest at the penultimate stage or for one to invest at this stage and the other to wait until the last stage. If both parties should invest at the penultimate stage, but one of them expects the other to defect and wait, the former party may not invest at the penultimate stage. Anticipating this, at the next earliest stage the other party would not invest, so the project will unravel. At some stage, there is a need for commitment.

To pursue the issue whether the law can help, denote the buyer’s expected return in the simultaneous regime as $g = \frac{1}{2}(\delta S) - x_b$. The buyer’s expected return in the sequential regime is denoted $q = \frac{1}{2}(\delta^2 S - \delta x_s) - x_b$. Part IIIC just proved that $q < g$. In the case we consider here, $q$ is negative while $g$ is positive (i.e., $q < 0 < g$). Also, let the subjective probability that the buyer assigns to seller defection from the simultaneous regime be $\gamma$. Finally, recall that though parties cannot contract on investment or on the fraction of investment, $\alpha$, that later becomes verifiable, the sum $\alpha x_b$ is verifiable ex post. If the law permitted the buyer to recover the verifiable portion of his reliance, then at $t^0$ the buyer’s expected return from an agreement to invest simultaneously would be

$$\gamma (q + \alpha_b x_b) + (1 - \gamma) g$$

The first term is the buyer’s expected return if the seller did defect: the loss from being forced into the sequential regime - $q$ - offset by the reliance recovery the law awards – $\alpha_b x_b$ – both multiplied by the probability of seller defection. The second term is the buyer’s expected return if the seller complies with her agreement.

When the buyer’s expected return in the simultaneous investment regime would be negative without the reliance offset and positive with it, a buyer who expects to recover reliance would make a preliminary agreement that he otherwise would have rejected. Hence, awarding verifiable reliance to promisees when promisors exploit them would increase the number of efficient preliminary agreements. Such awards also may deter parties from breaching these agreements. If a seller expects that a nontrivial fraction of her buyer’s reliance will become

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60The model here has at most two investment stages: both parties invest at the same time or one invests and then the other does. The model generalizes to multistage projects in which either it is efficient for both parties to invest at the penultimate stage or for one to invest at this stage and the other to wait until the last stage. If both parties should invest at the penultimate stage, but one of them expects the other to defect and wait, the former party may not invest at the penultimate stage. Anticipating this, at the next earliest stage the other party would not invest, so the project will unravel. At some stage, there is a need for commitment.
Courts sometimes can use evidentiary proxies for costs that would otherwise be private information. When those proxies would be helpful, the fraction, $\alpha$, of reliance that is verifiable will increase. For discussion of evidentiary proxies, see Scott and Triantis, supra note 47.

The buyer’s investment may benefit the seller by permitting her to use the investment in other situations. For example, the buyer may show the seller how to package her product to make it desirable to many buyers. If the benefit is verifiable, an alternative remedy to reliance would be quantum meruit: the buyer should recover the benefit he conferred on the seller. If this recovery would create a large enough offset to $q$, the buyer’s loss from holdup, the buyer again would be encouraged to invest.

The price is set out in note 57, supra.

The law should not require an inefficient performance, but it should discourage strategic behavior and encourage efficient investment. Thus, although the seller’s delay saved costs in this instance, delay should be treated as a breach. Permitting a buyer to recover reliance in a failed deal would not discourage sellers from participating. A fraction of the seller’s reliance costs would become verifiable if it had invested. Therefore, a seller could establish, by her investment behavior, that she had complied with her agreement to invest simultaneously. Only sellers that plan to behave in bad faith would be deterred.
the verifiable portion of a buyer’s reliance will be too small to sustain the incentive to make a preliminary agreement. Moreover, recall that we have normalized each party’s outside option to zero for modeling convenience. If the buyer’s option is positive, the base return of verifiable reliance in the deal may be too low to motivate efficient investment. First best is difficult to achieve in asymmetric information environments, however. The rule we recommend is a pareto improvement.

Third, prior analyses have shown that protecting the reliance interest will induce contracting parties to overinvest. Overinvestment is not a concern in the analysis here because investment is assumed to be discrete: the buyer invests $x_b$ or he does not. Since the model assumes that investment is ex ante efficient, the subsidy we advocate also is efficient. Overinvestment, however, conceivably could be a danger if, as will sometimes happen, the parties’ payoffs are a continuous function of the amount they invest. In these cases, because the remedy we advocate subsidizes the buyer’s reliance in the breach state, the buyer could be induced to invest too much. We argue in an Appendix that this danger is not serious.

To see the underlying intuition, in the sequential regime, the marginal dollar of the buyer’s expected return is subject to a large “hold up tax”: he realizes less than one half of that dollar because he must split gains with the seller and bear the seller’s investment cost (see Expression 3). The law would subsidize the marginal value of the buyer’s investment if it permitted the buyer to recover verifiable reliance. Even when the buyer believes that the seller will breach with certainty, and thus force him into the sequential regime, he would have an incentive to over rely at the margin only if the value of the “breach subsidy” would exceed the cost of the hold up tax. Since the tax is larger than 50%, the subsidy would have to be substantial (i.e., a large fraction of

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65 See Steven Shavell, Damage Measures for Breach of Contract, 11 Bell J. Econ. 466, 470–72 (1980) (noting that “in deciding on his level of reliance, [the victim of breach] does not recognize that reliance is in fact like an investment which does not pay off in the event of breach”); see also William P. Rogerson, Efficient Reliance and Damage Measures for Breach of Contract, 15 Rand J. Econ. 39, 47 (1984) (concluding that under expectation damages buyers will choose a greater than efficient level of reliance).
the buyer’s investment must turn out to be verifiable). In the simultaneous regime, the buyer also pays a hold up tax on the marginal dollar of his expected return, but he receives no breach subsidy. Thus, a buyer will under-rely if he believes that the seller will certainly comply with her agreement to invest simultaneously. When the buyer is making his investment decision, he will compare the net marginal return in the sequential regime, weighted by the probability of seller breach, against the net marginal return in the simultaneous regime, weighted by the probability of seller performance. Since the breach subsidy may not fully offset the tax in the sequential regime itself and sellers are more likely to perform than not, the expected value of the marginal dollar of the buyer’s return will ordinarily be less than $1. The buyer thus will invest too little even when the law subsidizes him.

Fourth, if protecting reliance enhances efficiency, there is a question why parties do not contract directly on reliance. Reliance contracts are not commonly seen for two reasons. First, much reliance is unverifiable. Second, there is moral hazard: The buyer, for example, is motivated to incur excessive exploration costs if he can partly externalize those costs to the seller. The moral hazard concern would deter buyers from contracting directly on reliance even when reliance would be verifiable. There is an analogy here to break up fees in mergers. Courts permit a disappointed acquirer to recover investigation and related costs when parties agree to a deal but the target later finds another buyer. Parties do not contract directly on these costs, however, but instead use break up fees. A break up fee ameliorates the moral hazard concern because the potential acquirer’s payoff when a deal breaks up is independent of the amount the acquirer invested in evaluating the acquisition. Courts treat break up fees as liquidated damage clauses, and will enforce a break up fee when it reflects a reasonable estimate of the buyer’s costs. Thus, the better question here is why parties do not liquidate reliance damages in the preliminary agreement. Our answer is that such clauses would probably be treated as penalties.

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66 In such cases, the parties may contract directly on costs. Patrick Bajari and Steven Tadelis, Incentives Versus Transaction Costs: A Theory of Procurement Contracts, 32 Rand J. of Econ. 387 (2001), thus show that when substantial costs are verifiable, parties write cost plus contracts.

Courts will enforce liquidated damage clauses only if the promisee has a right to the damages at issue.\textsuperscript{68} Thus, courts will permit a promisee to liquidate an estimate of her expectation because there is a prior right to recover the expectation; and courts will permit a disappointed acquirer to liquidate transaction costs because there is a prior right to recover them. In the preliminary agreement context, many courts will not protect the promisee’s reliance and other courts will protect reliance only if the promisor failed to bargain in good faith when a deal did not materialize. Thus, there is as yet no clear rule permitting the unjustifiably disappointed party to a preliminary agreement to recover its investment costs simpliciter. Because this is the law, a clause liquidating reliance costs in the preliminary agreement would probably be struck as a penalty. A prediction of our analysis, then, is that if the right to recover investment costs becomes clearly established, parties will prefer liquidating an estimate of those costs to suing directly for them.

Fifth, the prospect of a reliance recovery before the parties make a final contract conceivably could chill negotiations, and thus prevent the pursuit of efficient deals. This should not be a serious danger if courts refuse to find a binding preliminary commitment unless all three aspects of a preliminary agreement set out above (an intention to pursue a profitable project; a division of investment tasks, and agreement on an investment sequence) exist. We make two comments with respect to the possibility that a danger is still thought to remain. Initially, the seller is the party whose participation may be chilled but it is the seller who wants the ability to commit to the preliminary agreement; for when the buyer refuses to deal, the seller must forgo a positive expected return. Awarding reliance to the buyer is the only effective way, in this context, to permit the seller to commit to perform the preliminary agreement. A seller who does not want to commit can contract out because the rule we contend for is a default. Courts should, and do, enforce the analogue of merger clauses, that recite such intentions as: “No liability whatsoever is to attach to any representations made during negotiations and before a final written agreement is signed.”\textsuperscript{69}

\textsuperscript{68}See, e.g., Restatement (Second) of Contracts §356 (1979); UCC §2-718 (2003).

\textsuperscript{69}See cases cited note 28, supra.
To summarize, the seller breaches in this model by promising to invest simultaneously but then waiting until after the buyer has invested (and the project has become tangible) either to exit or to renegotiate to complete the project. Breach creates two inefficiencies: (a) If the buyer makes and complies with the preliminary agreement, and the project is profitable, breach causes project returns to be unduly delayed; (b) If the buyer would not invest in the sequential regime, the possibility that the seller would force the buyer into this regime by delaying would sometimes cause sophisticated buyers not to make ex ante efficient preliminary agreements. Awarding buyers reliance when sellers breach thus would increase the probability that parties would make these agreements. This conclusion can be restated in an illuminating way. The law encourages parties to invest efficiently and to trade efficiently by enforcing the contracts they make. This article shows that the law also can help by encouraging parties to make those exploratory investments that are a necessary condition to the later writing of efficient final contracts.

Turning more directly to the law, the distinction between whether there was a preliminary agreement or no agreement should not turn on whether the contract has a price or indicated agreement on a “sufficient” number of terms. Rather, a preliminary agreement should be found (i.e., there was an intention to make a binding preliminary commitment) when the parties have agreed, albeit imprecisely, on the nature of the project, on the categories of action into which their investments were to fall (i.e., marketing or construction), and on the order in which they were to act. There is breach of a binding preliminary commitment when the parties agreed to proceed at roughly the same time, but one of them materially delayed. If the buyer could recover verifiable reliance, then, as we have argued, parties would make more preliminary agreements. The courts, however, add the doctrinal requirement that breach triggers a duty to bargain in good faith. This duty is unnecessary, but if courts retain the obligation, the “mandatory subjects of bargaining” should be restricted to whether there actually was a breach (i.e., did the promisor actually delay investment?) and over the magnitude of the promisee’s reliance. It is unnecessary to require the parties to bargain over whether to pursue the project itself because parties are sufficiently motivated to pursue efficient projects.

**IV. APPLYING THE MODEL TO THE CASE LAW**
In this Part, we examine the contemporary case law in light of two questions. First, do the cases reveal a behavioral pattern that is consistent with the model’s description of how parties act in early reliance contexts? Second, do courts award damages in the circumstances that our analysis argues is desirable? The cases are the obvious vehicle for answering the second question, but, as a rule, cases are a poor vehicle for answering questions about commercial behavior. There are contract data bases that permit the predictions of theoretical models to be tested much more rigorously than by inferring commercial behavior from the factual descriptions in court opinions.70 Regrettably, however, the cases are our only convenient data source. In this article, we study preliminary agreements that sometimes are unwritten and, in any event, are not collected. As a positive matter, then, we show in the analysis that follows that the cases reveal behavior that is consistent with our model. We also show that courts sometimes decide cases as we think they should, but that they also make mistakes.

A. The Data Base and General Results

To test the model’s predictive power, we assembled a case sample that focused more precisely on the analytical framework established by Judge Leval in Teacher’s Ins. & Annuity Assoc. v. Tribune Co.71 A combination of a Westlaw Key Search and a parallel word search produced a large sample of cases from which we culled a random sample of 142 cases dating from 1989 to 2005.72 Forty of the cases turned on issues that were not relevant to the enforcement of preliminary agreements. The remaining 102 cases directly raised a claim for recovery of early

70Recent articles using these data bases to test theory include, e.g., Ronald Gilson & Alan Schwartz, Understanding MACs: Moral Hazard in Acquisitions, 21 J. Law, Econ. & Org. 330 (2005); Scott & Triantis, supra note 59.

71See note __ supra.

72The Key Cite Search was performed by pulling up Teachers Ins. & Annuity Assoc. v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987). We clicked on the key cite feature, and selected the view to show all citing references. We selected every other case on the list producing 120 cases. We then ran a word search for an additional 30 cases. This served to provide a second independently discovered set of cases against which to compare the results of the first 120 to check for bias introduced by the search method itself. The word search was: DA(AFT 05/25/2002) & (“LETTER OF INTENT” “PRELIMINARY AGREEMENT” “WORKING AGREEMENT” “PROTOCOL OF INTENT” “LETTER OF AGREEMENT” “MEMORANDUM OF UNDERSTANDING” “AGREEMENT IN PRINCIPLE” “LOI” “MOU”) & (“GOOD FAITH” “FAIR DEALING”) & BREACH (123 Docs). We selected every fourth case. Of those 30, 8 were redundant with the Key Cite search giving a total of 142 different cases.
reliance investments. In thirty-eight cases, the courts denied recovery on all grounds, including arguments based on Judge Leval’s preliminary agreement taxonomy and on alternative theories of promissory estoppel, quantum meruit, breach of fiduciary duty and misrepresentation. The court found, in the majority of these cases, that the parties were still engaged in negotiations, so that the facts could not sustain an inference that the parties intended to be legally bound.\(^{73}\)

The remaining sixty-four cases fall into two categories. In thirty-three of the cases, the court held that the agreement either was, or could be found by a jury to be, fully binding by its terms so that a court could protect the expectation interest.\(^{74}\) In the other thirty-one, the court found that the parties either had made a preliminary agreement or alleged sufficient facts to sustain a jury verdict finding a duty to bargain in good faith.\(^{75}\)

The cases indicate that parties often reach substantial agreement before they make reliance investments. Parties can protect their expectation interest if they agree on most terms but postpone the costs of drafting the contract documents and specifying the remaining terms. By signaling their intent to be fully bound, the parties will have made what the courts describe as a fully binding

\(^{73}\)Twenty cases denied recovery because the reliance occurred during negotiations. See e.g., Seval Argentina, S.A. v. General Motors Corp., 46 F. Supp. 2d 261 (S.D.N.Y. 1999); Horphag Research Ltd. v. Henkel Corp., 115 F. Supp. 2d 455 (S.D.N.Y. 2000); Phansaklar v. Andersen Weinroth & Co., L.P., 2001 WL 1524479 (S.D.N.Y. 2001); In re Kaplan Breslaw Ash, LLC, 264 B.R. 309 (Bk. S.D.N.Y. 2001). In thirteen cases, the court found that parties had made a comfort agreement that was too indefinite to enforce legally or had expressly declared that the agreement was not binding. See, e.g., Lieberman v. Good Stuff Corp., 1995 WL 600864 (S.D.N.Y. 1995); Tecart Industries, Inc. v. National Graphics, Inc., 198 F. Supp. 2d 719 (D.Md. 2002); Paramount Brokers, Inc. v. Digital River, Inc., 126 F. Supp. 2d 939 (D. Md. 2000). In seven cases, the court found the parties had explicitly contracted for express conditions precedent to enforcement of the agreement. When the excusing condition(s) materialized, the duty of the defendant to perform was discharged. See e.g., Alberta Ltd. v. Dataphon Cellular Partnership, 100 F.2d 967 (10th Cir. 1996); Universal Reinsurance Co., v. St. Paul Fire and Marine, 1999 WL 771357 (S.D.N.Y. 1999); Kimball Associates, P.A. v. Homer Cent. School Dist., 2000 WL 1720751 (N.D.N.Y. 2000).


\(^{75}\)See cases cited TAN infra. The preliminary agreement cases include those where the decision was to enforce the agreements (as binding preliminary commitments) as well as those where the court held that there were sufficient factual issues raised to get past summary judgment and go to trial on the merits.
agreement enforceable according to its terms.  

Alternatively, parties may make their agreement subject to conditions precedent that excuse the promisor if stated exogenous events occur. A common example in financing agreements is the required approval of a third party (such as a corporate board) as a condition precedent to performance. Finally, in a number of cases parties sign comfort agreements that specifically state they are non-binding. Here, parties appear to rely on trust contracts to protect early investment. All these examples suggest that parties have available to them, and commonly use, various formal and informal contractual methods for protecting early reliance investments.

The pre-contractual reliance problem does arise, however, in a significant number of cases. As we noted in Part II, in the absence of any agreement, courts will deny claims for recovery of reliance costs regardless of the theory of recovery advanced by the plaintiff. Moreover, even where a court finds a preliminary agreement sufficient to sustain an obligation to bargain in good faith, the defendant will still be able to exit the negotiations without liability in a number of instances. The courts’ reluctance to award damages in these cases may partly rest on the parties’ ability to protect early reliance themselves by using alternative contractual mechanisms. The cases thus raise the question why parties sometimes fail to use these options.

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76 In every case where the parties stated expressly their intention to be bound, the court enforced the contract as a fully binding agreement.


80 Appendix 3, infra, shows that the plaintiffs in our sample did not recover reliance in any of these cases.

The model in Part III provides an answer, and the case data offer some support for those conclusions. In twenty-five of the thirty-one cases where the promisee argued (with at least some success) that a preliminary agreement bound the promisor to bargain in good faith, the investment patterns of the parties fit the commercial behavior described in the model. In particular, the parties had made a preliminary agreement that committed them to make simultaneous but inchoate relation-specific investments. The reported facts also suggest that the parties’ investments become more tangible as the parties made them and as uncertainty was resolved. Finally, attempts at ex post renegotiation failed, apparently because one party delayed its investment or wished to exit the deal while the other did not. The other five cases either did not provide enough factual background to determine the pattern of the parties’ investments or reflected substantial confusion by the court about the nature of the transaction and the applicable law. We can better understand the contract complexity problem that motivates these preliminary agreements by grouping the cases into two dominant prototypes: (1) investments in joint ventures, partnerships and distributorships, and (2) corporate financing investments, such as acquisitions and capital financing deals. While these case groupings represent quite different commercial patterns, the complexity of the transaction is the factual element that best explains the parties’ use of preliminary agreements in both instances.

**B. Joint Ventures, Partnerships and Distributorships**

An exemplar of the first investment pattern is *Kandel v. Center for Urological Treatment and Research*. In *Kandel*, a doctor moved his practice and his family from New York to Tennessee to join a urological practice. The parties signed an employment agreement which provided that Dr. Kandel was to work for one year; then the parties would "negotiate in good faith" to permit Kandel to purchase stock in the group. At year’s end, the parties did negotiate but

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82 Eleven cases involve investments in joint ventures, partnerships, etc., while the remaining fourteen concern investments in financing projects.


84 The contract contained the following provision:

10. *Agreement to Negotiate in Good Faith Toward Purchase of Equity Ownership.* The Employer agrees that in the event Employee remains continuously employed by Employer for a period of one (1) year and
reached impasse over the financial terms of the partnership. Subsequently, negotiations ceased and Kandel’s employment was terminated. He filed suit against the group, alleging that the defendants breached their contract to "negotiate in good faith," and also committed promissory fraud in inducing him to sign the employment agreement. The appellate court affirmed the trial court’s grant of summary judgment in favor of the defendants on both counts, holding that even if Tennessee recognized a cause of action for breach of an agreement to bargain in good faith, the evidence did not demonstrate such a breach, and did not establish promissory fraud.

In this case, both parties undertook to make simultaneous investments. The partnership was to make a human capital investment in on-the-job training and access to proprietary information. The employee physician was to move to the new practice and make a human capital investment in treating a new set of patients, and in learning the defendant’s practice. He was to be paid for the portion of his investment that was contractible—moving costs and salary— but not for his opportunity costs or for his human capital contribution. The expected surplus from both parties’ investments was the marginal increase in the profits from adding Dr. Kandel to the partnership. This surplus, however, was not contractible ex ante. At the end of the year, and in consequence of both parties’ investment, the surplus probably would be sufficiently tangible for the parties to divide in a renegotiation.

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Employer anticipates that the purchase price of such stock shall be based on the GAAP book value of the Employer as of the date of the purchase.

(Emphasis added). Id.

85 The parties agreed on many terms of the buy-in, such as the formula to be used in determining the amount of Dr. Kandel's compensation, the formula to be used to calculate the amount of Dr. Kandel's buy-in, and the terms of the covenant not to compete. The parties disagreed, however, on the method for calculating the stock redemption value. Id.

86 Tangible evidence of the partnership’s gain would be the accounts receivable generated by Dr. Kandel in the practice as compared to his peers, evaluations of his performance by patients, and other professionals, and the like.

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In *Kandel*, the preliminary agreement was motivated in important part by asymmetric information: Dr. Kandel had private information as to his ability while the partnership had private information about its profitability. The parties’ investments would reveal enough information to make their project tangible, and so contractible. The parties appear to function in a complex environment in which a profitable project may take many forms and the form of the particular profitable project, if any, is unknown ex ante. This pattern of preliminary agreements motivated by complexity is apparent in a number of cases in the sample. For example, inchoateness that results from complexity is reflected in (a) a joint venture to manufacture clothing that requires simultaneous investments by the seller in manufacturing capacity and by the buyer in human and financial capital;87 (b) a joint venture to establish a cell phone network requiring simultaneous investments in securing FCC approvals and in constructing a prototype;88 and (c) a distribution agreement for a new product where the distributor agrees to invest in finding sales locations and the manufacturer agrees to secure financing and approvals.89

The outcomes in these cases are often consistent with the recommendations that our model supports. *Kandel* is illustrative. Dr. Kandel (as is the buyer in the model) is taking a risk. He could be subjected to hold-up after he moves and begins to work if the practice delays its investment. But if the practice group anticipated that a court would require reimbursement of Dr. Kandel’s verifiable reliance costs should the group delay its investment, however, the group would be motivated to honor its commitment to invest simultaneously. Anticipating this, in turn, would encourage Dr. Kandel to invest efficiently. On the other hand, Dr. Kandel bears a further risk that, once uncertainty is resolved, his opportunity cost of performing as a partner in the practice will exceed the value of his services to the firm. In that case, trade would be inefficient ex post. Dr. Kandel, if he were sophisticated, would relocate and join the practice group temporarily if he expected trade to be efficient ex post given the group’s appropriate simultaneous investment. The


law, however, should not give him reason to believe that he will be compensated if the group does what it should, but his prediction turned out to be wrong. Denying him damages on the facts of the case thus was correct.90

Many courts also focus on evidence of a delay in making a simultaneous investment as the key condition for establishing a breach by the promisor of a duty to negotiate in good faith. A case in point is In re Matterhorn Group, Inc.91 There, Swatch wanted to expand its franchise operations to sell watches in the United States. Matterhorn and Swatch signed a letter of intent granting Matterhorn the exclusive franchise for a list of possible locations. The agreement called for Matterhorn to invest in finding appropriate locations for retailing Swatch watches from among thirty possible sites. As Matterhorn filed applications for franchises at potentially profitable locations, Swatch undertook to process the applications diligently, and to seek financing and approval from its parent firm. Here again the parties agreed to make a simultaneous investment in an ex ante complex project: Swatch was to invest in opportunity costs (by granting exclusive rights to Matterhorn) and in the human capital needed to process applications and to become familiar with the American business climate; Matterhorn was to make human capital investments in search and information costs. The project– profitable retail sites for selling Swatch watches in shopping malls– could take many possible forms and precisely what form would work could not be specified ex ante. Investment and the passage of time apparently would reveal which sites, if any, would prove profitable.

In this case, however, Swatch engaged in the strategic behavior that our model predicts: It delayed processing several applications and failed to secure the necessary approvals.92 The court

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90Note that in the case the court found no bad faith. The facts tend to support the inference that trade was inefficient ex post.

912002 WL 31528396 (Bk. S.D.N.Y. 2002).

92The court held:
The rejection of the Vail application violated the Letter of Intent. The Letter of Intent granted Matterhorn the exclusive right to negotiate a lease in Vail despite Vail's geographical distance from Matterhorn's base of operation in the Northeast. Furthermore, it required Swatch to review the Vail application in good faith, and in a manner consistent with the criteria discussed above.... [Swatch] unilaterally rescinded the
found Swatch to be in breach of a preliminary agreement to bargain in good faith and awarded Matterhorn reliance damages based on its out-of-pocket costs of investigating the locations in question. The court denied Matterhorn’s claim for expectation damages based on lost profits, holding that “there is no guarantee that it would have opened a store in [that location].”

The result in Matterhorn is correct because, absent a legal rule protecting Matterhorn’s reliance cost, a rational party in Matterhorn’s position would anticipate the risk of ex post hold-up and could decline to make the efficient investment. Writing a preliminary agreement should legally commit Swatch to invest as promised, and to reimburse Matterhorn’s reliance costs if it did not. The decision did ultimately protect Matterhorn’s reliance interest but, as said above, the requirement that the parties bargain in good faith was unnecessary.

**C. Acquisitions, Venture Capital and Secured Debt**

The existence of a preliminary agreement may be less obvious in the second prototype we explore: capital financing through acquisitions, secured lending or venture capital participations. Nevertheless, a close analysis of these cases reveals a similar commercial pattern. We discuss two examples: (a) simultaneous investment by both parties followed by one party’s decision to exit, and (b) delayed investment by one party followed by its refusal to negotiate further.

An example of the former behavior is *Tan v. Allwaste, Inc.* Plaintiffs were shareholders of Geotrack, which was engaged in subsurface utility engineering. Allwaste considered acquiring Geotrack. The parties executed a letter of intent providing that the closing of the purchase was contingent on a “satisfactory review” of Geotrack’s financial statements and its exclusivity that the Letter of Intent had granted, and Swatch's [decision] to reject the Vail application was improper. In addition, Matterhorn sent the Vail letter of intent in late April 1996. ... Swatch took four months to complete its processing of the application.... Accordingly, Swatch breached the Letter of Intent by rejecting the Vail application for improper reasons. Id. at 16-17.

93Id.

941997 WL 337207 (N.D. Ill. 1997).
Sellers also sometimes invest in integration. See Gilson and Schwartz, supra note 63.

In particular, plaintiffs noted the acquisition of Geotrack was to be debt free, so Geotrack's tax liability should not have affected Allwaste’s analysis of the deal. Plaintiffs also provided evidence that Allwaste simply decided not to conduct any more acquisitions. Id.

The simultaneous investment model helps to explain the use of preliminary agreements to support such acquisition projects. Here the buyer invests in information costs (due diligence) and is protected by an exclusive dealings clause: the seller won’t shop for a better deal during negotiations. Thus, the seller makes an opportunity cost investment. Investment and the passage of time together indicate whether a profitable project exists, and permit the parties to write a contract to pursue it.

In this case, the court held that the letter agreement was not a fully binding contract to acquire Geotrack, but was a preliminary agreement obligating Allwaste to negotiate further in good faith. But the court concluded that the plaintiffs had provided sufficient evidence for a reasonable jury to conclude that Allwaste backed out of the deal for reasons unrelated to Geotrack’s actions, omissions, or financial status. Allwaste’s motion for summary judgment thus was denied. There was no evidence of delay in investment, however, such as a failure to undertake due diligence pending the resolution of uncertainty. Rather, the evidence suggests that Allwaste found the deal to be inefficient ex post owing to exogenous circumstances. Under these conditions, exposing Allwaste to the threat of a subsequent jury finding of bad faith could

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95 Sellers also sometimes invest in integration. See Gilson and Schwartz, supra note 63.

96 In particular, plaintiffs noted the acquisition of Geotrack was to be debt free, so Geotrack's tax liability should not have affected Allwaste's analysis of the deal. Plaintiffs also provided evidence that Allwaste simply decided not to conduct any more acquisitions. Id.
motivate inefficient trade ex post or the refusal to enter into potentially profitable negotiations.\textsuperscript{97} On this understanding of the facts, therefore, the decision in \textit{Tan v. Allwaste} was incorrect.

Contrast the commercial behavior in \textit{Tan v. Allwaste} with \textit{JamSports and Entertainment LLC v. Paradama Productions, Inc.}\textsuperscript{98} JamSports, a sporting events promoter, sued AMA Pro Racing for breaching an agreement that would have given JamSports the right to produce and promote the AMA Supercross Series for 2003-2009. The parties had signed a letter of intent obligating AMA exclusively and in good faith to negotiate with JamSports for 90 days over a Promotion Agreement.\textsuperscript{99} The letter of intent contemplated a simultaneous investment by both parties. AMA was to invest opportunity costs by committing to the exclusivity period. JamSports undertook to invest in developing a marketing plan for the Supercross series. The price to be paid by JamSports for promotion rights was dependent upon the outcome of both investments. During the agreement’s exclusivity period, Clear Channel, a competing promoter, sent letters to the AMA Board indicating that Clear Channel wanted to continue negotiations for the AMA contract. AMA failed to disclose this proposal to JamSports, and it ultimately entered into a promotional agreement with Clear Channel.

\textsuperscript{97} Even without a jury verdict, the cost of a full-blown trial will motivate Allwaste to settle and the anticipated costs of settlement will deter efficient exit thereafter.

\textsuperscript{98} 336 F. Supp. 2d 824 (N.C. Ill. 2004).

\textsuperscript{99} The relevant portions of the letter of intent read as follows:

AMA Pro Racing, owner of the Supercross Series, and JamSports hereby express their intent to enter into an agreement to promote AMA Supercross events and undertake related sales and marketing matters ... 1. \textit{Framework}. AMA Pro Racing and JamSports shall agree to produce and promote not less than fourteen (14) and up to a mutually agreed upon number of AMA Supercross events per season (currently January 1 through the first week of May) for a seven (7) year period beginning January 1, 2003, with an opportunity to extend the term based on criteria such as operating issues, financial issues, brand development and event attendance and such other criteria as to be further clarified by the parties hereto ....

13. \textit{Exclusivity}. Each of the parties agrees that for a period of ninety (90) days after the date this letter is fully executed by the parties hereto and for a period of [sic], AMA Pro Racing and JamSports shall negotiate exclusively and in good faith with one another, and neither party shall enter into any discussion or negotiations with any third party with respect to the subject matter hereof. If a party hereto shall receive any offer from a third party with respect to the subject matter hereof, the receiving party shall promptly notify the other party hereto of the offer, the name of the offeror and the terms thereof. The parties shall use their best efforts, negotiating in good faith, to enter into the Promotion Agreement within thirty (30) days from the date this letter is fully executed by the parties hereto.
JamSports alleged that AMA breached the preliminary agreement by entertaining a competing proposal while negotiations were ongoing with it. The court held that the letter of intent was a binding preliminary commitment to negotiate in good faith, and that JamSports had established as a matter of law that AMA breached its exclusivity obligation by failing to advise JamSports of its receipt of the Clear Channel proposal. The court also held that AMA’s insistence on having its parent entity approve the deal, a condition that did not conform to the preliminary agreement, was also a breach of the duty of good faith if put forth with “bad intent”.  

JamSports illustrates the uncertain grasp courts exhibit concerning just what behavior constitutes a bad faith failure to negotiate. On the one hand, AMA behaved strategically in the way our model predicts: It delayed its opportunity cost investment by entertaining Clear Channel’s proposal without informing JamSports. As it happened, the “delay” paid off for AMA; it was able to negotiate a profitable deal with Clear Channel. The court correctly found that this behavior constituted a breach of the duty to negotiate in good faith, so that JamSports would be permitted to prove its reliance losses at trial.

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100 The court held that “AMA Pro’s insistence on material contractual terms or conditions beyond those stated in the letter of intent could constitute a material breach of its contractual duty to negotiate in good faith” but that: “Based on our reading of the decisional law on the topic, the fact that AMA Pro insisted upon a significant condition that was not included in the letter of intent is not by itself sufficient to demonstrate AMA Pro’s lack of good faith. The concept of good faith appears also to require an inquiry into the breaching party’s intent. As one Illinois court noted in a different context, a “practical commonsense construction” of good faith is the absence of bad faith or bad intent.”

Id. at 848, citing A/S Apothekernes Laboratorium for Specialpraeparter v. I.M.C. Chemical Group, Inc., 873 F.2d 155, 158 (7th Cir. 1989). “For instance, a party might breach its obligation to bargain in good faith by unreasonably insisting on a condition outside the scope of the parties’ preliminary agreement, especially when such insistence is a thinly disguised pretext for scotching the deal because of an unfavorable change in market conditions.” Id.

But the court’s further finding that it was a per se violation of the duty of good faith for AMA, with “bad intent”, to insist on new conditions during the negotiations is questionable. Parties make preliminary agreements in considerable part because they do not know at the start just which project type from the set of potential project types will turn out to be profitable. If there is a profitable project, the parties will then propose a number of conditions to each other that will advance the pursuit of just that project. Thus, AMA likely would have proposed “new” conditions to JamSports even if it had invested in the exclusivity period, and those conditions could have included the approval of its parent. The court’s finding that introducing a new condition with “bad intent” is per se bad faith thus reflects a basic misunderstanding of how parties move from preliminary agreements to final deals. To be sure, there would have been bad faith if AMA had insisted on a new condition as a pretext to support its breach, but that is a separate issue.

To summarize, our data suggest that modern courts have an intuitive understanding that roughly correlates with the normative conclusions that we formally derive. Courts recognize that they have a role to play in enforcing preliminary agreements. Enforcement can motivate a party who fears being held up to invest in an ex ante efficient project although the other party may have an incentive to delay his own investment. The cases are consistent in finding a breach of a preliminary agreement, thereby triggering a duty to bargain in good faith, when there is a delay in undertaking a promised investment. Moreover, courts also enforce preliminary agreements when the promisor, after delaying her own investment, determines that the deal will be ex post inefficient and exits. Although the project is inefficient ex post, the delaying party should compensate the investing party for verifiable reliance costs. The courts also appear to have an intuitive grasp of the necessary conditions for finding a preliminary agreement. Consistent with

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the model, courts find preliminary agreements when the parties have agreed upon the nature of their project, on the nature of the investment actions that each is committed to undertake and on the order in which these actions are to be pursued.\textsuperscript{103} This baseline for finding an actionable commitment is independent of many of the factors that have been made doctrinally salient, such as the number of open terms and the extent of part performance.\textsuperscript{104}

The problem revealed by the cases, however, is that no matter how sharp are the intuitions of experienced judges, the lack of a theory that can explain the underlying commercial behavior inevitably leads to errors. First, there is no need for a duty to bargain in good faith; awarding reliance is sufficient to increase efficiency. Second, the duty may be unhelpful since courts will sometimes misapply it. Thus, we see evidence in \textit{Tan v. Allwaste} of a court permitting a jury to find bad faith where there is no evidence of investment delay and where apparently the deal would have been inefficient to pursue. And, on the other hand, in \textit{JamSports v. AMA} a party who does breach the obligation to bargain in good faith by delaying investment is also subject to a possible \textit{independent} finding of bad faith based on the introduction of new conditions during renegotiation. The lesson, in short, is that theory matters. The cases often make sense when one addresses the right question to them. But absent a theory even the wisest judges err.

\textbf{V. Conclusion}

Parties often make relation specific investments on the basis of preliminary understandings, with the intention later of formalizing their relationship. These investments are


\textsuperscript{104} See TAN infra.
lost when the contemplated deal turns out to be unprofitable. In some no-deal cases, a promisee who has sunk costs comes to believe that the promisor had treated him unfairly. The promisee had been induced to invest by promisor’s assurances but these assurances were not kept; instead, the promisor either abandoned the deal or attempted to exploit the promisee in a renegotiation. This behavioral pattern has produced hundreds of appellate cases in the last decade alone. It also has been the object of substantial case law and considerable scholarly commentary for an even longer period of time.

Litigation explosions occur in transactional fields, such as contracts, when the law is obscure, and the law is obscure here. We first show, in contrast to the regnant scholarly view, that courts will not award damages for reliance unless the parties had reached agreement on sufficient material terms to support an inference that the parties wanted legal weight to attach to their preliminary understanding. Understanding this rule, however, is only a necessary condition for providing parties and courts with sufficient guidance. Substantial confusion remains regarding just how complete a preliminary agreement must be to justify enforcement, and just what remedies for breach are appropriate. Indeed, since litigated deals commonly are ex post inefficient, and thus would be in neither party’s interest to pursue, it is difficult to see what behavior would constitute a wrongful breach. Disputes continue to arise because the foundational questions of intention and remedy are poorly understood.

The initial task, then, is to understand why parties sometimes conclude only preliminary agreements, make sunk cost investments under conditions of uncertainty, and sue each other over deals that both of them recognize should not be done. We create a model that attempts to answer these questions. It shows that commercial parties sometimes maximize expected surplus by beginning projects that, while promising, are too complex to describe in formal contracts. The parties nevertheless understand what their project will be, where each will have primary responsibility and the rough order in which their contributions will be best made. Commencing to invest in such a potential project may produce two types of gains: (a) Investment accelerates the realization of returns if the project turns out to be profitable; (b) Investment illuminates which, if
any, of the possible projects would be profitable, and so makes an efficient project sufficiently tangible to describe in a formal contract.

Typically, there are incentives for parties to engage in strategic behavior when, as here, little is written down, the behavior of a contract partner is difficult to observe, and the world is uncertain. Strategic behavior in the world we analyze takes a particular form: A party who agrees to invest when her partner invests will delay investment to see how things turn out. Delay has two advantages. If the deal turns out to be unprofitable, the party who delays will not have sunk costs in the project. If the project turns out to be profitable, so the parties renegotiate to set a price, the faithful party’s sunk costs will be ignored in the new bargain while the unfaithful party will be compensated for costs it must incur to make the project successful. As usual, the main inefficiency is ex ante: A party who anticipates such strategic behavior will decline to make the preliminary agreement, and potentially efficient projects will be foregone.

These conclusions show that the facilitative role for courts is somewhat broader than has previously been appreciated. Courts encourage efficient investment by enforcing contracts and encourage the exploration of investment opportunities by not protecting the expectation interest of parties disappointed by the failure to reach agreement. We show here that courts have a further facilitative role: to encourage exploration of investment opportunities by protecting the promisee’s verifiable reliance when the promisor strategically delays investment and thus breaches an ex ante efficient agreement to pursue a potentially profitable deal. Anticipating the availability of a reliance recovery can motivate parties to sink costs in the exploration of possibly profitable ventures, and thus will expand the set of efficient contracts that parties can create.

This analysis should help courts materially. First, it shows what must be settled for there to be an actionable preliminary agreement: the parties must agree on the type of project (a shopping center, a financing); on an imprecise but workable division of authority for investment behavior; and on the rough order in which their actions are to be taken. These are both necessary
Second, a breach is a deviation from the agreed investment sequence: in particular, breach is delay. Third, the law has two related goals: to deter strategic behavior and to encourage investment. These goals are advanced by awarding the faithful party its verifiable reliance costs if the other has wrongfully delayed investment. There is no need to protect the promisee’s expectation, which would be hard to do in any event for projects that never get off the ground.

We test our analysis against a large sample of reported cases. The sample offers some evidence that parties are motivated in the ways we identify and breach for the reason we have uncovered. Reported cases are a weak foundation for empirical conclusions, but should be taken seriously when the theory is plausible and apparently there is little competing evidence. The cases also show that some courts respond as if they were attempting to implement our policy proposal. In particular, these courts award reliance damages to promisees if their promisors breached the preliminary agreement and failed to bargain in good faith over exit conditions. Our analysis indicates that while awarding reliance damages for the breach of a preliminary agreement is efficient, imposing a further duty that parties should bargain over the remaining terms in good faith is unnecessary. To the extent that courts continue to impose the duty to bargain in good faith before preliminary deals are abandoned, we make the duty more concrete by specifying what the parties should bargain about: They should discuss the content of the preliminary agreement, whether there was breach and what the damages should be but they need not bargain about whether to pursue the project.

Our analysis also shows, however, that courts sometimes make mistakes, either by not enforcing preliminary agreements or by adopting an imprecise and overly broad definition of bad faith when they do enforce. Thus our primary contribution is normative: we offer a framework for treating early reliance cases that, we argue, would improve efficiency if courts would adopt it.

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105 The rule for which we contend is a default. Parties who are concerned that a court, even using the criteria for a preliminary agreement developed above, could award reliance too frequently can contract out by stating that no liability will attach to any statements or representations unless they are included in a formal written contract.
Appendix

In this Appendix, we consider whether awarding a buyer his verifiable costs when the seller breaches an agreement to invest simultaneously could cause the buyer to overinvest. There is no analytic answer to this question; under certain values for the relevant variables, the buyer will overinvest while under others he will underinvest. We show by example, however, that the buyer will underinvest unless the verifiable fraction of his costs is improbably large, and the seller is expected to breach with an unrealistically high probability.
Investment in our model is exploratory; the parties investigate whether they have a good project or not. Thus, it is natural to assume that investment affects the probability that a successful project will turn up rather than the returns from the project itself; later investment will affect those. Formally, then, we assume that the success probability is a function of both parties’ investments, where \( \pi(x_b, x_s) \) is twice differentiable, nondecreasing in both variables and concave:

\[
\pi_i = \frac{\partial \pi(x_b, x_s)}{\partial x_i} \geq 0, \quad \pi_{ii} = \frac{\partial^2 \pi(x_b, x_s)}{\partial x_i^2}, \quad i = b, s \text{ and }
\]

\[
\pi_{bb} \pi_{ss} - (\pi_{bs})^2 \geq 0, \quad \text{where} \quad \pi_{bs} = \frac{\partial^2 \pi(x_b, x_s)}{\partial x_b \partial x_s}
\]

Investment is efficient if \( \pi(x_b, x_s) \delta^2 S + (1 - \pi(x_b, x_s))(0) - x_b - x_s > 0 \).

To prove that the buyer will underinvest, first consider the buyer’s expected return in the simultaneous regime:

\[
\pi(\cdot) \frac{1}{2} (\delta S)^2 - x_b
\]

Eliminating the discount factor for convenience, first best has the buyer investing until \( \pi_b (\cdot) S = 1 \), where the subscript denotes the derivative with respect to \( x_b \), but the buyer’s actual first order condition is
\[ \pi_b(\cdot)\left(\frac{S}{2}\right) = 1. \] The buyer underinvests in the simultaneous regime because his marginal return is diminished by the seller’s discounted share. The fraction \( \frac{1}{2} \) is the “holdup tax”.

Now turn to the sequential regime and assume that the buyer could recover the verifiable portion of his investment costs. His return then is

\[ \pi(\cdot)\frac{1}{2}(\delta^2 S - \delta x_s) - (1 - \alpha_b)x_b. \]

The first order condition is

\[ \pi_b(\cdot)\frac{1}{2}(S - x_s) = 1 - \alpha_b. \]

The buyer recovers \( \alpha_b \) of his costs, so the last term is the portion he bears. The hold up tax – the left hand side – is higher in the sequential regime because the buyer’s return is reduced by the seller’s costs. The breach subsidy, however, offsets the buyer’s incentive to under rely to some extent.

We create an example to see whether the breach subsidy will cause the buyer to overinvest. In the example, the seller’s costs reduce the expected return \( S \) by 20%. Then in the sequential regime the hold up tax (again ignoring discount rates) is 60%. The buyer thus would invest efficiently if the breach subsidy were \( \pi_b(\cdot)(.4)S = 1 - .6 \), so \( \pi_b(\cdot)S = 1 \). The buyer therefore would not over rely in the sequential regime on the assumed parameters unless \( \alpha_b \) exceeded 60%. For example, if \( \alpha_b \) were \( 3/4 \) then we have that \( \pi_b(\cdot).4S = 1 - 3/4 \), so that the buyer overinvests because \( \pi_b(\cdot)S = .625 \). To see by how much, the marginal dollar of revenue is reduced by the hold up tax but the
marginal dollar of cost is reduced by the breach subsidy. When the hold up tax is 60% and the breach subsidy is 75%, the buyer would over rely by the difference, or 15%.

The issue, however, is not whether the buyer would invest too much in the sequential regime. Rather, the issue is whether the buyer would overinvest after making a preliminary agreement to invest simultaneously and when his costs would be subsidized only if the seller breaches. In the simultaneous regime, the buyer pays a hold up tax (his marginal return is reduced by 1/2), and he must bear all of his costs. Suppose, then, that the buyer believes the seller will breach with a 25% probability. The net expected effect on the buyer’s marginal dollar of investment is the expected value of the hold up tax when the seller will comply and the expected value of the tax/subsidy combination when the seller will breach. In the example when \( \alpha_b = \frac{3}{4} \) the net is \( .25(.15) + .75(-.5) = -.24 \). The first term is the probability that the buyer would be in the sequential regime \( \frac{1}{4} \) times the net incentive to over rely in that regime \( (15\%) \); the second term is the probability that the buyer will be in the simultaneous regime \( \frac{3}{4} \) because the seller will comply times the incentive to under invest there in consequence of the hold up tax \( -\frac{1}{2} \). The buyer will under rely because the net expected effect on his marginal incentive is negative.

In this example, when 75% of the buyer’s costs would be verifiable and the seller is expected to breach with a fairly high probability, the hold up tax would still cause the buyer to underinvest by a substantial amount. As to the intuition, in the sequential regime, the breach subsidy is offset by a large hold up tax while in the simultaneous regime there is no subsidy and the hold up tax also is large. In addition, since a party is reluctant to deal with a partner who is likely to breach, the defection probability – the probability that the buyer will be in the sequential regime – realistically is much below 50%. For these reasons, the buyer puts much more weight on the simultaneous regime, in which he is not subsidized, than on the sequential regime, in which he is (when the seller breaches). The net effect causes the buyer to underinvest. The breach subsidy we recommend thus could cause overinvestment only
if an improbably large fraction of the buyer’s costs are verifiable and the seller is expected to breach an unrealistically high percent of the time.