Uncertainty, Reliance, Preliminary Negotiations and the Hold Up Problem

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Section I – Introduction

Contract law enforces assent based contracts because they improve welfare for both the parties and for society.1 In a world without transaction costs or frictions, parties can achieve optimal outcomes on their own.2

In a real world, however, many frictions and impediments interfere with the parties achieving optimal outcomes. Uncertainties of various types impede parties as each decides whether to enter into a contract with another party.3 Parties lack knowledge about their counterparty, specifically about their characteristics and qualities, including their propensity to act opportunistically.4 That uncertainty makes it difficult to achieve a

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1 This assumes no externalities.
3 The decision to enter into a fully contingent contract is the ultimate decision but the parties could enter a number of preliminary agreements, including letters of intent, and agreements to agree. The legal treatment of these interim agreements will depend on a number of factors. See infra text accompanying notes x-y. See also E. Allan Farnsworth, Precontractual Liability and Preliminary Agreements: Fair Dealing and Failed Negotiations, 87 COLUM. L. REV. 217, 221-243 (1987) (discussing different bases for liability in precontractual negotiations including unjust enrichment, promise, misrepresentation and general obligation).
contract that expressly controls all of the possible permutations of the risk of moral hazard.5

The problem of uncertainty is pervasive in all negotiations towards a contract. Parties do not know what the probability of reaching an agreement is and if so, whether it is worth expending costs to find out and up to what point.6 Each potential party to a contract has a sense that a contract will improve their welfare (and the welfare of society) and each is therefore optimistic about the possibility of a bargain. But that optimism is tempered by two factors: first each party knows that they cannot give up too much and still produce joint gains from trade and they are therefore uncertain about whether the other potential party will be asking too much to enter into the deal. Second, each party knows that the success of the collaboration depends on a variety of factors that require a prediction as to future states of the world, including market conditions (or, more broadly, conditions beyond the control of either party) and the decisions and actions of the other party. In general, uncertainty applies to one’s own ability to perform, the other party’s ability to perform and states of the world that are unrelated to either party’s ability to perform. Third, each party is uncertain about its counterparty’s particular proclivity to engage in opportunistic behavior but does know that there is some potential for such opportunistic behavior in the general population as it is a facet of human nature.7 The potential for opportunistic behavior

5 For example, a principal hiring an agent lacks fundamental knowledge about the agent’s “propensity to diverge”5 (© RJC) and is uncertain about the precise ways in which such “propensity” will manifest itself. This uncertainty poses a contracting problem for the principal who cannot draft a complete contract to control for unknowable choices and predilections.

6 As Hermalin, Katz and Craswell explain “[i]n order to conduct exchange, the parties must not only find each other, but they must also determine whether trade is worthwhile.” HERMALIN, KATZ & CRASWELL, HANDBOOK OF LAW AND ECONOMICS 53 (forthcoming) (2007). That search is one to ascertain whether gains from trade exist.

7 The inability to know the exact degree to which a given party will act opportunistically makes it important to “expend[] resources to discriminate among types” in order to achieve gains. WILLIAMSON, supra note 4, at 48. Williamson observes that this variance among types
may be increased when certain structural factors affecting the sequence-of-investment are present.

The optimism of potential opportunities from joint gains of trade is therefore tempered by the risk that a party will invest in reducing the uncertainty only to find out that a bargain is not feasible or that a bargain that looked good (profitable) turns out to be bad (unprofitable) or that they have made themselves worse off by providing the other party with information that the other party can use opportunistically. It is this latter risk that the law grapples with in precontractual negotiation cases and, in ways that will be explored later, in the reliance on preliminary agreements where sequence-of-investment agreements exist.

Some of these uncertainties, particularly those relating to future status of the world, may be resolved by negotiating with another party over time since time itself may resolve some issues. Parties also can reduce uncertainty by undertaking search costs and making expenditures to acquire information.

Parties can also use the “courtship process” and proceed

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8 An investment in general market information may show that one bargain will not produce gains from trade but that a bargain with a different partner would, so the investment in that information is not lost when the first potential bargain is abandoned. That, of course, means that the incentive to produce that kind of market information will not be decreased or threatened by the possibility that a particular potential bargain will not work out.

9 See Avery Katz, When Should An Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations, 105 YALE L.J. 1249, 1269 (1996) (discussing optimal time to invest based on progressive reduction of uncertainty concerning certain variables over time).


incrementally to mitigate and resolve some of these uncertainties before they commit to one another. Negotiating has costs and parties will weigh the costs of negotiating against the benefits to be derived from a deal that may or may not be reached. During this initial period of uncertainty before a contract is formed, each party must decide when and whether to make investments of various kinds. If a deal is never reached, these investments may be lost forever. If a deal is reached, when and if each of the parties has invested will determine how much of the surplus is available for them to split. That prospect in turn will affect their incentives to invest in future negotiations and contracts.

Traditionally, under the aleatory view, the law took a “knife-edged” approach to compensating for reliance investment that was most likely to occur during this period of uncertainty. That conventional approach granted full enforcement to assent-based explicitly reciprocal contracts under consideration doctrine but denied any compensation for reliance without a contract. Absent such a contract, any reliance investment was deemed non-compensable. Parties relied at their own peril in the absence of a markets for complex and highly differentiated goods and services are created.” Id. at 388.

12 The possibility of reaching a deal will be the subject of a probability distribution. This same basic analysis of optimal negotiating costs applies to all sorts of costs incurred including search costs for possible contracting partners. “From the perspective of a social planner one would want the parties to undertake such efforts up to the point where the marginal costs of additional search just outweigh its expected marginal value.” HERMALIN, et al supra note 6, at 53.

13 The contract itself “will stipulate how to divide the surplus that will be generated in part by the reliance investments.” See Lucian Ayre Bebchuck & Omri Ben-Shahar, Precontractual Reliance, 30 J. LEG. STUD. 423, 424 (2001).

14 Under this view investments to win an ultimate contract made are done at one’s peril. See infra Section III.


16 The contract price and expectancy damages automatically compensated a party for his reliance expenditures since the contract price included an amount sufficient to cover one’s reliance investment in the contract and in addition included a profit that exceeded the reliance investment.
Following the adoption of Restatement Section 90, courts adopted a more liberal approach to reliance compensation issues sometimes finding liability when a promisee relied on the promises of a putative offeror despite the absence of a bargain in pre-contractual negotiations without the benefit of any agreement. *Hoffman v. Red Owl*17 is the paradigm case. At the same time, courts also began to uphold reliance claims in cases in which parties had reached a preliminary agreement and one party had invested after a preliminary agreement was reached and the other party walked away from the deal and refused to agree to a final contract.18

Recently, two scholars, Alan Schwartz and Robert Scott, have cast doubt on this conventional view.19 They have argued that courts deny recovery for reliance in cases involving precontractual preliminary negotiation20 but regularly grant recovery in cases involving reliance following a preliminary agreement. In this latter class of cases there is an “emerging legal rule” that makes the promisor who breaches an obligation of good faith “liable for the promisee’s reliance expenditures.”21 They identify a pattern or sequence in which success is likely and then provide an analytical framework to justify liability. When parties reach a preliminary agreement that also includes an agreement that they both invest simultaneously22 and one party strategically

17 133 N.W.2d 267 (Wis. 1965).
18 Schwartz & Scott, *supra* note 15, at 662-5 (discussing advent of claims under preliminary agreements and basis for success.)
19 See *supra* note x.
20 Schwartz and Scott explain the lack of success in such preliminary negotiation cases as follows: “[t]he courts’ reluctance to award damages in these cases may rest partly 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.” *Id.* at 693. My results show contrary results and point to success in these cases assuming the presence of a promise, transaction specific investment, detriment and reasonable reliance. *Id.* at 664-65.
21 *Id.* at 664-65.
22 As Schwartz and Scott point out, “neither the transaction nor what the parties are to do is precisely described and neither may be written down.” *Id.* at 663.
delays investment for personal gain, the law will permit the investing party to recover for reliance expenditures when the other party walks away from the deal.23 Courts find this sequence of events to constitute a breach of the good faith obligation that governs parties’ actions in preliminary agreements.24

Based on an extensive review of the reliance case law, this article suggests that contrary to the Schwartz and Scott thesis, courts do grant recovery for reliance expenditures made in precontractual preliminary negotiations25 even when the parties have not reached “an agreement.” Their willingness to do so depends on a pattern in which the promisor solicits reliance expenditures to reduce uncertainty or to hedge his bets pending the resolution of uncertainty and the promisee relies particularly if the reliance investment takes the form of a cooperative investment rather than a selfish investment.26 No promisee would want the promisor to have what amounts to an option that he does not pay for. That same risk of hold up is present whenever there is sequential investment. Thus, this article suggests that the courts are willing to grant recovery for reliance expenditures in both categories of cases (1) precontractual negotiations with no agreement and (2) reliance that follows a binding preliminary agreement. In each set of cases their willingness to do so is predicated on a framework in which courts seek to control the problem of opportunistic behavior.27 Presumably both parties would want to control because the uncontrolled risk of such behavior would discourage future transactions. It is that framework that connects the results of successful preliminary

23 Id. at 685 (discussing circumstances that will cause the party to delay investment).
24 Id. at 694.
25 See infra Section VI.
26 See Yeon-Koo Che & Donald B. Hausch, Cooperative Investments and the Value of Contracting, 89 AMER. ECON. REV. 125, 125 (1999) (defining ‘cooperative’ investments [as ones] that directly benefit the investor’s partner.”)
27 As Oliver Hart explains, “[W]e are all looking for a contract that, whatever happens, each side has some protection both against opportunistic behavior by the other party and against bad luck.” OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 2 (1996).
negotiation cases (the *Hoffman v. Red Owl* type case) and the successful cases of recovery for reliance in preliminary agreements identified recently by Schwartz and Scott. Whether a court is deciding whether the good faith obligation requires compensation for reliance made pursuant to a preliminary agreement or deciding whether a liability rule for reliance in precontractual negotiations is warranted, the courts are concerned with essentially the same problem of regulating the hold up problem.

This Article will provide guidance for courts considering whether, when and why reliance investments made during precontractual negotiations should be compensated. Where one party solicits investments to reduce uncertainty or to hedge the future and the soliciting party is aware that the other party is relying by undertaking such reliance, the reliance should be compensated to prevent the hold up problem and the consequent under-reliance that would occur whenever one party solicits investment and then defers any action or contracting until the investments are made by the first party.

Paying greater attention to how courts take account of strategic behavior in deciding whether, when and why to award reliance costs would provide greater certainty to the area of precontractual reliance case law. Precise delineation of the stages of negotiation and agreement and the degree of vulnerability to hold up by the other party may vary depending on the stage in which the investment is made and on whether the other party is investing simultaneously or has the discretion to defer until later on. These issues are important in resolving whether and when reliance costs should be reimbursed.

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28 See supra note 17.
29 Thus, contrary to Schwartz and Scott who posit that “[l]egal scholars and practicing lawyers have poorly understood these types of cases” because they have considered them all together, this article argues that it may be useful to consider these cases together if the problems of hold up and sequential investment are used to provide a unifying rationale. Schwartz & Scott, supra note 15. at 663
30 See Johnston, supra note 11, at 495 (highlighting the awareness of the investment as a factor in imposing liability).
31 See Bechuk & Ben-Shahar, supra note 13, at 431-2.
This Article proceeds as follows. Part II looks at the overall problem of uncertainty in contracting and its effects on hindering complete contracts, the effect on parties’ incentives to invest in the precontractual period given the hold up problem and the methods for mitigating uncertainty, including the solicitation of reliance investments that can facilitate opportunism. Part III examines the aleatory view of contracting that denied all recovery for reliance investments if no contract were achieved and reexamines whether the traditional view makes sense in situations of sequential investment. Part IV details the problem of hold up that occurs when one party invests and is subject to the other party appropriating part of the surplus in such a way that the investing party cannot gain the full benefit of its investment and so engages in suboptimal investment. It examines cases in which sequential investment may be a cure to strategic behavior as well as instances in which the sequential investment may require a legal response to curb a moral hazard problem and encourage investment. Section V links the two separate contexts in which reliance may occur, 1) following a preliminary agreement with an agreement to invest simultaneously; and 2) during early preliminary precontractual negotiations. Section V suggests that the two contexts can be linked since there is a risk of opportunism at each juncture. It suggests that the analytical framework embraced by Alan Schwartz and Bob Scott should be extended to cover precontractual negotiation where the risk of hold up is great. Section VI reexamines recent reliance case law to see if case outcomes are consistent with a liability rule when the risk of hold up is great. In finding such support this Article rejects the thesis of Schwartz and Scott that the case law rejects recovery on reliance unless an agreement is reached. Instead, it finds courts willing to find liability even when there is too much uncertainty for an agreement to exist if the defendant has solicited sunk costs to hedge while uncertainty is resolved or to actively reduce uncertainty about the investing promisee.

II. Uncertainty in Contracting

In many complex economies transactions are delayed and not instantaneous; parties enter contracts but defer performance of one or both of them until a future date. Uncertainty about many things, including the future, then complicates the bargaining process. Uncertainties about the past, including how one’s
counterparty has acted in prior transactions, may also hinder efficient bargaining. Many types of uncertainty exist *ex ante* that affect how parties bargain, the timing of offers, the relative probability of a deal with a particular party and the incentive to dissemble or to be honest to one’s counterparty, and the ability to reach a complete contract.

These uncertainties affect the parties’ incentive to invest in the pre-contractual period given the “hold-up” problem. The “*ex ante* hold up” problem is used to describe the negative effect on reliance investment that occurs when a party who invests expects “to be ‘held up,’ namely, he does not capture the full benefit of her reliance but only a fraction $\theta$ of it. . . .”

The types of uncertainty and how parties respond to such uncertainties in a variety of pre-contractual settings affect how the law should respond using a model of justificational analysis that seeks to intervene only when doing so would improve the parties’ welfare. In any transaction, parties initially do not even know

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32 These uncertainties act as a form of a drag on trade. Parties struggle to reduce and mitigate the negative effects of uncertainty in various ways but the costs of doing so constitute a type of transaction cost for parties. 33 Johnston, *supra* note 11, at 389. 34 Schwartz & Scott, *supra* note 15, at 683 explaining that “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 will be below his cost.” *Id.* 35 Bebchuck & Ben-Shahar, *supra* note 13, at 432. This is what Bebchuk and Ben-Shahar refer to as the Divergence Between Private and Social Gain. *Id.* at 432. 36 *See infra* note 151. 37 To determine what approach will promote optimal welfare for the parties, this Article focuses on the effect of the rule prospectively on parties who are planning future transactions. In deciding whether judicial interventions would improve welfare it will also explore private strategies that parties use to deal with the uncertainty problem in pre-contractual negotiations, to determine the law can play any useful role in the pre-contractual phase in facilitating investment that will help parties reach optimal contracts and investing efficiently.
whether there are gains to be made from a trade. The seller of an asset does not know what the opportunity cost of selling its asset is, and a buyer lacks knowledge of “what the opportunity would be worth to it.” For example, a company considering a merger faces substantial uncertainty of the first kind; it does not know ahead of time if the merger of the two companies will be successful and so the bidder will not know what to pay for the target company ex ante. Parties adopt different strategies to deal with the various types of uncertainty in transactions. They use a cost-benefit analysis about whether to proceed with negotiations, how much money to spend in reliance on the contract and at what point, how much pre-trade performance to engage in, and how much to expend to acquire information to reduce uncertainties that exist about the future state of nature and the opportunistic proclivities of one’s counterparty.

When we speak of uncertainty, and the effects that it will have on parties negotiating toward a final contract, it is also important to delineate the various types of uncertainty that exist, since parties may respond to them in different ways and the nature of the uncertainty may hinder contracting and investment in different ways and affect whether and when judicial intervention might be needed.

There is uncertainty about the state of nature, about events both past and present. One cannot know what the future will bring no matter how much one expends in resources. There is also uncertainty about behavior, both past and present. One does not know how one’s counterparty has acted in the past or how he is likely to act in the future. One lacks information on that party’s propensity to diverge (©R. J. Coffey) or what Oliver Williamson calls the problem of opportunism.

38 Email from Peter M. Gerhart, Professor of Law, Case Western Reserve University to Juliet P. Kostritsky, Professor of Law Case Western Reserve University dated 9-27-2007.
39 Johnston supra note 11, at 388.
40 Id. at 389.
41 Email from Ronald J. Coffey, Professor of Law Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law Case Western Reserve University dated 1/27/2005.
42 Parties who exchange goods simultaneously do not need to worry
Even in contracts that involve future performance, if uncertainty did not exist, the bargaining process would be simple and parties could achieve fully contingent contracts that are self-enforcing. Parties could draft complete contracts that took account of all relevant contingencies and events that would affect the payoff and could price those contracts to take account of different possible future events. Even uncertainty about the opportunistic tendencies of one’s counterparty could be controlled by detailed contracts that restricted the behavior of one’s counterparty and mapped out all the possible choices that would come up.

Uncertainty in the context of a contract continuing into the future complicates contracting and makes it hard for the parties to achieve a completely contingent contract that deals with the full range of uncertainty about behavior and about the future state of nature. Uncertainty about one’s past behavior may make it difficult to evaluate how risky a partner one is dealing with. This is the classic problem of adverse selection.

43 Cite literature on incomplete contracting.
44 Uncertainty about the choices that a party will have to make in the future makes it difficult for a principal to control the potential opportunistic behavior of an agent, a classic example of how uncertainty renders complete contracting difficult to achieve.

An insurance company may be uncertain about an insured’s past risky behavior and that may make it difficult to price the insurance in a contract.
Of course, if the investment could be deferred until the time of the final contract, then the contract could protect those investments because the bargain, the price, would more than cover reliance expenditures; it would include a profit as well.

If parties do not invest any sunk costs (reliance) in a project until the uncertainty about events and returns is resolved, then the contract will protect them. Any sunk costs that are made after a contract is entered into meet with the assurance that if the other party defaults or breaches, the investing party will be protected by the expectation interest.

If a party invests in the interim period before uncertainty is resolved and before a final contract is entered into, they may be taking the risk that the precontractual reliance cost will not be compensated.

When a party invests transaction-specific sunk costs, the situation becomes even more complicated. If no sunk costs exist, it does not matter when parties are unable to achieve a complete contract that addresses all possible problems and the future, because of the cognitive limits and the cost of acquiring information (bounded rationality), and uncertainty, because parties may simply exit the relationship without any adverse consequences. The presence of sunk costs means that it will be costly to simply terminate and the failure to control for future contingencies or behavior through a complete contract may reduce the amount of joint surplus that parties could realize from the relationship.

Parties may proceed on their own with search costs to mitigate uncertainty to determine whether gains from trade exist, etc. When we talk about potential bargains then we are always

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45 See WILLIAMSON, supra note 4, at 47. See also Kenneth J. Arrow, The Economics of Agency in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS, (J. Pratt & I. Zeckhauser eds., 1985).
46 The investment of such costs contributes to what Williamson calls the “fundamental transformation” in the relationship. WILLIAMSON, supra note 4, at 61.
47
talking about reciprocal uncertainty because each party is uncertain about the costs and benefits of a potential bargain. But because there is a possible bargain that means that each party also has a reason to reduce the other party’s uncertainty, at least if that can be done with investments that are justified by the potential gains in trade from an eventual bargain. A and B are each optimistic but uncertain, but because of their optimism each will have an incentive to invest something in reducing the other party’s uncertainty and move closer to a bargain. Each party will do that when the investment in reducing the other party’s uncertainty is offset by the actual or potential benefit of reducing the other party’s uncertainty (which could be in the form of future gains from trade).

Some of these search costs may be significant and parties’ willingness to undertake such costs “depends on whether they can be recouped”48 in an ultimate contract. Such an expense by a buyer of securities of a particular company might include purchasing a Dun & Bradstreet report or perusing a company’s financial statements.

In other cases if some of the uncertainties cannot be resolved before a commitment is given, the parties may also negotiate safeguards to protect them in the event that a matter whose outcome is uncertain ex ante is later resolved in a way that makes contracting disadvantageous. A common example is the inclusion of an express condition that permits one party to exit the

48 HERMALIN, et al supra note 6, at 53. This would not be true if the parties could contract in advance on the amount to be invested and if the “party whose expected return is positive [could]...guarantee his partner a non-negative return by agreeing to reimburse his partner for investment costs if the project is not pursued.” Contracting difficulties may make this impossible. Schwartz & Scott, supra note 15, at 683. Incentives to invest would also continue even if no reimbursement promise could be made if the party was investing in general market information that might show that one bargain would not produce gains from trade but another bargain would. In that case the investment in the information is not lost when the first potential bargain is abandoned.
contract if a certain event (that cannot be known *ex ante*) materializes.49

Other uncertainties, such as the value of a company post-merger, that cannot be resolved through search costs *ex ante*, will prompt parties to seek creative solutions to reach a contract *ex ante* that will postpone certain aspects of the deal, including pricing, until the uncertainty is resolved over time. Parties might implement structural solutions to provide incentives for the parties to work toward a successful outcome50 and make the price contingent on a successful merger.51

One major tool that each party has for contracting or negotiating in the face of uncertainty and that is used in precontractual negotiations is to solicit information from the other party52 that will reveal qualities that will be valuable in helping the putative offeror decide whether to make an offer and if so, on what terms.53 Sometimes the information is relatively costless

49 Need cite.
51 That solution can serve to mitigate the moral hazard problem that would otherwise exist.
both to give and receive. A party may signal its type by sending out pessimistic statements if the chances of a deal are low and optimistic statements if the chances of a deal are high. The advantage of sending a low-cost accurate signal about one’s type is that it helps to weed out recipients with whom the probability of a deal is low. The seller who sends a signal (that he is high-cost) can get information from the recipients about buyers’ types merely by awaiting a response. Recipients will respond only to the types of sellers with whom there is a large probability of a trade occurring; low value buyers will not respond to high-cost sellers and vice versa. Because the sender of the message wants to deal only with the subgroup with whom a deal is probable or likely, the sender will send out accurate messages about his or her type in order to ensure that the class who responds actually have a high likelihood of proceeding towards a deal. The sender would not want to send inaccurate messages because doing so would prompt too many recipients of the wrong type to respond, thereby raising negotiating costs and lowering the probability of reaching a deal.

At other times, one or both parties during preliminary negotiations that occur without a preliminary agreement do not really know enough to be sending cheap signals that take the form of a statement that the probability of reaching a deal are high or low because what the probability of reaching a deal is with the other party depends on a myriad of factors that are not yet known. Thus, cheap signals that are limited to information about one’s own type that are designed to solicit information from the other party about the other party’s type that is costless to supply may not really solve the bargaining problem posed when parties remain uncertain about the probabilities of trade and about the characteristics of the other party. To mitigate such uncertainty a party can solicit information in the form of reliance investment that is transaction specific and therefore potentially costly because it

54 Johnston, supra note 11, at 389. Examples of such low cost messages, “cheap talk” include statements such as “everything looks great . . . [or] we are not optimistic.” Id.
55 Id.
56 Id.
57 Johnston, supra note 11, 409-410.
58 Oliver Williamson highlighted the importance of such transaction specific investments posed for contracts pointing out that where they
will be worthless if no contract is formed. The cost means that the information may be difficult to procure. The active role that such cooperative investment reliance can play in reducing uncertainty during the preliminary negotiation process has been overlooked in analyses of promissory estoppel and a liability rule to govern negotiation.59

The likelihood that a party will invest assets (through reliance) that will be without value if no contract is formed can lead to a problem of opportunism where one party is exposed to and vulnerable to hold up by the other party (if that other party defers investing until later on). It is a problem of moral hazard or risk that if one invests first, the other party may decline to invest at all or to delay investing if it is privately more beneficial to do so.60

This form of strategic behavior is made more problematic because of the uncertainty that exists with respect to the future state of nature and more importantly the future behavior of one’s counterparty.

If one party defers investment until after the other has invested, and after the investment if that project succeeds, the parties will renegotiate. However, the renegotiation price will ignore the sunk cost that has already been made and the party who has already invested will be left with less of the surplus than the party who has not. This is the hold up problem. Parties could delay a contract until the resolution of certain of these

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59 Kostritsky notes the neglected connection between reliance and the reduction of uncertainty in Kostritsky, supra note 50.
60 Presumably it will be beneficial to defer investment because then when the surplus is split between the parties, the entire portion otherwise available to the non-investing party will be there whereas the investing party will gain whatever portion of the surplus would be available but there will be no reimbursement or other recognition of the prior investment by the one party.
uncertainties.61 This strategy might lead parties in the direction of delaying performance until the future date, resulting in an instantaneous exchange rather than a deferred performance contract. Delaying performance would eliminate the risk of contracting under uncertainty but would have other negative effects (loss of benefits of investing early in contract when costs are low62). They would also be subject to certain risks (such as the unavailability of a product) that could be contained by a contract.

However, it is far more likely that parties will begin relying even before a final agreement is ever reached, leading to the hold up problem.

III. The Aleatory View of Reliance Investments

Traditionally under the aleatory view of contract that was a consequence of the “knife-edged” view of contract liability,63 any reliance undertaken in the pre-contractual period was taken at one’s own risk and was part of an investment in a gamble that might or might not pay off in a consummated transaction.64 Parties investing in an asset were denied compensation (pre-contract) on the theory that investors “should take the risk of wasted investments into account before making them.”65

The idea that each party invests and takes a gamble about success seems reasonable on one level, and has been justified on

61 Professor Avery Katz discusses delay as a possible response to certain types of certainty that will be resolved over time.
62 Katz discusses this concept of the benefits of early investment. See Katz, supra note 9, at 1267. Professors Goetz and Scott originated the term “beneficial reliance” to describe the ways in which promisees would adapt in advance of the promise being performed. See Charles J. Goetz and Robert E. Scott, Enforcing Promises: An Examination of the Basis of Contract, 89 YALE L.J. 1261 (1980).
63 Farnsworth, supra note 3, at 221. As Professor Farnsworth explains, under the “common law’s ‘aleatory view’ of negotiations. . . a party that enters negotiations in the hope of the gain that will result from ultimate agreement bears the risk of whatever loss results if the other party breaks off negotiations.” Id.
64 Id.
65 HERMALIN, et al, supra note 6, at 55.
the ground that imposing liability during preliminary negotiation “might discourage parties from entering negotiations,”66 non-protection for investments during preliminary precontractual negotiation may pose other contracting risks. However, although perhaps each party should have to take the risk that ordinary preliminary search costs that benefit oneself should be non-compensable,67 non-reimbursement may not be the optimal universal default rule since a rule (denying reimbursement) would discourage trade in some instances. Investments, particularly if they are transaction specific, and if they are made before the other party has invested, formed a contract or entered a preliminary agreement, and if they are invested primarily to benefit the other party,68 may pose a risk in contracting that, if unaddressed, will act as drag on gains from trade.69

There may be differences in the nature of risks for investment that parties would be willing to assume as part of the cost of doing business. They might be willing to consider some types of investment, as one judge described it, “part of the overhead expenses of his business which he hopes will be met out of the profits of such contracts as are made especially when each party invests simultaneously.”70 If, however, a party makes investments known as “cooperative investments” which benefit the non-investing party, without simultaneously lowering costs for the investing party should the deal go through, it may be harder to provide appropriate incentives for such investments when contracts are incomplete ex ante.71

66 Id.
67 This would especially be true if the investments were not transaction specific. See supra note x. An exception would apply if the parties agreed on an agreement expressly providing compensation.
68 See supra note x (discussing cooperative type investments).
70 Id. citing judge in William Lacey (Hounslow) Ltd. v. Davis [1957] 1 W.L.R. 932 (Q.B.).
71 See Yeon-Koo Che & Tai-Yeong Chung, Contract Damages and Cooperative Investment, 30 RAND J. OF ECON. 84, 103 (1999). This article assumes that the parties cannot contract ex ante on the ideal investment because of difficulties in specifying “investment related information” and therefore a contract cannot curb the opportunism that
The aleatory view may be founded on an erroneous assumption that each party would invest simultaneously and neither party would be subject to the particular problem of hold-up that occurs with sequential investment. It may assume that each party would invest a certain amount of parallel search and lawyer costs to ascertain whether a deal is profitable. If so, the aleatory view denying recovery for precontractual reliance may have survived on assumptions that ignores the potential problem that arises when there is sequential investment. Sequential investment can occur 1) in precontractual negotiation when one party (the putative offeror) delays investment to collect information on putative offerees and 2) following explicit agreements in which one party delays investment to increase private advantage. This Article suggests that analysis of the normative question of whether reliance should be compensated should pay particular attention to whether the danger of hold up with sequential investment is present, whether that occurs because one party has acted strategically for private gain in delaying a simultaneously agreed-to investment or because there is an

necessarily accompanies transaction specific investments. If such investments could be contracted on, then parties would invest optimally but without such contracts, a party will invest suboptimally. See Che & Hausch, supra, at 125. Even in the absence of a contract that would guarantee optimal investment, parties could enter into an incomplete contract and renegotiate subsequently “to the quantity that is ex post efficient.” Che et al, supra, at 126. Even if such renegotiation might result in suboptimal investment because an investing party might not receive all of the surplus due to inequalities in bargaining power, there are independent reasons and incentives to invest and those reasons might mean that even with incomplete contracts and the possibility of renegotiation ex post, “an appropriately chosen initial contract can provide the right incentives for investments.” Id. However, these optimal results could only be achieved if selfish, not cooperative investments, are made.

72 Need authority
73 William P. Rogerson, Contractual Solutions to the Hold-Up Problem, 59 REV. ECON. STUD. 777 (1992). The aleatory view was accepted without critical analysis of its underlying assumptions so it is hard to know whether the aleatory theory of reliance investment continues to make sense once the hold up problem is accounted for. See Johnston, supra note 11, at 388.
incentive by putative offerors to delay investment to solve one or more uncertainties. It is no longer possible to rationalize the denial of all compensation for reliance under one universal theory of gambling on risk in which each party could and should judge what each was willing to invest in a gamble when there was no guaranteed success in outcome. While one should make certain types of investments at one’s own risk, particularly when the other party is making simultaneous investments and thus maximizing the chances that a deal will materialize, the willingness to invest and the nature of the risks involved may change either when the investment is a cooperative investment that is likely to be of most benefit to the other party or when the investment subjects the investing party to hold up. For that reason the aleatory view of contract that denies all compensation for pre-contractual reliance should be modified.

IV. The Hold Up Problem

To fully understand the problem of sequencing of investment in precontractual negotiation, the hold-up problem and the law’s possible responses, one must 1) examine how and when parties rely when contracts are incomplete and 2) the risks that are posed by such reliance investment.

The investment of a transaction specific sunk cost can render one vulnerable to the problem of “hold-up.” Hold up may occur at several stages of the bargaining process. If a party invests sunk costs without a binding commitment from the other party during precontractual negotiation, the other party may exploit that investment by holding out for a higher price. The investing party risks losing all of the investment if no deal is consummated and so is vulnerable to this kind of pressure.74 Hobbes himself identified

74 Richard Craswell, *Offer, Acceptance and Efficient Reliance*, 48 STAN. L. REV. 481, 492 (1996). Hold up can of course occur at a later point in time after contracts have been entered into. As parties begin to invest in what Williamson calls “special purpose technology,” WILLIAMSON, supra note 4, at 54, the parties ability to deal with strategic behavior by simply terminating becomes impossible. *Id.* It is for that reason that Williamson thinks that “governance structures that attenuate opportunism and otherwise infuse confidence are evidently needed.” *Id.* at 63.
this vulnerability as fundamental to explaining the need for enforcement in contract.75 Because these investments may be unverifiable,76 and uncertain ahead of time, ex ante contracting on such reliance investments may be impossible.77 Another way to provide incentives to make efficient investments is through an ex ante agreement to divide the surplus in such a way that those parties who invest more receive a greater share of the surplus. Another way to provide incentives to make efficient investments is through an ex ante agreement to divide the surplus in such a way that those parties who invest more receive a greater share of the surplus. However, where the projects undertaken have an unverifiable surplus, such efforts to reward and protect reliance investments will not work.78

Without such ex ante contractual protection, the investing party has to depend on ex post arrangements.79 However, the postponement makes the investing party vulnerable to his expenses not being recouped in the surplus.80 This vulnerability disincentivizes investment in future transactions and discourages trade from occurring in the first place. A party may be reluctant to undertake significant costs without some safeguard.81 In a

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75 THOMAS HOBBES, LEVIATHAN (JK to check cite.)
76 Sergei Guriev and Dmitriy Krasov, Contracting on Time, 95 AMER. ECON. REV. 1369, 1369 (2005).
77 See supra note x.
78 Schwartz & Scott, supra note 15, at 678.
79 Id.
80 Id.
81 See WILLIAMSON, supra note 4, at 33 (suggesting that parties will seek safeguards against hazards in order to increase the overall gain from trade. Transactions without safeguards pose a higher risk and will be priced accordingly.) Id. at 33. (Add figure 1-2 on p. 33.) To solve this problem Jason Johnston has proposed a rule making the non-investing party liable for pre-trade performance (a form of reliance) in order to encourage those who are pessimistic about a trade occurring to speak up. Johnston, supra note 11, at 397. This Article suggests that the problem is one of uncertainty that makes the non-investing party uncertain about whether a trade will occur until the investment is made rather than concealment of the true probabilities. Thus, this Article suggests adopting a default rule for solicited investments that are useful in mitigating uncertainty for one party. That rule should apply as a default
recurring pattern in the case law, party B is uncertain of party A’s ability to perform and party A makes investments to reduce that uncertainty. Under some circumstances – particularly where the investment by A has no value outside the potential bargain with B – the parties would either expressly or impliedly agree to protect A in making that investment. If obstacles exist to contractually protecting such transaction specific investments, and if it is an investment that would not otherwise occur, or where the incentive to invest would be suboptimal or the incentive to enter future transactions would be jeopardized, the law would have an interest in protecting the value of that investment by recognizing and enforcing that express or implied agreement to reimburse such investments.

Prior scholarly analyses of reliance investments have evaluated reliance from the perspective of providing optimal incentives for parties to engage in efficient reliance, given the probabilities of a trade occurring. The law encourages efficient behavior by reimbursing parties only when they engage in efficient reliance, but not otherwise. That approach prevents parties from wasting assets towards the realization of transactions when the likelihood of success is too low. These analyses evaluate a rule because the soliciting party is often uncertain about whether a trade will occur but needs and is benefited by an investment.

82 As Avery Katz makes clear, “the only reliance investments needing protection are those that are specific to the transaction or relationship. If the offeree’s investment is fully salvageable through resale or a substitute contract, then there is no holdup problem. Because the offeree can then make the offeror compete against all other possible market uses for the investment, he will have all the bargaining power and the [offeror] will have none.” Katz, supra note 9, at 1276.

83 The problem of the presence of idiosyncratic sunk costs deterring professionals from entering service contracts, such as construction, because of the danger of ex post hold up has been studied. See Lee & Png, The Role of Installment payments in Contracts for Services, 21 RAND. J. OF ECON. 83 (1990). Lee & Png suggest that installment payments can incentivize greater initial efforts, as would a law-supplied rule installment payment scheme to provide incentives to enter contracts where the danger of hold up would otherwise deter such contracts. Id. at 95.

84 See e.g., Craswell, supra note 72.

85 Id. at 493.
reliance decision as a cost-benefit analysis that occurs at a moment in time.86

In deciding whether to invest reliance costs, a party looks at how an investment will benefit the investing party. Using a Learned Hand approach to reliance investment,87 scholars have urged that efficient reliance occurs when the investment is worth the cost. The cost is measured by the investment that will be lost if the deal does not materialize and the benefit is measured by the benefits that will accrue if the deal goes through. The investing party weighs the probability of the trade materializing in order to determine whether an investment is justified.88 Craswell argues that judicial decisions often reach results consistent with the protection of efficient reliance.89

Under this cost-benefit approach, a promisee will not want to invest too early when the probability of a trade occurring is low90 but will not want to delay investment for too long since some of the benefits of investing in the deal early would be lost.

A significant drawback to this prior approach as a method for determining whether the law should impose liability for reliance costs on the other party – a normative question – is that it ignores the essential structural problem of sequential investment that may result in a distortion of reliance incentives through the hold up problem.91

The notion that a party will invest efficiently given the probabilities of a future trade occurring is only true if one ignores that an investing party is in a vulnerable position once the

86 See also Katz, supra note 9, at 1269.
87 Sometimes the parties themselves will engage in efficient reliance calculations without the law having to intervene. At other times, the parties may have insufficient incentives to invest, particularly when the prospect of a hold up problem looms large. See infra text accompanying note x.
88 Craswell, supra note 72, at 491.
89 Id. at 507.
90 Id. at 493. See also Katz, supra note 9, at 1268.
91 Craswell, supra note 72, at 493 (discussing the “distortion” in incentives problem.)
investment is made, if there is no enforceable commitment from the other party. Once a promisee has invested first before a contract is formed, that party becomes subject to hold-up by the other party and the investing party will have a reduced incentive to invest.92 Anticipating this possibility a promisee may forego a trade even if there are gains from trade. Even if a bargain is struck later, the investing party will not be able to capture all of the gain in the bargain.93 Whoever invests first is subject to this loss and under such circumstances “investment will be inefficient.”94 This is because the party “would invest only until the marginal cost equaled the fraction of the expected gain.”95

A different version but equally problematic version of the hold-up problem can also occur if “the distribution of ex ante costs across the parties is sufficiently ‘mis-matched’ with the

92 This would not be true if the parties could contract in advance on the amount to be invested and if the “party whose expected return is positive [could]. . . guarantee his partner a non-negative return by agreeing to reimburse his partner for investment costs if the project is not pursued.” Schwartz & Scott, supra note 15, at 683. Contracting difficulties, however, may make this impossible. Id.

93 As Professor Craswell explains, The “ability [of the noninvestor] to hold out for a share of B’s profits is what distorts B’s reliance incentives in the absence of a binding commitment. B must still bear all the downside risks of his reliance, for if it becomes inefficient for S to perform, then she will walk away from the deal without paying anything. But if B’s reliance becomes worthwhile—that is, if it becomes efficient for S to perform—then B will not capture all of the gains from his reliance because S may extract some of those gains by holding out for a higher price.” Craswell, supra note 72, at 492.


95 Schwartz & Scott, supra note 15, at 679. One possible solution that would result in the party investing efficiently would be to allow that party an option of making it a “take it or leave it offer” to the non-investing party. That prospect would permit the investing party the option of recovering all of the surplus and that would encourage efficient reliance. However, these solutions are dependent on an assumption of no renegotiation and that cannot be guaranteed so these solutions will not solve the underinvestment problem. Id. at 679.
distribution of surplus.”96 In that case, an investing party may be disinclined to invest because the amount that he/she receives in surplus will not cover the investment.97

As Craswell deftly explains it, “any reliance by B must make consummation of the deal more important to him, since reliance increases the difference between the benefit B receives if S performs, and the loss B suffers if S fails to perform. But once consummation of the deal becomes more important to B, S can exploit this by threatening not to perform, unless B agrees to pay her a higher price. . . .”

This structural hazard of hold-up can be looked at as a specific example of the general problem of opportunism. The investing party does not know ahead of time whether the party soliciting the sunk cost will strategically use of the investment by denying the investing party the full benefit, either in the negotiated bargain or in a side payment of reimbursement.

The promisee is subject to the risk that if a bargain is ever reached between them, it “will reimburse only the promisor’s costs.”98 The disincentive to invest ex ante could be exacerbated if the part of the surplus available to the investing party did not even cover the ex ante investment costs. The promisee, because of a poor bargaining position that exists when he has sunk costs and the promisor does not have such costs, could theoretically, following the sinking of such costs, tell the promisor that he will not proceed but such “threat to exit unless his investment costs are reimbursed

97 Id. at 230, with Anderline and Felli explaining that “the parties will pay the costs only if the distribution of the surplus generated by negotiation will allow them to recoup the costs ex post.” That may not occur if there is a mis-match between investment and distribution of the surplus. The authors point to a famous incident involving a decision by a small research company (that had an operating system for PC’s that IBM was interested in acquiring right to) to refuse to make the necessary preliminary investments because of a fear of a holdup by IBM. Id at 227. That decision was an inefficient outcome caused by the fear of holdup.
98 Id.
is not credible....”

In any project the parties choose when to begin investing (reliance costs) in a project, each party can invest at the same time or one party can choose to defer investment until the first party has invested. Each of these investment regimes may be efficient or inefficient in different circumstances and each legal regime governing such factual scenarios may address or exacerbate the problem of hold-up, incentives to invest or create a new problem of follow-up opportunism.

Sometimes sequential investment may be necessary as an antidote to a certain type of hold-up problem. If a financer lends a new and untested entrepreneur (a species of the uncertainty problem) funds at the same time that the entrepreneur makes contractual promises to repay, the lender may decline to lend as it will yield a negative return. The entrepreneur will be subject to a risk of hold-up or moral hazard by the entrepreneur, who can appropriate the loaned funds without building a company or any assets. This is a form of opportunistic behavior by a borrower.

In such cases, sequential or staged investment by the financer or staged financing could provide a needed antidote or safeguard to the financer without which safeguard the financer would not lend. If the financer loaned all of the money up front to start up a project for example, the financer would be subject to the moral hazard of the entrepreneur expropriating the cash without using it to make the venture profitable or engaging in a holdup and asking for a renegotiation of terms more favorable to the borrower. Since the financer has little leverage at the point where the project is yet unbuilt, the financer might make concessions in order to recover some of the money back. This is the problem posed by a kind of sequential investment in which one party invests everything up front, leading to a moral hazard/hold up problem. To alleviate the problem the financer could target lending to the entrepreneur to the stages when assets are built up in the new company, thereby rendering the financer less subject to hold-

99 Id.
100 Id. at 388.
Once the assets are established, the financer will have the ability to realize monies to cover any default by the borrower. In such a case deferred investment is a private strategy to curb the hold up by the entrepreneur.

In other cases however, rather than being a response to a hold up problem, sequential investment may be a form of strategic or opportunistic behavior that may need to be controlled through a law-supplied default rule.

The promisee sinking costs in a manner that leaves him vulnerable to hold up because he will not be able to capture the entire surplus will act as a disincentive to reliance investment if there is no reimbursement for such reliance costs. For that reason this Article suggests that because the same danger of moral hazard exists whenever a promisor faces uncertainty about the nature of the ultimate transaction and deliberately delays any investment until the promisee has invested during precontractual negotiations, or when a party agrees to invest simultaneously and then delays to gain a private advantage following a preliminary agreement, the law should consider in each case what rules to craft to avoid the threat of a hold up. That may involve formulating a liability rule that compensates the investing party.

In the next section, the Article will trace how the threat of hold up permeates both precontractual negotiation and preliminary agreements that involve an express simultaneously agreed to sequence of investment. It argues that the two phases both involve a unified threat and should therefore be considered part of one problem demanding judicial attention.

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102 Id.
103 Id.
104 For a discussion of opportunism and its costs, if uncontrolled, see WILLIAMSON, supra note 4, at (including the risk that gains [can] be dissipated by costly subgoal pursuit.”)
105 Bebchuck & Ben-Shahar, supra note 35, at 425. Contrary to what one might expect, the problem of underinvestment can occur even if both parties invest. Id. at 425.
Section V Preliminary Agreements and Precontractual Negotiation: Two Contexts But One Risk of Hold Up

Schwartz and Scott have provided particular guidance to solve one type of hold up problem – of one party acting opportunistically following the preliminary agreement on some terms and an agreement by both parties to invest simultaneously following which one party chooses to delay its investment. The delay gives one party the advantages associated with sequential investment and constitutes a form of hold up.106 As the authors point out, one party may have “an incentive to defect from any such agreement,”107 because “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.”108

These preliminary agreements often take the form of letters of intent, or other agreements in which parties agree to some but not all terms and postpone negotiation of those open terms until a later date.109 Depending on the parties’ intentions, these preliminary agreements may be either (1) fully enforceable,110 (2) not binding at all if the parties have indicated their intent that no enforceable contract would exist absent a further formal agreement,111 or (3) binding only in the sense of committing the

106 Schwartz & Scott, supra note 15, at 666.
107 Id.
108 Id. (emphasis supplied).
109 Id. at 664. See also Johnston, supra note 11, at 450. This postponement of some terms with an agreement reached in stages is particularly likely to occur in “corporate mergers or acquisitions, commercial lending, executive employment and the sale of highly customized goods.” Id.
110 Preliminary agreements will be interpreted as fully enforceable if the parties intend the final written contract to act merely as a memorial of a fully negotiated agreement. Id. 467. See also United States v. P.J. Carlin Constr. Co., 224 F. 859, 862-3 (2d Cir. 1915).
111 See e.g., R.G. Group, Inc., v. Horn & Hardart Co., 751 F.2d 69 (2d Cir. 1984); see also Feldman v. Allegheny International, 850 F.2d 1217 (7th Cir. 1988)(cited in Robertson where Easterbrook explains Feldman as holding that “Illinois is averse to enforcing tentative agreements that are expressly contingent on the signing of formal or final documents”).
parties to bargain in good faith towards a profitable outcome.112

After such agreements one or both parties may rely and when such agreements exist, both parties are obligated to abide by an obligation of good faith to reach an ultimate agreement.113 If one party invests and the other party breaches its obligation to act in good faith (triggered by the binding preliminary agreement), then those reliance costs may be compensable.114 These interim

112 Id. at 664. See also Teachers Ins. & Annuity Assoc. v. Trib. Co., 670 F. Supp. 491 (S.D.N.Y. 1987) (providing a framework for determining which preliminary agreements would be considered binding commitments that required parties to bargain in good faith toward a final contract). Courts developed a multi-factor test to determine the parties’ intent in these preliminary agreements. However, such tests have resulted in “doctrinal ambiguity” Johnston, supra note 11, at 467. Professor Johnston finds fault with the current tests for judging whether preliminary agreements should be binding due to the uncertainty posed by applying tests that depend on “ex post investigation of negotiating history.” Johnston supra note 11, at 474-5.


114 Id. at 664-65. Schwartz and Scott argue that the emerging new legal rule requiring parties to compensate the other party for reliance costs when there has been a breach of an agreement to invest simultaneously. Id. at 667, 675. However, Schwartz and Scott, while applauding the tendency of courts to reach outcomes awarding reliance investment to the investing party against the party who has delayed investment, find the legal approach that ties the liability to the obligation of good faith to be “deficient” and “unnecessary” id. at 667, in part because of the lack of clarity about the scope and content of the good faith obligation. Id. Schwartz and Scott would award reliance costs whenever there has been a breach of the agreed-on investment sequence.

This Article argues that the reason for imposing an obligation of good faith and with it a liability rule to govern breaches of bad faith is linked to the obligation to prevent opportunism and hold up. The problem with jettisoning good faith and grounding the liability rule in the breach of an agreed on investment sequence is that it is not a broad enough basis to permit courts to impose liability in the precontractual phase where there is no agreed on investment sequence in the picture and no preliminary agreement. Rather than limiting the obligation to compensate for reliance investments to an ex ante agreement to invest simultaneously, the law should be looking at when is intervention justified to prevent
agreements protect reliance investments if a court decides that a preliminary agreement is binding in the third sense above and one party has breached by refusing to bargain in good faith.115 The threat of such a liability rule encourages parties to live up to their obligations of good faith and permits both parties to invest and rely efficiently.116 The law-supplied obligation of good faith discourages the problem of hold up that might otherwise exist.117

Schwartz and Scott reinvigorated the study of these preliminary agreements contexts by identifying the problem of hold up. Such hold up demanded new scrutiny. In their recent article, hold up occurs when one party invests simultaneously and the other party who had promised to invest simultaneously, delays its investment. That delay would subject the investing party to ex post hold up as the non-investing party may suffer when the other party declines to invest simultaneously even when it had previously agreed to such investment. That delay by one party can

hold up problems that occur at different phases of negotiation and contracting. It can occur in cases where the parties have breached an agreement to invest simultaneously but it can also apply in other settings that do not involve an express agreement to invest simultaneously. Thus, the question becomes how and when can a liability rule obligating one party to reimburse the other party for reliance costs be justified? An obligation of good faith is simply a broad legal rubric that provides a foundation for protecting reliance costs when doing so is necessary to prevent opportunistic behavior. That might be the case in a case involving no preliminary agreement at all, as in Wood v. Lucy, 118 N.E. 214 (N.Y. 1917) (finding implied obligation to use reasonable best efforts to deter opportunistic behavior that would otherwise occur if marketer could enter into exclusive contract but then fail to use any efforts thereby depriving designer of any profits at all) or it might be in the context of precontractual negotiations that do not result in any preliminary agreement or any agreed-on investment sequence.

115 Schwartz & Scott, supra note 15, at 667.
116 id. at 696 (hypothesizing good incentive effect from liability rule in terms of encouraging duty to invest simultaneously following preliminary agreement).
117 Schwartz and Scott would streamline the process and dispense with the need to determine whether the obligation of good faith was breached by making liability turn solely on whether verifiable reliance investments were made by one party after one party breached a promise to invest simultaneously and then delayed doing so.
subject the investing party to the prospect of a negative return on the transaction.118 Because there is some unknown probability of such hold up occurring,119 parties will simply decline to invest or transact120 as means of self-protection. This results in lost gains from trade.121

Schwartz and Scott argue that reliance investments should be compensated when they arise in the course of such preliminary agreements if one party has promised to invest simultaneously (which investment is needed for a successful project) but has deferred investment for strategic reasons.122 The authors provide the case law evidence that courts reach results to protect reliance investment in such fact patterns.123

The identification of hold up by Schwartz and Scott as a reason for protecting reliance expenditures provides a real advance in understanding one particular problem that has arisen when parties rely after preliminary agreements and agreements to invest simultaneously have been reached and the other party “defects” from this plan.124 Prior judicial determinations of the

118 Id. at 685.
119 Id. at 686 n.64 (detailing particular circumstances in which “the prospect of breach can be sufficiently great to deter the buyer from participating.”) Then parties would make Bayesian estimates about the likelihood of a departure from the agreed on investment sequence.
120 Id. at 686.
121 When the parties have actually reached an agreement, albeit one that is incomplete on the surplus division, there may be a different kind of hold up that occurs as a result of renegotiation. If one party invests, and the parties cannot commit not to renegotiate, then after investment, a party who invested “seldom could bargain to capture the entire gain.” Id. at 679. That would lessen the incentive to invest as the non-investing party would through renegotiation be able to capture some of the surplus.
122 Id. at 685-6. The example given by Schwartz & Scott involves a doctor who invests in a practice by moving and joining a practice with the expectation that the practice would invest by training the doctor. If the practice declined to invest in training after promising to do so, then the doctor would be subject to hold up. Id.
123 See cases discussed id. at 694-702.
124 This would facilitate efficient investment because there are instances where “the buyer’s expected return is negative without the reliance offset and positive with it . . . [so] a buyer who expects to recover reliance will
compensability of reliance investments following preliminary agreements had turned on ascertaining the parties’ intent but that approach failed to provide adequate guidance to courts.125 Although many courts have apparently reached results consistent with Schwartz and Scott’s thesis,126 they have done so without specific guidance on the normative importance of a deviation from an agreed on investment plan and the danger of an ex post hold up.

Schwartz and Scott’s analysis of many factual scenarios in which parties reach a preliminary agreement and an agreement to invest simultaneously and then one delays while the other relies identifies a key factor that correlates with a plaintiff’s likely success on a reliance claim. That factor could be applied to other cases of reliance not involving agreements to invest simultaneously. It suggests a broad justificative framework that suggests where one party’s reliance leaves it vulnerable to hold up, a liability rule might be required to prevent problems of under-reliance and to encourage transacting that might otherwise not occur.127 The authors, however, conclude that to determine whether a reliance claim should be compensable, courts should ascertain if the parties reached a preliminary agreement that included a planned sequence of investment. Where both parties agree to invest simultaneously, and one party strategically delays investment for private benefit, the party who delays should be liable to the other party for verifiable reliance costs.128 Liability would be optimal since the assumption is that the greatest gains from trade would have been realized from simultaneous investment and when one party defers investment for private gain (the same problem that a principal faces with a shirking agent129), that behavior acts as a drag on gains from trade that should be controlled.

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125 Id. at 675.
126 See cases cited in id. at 694-702.
127 See email from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law.
128 Schwartz & Scott, supra note 15, at 686-87 (pointing to the fact that a “portion of the buyer’s investment cost . . . is verifiable ex post,” id., even if not ex ante contractible.
129
Although Schwartz and Scott’s suggested liability rule is a narrow one and involves 1) reliance investments 2) undertaken after a preliminary agreement is reached; and 3) after an express agreement is reached that obligates both parties to undertake simultaneous investment, this Article contends their analytical framework can and should be extended to the precontractual negotiation context, an area that many scholars, including Schwartz and Scott, contend demonstrates “scant support in the law of contracts” for liability. When Schwartz and Scott argue that Hoffman is “wrong as a matter of doctrine” id., at 670, they do so partly on the basis that the RESTATEMENT itself contains only a single definition of promise and that there is no separate section between promises that induce unbargained for reliance and promises that are “the product of a bargained-for exchange.” id. The fact that the RESTATEMENT (SECOND) OF CONTRACTS makes no distinction within §2 itself can best be understood by the fact that a separate section exists on the definition of an offer in §24. When a promise reaches the point where it would constitute an offer, then that is the point at which one can conclude that there is a bargained for exchange; the offeror has named the price that would make him better off if the offeree were to accept. Thus, one could certainly argue that the drafters of the Restatement knew how to make a distinction and when the drafters defined promise in §2 they deliberately did not use the word offer. In not doing so, and using the word promise, they were distinguishing it from cases in which the putative offeror had reached the point that he names the price on which he is willing to be bound, as in a bargained for exchange in §§24 and 71. Had they intended the word “promise” in §90 to have the more fully developed meaning of an offer, they could have done so as they did in §87. In §87 the drafters used the word offer to refer to cases in which the Restatement will enforce offers that induce reliance, thereby suggesting that §90, if it is to have any separate meaning and not be superfluous, must mean “promise” to refer to commitments that do not rise to the level of a full-fledged offer and are therefore less fully formed.

Further, even beyond the textual arguments, to decide whether the Hoffman court had any precedential support for construing “promise” in §90 to refer to a commitment that did not reach the level of an offer, one would have to analyze case law. Certainly, there are cases in which courts, prior to Hoffman, enforced promises and construed language to rise to constitute an actionable promise under §90 even if it did not constitute an offer.
Scott to determine that the delay in a planned simultaneous investment should lead to liability is that one party has acted strategically to delay because that delay would be privately beneficial though not mutually beneficial. Such delay would have the negative effect of discouraging buyers from pursuing efficient projects. That decision to impose liability for breaches of agreed-on investment plans cannot be answered reflexively without invoking a normative framework built on certain assumptions about how parties are likely to behave in response to the rule and what effect it will have on the parties’ goal of maximizing welfare. The second party will benefit, especially when the likelihood of success is high and the investment cost is significant. Waiting will allow the party to recover investments through the *ex post* bargain. Investments made beforehand would not be recoverable because they would already have been sunk at the time of the bargain.

Under a normative framework investors would anticipate that non-investors would act opportunistically and would not believe any promises by non-investors to refrain from such behavior and consequently, they would forego opportunities as the only means of protecting themselves against the possible negative returns that will occur when sellers defer investment.

The problems with deferring investment are twofold. First, even if simultaneous investment would be ideal, one party may depart from the ideal to increase private gain, causing a reduction in gains from trade. Second, the anticipation of this strategic behavior may cause some (first) parties to refuse to participate at all because they fear the breach of the second party’s promise to invest simultaneously. Deals that would have been efficient therefore will not take place. A liability rule for broken promises to invest simultaneously encourages parties to invest optimally and could solve the hold up problem.

This Article suggests that a liability rule for reliance

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131 Thus, there may be social advantages for both parties to invest simultaneously.
132 *Id.* at 685.
133 *Id.* at 686 (discussing problem of credibility of promises to invest).
134 *Id.* at 686-6.
expenses should be adopted more broadly to apply whenever there is a structural problem posed by sequential investment. This problem of hold up is particularly likely to occur when the putative promisor seeks investment from the promise to alleviate uncertainty about the promisee.\textsuperscript{135} The putative offeror makes promises intended to cause the other party to invest sunk costs that can reduce uncertainty about the investing party in a manner that will allow the promisor to decide whether to proceed at all and if so, on what terms or in a manner on a timetable that will permit some other uncertainties to be resolved. The parties may not be in a position early on to agree on what each must invest\textsuperscript{136} since they are not even sure that they are going to proceed.

Not being able to contract ahead of time on the investments poses problems for investment.\textsuperscript{137} Contracts remain incomplete and fail to provide certain contractual protection for investments made. Another problem is that the exact best timing for the investment may not be clear ahead of time either\textsuperscript{138} and that uncertainty may mean that parties can act strategically once investments have been made by one party. Other efforts to protect specific investments may be unavailing as well. These might include an effort to “contract on surplus” in such a way that the party investing more ahead of time is given a “larger share” of the surplus \textit{ex post}.\textsuperscript{139} Then, even if contractual solutions were unavailing, parties could leave the compensation issue to \textit{ex post} negotiations. Such arrangements, however, could discourage investment since that would present the classic hold up problem since in those cases, “the investing party generally does not appropriate the full marginal returns on the investment.”\textsuperscript{140}

\textsuperscript{135} This would be true even if there is no agreement to invest simultaneously.
\textsuperscript{136} This makes the investments non-contractible.
\textsuperscript{137} Che & Hausch, \textit{supra} note 26, at 125 n.1 (detailing impediments to direct contracting on the investments including the fact that “specific investments often take a nonmonetary, intangible form, such as human capital investment.”) \textit{See also} Rogerson, \textit{supra} note 71, at 777 (discussing need to make “non-contractible specific investments prior to the transaction in order to prepare for it.”)
\textsuperscript{138} Rogerson, \textit{supra} note 71, at 777.
\textsuperscript{139} Schwartz & Scott, \textit{supra} note 15, at 678.
\textsuperscript{140} Guriev & Kvasov, \textit{supra} note 74, at 1369.
When a promisee invests at this preliminary stage, and is not protected by any contractual agreement, the problem of sequential investment presents itself with its attendant risk of underinvestment and lost trading opportunities.141 Once the promisee invests, he faces the possibility that no deal will materialize and he will lose his investment. Even if a deal materializes, the investing party may not be able to recover all of the benefits in the price. The investment will render him subject to a hold-up prospect.142 All of this will lessen his incentive to invest and cause him to forego trading opportunities unless safeguards are provided either through private agreements or law-supplied default rules. The risk is the same in all of these cases and that is that the investing party will be subject to the other party appropriating part of the benefit in the negotiated surplus.

In this recurring situation one can conceptualize the position of the promisee and the putative promisor as one in which the promisee is investing the putative promisor with the authority to proceed to collect enough information but only if the promisor will commit not to act opportunistically, however, in the pricing of the deal, should a contract be achieved. A commitment to refrain from acting opportunistically would not be credible because once the investment is sunk, the promisee will not be able to earn all the benefit from it.143 That promise would be difficult to make credible, in part because courts might not enforce such a vague promise.144 Moreover, because of the uncertainty problem, promisees do not know how trustworthy their counterparties are and thus, they do not know whether the promisor’s commitment should be trusted. If all of the possible sunk costs that the promisor desired could be specified and priced in advance, then the promisor might agree that the investing party will receive a “non-negative expected return by agreeing to reimburse the partner for investment costs if the project is not pursued.”145 When such investments are “non-contractible,” however, that solution will not

141 See supra note x.
142 The problem may be even more severe if there is a ‘mis-match’ in surplus. See Anderlini & Felli, supra note 94, at 230.
144 WILLIAMSON, supra note 4, at 63.
145 Schwartz & Scott, supra note 15, at 683.
The particular problem of hold-up occasioned by sequential investment that occurs when one party is seeking to reduce its own uncertainty or to hedge could be cured if each party bargained over each incremental step and negotiated a price to pay for such investment. Then investment would only occur on the payment of a price and ex post hold-up would not occur. The downside of bargaining in such a way is that it would be costly and add to the transaction costs of preliminary negotiation. When other solutions to guard against hold up are not feasible or are too costly, the law could and does imply a liability default rule that obligates the promisor to pay for the sunk costs of the promisee (his reliance costs) through the legal doctrine of promissory estoppel.

In many successful promissory estoppel cases the parties do not agree or map out an investment strategy so there is no actual agreement beforehand about the investment strategy, but one party solicits investments to learn more about the party through investments. Once those investments are made, the investing party is subject to the hold-up problem occasioned by sequential investment. If the parties proceed to a final deal, and the other party waits until later to invest, the investing party will recover one-half of the surplus but less his investment and the non-investing party will recover one-half of the joint surplus and will profit by delay.

Since the putative promisor stands to benefit from the sunk costs taken by the counterparty through a reduction in uncertainty about the promisee, since the sequence of the investment subjects the promisee to the risk of hold-up, since the costs of private solutions negotiated on a case by case basis are costly or not feasible, and the risk is a generalized one affecting many preliminary negotiations, the law should and does impose a generalized default rule making the soliciting party responsible for the transaction specific costs of the other party. The putative

146 Id.
148 See supra note x.
149 See supra note x.
promisor benefits from this default rule\textsuperscript{150} and it is presumably one that he would bargain for to continue to induce promisees to invest in ways that reduce uncertainty for the promisor and encourage trade.

The risk that parties will act opportunistically and in doing so may discourage trade unless parties can control such hazard at a reasonable cost can occur at all different stages of negotiation. It may occur, as Schwartz and Scott posit, when parties defect from an agreement to invest simultaneously following an initial preliminary agreement on some but not all terms.\textsuperscript{151}

The risk, however, may also affect pre-contractual reliance that is distinct from the reliance on a “preliminary agreement.”\textsuperscript{152} The results of the case law are consistent with a judicial default rule protecting such reliance investments in both contexts. Courts take account of the uncertainty and hold up problems in deciding cases in favor of plaintiffs bringing claims on promissory estoppel or other substantive grounds in cases that lack a bargained-for contract. The Article suggests that courts implicitly consider the same elements when they determine whether there has been a breach of the obligation of good faith in preliminary agreement cases and when they decide whether to impose liability in the precontractual liability cases. This universe of cases thus shares a unifying justificative framework\textsuperscript{153} useful in determining when pre-contractual reliance should be protected.

In deciding whether and why to impose liability for reliance investments that do not result in a contract, it is important

\textsuperscript{150}See Kostritsky, Schwartz & Scott, \textit{supra} note 15, at 686.
\textsuperscript{151} For a complete treatment of the available theories available to plaintiffs seeking compensation for investments see Farnsworth, \textit{supra} note 3 (detailing unjust enrichment, promissory statements, fraud and general obligation as possible theories for precontractual reliance recovery actions).
\textsuperscript{152} See Ronald J. Coffey, \textit{Interventional Implementation, BA1 Methodology} (exploring fundamental attributes of justificational analysis for legal intervention in private agreements)(on file with author); see also Peter M. Gerhart, \textit{An Introduction to Justifictional Analysis}, (manuscript on file with author).
to consider 1) the timing of the investment 2) the precise way in which the hold up problem will manifest itself, 3) the incentive of the parties to undertake efficient investments with and without a liability rule and 4) whether a legal intervention is needed to counteract incentives to act in ways that will encourage inefficient investments.

The problem of moral hazard thus exists outside the factual scenarios identified by Schwartz and Scott and presents itself at all phases of negotiation and preliminary negotiations. It exists whenever one party “has a greater ability than the other to delay a material portion of her work.”154 The potential for one party to delay investment exists when the promisor is soliciting sunk costs from the promisee in order to make determinations about whether to proceed and if so, on what terms. Because of the relationship between the promisor and the promisee in which the promisor is gathering information to formulate the terms of the offer, and of the fact that the promisee must provide information in the form of investment in the form of reliance and sunk costs in order to enable the putative promisor to proceed to an offer, the promisor has the discretion to delay making any investments of its own and to hedge when uncertainties are greatest.155

Promisors are all genuinely uncertain about qualities of promisees and often until they receive information from promisees in the form of the reliance investment, they will not be able to assess accurately the chances for trade or distinguish among possible contracting partners.156 Promisors who are uncertain about the probability of a trade or about contracting partners depend on information to resolve uncertainty. For soliciting that benefit, they should be liable for its cost to the investing party because it inevitably subjects the other party to hold-up vulnerability.157 What promisees require for investment is a commitment that they will be compensated for their reliance investments if promisors encourage them to invest;158 otherwise they will be hesitant to invest because of the risk of being held up.

154 Schwartz & Scott, supra note 15.
155 See supra note ___
156 See cases cited infra in note 195. (Section VI).
157 See supra note 35.
158 This limitation may curb the problems of excessive reliance.
The liability rule governing precontractual negotiations that makes the promisor liable for induced reliance provides a law-supplied safeguard. It parallels protection the law affords against strategic behavior when promisors promise to invest simultaneously and then delay for private gains in ways that reduce the potential surplus. In each case, the risk is that the strategic behavior of one party will deter reliance in the future and discourage trades.

It is the same risk that a party might have faced before the advent of constructive conditions of exchange. Without that doctrine, one party who had not expressly stipulated that his performance was conditional on the other party’s performance, could be forced to go forward with his or her own performance, leaving one vulnerable to risks that the other party would act opportunistically. Mansfield’s famous doctrine of constructive conditions of exchange—by making each party’s duty of performance constructively condition on the other party’s similar performance—guaranteed against such risk.159

The need for clarifying information exists when the promisor does not actually know what the probability of a successful trade is. The promisor will solicit investments in order to clarify that probability. Thus, the problem is not necessarily one of misrepresenting the facts since the facts are not yet known. It is the inherent structural risk that arises whenever the promisor solicits information and the other party, the promisee invests, leaving that investing party vulnerable to hold up.

One commentator, Jason Johnston, who has been concerned with the same problem of providing solutions to encourage efficient reliance, has suggested solution of protecting pre-trade performance whenever the promisor is aware of the performance and has not acted to actively discourage such performance through sending a pessimistic message.160 The aim is to discourage overly optimistic messages. Johnston’s solution advocates a rule making promisors liable for pre-trade performance in order to flush out those promisors who are actually pessimists

160 Johnston, supra note 11, at 499.
(for whom the probability of trade is low) but are parading as optimists in the latter stages of negotiation following a preliminary agreement in order to encourage promisees to invest by beginning to perform and to encourage other parties not part of the preliminary agreement to drop out. 161 In some ways, until that performance starts, sellers will all look the same 162 and the only way for the sellers to distinguish themselves in a meaningful way to buyers is to begin performing. 163 Because buyers need such information in order to be able to determine if a deal makes sense, buyers will send encouraging messages to all sellers about the possibility of a trade without any factual justification for doing so. 164 A liability rule would encourage pessimists to speak out and to issue a pessimistic statement reflecting the actual low probability of a deal. That would make sense because in those cases it would be inefficient for promisees to rely because the chances of a trade are too low.

This Article suggests a liability rule founded on a different rationale. It seeks to solve the hold-up problem posed by sequential investment and to control the opportunistic exploitation of such investments to gain information needed to reduce uncertainty.

In the early stages the need for information exists since the promisor does not actually know what the probability of a successful trade is and will solicit investments in order to clarify that probability. 165 The problem is not necessarily one of misrepresenting the facts about the probability of trade since the facts are not yet known. It is the inherent structural risk that arises

161 Jason Johnston provides this insight. Id. at 494. This will eliminate competitors.
162 Id. at 494 (explaining that sellers of services that are complex may remain indistinguishable to buyers until they actually start performing).
163 Id.
164 Id. at 498.
165 Scholars have dealt with the reliance issue occurring in pre-contractual negotiations from a number of different vantage points. Some have examined the parties’ incentives to make, and the courts’ protection of, efficient reliance investments. Others have focused on the optimal timing of reliance investments and the regulatory role courts should play in protecting promisees who rely when the promisor has all of the bargaining power. 165
whenever the promisor solicits information and the other party, the promisee invests, leaving that investing party vulnerable to hold up and the non-investing party relieved from actually paying anything for these benefits. The promisor should be liable for sunk costs that are invested by the promisee with no apparent gift motive, when solicited by the promisor, unless the promisor gives notice to the promisee that it will not be responsible for such costs. All promisors need promisees to rely early on. The rule can be rationalized as part of an implicit bargain in which the promisor agrees to pay for investments that are useful in resolving whether to go forward and in which the putative promisor soliciting sunk costs has a way of making a credible commitment not to opportunistically “hold up” a party who invests.

This liability rule will deal with a problem that is likely to arise in all cases of solicited sunk costs when it is doubtful that the promisor has any accurate assessment yet of the probabilities of trade. The law imposes liability not to force pessimists to disclose their true assessment of the likelihood of a trade, since such probability is unknown as yet but because such a rule will promote the parties’ mutual welfare by encouraging promisees to invest who would otherwise decline to do so. This rationale is not tied to the concealment issue but is grounded in efficiency concerns.

VI. The Hidden Element and Connecting Thread in Reliance Case Law in Two Phases of Bargaining: The Case Law Revisited

A liability default rule protecting reliance investments

166 This suggested liability rule is not new. See Kostritsky, supra note 51. What is new is that the author has undertaken a comprehensive search of the recent case law to determine whether case outcomes comport with the parameters of the liability rule suggested here.  
167 Id. at ___.  
168 Johnston also desires to promote the instrumental end of efficiency but he aims to do so through a rule that will make pessimists disclose actual low probabilities of trade.  
169 This Article does not purport to decide which amongst several intermediate liability rules would be optimal. See Bebchuck & Ben-Shahar, supra note 13, at 435-9 (discussing alternative liability regimes). Instead, it seeks to (1) demonstrate that there is support for imposing
made in the precontractual period of negotiation that are solicited to reduce uncertainty for the noninvesting party or to hedge pending the resolution of uncertainty would encourage investment by promisees who would otherwise invest sub-optimally. The structural problem of hold up that occurs when one party invests first in precontractual negotiation would be alleviated. The danger that a promisee would invest and then not be able to recoup the investment in the bargain price since the bargain would ignore costs already sunk would be solved.

Courts have continued to protect such reliance investments in pre-contractual negotiations in cases that resemble the *Hoffman v. Red Owl* case, presenting a fact pattern in which the putative offeror solicits and the promisee invests non-redeployable reliance investments to determine whether to proceed further and if so on what terms. In many of these cases the law protects these investments through an application of promissory estoppel case law. In some cases, the law also protects such reliance and guards against the hold up problem through the creative application of other doctrines, such as restitution.

Because many recent scholars have posited the demise of promissory estoppel as a viable cause of action, and some liability in at least a subclass of reliance cases that are brought to trial and (2) to connect the successful reliance cases in precontractual negotiation to the related problem of hold up when parties rely on a preliminary agreement and one party seeks to delay investment.

170 *Id. at 432.*
172 See *supra* note 17.
173 The courts do so without any requirement that there be an “agreement.” For a contrary view see Schwartz & Scott suggesting that the law denies compensation for such investments absent an “agreement.” See Schwartz & Scott, *supra* note 15, at 668.
CORNELL L. REV. 1263 (1994). Schwartz and Scott continue to question promissory estoppel as a viable cause of action. They argue that the cases provide evidence that courts are unlikely to find liability for reliance costs in cases that involve “reliance in the absence of any agreement by the parties regarding terms.” Schwartz & Scott, supra note 15, at 671. Schwartz and Scott culled these cases from a larger list that “examin[ed] all public case law 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.” Id. As they explain it, their “initial” search yielded 280 cases. They then proceeded to isolate separately cases that only looked at cases involving “reliance in the absence of any agreement by the parties regarding terms” and then found that when the court has failed to find an agreement, plaintiffs have a failure of rate of 87%. Id. (emphasis supplied).

Their search may have undercounted cases involving promissory estoppel precontractual cases in which parties rely but without having reached any material terms in any kind of preliminary agreement. If, as their article seems to indicate, their search proceeded first under “preliminary negotiation” rather than conducting the initial search under promissory estoppel or Section 90 fewer cases might have been identified. It may be that if the search looked only at promissory estoppel cases if they appeared in a case also involving the particular terms “preliminary negotiation,” the search would undercount the number of reliance cases. This undercounting is consistent with my own study of this period which yielded a data base of 352 cases in the same time period using the search terms “promissory estoppel” or “Restatement Section 90 w/10 and da (aft 1/1/99 and bf 12/31/03’).

Thus, if one searches for promissory estoppel cases that appear only in cases in which the court also uses the term “preliminary negotiation,” some cases that involve reliance may be omitted. If a case did not involve the term “preliminary negotiation,” it may have been omitted from the Schwartz and Scott data base even though it involved a case in which a reliance or promissory estoppel claim was alleged and the plaintiff prevailed (either on the merits or by surviving a defendant’s motion for summary judgment).

Second, and perhaps equally important, calculating an 87% failure rate in cases in which the terms are not agreed to may not tell us enough to be able to draw a firm conclusion that courts require some sort of agreement to be in place for the court to grant reliance damages.

Certainly it is true that plaintiffs sometimes prevail when they allege
promissory estoppel claim as an alternative theory of recovery as a means of overcoming the defendant’s Statute of Frauds defense. In such cases, there may be an “agreement” which is not enforceable because of a technicality and the plaintiff prevails on a promissory estoppel claim. See e.g. Amber Chem. v. Reilly, Inc., 2007 U.S. Dist. Lexis 14451 (where alleged oral requirements contract never reduced to writing, promissory estoppel claim sufficient to withstand defendant’s motion for summary judgment).

But in other cases the absence of an agreement per se may not be an obstacle to recovery. Instead, many of the cases involving an absence of agreement also involve a failure of one or more of the key elements of Section 90, so the failure may be explained by the plaintiff’s bringing a case that lacks one of the elements of Section 90. This footnote will highlight the facts of various cases cited by Schwartz and Scott as evidence that “in the absence of any agreement by the parties regarding terms,” the plaintiff will be very unlikely to prevail. Id. at 671. While the cases may have involved an absence of agreement, one cannot necessarily draw the conclusion that to succeed a claim a plaintiff would have to show an agreement. Later in the Article itself and infra in footnote 195, I will highlight the types of cases in which, despite the absence of agreement, a plaintiff bringing a reliance claim prevails. I will tie the success of those cases into a larger analytical framework exploring how uncertainty and sequential investment and the problem of hold up can influence a court to find in favor of a promissory estoppel claimant despite the absence of a traditional bargained for agreement. Many of the cases that show a low failure rate for reliance claims do not clearly support the Schwartz and Scott conclusion that plaintiffs will not prevail on reliance claims absent a showing of an agreement. Schwartz & Scott, supra note 15, at 668. Instead, many of the cases cited as failures do not reveal that courts require, as a condition of recovery, that the plaintiff demonstrate agreement but rather that plaintiffs will not succeed in a reliance claim if one of the prime elements of promissory estoppel is lacking.

Because the cases cited by Schwartz and Scott seem to involve weak cases in which one or more elements of a Section 90 cause of action is lacking, they do not reveal whether the court would have denied a claimant’s cause of action who had met all of the elements of Section 90 but failed to prove agreement. If Schwartz and Scott had been able to cite such cases, then their conclusion for courts requiring agreement as a “precondition for recovery,” id., at 668, would have been stronger. See e.g., Abt Assocs., Inc. v. JHPIEGO Corp., 104 F. Supp. 2d 523 (D. Md. 2000) cited by Schwartz & Scott, supra note 15, at 672 n.31, is a weak
case not because it lacks a traditional agreement but because the plaintiff cannot demonstrate any detriment. *Id.* at 536. In *Abt* the plaintiff had no reliance damages because all of the pre-breakdown costs were covered and paid by the defendant. Since the promise that was made to cover pre-agreement expenses was fulfilled, *id.*, at 533 promissory estoppel which grants recovery for broken promises was not available. The *ABT* case seems to be a particularly weak one since the court found no “demonstrable detriment,” *id.* at 536, and there was an initial presubcontract “which was fully performed,” *id.* at 531, and this was not a case in which the plaintiff took steps and incurred expenditures that benefited the defendant and for which the plaintiff would not be compensated if the court failed to find liability under promissory estoppel since the presubcontract provided compensation to the plaintiff. Thus, *Abt* and other cases cited as evidence of the high failure rate of reliance claims in the absence of agreement or deceit instead stand for evidence that promissory estoppel will not succeed when one of the major elements of the claim is absent. See also *Beer Cap. Distrib., Inc.*, v. Guiness Bass Import Co., 290 F.3d 877 (7th Cir. 2002) cited by Schwartz & Scott, *supra* note 15, at 672 n.31 (statement by beer company that plaintiff was the “leading candidate” and question by defendant inquiring whether plaintiff “would be willing to pay 2 to 9 times earnings . . . to gain exclusive” rights did not constitute an actionable promise so promissory estoppel cause of action would not lie *Id.* at 879); *Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A.*, No. 03 Civ. 1537 (MBM), 2003 U.S. Dist. Lexis 23062/21, cited by Schwartz & Scott, *supra* note 15, at 672 n.31, (where letter of intent contained express denial of any motivating factors for purchase of notes other than those included in the express materials and signed such materials including the offering memoranda contained express disclaimers of any reliance on defendant’s representations, plaintiff’s reliance was unreasonable); See also *Fimon v. Kenroc Drywall Supplies, Inc.*, 2003 Minn. App. LEXIS 311 (plaintiffs lost on promissory estoppel claim for a 5% ownership interest when the plaintiffs “testified in depositions that they did not remember or recall any specific details of their conversations with the corporation’s [defendant’s] president about their ownership interest,” plaintiffs cited no specific promises, making reliance unreasonable, plaintiff took no risks in the start up and plaintiffs were paid in the form of bonuses). Cases that are lacking one of the elements such as the three cases cited here (promise, harm, etc.) do not support the proposition that absent agreement, a court will not find promissory estoppel. Even absent agreement in the midst of preliminary negotiations parties can prevail on a promissory estoppel claim if the other elements are met. See infra cases cited in note 195.
recent commentators have argued that “[c]ourts actually make some form of agreement a necessary condition to a promisee’s recovery”\textsuperscript{176} this Article reexamines recent case law\textsuperscript{177} to see if

To prove the claim that absent agreement or deceit, plaintiffs cannot prevail on a promissory estoppel claim, the authors would need to find cases in which the plaintiffs can show all of the elements of promissory estoppel (including promise, reasonable reliance, and foreseeability of reliance) and yet the plaintiffs lose their claims without a showing that there is an “agreement” or deceit. When plaintiffs lose a claim, as in \textit{Beer Capitol}, when there is no or a weak promise, there is no indication in the holding itself that in order to prevail on a promissory estoppel claim, the plaintiffs must demonstrate that an agreement exists.

Alternatively to demonstrate the proposition that plaintiffs cannot prevail on a promissory estoppel claim, absent an agreement, the authors could point to cases-outcomes-in which the plaintiff has met all of the elements of a promissory estoppel claim but the plaintiff lost nonetheless because there was no agreement. \textit{See} Jody Kraus, \textit{The Methodological Commitments of Contemporary Contract Law}, 12-15 available at \url{http://papers.ssrn.com/paper.taf?abstract_id=269975} (discussing efficiency theorists’ interest in rationalizing case outcomes.) The authors could rest their conclusion on actual language in a case denying recovery in cases where the elements were met but the plaintiff nonetheless lost because a court explicitly articulated that the plaintiff’s loss was due to the failure to prove “an agreement.” However, the cases that Schwartz and Scott cite in their article do not fall into either category. Courts do not appear to require “agreement” as a pre-condition to recovery either in the articulated holding nor is the requirement of an agreement reflected in the outcomes of cases. Without identifying a pattern of cases in which plaintiffs bring strong claims with a definite promise, foreseeable and justifiable reliance and detriment (loss) but then lose because the courts seem to require either explicitly or implicitly, an additional requirement that the plaintiff show agreement, it is hard to understand the support for their thesis that agreement is a precondition to recovery in negotiation cases. Cases like \textit{Beer Capitol} involve the absence of a promise and, of course, without a promise to begin with there can be no agreement. However, the presence of recovery in cases where the elements are met but there is no agreement, discussed in \textit{infra} note 195, suggest that agreement is not a \textit{sine qua non} of a promissory estoppel recovery. 176 Schwartz & Scott, \textit{supra} note 15, at 668.

177 The cases that I looked at came from a list of cases identified by Lexis and Westlaw searches for the period 1999-2007. The search terms included Restatement 90 and promissory estoppel. \textit{See supra} note x. I read cases identified by my research assistants as relevant and meeting
the results support the view that courts allow claimants to recover for reliance only if the court finds “agreement” or if the defendant breached a promise to invest simultaneously, the template of liability as envisioned by Schwartz and Scott. This Article identifies a subset of cases where promissory estoppel is likely to succeed in precontractual negotiation despite the absence of an agreement or a promise to invest simultaneously. It offers a rationale for the success in such cases that is based on the parties’ hypothetical consent to prevent a hold-up sequencing of investment problem that would otherwise occur. If a subset of precontractual negotiation cases that present the sequential investment/hold-up problem is isolated analytically from the “preliminary agreement” cases, then it appears that promissory estoppel protects reliance, without regard to whether a court finds that an agreement exists or whether there is an agreement to invest simultaneously.

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the criteria I had outlined. I also shephardized important cases such as Hoffman and Esquire Radio to identify other cases to read. I also read cases identified and discussed in the text or the footnotes by Schwartz and Scott in their article, see supra note 15, as important paradigm cases in their theory of when reliance claims succeeded in cases involving preliminary agreements.

178 Preliminary agreement cases tend to concern letter of intent cases where “parties often reach substantial agreement before they make reliance investments.” Id. at 693. In contrast, this Article focuses on reliance investments at a prior stage where uncertainty is greater, thereby precluding any preliminary agreement. The fact patterns in Schwartz and Scott’s article often arise in cases that courts treat under the doctrinal label of “preliminary agreement” cases. The courts are trying to ascertain whether the parties have reached a binding agreement that the parties intended to be binding despite the failure to agree on certain terms. If that intent can be found, the parties are not then seeking reliance investments to resolve remaining uncertainty since they have indicated assent and a willingness to go forward without resolving uncertainty. The remaining negotiations often concern how the surplus will be split.

179 It is not completely clear what the authors mean by “agreement” in this context. They could be referring to a full fledged explicitly reciprocal contract though in such a case it would be difficult to see why the plaintiff was bringing a promissory estoppel claim except in cases involving a failure to meet an applicable Statue of Frauds requirement. Alternatively, they could be referring to the presence of an agreement that fell short of the ultimate agreement but did reach consensus on some
terms. Again, it is difficult to know why these cases would be relevant to precontractual negotiation cases which seem to evolve in the absence of any preliminary agreement. The broad claim by Schwartz and Scott that reliance claims rarely succeed absent an agreement does not seem to be supported by the case law. Instead, the cases cited tend to demonstrate that promissory estoppel cases tend to fail when one of the elements is weak. If the promise is weak or unreliable, the reliance claim will fail. See e.g., Beer Capitol Distrib., Inc., v. Guiness Bass Import Co., 290 F.3d 877, 879 (2002) (statement that plaintiff was “leading candidate” for a distributorship not actionable promise).

Success is unlikely as well if the agreement specifically indicates that reliance expenditures in the precontractual period will not be compensated (a type of disclaimer) or the agreement indicated that it is not legally binding (both letters of intent contained such a disclaimer) or if there is an absolute right to terminate. See e.g. Universal Reinsurance Co., Ltd. v. St. Paul Fire and Marine Ins. Co., 1999 WL 771357 (S.D.N.Y.) at 1, 2. These results make sense if one wants to discourage unreasonable reliance by promisees who have been alerted that the agreement has no binding effect.

The plaintiff is also going to lose on a promissory estoppel claim where there is no evidence that the defendant solicited reliance investments by the plaintiff in order to hedge or reduce its own uncertainty. See e.g. Industrial Maxifreight Servs., LLC v. Tenneco Auto. Operating Co., Inc., 182 F. Supp. 2d 630, 636 (W. D. Mi. 2002) where court found reliance by lessor on lessee’s promise to lease to be unreasonable in light of unrebutted evidence of repeated statements by defendant that home office approval needed for lease. Maxifreight, cited in Schwartz & Scott, supra note 15, at 672, as evidence of case data that “show that, absence misrepresentation or deceit, there generally is no liability for induced reliance investments”id., really concerns a case in which the plaintiff’s alleged reliance took place largely “prior to the initial lease discussions”id., and thus does not present the Hoffman paradigm in which the defendant induces the plaintiff to take reliance steps that benefit the defendant by allowing it to hedge pending the resolution of uncertainty or actually diminish uncertainty about the plaintiff by shedding light on the plaintiff’s characteristics. Thus, the case is not a compelling case for the application of a liability default rule since it does not present the same risk of hold up.

A case like Galaxy Networks, Inc. v. Kenan Systems Corp., Nos. 97-56386, 97-56435, 2000 WL 714554 (9th Cir. June 2, 2000) is cited by
Schwartz & Scott, supra note 15 at 672 n.31, for a case that “granted the defendant’s motion for summary judgment on the plaintiff’s breach of contract claim.”  *Id.*

Yet, the *Galaxy* case is not a case that fits the paradigm of precontractual negotiations in the *Hoffman* paradigm/mode and indicates very little about whether and under what circumstances a plaintiff could prevail in early negotiation. *Galaxy* was clearly a case in which the parties were negotiating piecemeal and had reached agreement on some but not all terms but were clearly intending to reach a fully enforceably future agreement that did agree to all material terms.  *Id.* at 2.  Because the case was treated in the category of cases in which there is no legal obligation until such future agreement is made,” *id.*, the case really says very little about how a court would approach the question of liability when parties were not really at the point where they were able to agree on certain terms but reserve agreement on others for the future.  Cases, like *Hoffman*, that involve parties who are making promises and assurances on which others rely in order to reduce uncertainty for the promisor, are very different from a case like *Galaxy*.  When parties are striving to reach a fully enforceable complete agreement in the future, but reach agreement on such matters early on, there is always the question of whether they intended the agreement on some terms to be enforceable as stand alone clauses or whether enforceability would not obtain until a binding complete agreement was reached.  In such negotiations, there is always a risk that a party who got one party to agree to some terms would then try to enforce those terms without regard to whether agreement on the remaining terms was ever reached.  Enforceability of the individual clauses could bind a party to a term that they would never have greed to unless other pieces of the agreement were forthcoming.  *See* Easterbrook’s opinion *infra* at note 179 for a discussion of this risk.

The plaintiff in *Galaxy* never brought a claim for a reliance cause of action and the court never addressed whether a reliance or Section 90 cause of action would lie.  Thus, an adverse judgment for the plaintiff on a breach of contract action says little about what result a court might reach in a case involving no agreement on interim terms but an earlier stage of negotiations involving a possible hold up due to sequential investment.  Therefore, the plaintiff’s loss in claims involving preliminary negotiations that resulted in agreement on some terms but which were negotiated and agreed to with the expectation that a final agreement would resolve other issues in comprehensive way does not shed light on how a court would decide a case involving promises and reliance but no claim by one party to enforce separately agreed on material terms absent the more complete agreement and without which
The difficulty with some of the cases cited by Schwartz and Scott to support the proposition “courts actually make some form of agreement a necessary condition to a promisee’s recovery”180 is that the cases do not support the proposition if broadly interpreted. It seems to be accurate if one focuses only on a subset of cases in which the parties are engaged in preliminary negotiations whose major efforts were directed at reaching a final written contract and one party attempts to recover on the basis of an interim agreement when there is no final contract embodying agreement on all of the terms. If the case does not involve a fact pattern involving preliminary agreement on some points with final agreement postponed on others with at least the possibility that the parties understand that the parties will not be bound until the final, complete agreement, then a court is free to reach a different result (i.e., liability) and does not seem to require that a promise in a reliance cause of action under Section 90 establish “agreement” as a precondition to recovery.

*PFT Roberson Inc., v. Volvo Trucks* is a case of the first kind in which the parties were negotiating toward a final agreement whose interim terms might not make sense.

If expenses are not transaction specific, do not involve significant expense, can be redeployed or are merely preparatory, or some other element required for a successful reliance claim on promissory estoppel is absent from the facts, success is also unlikely.

The failure to succeed in these cases cited by Schwartz and Scott indicates that the plaintiffs have brought weak claims. In some cases they have brought a case in which the promise is ambiguous or really not a promise at all and it is not clear why the plaintiffs brought the case. In other cases the lawyers have brought a claim that might be justified by the actual language of Section 90 but case law has grafted on an additional nuance as to how the elements are interpreted. Courts may require the reliance taken to constitute sunk costs that are not redeployable or they may require the reliance to have advanced beyond the merely preparatory investigation that each side normally takes at its own risk. Losses in cases that do not meet the elements required of reliance claims do not indicate that reliance claims are no longer winnable.

agreement -- and the court denied recovery to the plaintiff who tried to argue that certain interim emails were binding.181 In *PFT* a truck operator of long haul trucks who derived its trucks and maintenance from Freightliner began negotiations with Volvo when its initial fleet agreement with Freightliner was terminated. Those negotiations consisted partly of emails that reached agreement on some individual issues though no final comprehensive final agreement was ever reached by the parties or signed.182 The truck operator later argued that the emails at least raised a jury question as to “whether there is a contract” on each of the individually agreed to terms.183

Judge Easterbrook found that because it was clear that the parties were negotiating toward a final “global” agreement, that their emails reciting agreement on some individually agreed to terms, demonstrated no intention by the parties to create binding enforceable agreements on such individual terms in advance of a comprehensive agreement.184 Summary judgment was therefore appropriate.185

But citing a case like *PFT Roberson* to support at proposition, as Schwartz and Scott have,186 that preliminary negotiations in which the parties “have discussed a deal but have not agreed to one”187 will deny the disappointed party all recovery, proves too much on the one hand and on the other hand reveals very little about when parties engaged in preliminary negotiations, even absent agreement, will succeed. When parties reach agreement on a series of issues in stages,188 but they always intend that there will be a final binding comprehensive agreement, allowing a party to insist that the individually negotiated separate points of agreement were enforceable as a contract would, as Easterbrook explains, be equivalent to “[l]etting one side accept the favorable terms without the compensatory ones [and] would be

181 420 F.3d 728 (2005).
182 *Id.* at 728.
183 *Id.* at 731.
184
185 *Id.* at 733
187 *Id.* at 664.
188 420 F.3d at 731.
like permitting the buyer to say: ‘We have agreed on quantity but not price; I now accept the quantity term and am entitled to the goods at whatever price a jury thinks reasonable.’ Firms do not put themselves at the mercy of their counterparts in that way.”189

The fact that Easterbrook found no liability on the individually created points of interim agreement when the parties were negotiating toward a final contract and made their agreement subject to further resolution at the stage of the final agreement says very little about how courts should or do decide cases in which the parties are engaged in preliminary negotiations but have not discussed the details of a deal and their efforts are not done in the shadow of or subject to a looming final negotiated agreement but involve preliminary promises and reliance. Schwartz and Scott’s statement that when “parties have discussed a deal but have not agreed to one” they are denied recovery190 should be read very narrowly to apply only to cases where the parties are negotiating on a series of points towards a final written agreement and then one party seeks to impose contract liability on the other party on the basis of individually agreed to points even though it was clear that there was to be no liability absent a comprehensive agreement. That is why this Article posits that the statement by Schwartz and Scott proves too much when it suggests that the absence of agreement would mean no liability191 when it is not really the absence of agreement that defeats recovery so much as it is the fact that when it is clear to everyone that there would be no contract liability without a comprehensive agreement, a plaintiff will not succeed absent such agreement.

Thus, the suggestion that there will be no liability “absent agreement” is far too broad a statement to address whether there is or should be liability in precontractual negotiations when the parties have not even begun to negotiate individual points that may make up the final agreement and they have not yet begun to zero in on such terms with the understanding that liability will await a comprehensive agreement. Rather, the fact pattern involves reliance on promises made early on these contexts. Here Schwartz

189 Id. at 732.
190 Schwartz & Scott, supra note 15, at 664.
191 Id.
and Scott are willing to admit that there might be liability though their overall thesis is that agreement is a precondition for recovery in preliminary negotiation cases. In fact, Schwartz and Scott admit that there may be liability for induced reliance if a misrepresentation or promise is present. If that is the case and liability exists on the basis of induced reliance on promises, and those cases do not involve an agreement, then the statements that courts will not find liability for preliminary negotiations absent agreement is too broad. Perhaps courts will not find liability absent an agreement when the preliminary negotiations are all conducted in the shadow of and directed toward a final agreement and there is evidence that the parties did not intend any interim preliminary agreement to be binding about a final, further complete agreement. If that more narrow interpretation is accepted, then the following question still remains an open one: what results do courts reach in preliminary negotiations, in Hoffman type cases, and why are those outcomes justifiable?

Without a liability rule (imposed through promissory estoppel) to prevent opportunistic exploitation of sunk costs, promisees will underinvest and the promissor’s ability to reduce uncertainty in preliminary negotiation would be diminished. Because the default rule can be rationalized as part of an implicit contract, it would make sense that precontractual reliance claims have less traction and success in cases in which parties are operating on the basis of letters of intent or exchanged drafts that have an express or implied desire to postpone enforceability until a forthcoming formal contract is achieved. The presence of such agreement, particularly in cases where the court finds no intent to have an enforceable agreement absent a more complete formal agreement, would render reliance on such preliminary agreements unjustified or unreasonable and, therefore, non-compensable.

Nevertheless, in some preliminary agreement cases, at least those in which courts find that the presence of a binding agreement imposes an obligation to bargain in good faith and to compensate a party who has invested when the other party has breached its obligation to invest at the same time, the court’s goal in finding

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192 Schwartz & Scott, supra note 15, at 664.
193 Cites needed on implicit contracts.
bad faith is to prevent opportunistic behavior. The law provides a safeguard with a liability rule as a way of providing protection against one form of strategic behavior that occurs after a preliminary agreement is entered into and a joint plan of simultaneous investment is agreed to but then breached by one party who defers investment.

This emerging case law on breaches of promises to invest simultaneously made simultaneously or after a binding preliminary agreement has led Schwartz and Scott to argue that lawyers should turn their misplaced attention away from precontractual preliminary negotiation *Hoffman* type cases. Instead the focus should be on the preliminary agreements that are accompanied by a promise to invest simultaneously. This goal is the same one that animates the imposition of a liability rule to govern early precontractual negotiations to prevent hold up by compensating a promisee whose sunk costs have been solicited to reduce promisor uncertainty. In both instances courts have demonstrated a willingness to protect reliance investments to prevent hold up.

Nevertheless, commentators have argued against the expansion of promissory estoppel as a doctrine. They have that advanced several arguments about promissory estoppel claims: that they rarely succeed in the case law, 194 that liability has gone too far, that the current doctrinal scheme is too uncertain,195 and that promissory liability will chill negotiation196 or that there is only a “myth of pre-contractual reliance.”197

Contrary to the belief of recent scholars who argue that judicial protection of precontractual reliance investments absent an agreement is merely a myth,198 courts routinely protect transaction specific precontractual reliance investments when they

194 See supra note 173.
195 Schwartz & Scott, supra note 15, at 663.
196 Johnston, supra note 11, at 493.
198 See Scott, supra note 195. Certainly cases do exist in which there are agreements and reliance. Often these involve contracts that are not enforceable under the Statute of Frauds and the court chooses to protect the promisee’s reliance.
are solicited by promisors in cases where the investments in precontractual negotiations when by the promisee will leave it vulnerable to hold up by the other party. Promissory estoppel does and should play an important role in these contexts.

The criticisms of promissory estoppel—including the idea that it has been a colossal failure in the cases—have gained traction in part because all types of promissory estoppel reliance cases have been lumped together. Reliance cases in which one or more of the doctrinal elements is lacking have been lumped together with cases involving preliminary agreements in which the parties may have intended no contractual liability until the final complete contract with reliance cases in which the plaintiff presents a strong or plausible case. At the same time, sometimes reliance cases have been artificially segregated by recent authors into two separate categories, those involving reliance in precontractual negotiations and reliance following a binding preliminary agreement that occurs after an agreement to invest simultaneously and one party defects. There has been little understanding of how the cases may be linked conceptually through the analytical link of preventing hold up. Thus, when commentators link all promissory estoppel/reliance cases involving precontractual preliminary negotiations into one category and fail to separate out demonstrably weak cases from that set, the reader can gain a distorted view of whether and when a reliance claim will succeed. It would be helpful instead if scholars focused on when reliance claims succeed and why. This Article argues that where one party, deciding whether to proceed with a transaction seeks to reduce uncertainty for itself or to hedge in the negotiation process by soliciting sunk cost investments from the other party, promissory estoppel is and should be particularly likely to succeed, if the other elements are present including a definite

199 Cosgrove v. Bartolotta, 150 F.3d 729, 732-735 (7th Cir. 1998) (finding plaintiff proved reliance sufficient to support jury's award of damages for promissory estoppel where Plaintiff promised to make a 100k loan and provided significant legal advice and defendant faced many uncertainties, including: whether or not the restaurant would succeed or fail, whether defendant could secure a bank loan, and what type of legal services would be needed; and defendant benefited greatly because 1) it was able to secure whatever legal services were needed, and 2) had a commitment to receive 100k in the even that it did not receive a
bank loan, and 3) the pledge of a 100k loan from plaintiff possibly helped defendant obtain the bank financing; Esquire Radio & Elecs., Inc. v. Montgomery Ward & Co., 804 F.2d 787, 791-795 (2d Cir. 1986) (finding that promissory estoppel claim was properly submitted to a jury where defendant, uncertain of whether plaintiff would provide spare parts for competitors and arguably uncertain of the quantity of spare parts it would need, assured plaintiff that it would purchase the spare parts that plaintiff imported and stored and in reliance upon that, plaintiff phased out its work with other competitors and allowed its spare parts inventories to accumulate over the course of a twenty-year, informal buy-back arrangement); Amber Chem. v. Reilly, Inc., 2007 U.S. Dist. Lexis 14451 (where defendant’s promise to plaintiff to supply product to plaintiff for a year if plaintiff purchased as much as in prior year allowed defendant to hedge; if the sale to a third party of that part of the business did not work out, defendant had guaranteed sales to plaintiff and if the sale went through, defendant could insulate itself from liability by pleading absence of a contract; promissory estoppel claim withstood defendant’s motion for summary judgment); Henneberry v. Sumitomo Corp. of Am., 415 F. Supp. 2d 423, 456-459 (S.D.N.Y. 2006); (finding a claim of promissory estoppel could survive summary judgment where plaintiff, in reliance on expectation of defendants 3-5 million dollar investment, filed a restated certificate of incorporation as directed by defendant, convinced its shareholders to subordinate their class of shares to defendants', and convinced original investors to reduce or forego dividends and invest more money, advised other investors that plaintiff had accepted defendant’s offer and that more investments were to follow, and made a bridge loan for 100k; and where defendant was uncertain that plaintiff could run the company); Cin-Doo, Inc. v. 7-Eleven, Inc., No. Civ. 04-CV-50-SM, 2005 WL 768592, at *4 (D.N.H. Apr. 6, 2005) (finding plaintiff’s request for injunctive relief could survive based on promissory estoppel where defendant, uncertain about future of 7-Eleven store and about plaintiff franchisee’s willingness to support a reconstruction, assured plaintiff that a complete reconstruction of the store would happen and that it would be beneficial; and plaintiff, in reliance, did not object to a transfer of real estate from the 7-Eleven to a neighboring Home Depot, and sold another 7-Eleven in anticipation of increased profits from the reconstructed store); Carey v. FedEx Ground Package System Inc., 321 F.Supp.2d 902 (S. D. Oh. June 15, 2004)(where plaintiff wanted a delivery contract with a shipping company and given repeated assurance that a route would be available and plaintiff relied by purchasing a van and took other steps such as taking courses and finding back up drivers and plaintiff’s steps permitted the defendant to hedge during an initial period of uncertainty while deciding on which driver would be best for the available routes, plaintiff
allowed to prevail on promissory estoppel by withstanding defendant’s motion for summary judgment); Nutrition Management v. Harborside Healthcare Corp., No. Civ. A. 01-CV-0902, 2004 WL 764809, at *9 (E.D. Pa. Mar. 19, 2004) (finding plaintiff’s claim for promissory estoppel survives summary judgment where defendant induced plaintiff to continue to provide food operation services for its healthcare facilities based on assurance of long term relationship and plaintiff relied on this by continuing to provide food services even though there was dispute over payments and plaintiff was operating at a loss); Schade v. Dietrich, 1987 Ariz.App. LEXIS 667 (where plaintiff asked to resign but defendant wanted plaintiff to continue working on a project and defendant offered “appropriate” but still uncertain severance benefits and defendant benefited from plaintiff’s work while details of severance worked out, plaintiff’s reliance on the promised severance package entitled plaintiff to recover under Section 90); Robinson v. Detroit News, 211 F. Supp. 2d 101(D. Ct. D.C. 2002)(plaintiff’s promissory estoppel claim withstands summary judgment where defendant hires plaintiff despite uncertainty about her transactional skills and promises to train her in needed skills; plaintiff’s reliance allows defendant to hedge while it determines if others are available to do transactional work); Sprouts for Better Living, LLC v. Lake Hills Shopping Ctr., No. CV040408837S, 2005 WL 2008871, at *3 (Super. Ct. Conn. July 11, 2005) (finding claim for promissory estoppel could withstand summary judgment where defendant, a shopping center uncertain that it could accommodate a Trader Joe’s, induced plaintiff to relinquish half of its space prior to the expiration of the lease); Ramone v. Lang, No. Civ. A. 1592-N, 2006 WL 905347, at *14-19 (Del. Ch. Apr. 3, 2006) (finding plaintiff is entitled to reliance damages for claim of promissory estoppel, where he put out flyers and made plans for a swim camp at pool he intended to lease from or buy with defendant, and where defendant was uncertain that he could get zoning approval for the project, and frequently represented to the media and city officials that the Plaintiff would be involved in the project. plaintiff’s good reputation helped defendant obtain zoning approval and buy the building); Christiana Marine Service Corp. v. Texaco Fuel & Marine Marketing Inc. 2004 Del. Super. LEXIS 3 (2003) (where defendant wanted plaintiff to act as defendant’s exclusive provider of bunker transportation and defendant wanted assurance that plaintiff could meet defendant’s needs for transportation and defendant assured plaintiff that it planned to put through 200,000 barrels of oil monthly but defendant remained uncertain about what its equipment needs would be, plaintiff’s reliance allowed defendant to hedge and to benefit from having an entire line of barges waiting for them but defendant did not need to pay and fees or delay costs and secured reduced rate and was compensable); Chrysler v. Chaplake, 822 A.2d 1024 (S. Ct. Del. 2003)(where defendant was unsure
promise, justifiable reliance and demonstrable detriment.

This section will look at cases involving preliminary agreements and precontractual reliance cases to see how these cases are resolved and it will also consider the cases involving
promises to invest simultaneously when those promises are made in connection with a binding preliminary agreement—the cases discussed by Schwartz and Scott. The thread that connects protection for reliance investments at these two different stages of the contracting process is the prevention of opportunism and hold up. It can occur when one party who has entered into a preliminary agreement chooses to delay investment for strategic reasons, leaving the investing party vulnerable to hold up. Hold up can also occur at the beginning of the negotiating process where no preliminary agreement has been negotiated because the uncertainties are too great and one party invests at the other party’s request, leaving it unable to recoup all those costs as the other party captures part of them in the surplus.

The success of claimants in both types of cases can be rationalized as a means of improving welfare. Without a liability rule, underinvestment *ex ante* is likely to occur because the investing party fears the expropriation of its sunk costs and hold up. The problem of sequential investment where one party, the putative promisor, delays investing himself while securing sunk costs by the promisee, suggests that a liability default rule should govern these cases. It would mitigate the potential for lost trades and underinvestment that inevitably accompany a sequential investment sequence with the possibility of the promisor deferring any investment until it can be fully recouped in a bargain. The very same danger of lost trading opportunities is presented by the scenario in which two parties enter into an agreement to invest simultaneously and one party breaches the agreement when it would be more privately beneficial to do so. The danger is one of opportunism, although it takes a slightly different form in which the party who promised to invest simultaneously decides to delay whereas in the preliminary precontractual negotiation setting, the danger is that the promisor will solicit and use information without ever paying anything for it. In each of these two cases one party would like to be able to offer assurances to the other party to encourage the party to continue to invest and without which the party will be reluctant to invest, especially when they take the form

200 See Smirov & Wait, *supra* note x, at 399 (suggesting that “[t]he disadvantage of staging [sequencing of investment] is that it reduces the payoff of the first mover.”)
of transaction specific investments. Promises may lack credibility because there is no way to know how reliable or trustworthy the promisor is nor to know ahead of time what events will affect the person making a promise, as to invest simultaneously, and make it unprofitable to keep the promise.201 In the preliminary negotiation context, the investing party can only make estimates of probabilities regarding the opportunistic proclivities of the other party. Moreover, the investing party may assume a promise to compensate for verifiable reliance expenses would be part of their implicit bargain since without that protection, the promisee would be wary of investing at all and that result would not maximize gains from trade.

The identification of a core subset of successful cases in each category, both precontractual Hoffman type paradigm cases and preliminary agreement cases involving promises to invest simultaneously, together with the costs of alternative solutions to the investment problem, may help to explain why and when promissory estoppel and reliance claims should succeed: namely when the particular danger presented by sequential investment is present.

Instead of trying to draw connections, Schwartz and Scott have separated these cases of precontractual and preliminary agreement cases. They argue that merely because both preliminary agreement cases (involving letters of intent) and precontractual liability cases (the Hoffman-type case) involve reliance and lack a heterodox bargain that would be fully enforceable under bargain theory,202 “legal doctrines invoked in preliminary agreement cases are also used to support unrelated claims of precontractual liability.”203 They argue that these types of claims should be separated to avoid confusion.204 Consequently, they have focused narrowly on a particular subset of cases in which plaintiffs prevail when they rely on preliminary agreements. These cases involve the particular form of opportunism and hold up that occurs when

201 Schwartz & Scott, supra note 15, at 686.)
202 The preliminary agreements are often incomplete, agreements to agree, that may be fully binding or unenforceable depending on the circumstances.
203 Schwartz & Scott, supra note 15, at 663.
204 Id. at 663.
parties agree on a simultaneous reliance investment and one defects to invest sequentially to enhance private gain.

Other scholars of reliance in the courtship period have focused more broadly on whether liability is needed by analyzing whether and when a putative promisor is likely to be honest about the probability of a trade occurring.\textsuperscript{205} During the course of negotiations, the incentives for honesty may change. Where natural incentives for honest disclosure exist, then the law may not need to intervene\textsuperscript{206} but where a large incentive to conceal the actual probabilities of a trade exists, the law may need to impose liability to ensure more honest revelations.\textsuperscript{207}

Each of these scholarly treatments has analyzed why and when reliance investments should be protected in order to achieve certain goals and offered powerful reasons for protection in a limited set of cases (where an agreement regarding promises of simultaneous agreement) or in a broader set of cases (if needed to promote honest disclosure regarding the probability of a trade).

In fact, it may be possible to see many reliance claims as related if the underlying problem of hold up is analyzed at each stage of the negotiation process.

This Article does not try to provide a model to rationalize all reliance cases in all types of contexts—whether they occur pursuant to an agreement regarding the timing of an investment or whether after a letter of intent is negotiated. Instead, it suggests that in evaluating precontractual liability claims, the law ought to pay attention to the particular difficulties that uncertainty about the future state of the world and the future behavior of one’s counterparty poses for promisors who are in the process of deciding whether to make an offer. The dual problem is that the investment reliance needed to reduce such uncertainties will also subject the promisee to the hold up problem with its concomitant underinvestment possibility must be recognized. These

\textsuperscript{205} Johnston, \textit{supra} note 11.
\textsuperscript{206} This is most likely to be the case where the promisor is trying to ensure that only appropriate counterparties respond to increase the chance of a successful trade.
\textsuperscript{207} Johnston, \textit{supra} note 11, at 491.
considerations suggest that in all types of precontractual cases, unless the promisor can make a credible commitment not to act strategically, a legal default rule protecting such reliance and safeguarding against hold up is likely to improve welfare.208 When reliance cases involve a fact situation in which a solicited reliance investment is linked to a reduction in uncertainty for the promisor and the promisor is using the reliance to hedge pending the resolution of the uncertainty, the plaintiff is and should be likely to succeed.

The default rule can be connected conceptually to the protection of reliance at other junctures, including the protection of reliance when one party defects from a promise to invest simultaneously; the protection of reliance investment shares the common element of protecting against strategic behavior.

At first glance because the cases involving preliminary agreements with explicit agreements on investment by the parties are explicit agreements, they may not seem apt analogies to use in determining whether the law should intervene with a liability rule in precontractual contexts where no explicit agreements of any kind exist. In precontractual preliminary negotiations the parties have not reached an express preliminary agreement nor have they reached an express agreement on the order of investment by each party. By its terms, Schwartz and Scott’s suggested approach would permit judicial intervention in the form of a liability rule holding one party responsible for the reliance investment of the other, only if there is an express preliminary agreement and an express agreement on the order of investment.209

Schwartz and Scott have provided helpful normative guidance for the problem of parties acting opportunistically following the establishment of an agreement by both parties to invest simultaneously following which one party refuses to invest

208 See supra note x.
209 Some cases turn on whether specific reference to a future formal agreement would preclude recognition of an agreement before the achievement of such a formal contract and those matters turn on analysis of the parties’ intent and contract language, which should preclude the invocation of an implied bargain.
despite an agreement to do so. 210 As the authors point out, one party may have “an incentive to defect from any such agreement,” 211 explaining that “by delaying her decision whether to invest until after the promisee has invested...[since] the promisor benefits from defection if the project turns out to be unprofitable because she will not have sunk costs in a losing deal.” 212 Parties defect from an agreement to invest simultaneously, when doing so will benefit one of them at the expense of the other party and will also fail to maximize the parties’ surplus. 213

Although the precise situations are different and involve reliance that occurs at different stages of the negotiation process, the cases and factual scenarios can be connected by an unexpressed implied intention to be responsible for reliance costs of a party who becomes subject to hold up after investing. A liability rule is needed because otherwise the parties will fear that they will make themselves worse off by providing the other party with information that it can use opportunistically in the sense that the party soliciting investment will use the information (from the reliance) for its own benefit without paying for it and without promising to pay for it out of the surplus without a legal role imposing liability for reliance, the investing party will be unable to recoup in the surplus. That same deterrent effect will operate in the promise to invest sequentially when the investing party worries about defection by his investing partner and therefore fails to invest: the ex post hold up problem.

Parties will act opportunistically and that may discourage trade unless parties can control such hazard at a reasonable cost; moral hazard will occur at all different stages of negotiation.

If so, it becomes important to look beyond the precise factual scenario identified by Schwartz and Scott. The danger exists whenever one party “has a greater ability than the other to

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210 Schwartz & Scott, supra note 15, at 666.
211 Id.
212 Id.
213 Schwartz and Scott assume that there are some instances where simultaneous investment would maximize surplus, id., so a defection from that regime would fail to maximize surplus.
delay a material portion of her work.”214 The potential for one party to delay investment exists outside of cases where parties explicitly agree to invest simultaneously. It also exists when the promisor is soliciting sunk costs from the promisee in order to make determinations about whether to proceed and if so, on what terms. Because of the relationship between the promisor and the promisee in which the promisor is gathering information to formulate the terms of the offer, and the promisee must provide information in the form of investment in the form of reliance and sunk costs in order to enable the putative promisor to proceed to an offer, the promisor is in effect given the discretion to delay making any investments of its own.215

In preliminary negotiation, where one party, the promisor, has the ability to delay investment until the promisee invests as a means of clarifying whether a deal that is mutually beneficial even exists, the promisee is continually subject to the risk that if a bargain is ever reached between them, it “will reimburse only the promisor’s costs.”216 The promisee, because of a poor bargaining position that exists when he has sunk costs and the promisor does not have such costs, the promisee can, following the sinking of such costs, tell the promisor that he will not proceed but such “threat to exit unless his investment costs are reimbursed is not credible....”217

For that reason this Article suggests that because the same danger of moral hazard exists whenever a promisor faces uncertainty about the nature of the ultimate transaction, and deliberately delays any investment until the promisee has invested, a default rule making the promisor responsible for such solicited verifiable reliance investments would be optimal to avoid the threat of a hold up.

A discussion of the cases examining this proposition follows.

A. Factual Scenarios Representing Successful Claims.

214 Id. at 666 n.12.
215 Id.
216 Id.
217 Id.
Chrysler Corporation v. Chaplake Holdings, Ltd. typifies the type of case in which plaintiffs are successful in a promissory estoppel claim that involves precontractual negotiation. The case illustrates a pattern in which the defendant faces uncertainty about whether a particular project will succeed. To permit the defendant to preserve the benefit of being positioned to proceed should the project succeed, the defendant solicits sunk cost reliance investments by the plaintiff. Those sunk costs provide significant benefits to the defendant by allowing it to hedge pending the resolution of the uncertainty about the project. It gives the defendant the benefit of insuring that it will be well positioned to proceed if the project goes ahead. In a sense the plaintiff’s sunk cost earns the defendant the ability to proceed, a kind of option, but it is one that the defendant does not pay for expressly.

In Chrysler the plaintiff had an exclusive right to sell high end Lamborghini cars in a broad market that included the Channel 218

218 A.2d 1024 (Del. 2003).
219 See also Roeder v. Pacificorp Financial Services, Inc., 2006 U.S. Dist. LEXIS 79996 (holding defendant’s counterclaim for promissory estoppel survives where defendant uncertain whether a new project would be successful, told plaintiff “to go back and work hard” and plaintiff believing that he would be receiving a long term incentive plan, took on compensation at below market value, traveled significantly and worked long hours); School-Link Technologies, Inc., 471 F.Supp.2d 1101 (Dist. Kan. 2007) (holding defendant’s counterclaim for promissory estoppel survives where the plaintiff a vendor that wished to use defendant’s kiosks in a project, was unsure that it could produce the kiosks itself; in reliance on plaintiff’s promises that defendant would be the sole kiosk supplier, defendant produced 1500 kiosks); Tour Costa Rica v. Country Walkers, 171 Vt. 116 (2000) (where defendant was able to gauge the interest in Costa Rican tours with minimal expense since plaintiff did all the work and plaintiff’s investment allowed defendant to gauge viability of the area as a tour site); Cosgrove v. Barlotta, 150 F.3d 729 (7th Cir. 1998), see also older cases in this line, Esquire Radio & Elecs., Inc. v. Montgomery Ward & Co., 804 F.2d 787 (2d Cir. 1986) (recovery on promissory estoppel allowed where plaintiff relied on assurances of defendant to import and store product for ultimate repurchase and scheme allowed defendant to deal with uncertainty as to future quantities needed). Chrysler v. Quimby.
Islands, the U.K. and Ireland. Although the plaintiff sold the small number of 30 cars annually, that small number still earned it the honor of being the “largest Lamborghini dealer in the world” given the total annual sales of 250 cars.

During the 1980’s Chrysler developed an Expansion Plan that would bring on a new model lower priced car that would achieve higher volume sales while doubling the size of the high end Lamborghini. The top management of Chrysler was involved in the Expansion plan and “had absolute control” of the plan. Chrysler wanted overall sales annually to reach 5,000 per year within a five year window. However, there was uncertainty at Chrysler about how long the plan would take to achieve its goals and whether its goals were achievable. Chrysler was concerned that even if it ratcheted up the production of low and high end Lamborghini, the dealer network might not be able to handle that increased number. To alleviate the uncertainty that the Chrysler plan might fail if the dealership capacity for selling a larger number of cars faltered, Chrysler offered assurance to the plaintiff that it would maintain its exclusive dealership only by taking steps to demonstrate an increased ability to handle a larger volume of cars.

After a Chrysler representative reiterated its assurance that the plaintiff’s exclusive rights would depend on its ability to expand the capacity of its dealership to handle larger volume, the plaintiff developed a plan with its Credit Suisse bankers. The plaintiff’s plan included a series of steps to facilitate the handling of larger volumes of cars including more staff, larger showrooms in various locations and other capital improvements. Credit Suisse also authorized an increase in its overdraft facility to fund the plaintiff’s plan. After the plaintiff’s plan was developed

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220 822 A.2d at 1027.
221 Id. at 1028.
222 Id.
223 Id.
224 Id. at 1029 (detailing Iaccocca’s extension of the time frame for expansion from five to six years).
225 One Chrysler representative testified that “if and when we get to 3000 a year” then Chrysler might consider expanding its existing dealer network.” Id.
226 Id.
227 Id.
Chrysler endorsed the plan in 1989 and reiterated its commitment to the plaintiff with the plaintiff’s accountant.

During this time period certain factors, including an economic downturn, cast doubt on the wisdom of Chrysler’s proceeding with its expansion plan, particularly the lower cost Lamborghini. Chrysler started to explore “an exit strategy” due to increased doubts about its own plan’s feasibility but Chrysler still continued to offer assurances to the plaintiff that “production for both the Diablo [high end] and the P140 [low end] was on schedule.”

Despite the assurances, Chrysler’s production delays “eroded...profitability” for the plaintiff. These delays deprived the plaintiff of an income stream that could help service its debt obligations and the bank called the plaintiff’s loan that had been taken out to fund the expansion.

A jury found for the plaintiff on its promissory estoppel claim. This judgment was affirmed on appeal. This result makes sense because it involved a number of factors that make success more likely and defensible as a normative matter. The case involved significant uncertainty about the future which the defendant was trying to hedge by soliciting significant sunk costs from the plaintiff. Those sunk costs provided significant benefit to the defendant by helping to position the defendant to take advantage of a future lucrative opportunity once the uncertainty was resolved. By soliciting the sunk costs the defendant gained an option to proceed but without paying for that privilege. The sunk cost investments by the plaintiff were also useful in helping to distinguish the plaintiff as an able player in the future opportunity and distinguished the plaintiff from other players. The plaintiff’s sunk cost subjected it to the possibility of a hold up possibility. Once the investments were sunk, the plaintiff would lose the

228 Id.
229 Id.
230 Id. at 1030.
231 Id.
232 Id.
233 Id.
234 Id.
235 Id. at 1038.
investment altogether if no deal materialized. But more importantly, the sequential investment subjected the plaintiff to the risk that should a deal materialize, the plaintiff would be subject to the defendant’s ability to capture part of the investment in the bargained for surplus. This case and others like it are often successful claims for plaintiffs and have been overlooked in the scholarly literature.

B. Cases from Other Doctrinal Areas that Protect Reliance

An example of a case which a court protects pre-contractual reliance investments that are solicited by the putative offeror but under a different (non promissory estoppel rubric) is Earhart v. William Low Co.236 Though decided on a theory of quantum meruit, the case ended by protecting the investments that were made by the plaintiff on the basis of assurances by the defendant and thus is similar to cases decided under promissory estoppel. The investments were solicited by the defendant during a period of uncertainty. The defendant did not know about certain matters including whether a second tract of land could be acquired in addition to the initial tract and whether financing would be obtainable. Nevertheless, the reliance investment solicited by the defendant during this period of uncertainty was valuable and allowed the defendant to avoid forfeiting the permit to build that might occur unless the plaintiff took certain steps including investment on the second tract.

In that case a contractor began work on the construction of a trailer park at the request of the defendant.237 The defendant owned one tract of land and was negotiating for the acquisition of a second tract owned by a third party. The defendant negotiated a contract of construction with the plaintiff that would employ the plaintiff to construct the park on both tracts of land. The contract would not become binding until the defendant secured financing for the project and the second tract would not belong to the defendant without that financing.

During the period when the defendant was unsure whether

237 Id. at 505.
it would secure the financing or the second tract, the defendant learned from the plaintiff that the ability to build a trailer park on the second tract owned by the third party might expire unless construction on it began. The defendant then requested that the plaintiff begin work on the mobile home park. The defendant did not know at that juncture whether it would acquire the second tract or land or whether it would get the financing but one can see why the defendant may have wanted the plaintiff to invest money in construction. That helped to preserve the right to build on the mobile home park and that may in turn have been important in helping to secure the financing by making the project viable.

After the plaintiff had commenced work, the defendant refused to pay the plaintiff for the work done, citing as an excuse the hiring of another contractor. When the plaintiff sued in quantum meruit, it faced a particularly difficult problem: the work on the second tract, since it did not belong to the defendant but to a third party, did not directly benefit the defendant and so might not be recoverable on a quantum meruit theory. Normally quantum meruit would require that that which is disgorged as an unjust enrichment is the benefit to the defendant who could argue that the benefit was to third party, not to the defendant.

The court nevertheless found a benefit to the defendant basing its decision on an “extraordinarily broad concept of benefit” developed in the case law that looked to the “theory that performance at another’s request may itself constitute a benefit”238 In reaching that conclusion and rejecting the narrow concept of “direct benefit” that the trial court had applied, the court looked into an opinion concurrence by Chief Justice Traynor in which he argued that direct benefit should not be the governing issue. Traynor advocated a rule granting plaintiff a quantum meruit recovery as one that appropriately “places the loss where it belongs—on the party whose requests induced performance in justifiable reliance on the belief that the requested performance would be paid for.”239

238 Id. at 511.
Although Farnsworth may be correct that the notion of benefit applied in Earhart is “artificial,”240 the case may be more important if one thinks of Earhart as part of a larger group of cases in which courts protect a party who relies in a way that benefits the other party even if no direct tangible benefit because of the problem that solicited investments pose in terms of opportunistic behavior and hold up. Unless those investments, which are solicited during a period of uncertainty for the defendant, and which may help the defendant to hedge or to reduce uncertainty, are compensated, future parties may decline to invest and putative offerors will be deprived of needed information.

Maybe Earhart was a stretch doctrinally when it expanded quantum meruit to include a case in which the only direct benefit was to a third party. However, the case makes sense in the context of the danger of hold up and the incentive problem created when investments are solicited by a party as a way of helping the non-investing party hedge and then not compensated or reimbursed by a liability rule. Without a liability rule to cover cases like Earhart future parties may be unwilling to invest and the risk of uncontrolled opportunism will act as a drag on future trades. Similar arguments can be made to support promissory estoppel liability in pre-contractual negotiation cases, even those that do not involve a traditional “agreement.”

C. What the Schwartz and Scott Preliminary Agreement Cases Teach Us About the Hold Up Problem in Precontractual Hoffman type cases.

Recently, two authors, Alan Schwartz and Bob Scott, have suggested that reliance investments that occur following a preliminary agreement where the parties, as part of their preliminary agreement, promise to invest simultaneously and one party defers that investment in a way that disadvantages the other party, should be compensable. The delay is often considered a breach of the duty of good faith that applies to preliminary agreements and the promisee should be able to (and is under the case law) able to recover its reliance expenses.241

240 Farnsworth, supra note 3, at 224.
241 Schwartz & Scott, supra note 15, at 662.
The cases considered by Schwartz and Scott to illustrate protection for reliance cases involve reliance following a binding preliminary agreement may be useful to examine to see if there is a common justificative framework operating that can explain or justify when the law should intervene to protect reliance investments, particularly where sequential investment is present. In both situations, both in reliance following a preliminary agreement and in reliance in preliminary negotiation, uncertainty hampers the ability to reach a fully contingent contract that would protect all reliance investments and transaction costs prevent bargaining over reliance investments since they remain non-contractible.  

To illustrate how the obligation of good faith operates to protect reliance in the period following a preliminary agreement Schwartz and Scott chose to analyze *Kandel v. Center for Urological Treatment and Research*. In that case the plaintiff doctor joined the defendant’s urology practice. The plaintiff’s employment contract with the corporation obligated both parties to negotiate in good faith at the end of one year toward an agreement that would permit the plaintiff to buy a one-third share in the practice through an acquisition of shares in the corporation owning the practice.

After the year expired, the parties negotiated but could not reach an agreement on terms. The plaintiff argued that the defendant had not bargained in good faith because of the amount that the corporation would require the plaintiff to pay to the corporation on termination of his employment. The legal question for the court was whether the urology corporation defendant had breached its good faith obligation when it negotiated but failed to reach terms.

In deciding whether the court’s decision to deny relief to the doctor was appropriate the authors consider whether either of

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242 *Id.* at 667.
243 2002 WL 598567 (Tenn. Ct. App.)
244 This obligation to bargain in good faith was explicit. *Id.* at ___
245 *Id.* at ___
246 *Id.* at ___
the parties breached an obligation to invest simultaneously in the success of the enterprise and whether even if both parties complied with their obligation to invest simultaneously either could be found to be in violation of the obligation of good faith that would govern a binding preliminary agreement. The court had to consider what the scope of good faith entailed when the parties were negotiating over the terms of a buy-in of the new partner to the corporation. To determine the scope of the obligation of good faith and to whether it was breached, Schwartz and Scott rightly focus on the difficulties of contracting and the risks that each party faced \textit{ex ante} when the corporation hired the doctor. Those difficulties in turn explain why it was not possible or optimal for the parties to reach a fully contingent contract that fixed the terms of an ultimate buy-in for the new physician immediately upon the hiring of a new doctor.

Each side needed to invest further in order to resolve uncertainties and contribute toward the success of the new partner’s contribution. Uncertainty \textit{ex ante} would make it unclear whether the new partner would in fact be worthwhile enough to bring in as a full fledged partner. Asymmetric information problems meant that the corporation lacked information about how valuable the prospective partner was and the prospective partner did not know how valuable a practice he was potentially joining.\footnote{Schwartz \& Scott, supra note 15, at 695.} To deal with these uncertainties, the parties put off the negotiation of the ultimate agreement until the end of the first year but committed to invest right away. The advantage of postponing the final agreement was that some of the uncertainties and asymmetries would have been resolved; the corporation would know how much value the partner could bring to the practice and the partner would have better information about the value of joining this practice (as distinct from other practices).

Given those difficulties, postponement of a final agreement served many purposes. The corporation could postpone a decision about the final terms until the final worth of the prospective member of the corporation had been revealed over time. Because the parties each met its obligation to invest simultaneously in the practice, Schwartz and Scott agree with the court that there was no
breach of the good faith obligation.248

The legal issue in Kandel was whether the corporation breached its obligation of good faith when it offered certain terms that the doctor/prospective member of the corporation found objectionable.249 Because the value that the plaintiff would bring to the practice was uncertain ex ante, the defendant would have been unwilling to set the terms of the ultimate contract of buy-in terms for the plaintiff ex ante. However, the defendant and the plaintiff were both willing to invest simultaneously in the interim and to obligate themselves to attempt to work out final terms after some of that uncertainty was resolved in the first year of practice. The court found no breach; Schwartz and Scott explain that such outcome is justifiable because each party was committed to furnish certain investments simultaneously and each party performed its obligation to invest in the practice. The corporation invested in training the doctor/plaintiff and the plaintiff made an investment of human capital.250 Since neither party failed to invest, neither party was subject to hold up as would have been the case, argue Schwartz and Scott if the practice had failed to invest in training even after the doctor has undertaken sunk costs of moving etc.251

Since each party met its obligations to invest simultaneously, the doctor could not successfully argue that the corporation had breached its good faith duties.252 The corporation had an obligation not to withhold an investment in such a way that it would subject the other party to hold up but if the corporation invested in training, the corporation was not obligated to reach an agreement with the doctor. Extending good faith to obligate the corporation to reach an agreement with the doctor would shield the doctor from a risk that he undertook ex ante. It was possible that after each party invested, the preliminary agreement would not be finalized because it no longer seemed profitable but the parties should not be insulated from such risk and so the good faith obligation should not be interpreted to mandate agreement on

248 2002 WL at ___.
249 These objectionable terms included: Id. at ___
250 Schwartz & Scott, supra note 15, at 695.
251 Id. at 696.
252 Id.
The authors thus suggest that where there is a promise to invest simultaneously and one party delays investment, then a cause of action should lie because of the possibility that one party will be subject to hold up by the other party. To prevent that outcome and to encourage investment, liability should obtain when there is delayed investment that subjects the other party to “holdup.” Where the parties have invested simultaneously but failed to reach agreement on the ultimate terms,254 as in Kandel no cause of action should lie because it is not necessary to induce efficient investment. What is needed to induce efficient investment is legal protection against a particular form of hold up – that of a delay in investment by one when each agreed to invest simultaneously. If the plaintiff is protected against that, there is no need to protect him against the risk that the parties will fail to reach a final contract. One of the risks that the plaintiff assumes is that his work in the practice over a year’s duration will demonstrate that even with training from his employer, he does not appear to be a desirable partner.

In the cases that are at the center of this Article no preliminary agreement on the type or order of investment that each party will make exists in part because it is too early to even agree on a preliminary agreement. Thus, if one applies the insight of Schwartz and Scott literally, it would suggest that there should not be liability for reliance investments made during the pre-contractual period where there is no preliminary agreement and no agreement on a sequence of investments.255 The particular rule suggested by Schwartz and Scott and examined in cases like Kandel that “should permit a promise to recover sunk costs if his promisor deviated from an agreed investment sequence”256 would

253 *Id.*
254 This would likely be the case where the investment demonstrated that the doctor’s worth was not as high as expected. *Id.* This would demonstrate “that trade was inefficient ex post.” *Id.* at n.97.
255 That outcome would be consistent with many cases that hold there is no obligation of good faith that applies in the preliminary negotiation phase to protect reliance. There are some notable exceptions to this principle.
not technically apply to preliminary negotiation which lacks a preliminary agreement or an agreement to invest. Nevertheless, there is a similar danger of “hold-up” that obtains when one party is solicited to invest in ways that benefit the other party, often by reducing uncertainty about whether a transaction would be profitable. For that reason the law should look to the underlying logic of the Schwartz and Scott analysis that protects an investing promisee against a “promisor who defects by delaying his investment has forced the promise involuntarily into the relatively disadvantageous sequential investment regime to determine liability for reliance.”257 The logic suggests that the law should compensate for a reliance investment when made in precontractual negotiations when doing would protect the investing party from the “hold up” risk that obtains should one party invest first. In the precontractual early negotiation cases there is no expectation that there will be simultaneous investment. Instead, the party deciding whether to formulate an offer (the promisor) is delaying investment until it can be determined if a full fledged offer should be made. In the precontractual early negotiation cases, because there is no agreement or promise to invest simultaneously, the delay in investment by the putative offeror is not a breach of any explicit promise nor does it specifically fall within the scope of cases subject to Schwartz and Scott’s admonition that delays of agreements to invest simultaneously following a preliminary agreement should entitle the other party to recover. Nevertheless, the prior investment by the promisee should be protected to achieve the goal of efficient investment and prevent hold up; otherwise, there will be underinvestment and fewer trades.

Conclusion.

This article has examined the precontractual negotiation period for two purposes: (1) to see if a liability rule making one party responsible for the reliance costs of the investing party is justified; and (2) to ascertain whether the case law outcomes are consistent with such a rule. To determine whether a liability rule is justified, the Article has examined how the problem of incomplete contracting, uncertainty, and sequential investment all contribute to the conclusion that without a liability rule, reliance would be

257 Id. at ___
suboptimal. Uncertainty about the future makes it hard to reach a complete contract and without such a contract, one party may be reluctant to invest since the investment will be lost if the deal doesn’t materialize, the contract itself won’t offer complete protection because the investment may be non-contractible and the investment by one party because of the sequential nature of the investment can subject it to hold up by the other party. If a contract ultimately is formed, the non-investing party may capture part of the surplus, leaving an inadequate incentive in the other party to invest.

Traditionally, the law nonetheless denied all recovery to an investing party if there were no contract. Following Section 90 courts took a more liberal view and found liability even absent a full-fledged bargain. *Hoffman v. Red Owl* represented the “high-water mark” for such liability.

Recently, two scholars, Alan Schwartz and Bob Scott, have argued that the case law demonstrates that courts deny recovery in preliminary negotiations unless there is an agreement but do impose liability and grant reliance recoveries when the parties achieve a preliminary agreement which includes an agreement to invest simultaneously and one party delays investing for strategic reasons.

These two authors have drawn a strong line between precontractual negotiation where claims fail and reliance following preliminary agreements where claims succeed. This Article has challenged the conclusion that precontractual negotiation claims fail absent a showing that an agreement exists. In so doing the Article rationalizes both sets of cases into a unifying justificative theory in which the law protects reliance in both sets of factual scenarios at different states of the negotiation if the law can mitigate the effects of opportunistic hold up through a liability rule.