Uncertainty, Reliance, Preliminary Negotiations and the Hold Up Problem

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CONTENTS

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]

* John Homer Kapp Professor of Law, Case Western Reserve University School of Law. Sincere thanks are due to Miranda Bureau, Brian Carney, Randeep Dhiman, Jeff Dornbos and Michael Halper who provided valuable research assistance. Professors Omri Ben-Shahar, Dick Craswell, Peter M. Gerhart, and Ronald J. Coffey provided valuable comments. Thanks are also due to Dean Gary Simson and to the Case Western Reserve Law School which provided research funds. The paper also benefited from presentation at the American Law and Economics Association Annual Meeting, held May 16-17, 2008. Final and heartfelt thanks are due to Eleanore Ettinger, whose technical assistance, encouragement, and supreme attention to detail made a significant contribution to this and all my other articles.

1. This assumes no externalities.
2. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

In the 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 contract that expressly controls all of the possible permutations of the risk of moral hazard.[5]

The problem of uncertainty is pervasive in all contract negotiations. 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 the contract will improve his welfare (and the welfare of society), and each is therefore optimistic about the possibility of a bargain. But that optimism is tempered by three factors. First, each party knows that it cannot produce joint gains from trade if it gives up too much.[7] The party is therefore uncertain about whether the other side 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 predictions as to the 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.[8] 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

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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 161-169; *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, specific promise, misrepresentation, and general obligation).

4. OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 47-49 (1985). For a recent treatment of the important role that the problem of curbing opportunism plays in interpretation, see generally Juliet P. Kostritsky, *Plain Meaning v. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Rule for Interpretation*, 96 KY. L.J. 43 (2007) (discussing opportunism and contract interpretation).

5. *See* WILLIAMSON, *supra* note 4, at 48. For example, a principal hiring an agent lacks fundamental knowledge about the agent's "propensity to diverge" and is uncertain about the precise ways in which such "propensity" will manifest itself. Email from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet Kostritsky, Professor of Law, Case Western Reserve University School of Law (Jan. 27, 2005) (on file with author). This uncertainty poses a contracting problem for the principal who cannot draft a complete contract to control for unknowable choices and predilections.

6. As Professors 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." Benjamin Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, *in* HANDBOOK OF LAW AND ECONOMICS 3, 59 (A. Mitchell Polinsky & Steven Shavell eds., 2007). The search is to ascertain whether gains from trade exist.

7. *See id.*

8. WILLIAMSON, *supra* note 4, at 57.

party is uncertain about its counterparty's particular proclivity to engage in opportunistic behavior but knows that there is some potential for such opportunistic behavior in the general population, as it is a facet of human nature.[9] The presence of certain structural factors affecting the sequence of investment may increase the potential for opportunistic behavior.[10]

The optimism of potential opportunities from joint gains from 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 he has made himself worse off by providing the other party with information that the other party can use opportunistically.[11] The law grapples with this latter risk in precontractual negotiation cases[12] and, in ways that will be explored later, the risk also exists in the reliance on preliminary agreements where parties agree on a sequence of investment.

Some of these uncertainties, particularly those relating to the future, may be resolved by negotiating with another party over time, since time itself may resolve some issues.[13] Parties also can reduce uncertainty by undertaking search costs and making expenditures to acquire information.[14]

Parties can also use the "courtship process" and proceed incrementally to mitigate and resolve some of these uncertainties before they commit to one another.[15] 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.[16] During this initial period of uncertainty before a contract is formed, each party must decide whether and when to make

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9. 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. *Id.* at 48. Williamson observes that this variance among types means that "problems of economic organization are compounded if the propensity to behave opportunistically is known to vary among members of the contracting population. . . ." *Id.*

10. *See id.* at 58.

11. *See* Hermalin et al., *supra* note 6, at 59-61. 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.

12. *Id.* at 61.

13. *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).

14. *See* Richard Craswell, *Precontractual Investigation as an Optimal Precaution Problem*, 17 J. LEGAL STUD. 401, 403-04 (1988).

15. Jason Scott Johnston, *Communication and Courtship: Cheap Talk Economics and the Law of Contract Formation*, 85 VA. L. REV. 385, 388 (1999). Johnston explains that "courtship" is a "process by which markets for complex and highly differentiated goods and services are created." *Id.* at 388.

16. *Id.* at 388-89. 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

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.[17] In turn, that prospect will affect their incentives to invest in future negotiations and contracts.

Traditionally, under the aleatory view,[18] the law took a "knife-edge" approach to compensating for reliance investment that was most likely to occur during this period of uncertainty.[19] That conventional approach denied any compensation for reliance without a contract but granted full enforcement to assent-based explicitly reciprocal contracts with consideration.[20] Absent such a contract, any reliance investment was deemed non-compensable.[21] Parties relied at their own peril in the absence of a bargained-for contract.[22]

Following the adoption of Section 90 of the *Restatement (First) of Contracts*,[23] courts adopted a more liberal approach to reliance compensation issues. They sometimes found liability when a promisee relied on the promises of a putative offeror despite the absence of a bargain in precontractual negotiations without the benefit of any bargained-for agreement.[24] *Hoffman v. Red Owl*[25] is the paradigm case permitting such recovery. Recently, courts have also begun to uphold reliance claims in cases where parties reached a preliminary agreement together with an agreement to invest simultaneously, one party had invested after the preliminary agreement was reached, and the other party walked away from the deal and refused to agree to a final contract.[26]

Recently, two scholars, Alan Schwartz and Robert Scott, have cast doubt on the liberal theory of reliance recovery.[27] They argue that courts generally deny recovery for reliance in cases involving precontractual preliminary negotiation[28] but grant recovery in cases involving reliance

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point where the marginal costs of additional search just outweigh its expected marginal value." Hermalin et al., *supra* note 6, at 53.

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

18. Farnsworth, *supra* note 3, at 221. Under this view, investments made to win an ultimate contract are done at one's peril. *See infra* Section III.

19. Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 675 (2007).

20. Farnsworth, *supra* note 3, at 221-23. The contract price and expectancy damages automatically compensate a party for his reliance expenditures since the contract price includes an amount sufficient to cover one's reliance investment in the contract and includes a profit that exceeded the reliance investment. *Id.* at 223.

21. *Id.* at 221.

22. *Id.*

23. RESTATEMENT (FIRST) OF CONTRACTS § 90 (1932).

24. *See* Farnsworth, *supra* note 3, at 236-37.

25. Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267 (Wis. 1965).

26. Schwartz & Scott, *supra* note 19, at 662-65 (discussing the advent of such claims under preliminary agreements and explaining the basis for success).

27. *Id.* at 663-65.

28. *Id.* at 673. Schwartz and Scott explain the lack of success in such preliminary negotiation cases as follows: "The courts' reluctance to award damages in these cases may rest

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."[29] They identify a pattern 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 simultaneously[30]—what I will refer to as agreements to jointly investigate or explore—and one party strategically delays investment for personal gain, the law permits the investing party to recover for reliance expenditures when the other party walks away from the deal.[31] Courts find the party who exits the deal to be guilty of a breach of the good faith obligation that governs parties' actions in preliminary agreements.[32]

Based on an extensive review of case law, this Article suggests that, contrary to the Schwartz and Scott thesis, courts do grant recovery for reliance expenditures made in precontractual preliminary negotiations even when the parties have not reached "an agreement."[33] The courts' 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.[34] Neither the promisor nor the promisee would want the promisor to have what amounts to an option that he does not pay for if it would disincentivize promisees from investing and/or discourage trades.

The risk of holdup is present whenever there is sequential investment. Once one party invests a sunk cost, one of two possibilities exist: either the deal never materializes, in which case the sunk cost is lost, or the deal materializes but the non-investing party shares in the surplus.[35] That need to share part of the surplus renders the investing party vulnerable to holdup and discourages promisees from investing.[36] Thus, this Article suggests that courts *are* willing to grant recovery for reliance expenditures in both categories of cases: (1) precontractual negotiations with no agree-

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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 are contrary and point to success in these cases assuming the presence of a promise, a transaction-specific investment, detriment, and reasonable reliance. *See id.* at 664-65. These results may be explained in part by the difficulties that parties might have in drafting contractual protective mechanisms. *See infra* notes 127-28.

29. Schwartz & Scott, *supra* note 19, at 664-65.

30. 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.

31. *Id.* at 685 (discussing circumstances that will cause the party to delay investment).

32. *Id.* at 694.

33. *See infra* Section VI.

34. *See* Yeon-Koo Che & Donald B. Hausch, *Cooperative Investments and the Value of Contracting*, 89 AM. ECON. REV. 125, 125 (1999) (defining "'cooperative' investments [as ones] that directly benefit the investor's partner").

35. Bebchuk & Ben-Shahar, *supra* note 17, at 423-24.

36. *Id.* at 431-32.

ment 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.[37] Presumably, both parties would want such control because the uncontrolled risk of such behavior would discourage future transactions.[38] That framework connects the results of successful preliminary reliance negotiation cases (the *Hoffman v. Red Owl*[39] type case) and the successful cases of recovery for reliance on preliminary agreements with an agreement to jointly invest, identified recently by Schwartz and Scott.[40] Whether a court is deciding if the good faith obligation requires compensation for reliance made pursuant to a preliminary agreement for joint investment or if a liability rule for reliance in precontractual negotiations is warranted, the court is concerned with essentially the same problem of regulating the holdup problem.

Schwartz and Scott endorse enforcement of preliminary agreements with concomitant agreements to jointly investigate or explore only where the joint promise to investigate is relatively explicit.[41] By contrast, this Article advocates a legal default rule[42] that would grant compensation where the promise to investigate jointly is only implicit. An implicit agreement is found where one party would not have invested unless there had been an understanding that the investing party would be compensated if the other party operated opportunistically with respect to that

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37. As Oliver Hart explains, "[w]e are all looking for a contract that will ensure that, whatever happens, each side has some protection, both against opportunistic behaviour by the other party and against bad luck." OLIVER HART, FIRMS, CONTRACTS AND FINANCIAL STRUCTURE 2 (1996).

The cases that I identify to illustrate successful claims to prevent opportunistic conduct do not necessarily involve cases in which the defendant has actually acted to hold up the plaintiff following a sunk cost investment. In some instances the defendant exits the relationship without actually attempting to hold up the plaintiff. However, the potential for opportunism is there in either case. If the defendant goes on to consummate the deal, he can hold up the plaintiff through demands for part of the surplus. If the defendant exits the relationship, the investment is wholly lost. It is the potential for opportunistic hold up that the court must be concerned with because that prospect will act as a drag on gains from trade in future transactions. I am grateful to Dick Craswell for raising this issue of the presence of actual attempts at hold up. Email from Richard Craswell, Professor of Law, Stanford University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University School of Law (Aug. 8, 2008, 16:07 CST).

38. *Id.*

39. *See generally* Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267 (Wis. 1965) (granting recovery for reliance investments made during preliminary negotiations).

40. Schwartz & Scott, *supra* note 19, at 694. 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 holdup and sequential investment are used to provide a unifying rationale. *Id.* at 663.

41. *Id.* at 690-91.

42. Richard Craswell provided valuable insight into the default rule approach of this Article. *See* Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 515 (1989) (explaining that "any default rule would also be consistent with individual freedom, as long as the parties are allowed to change the rule. . . .").

investment *or* had the ability to hold up the other party based on the sequence of investment.

This Article will provide guidance for courts considering whether, when, and why reliance investments made during precontractual negotiations should be compensated through a default rule.[43] 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 investment, the reliance should be compensated to prevent both the holdup problem and the consequent under-reliance[44] that occurs when one party solicits investments and then defers any action or contracting until the investments are made by the first party.[45]

Paying greater attention to how courts take account of the potential for strategic behavior, holdup, and the problem of under-reliance in deciding whether, when, and why to award reliance costs would provide greater certainty to the area of precontractual reliance case law and give a more complete picture of when courts will and should find liability. 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.

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 holdup 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, which denied all recovery for reliance investments if no bargain contract were achieved,[46] and reexamines whether the traditional view makes sense in situations of sequential investment. Part IV details the problem of holdup 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.[47] Part IV also examines cases in which sequential

43. Professor Omri Ben-Shahar would also provide guidance to courts, but he would use a different approach: not a default rule, but a liability rule with the advantage that it would obviate the need for line drawing. Omri Ben-Shahar, *Contracts Without Consent*, 152 U. PENN. L. Rev. 1829, 1834 (2004). Under his approach, "[w]hen parties reach an agreement in principle over some fundamental terms but plan to further negotiate, each party acquires the option to bind the other to a deal that includes the terms agreed upon, supplemented by proposals made by the other party and terms most favorable to that party." *Id.* This Article, instead, offers a way of determining liability based on a number of factors, which will make liability determinations more predictable.

44. *See* Bebchuk & Ben-Shahar, *supra* note 17, at 431-32.

45. *See* Johnston, *supra* note 15, at 495 (highlighting the awareness of the investment as a factor in imposing liability).

46. Farnsworth, *supra* note 3, at 221.

47. Bebchuk & Ben-Shahar, *supra* note 17, at 432.

investment may be a cure to strategic behavior. It discusses instances in which the sequential investment may require a legal response to curb a moral hazard problem and encourage investment, at least whether there are reasons to think that the parties would have agreed on such a liability rule were it not for a variety of obstacles to its express adoption by the parties, and where there are reasons to think that requiring parties to expressly adopt a liability rule in each case would be more costly or less effective than the alternative default rule of requiring parties to expressly opt into a liability rule. Part 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.[48] Part V suggests that the two contexts can be linked since there is a risk of opportunism in each setting. It suggests that the analytical framework embraced by Professors Alan Schwartz and Robert Scott[49] should be extended to cover precontractual negotiation where the risk of holdup is also great. Part VI reexamines recent reliance case law to see if case outcomes are consistent with a rule imposing liability when the risk of holdup is great. The support for such liability refutes the thesis of Schwartz and Scott that the case law rejects recovery on reliance unless an agreement is reached.[50] This Article 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.

The real question is whether on a comparative cost basis it is *a priori* irrational to think that sometimes bargaining is relatively more wasteful than law-supplied terms.[51] If so, then a law-supplied liability default rule presumption makes sense in certain sets of cases.

II. UNCERTAINTY IN CONTRACTING

In 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.[52] Uncertainties about the past, including how one's counterparty has acted in prior transactions, may also hinder efficient bargaining.[53] Many types of uncertainty exist *ex ante* that affect how parties bargain: the timing of offers, the relative

48. Schwartz & Scott, *supra* note 19, at 693-94.

49. *Id.* at 690-91.

50. *Id.* at 693.

51. Email from Peter M. Gerhart, Professor of Law, Case Western Law School, to Juliet P. Kostritsky, Professor of Law, Case Western Law School (May 19, 2008, 14:46 CST) (on file with author).

52. *See* WILLIAMSON, *supra* note 4, at 30-32.

53. *See id.* at 58. 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. *See* Hermalin et al., *supra* note 6, at 60.

probability of a deal with a particular party,[54] the incentive to dissemble or to be honest to one's counterparty,[55] and the ability to reach a complete contract.[56]

These uncertainties affect the parties' incentive to invest in the pre-contractual period given the holdup problem. The "*ex ante* holdup" problem[57] 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 [sic] reliance, but only a fraction of it. . . ."[58]

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[59] that intervenes only when doing so would improve the parties' welfare.[60] In any transaction, parties initially do not even know whether there are gains to be made from a trade.[61] The seller of an asset does not know the opportunity cost of selling its asset, and a buyer lacks knowledge of "what the opportunity would be worth to it."[62] 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*.[63] Parties adopt different strategies to deal with the various types of uncertainty in transactions. They use a cost-benefit analysis to determine whether to proceed with negotiations,[64] 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[65] and the opportunistic proclivities of one's counterparty.[66]

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54. Johnston, *supra* note 15, at 389.

55. *See* WILLIAMSON, *supra* note 4, at 58.

56. Pierpaolo Battigali & Giovanni Maggi, *Rigidity, Discretion, and the Costs of Writing Contracts*, 92 AM. ECON. REV. 798, 798 (2002).

57. Schwartz & Scott, *supra* note 19, 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").

58. Bebchuck & Ben-Shahar, *supra* note 17, at 432. This is what Bebchuk and Ben-Shahar refer to as the "Divergence Between Private and Social Gain." *Id.*

59. *See infra* note 210.

60. 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 intervention would improve welfare, it will also explore private strategies that parties use to deal with the uncertainty problem in pre-contractual negotiations, to determine if the law can play any useful role in the pre-contractual phase by facilitating investment that will help parties reach optimal contracts.

61. Email from Peter M. Gerhart, Professor of Law, Case Western Reserve University to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (Sept. 27, 2007, 10:28 CST) (on file with author).

62. Johnston *supra* note 15, at 388.

63. *See id.* at 387-88.

64. *Id.* at 389.

65. Hermalin, et al., *supra* note 6, at 59-60.

66. *See* WILLIAMSON, *supra* note 4, at 58.

When we speak of uncertainty and the effects that it will have on parties negotiating toward a final contract, we must also 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, 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.[67] One does not know how one's counterparty has acted in the past or how he is likely to act in the future.[68] One lacks information on that party's "propensity to diverge,"[69] or what Oliver Williamson calls the problem of opportunism.[70]

If uncertainty did not exist, even in contracts that involve future performance, the bargaining process would be simple, and parties could achieve fully contingent contracts that are self-enforcing.[71] Parties could draft complete contracts to take 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.[72] 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.[73]

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[74] that deals with the full range of uncertainty, both about behavior and the future state of nature.[75] Uncertainty about

67. *Id.* at 58.

68. *Id.*

69. Email from Ronald J. Coffey, Professor Emeritus of Law, Case Western Reserve University, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (Jan. 27, 2005) (on file with author).

70. Parties who exchange goods simultaneously do not need to worry about what the future will hold (what economists call the state of nature) or how to build in protections in the contract to deal with future uncertain events, since the parties' obligations do not extend in the future. Even the uncertainty about whether one's counterparty is likely to act opportunistically in the future will be of no concern if performance is rendered simultaneously. Uncertainty about how one's counterparty has acted in the past and how that might affect the terms or willingness to transact if one has to depend on the future performance of such person will be of no concern with instantaneous exchange, where one party does not have to depend on the other. Because a party to an instantaneous transaction does not have to depend on the other party for continuing performance obligations, any uncertainty about the counterparty is irrelevant.

71. WILLIAMSON, *supra* note 4, at 30-31.

72. *Id.*

73. *See id.* at 48.

74. *See e.g.*, Battigali & Maggi, *supra* note 56, at 798; Jean Tirole, *Incomplete Contracts: Where Do we Stand?*, 67 ECONOMETRICA 741, 743 (1999).

75. 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. *See* Frank

a counterparty's past behavior may make it difficult to evaluate how risky a partner one is dealing with.[76] This is the classic problem of adverse selection.[77]

Of course, if the investment could be deferred until the final contract, then the contract could protect those investments because the bargain and 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 the parties. Any sunk costs that are made after a contract is entered into meet the assurance that if the other party defaults or breaches, the investing party will be protected by the expectation interest.[78] If a party invests in the interim period before uncertainty is resolved and before a final contract is entered into, it may be taking the risk that the precontractual reliance cost will not be compensated.[79]

When a party invests transaction-specific sunk costs, the situation becomes even more complicated.[80] If no sunk costs exist, it does not matter if parties are unable to achieve a complete contract that addresses all possible problems because of the cognitive limits and the cost of acquiring information (bounded rationality), and uncertainty. Parties may simply exit the relationship without any adverse consequences.[81] The presence of sunk costs makes it costly to simply terminate.[82] Moreover, 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.[83]

Parties may proceed on their own with search costs to mitigate uncertainty to determine whether gains from trade exist.[84] When we talk about potential bargains, we are always talking about reciprocal uncertainty because each party is uncertain about the costs and benefits of a potential bargain.[85] But because there is a possible bargain, each party also has a reason to reduce the other party's uncertainty, at least if that can be done

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H. Esterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J. LAW & ECON. 425, 427 (1993).

76. WILLIAMSON, *supra* note 4, at 58. 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.

77. *See id.* at 47. *See generally* Kenneth J. Arrow, *The Economics of Agency*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37, 38 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (defining two types of principal-agent problems: moral hazard and adverse selection).

78. *See* Schwartz & Scott, *supra* note 19, at 664.

79. *E.g.*, E. ALLAN FARNSWORTH, CONTRACTS § 3.26 (4th ed. 2004).

80. The investment of such costs contributes to what Williamson calls the "fundamental transformation" in the relationship. WILLIAMSON, *supra* note 4, at 61.

81. *Cf. id.* at 62 (stating that party with sunk costs (transaction-specific) is "effectively committed to the transaction . . .").

82. *Id.*

83. *See* Bebchuck & Ben-Shahar, *supra* note 17, at 423-24.

84. *See* Craswell, *supra* note 14, at 401.

85. *See* Johnston, *supra* note 15, at 388.

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 has an incentive to invest something in reducing the other party's uncertainty in moving closer to a bargain. Each party will move closer when the investment in reducing the other party's uncertainty is offset by the actual or potential benefit of that reduction (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"[86] 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 the 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 themselves in the event that a matter whose outcome is uncertain *ex ante* is later resolved in a way that makes contractual performance disadvantageous.[87] A common example is the inclusion of an express condition that permits one party to exit the contract if a certain event that cannot be known *ex ante* materializes.[88]

Other uncertainties that cannot be resolved through search costs *ex ante*, such as the value of a company post-merger, may 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.[89] Parties might implement structural solutions to provide incentives for the parties to work toward a successful outcome[90] and make the price contingent on a successful merger.[91]

One major tool that each party has for negotiating in the face of uncertainty is to solicit information from the other party[92] that will reveal qual-

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86. Hermalin et al., *supra* note 6, at 59. 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 nonnegative return by agreeing to reimburse his partner for investment costs if the project is not pursued." Schwartz & Scott, *supra* note 19, at 683 (detailing noncontractible investments interfering with contractual guarantees). Contracting difficulties may make this impossible. Incentives to invest would also continue, even if no reimbursement promise could be made, if the party invests 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.

87. *See* WILLIAMSON, *supra* note 4, at 60.

88. FARNSWORTH, *supra* note 79, § 8.2 (detailing purpose "that conditionality presupposes some degree of risk arising out of uncertainty. . .").

89. Brian JM Quinn, *Asset Specificity and Transaction Structures: A Case Study of @ Home Corporation* 2 Stan. L. & Econ., Olin, Working Paper No. 354 (2008), *available at* http://www.ssrn.com/abstract=1099382.

90. Janet Whitman, *Company Finds Joint Ventures Ease Transitions*, WALL ST. J., July 3, 2002, at B10.

91. That solution can serve to mitigate the moral hazard problem that would otherwise exist.

92. For a discussion of the relevance of reliance investment in resolving uncertainty problems, see Juliet P. Kostritsky, *When Should Contract Law Supply a Liability Rule or Term?: Framing a Principle of Unification for Contracts*, 32 ARIZ. ST. L.J. 1283, 1306-13

ities valuable in helping the putative offer or decide whether to make an offer, and if so, on what terms.[93] Sometimes the information is relatively costless, both to give and receive.[94] 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.[95] The advantage of sending a low-cost, accurate signal is that it weeds 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 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.[96] 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 type in order to ensure that the class who responds actually has a high likelihood of proceeding towards a deal. The sender would not want to send inaccurate messages because doing so would prompt too many responses from recipients with incompatible qualities, thereby raising negotiating costs and lowering the probability of reaching a deal.[97]

At other times, one or both parties do not have enough information during preliminary negotiations to send cheap signals that take the form of a statement that the probability of reaching a deal is high or low because the probability of reaching a deal with the other party depends on a myriad of factors that are not yet known.[98] Thus, cheap signals that are (1) limited to information about one's own type; (2) designed to solicit information from the other party about the other party's type; and (3) 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[99] and therefore potentially costly because it will be

(2000) (discussing neglect of the uncertainty problem in prior analyses of precontractual liability issues). *See also* Johnston, *supra* note 15, at 494 (detailing structural conditions under which pretrade performance might be the only way of reducing uncertainty about "relatively indistinguishable seller types" to buyers).

93. Daniel Farber & John H. Matheson, *Beyond Promissory Estoppel: Contract Law and the "Invisible Handshake,"* 52 U. Chi. L. Rev. 903, 922 (1985) (discussing the importance of benefit to promisor as a reason for finding liability under promissory estoppel). *See also* Juliet P. Kostritsky, *An Assent Theory of Liability Emerging Under the Guise of Promissory Estoppel: An Explanation and Defense*, 33 Wayne L. Rev. 895, 943 n.202 (1987) (documenting importance of benefit to defendant-promisor in finding of liability in promissory estoppel cases).

94. Johnston, *supra* note 15, at 389. Examples of such low cost messages, "cheap talk" include statements such as "everything looks great" or "we are not optimistic." *Id.*

95. *Id.* at 388-89.

96. *Id.* at 408-09.

97. *Id.* at 390, 409-10.

98. *Id.* at 389.

99. Oliver Williamson highlighted the importance of such transaction-specific investments posed for contracts, pointing out that where they existed, a "fundamental transformation" occurred that made it more important for parties to control contractual hazards

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.[100]

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,[101] where one party is exposed and vulnerable to holdup 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.[102] 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.[103]

If one party defers investment until after the other has invested and the project succeeds, the parties will negotiate.[104] However, the negotiation price will ignore the sunk cost that has already been made; the party who has already invested will not recover the reliance in the price since some of the surplus will be shared. This is the holdup problem.[105] Parties could delay a contract until the resolution of certain of these uncertainties.[106] This strategy might lead parties in the direction of delaying performance until a 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, such as loss of benefits of investing early in the contract when costs are low.[107] Parties would also be subject to certain risks that could be contained by a contract, such as the unavailability of a product.

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since transaction-specific investments make a costless exit impossible. *See* WILLIAMSON, *supra* note 4, at 61-62.

100. The author noted the neglected connection between reliance and the reduction of uncertainty in Kostritsky, *supra* note 93, at 1313-14.

101. *See id.* at 1315.

102. Presumably it will be beneficial to defer investment because 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 for the prior investment by the one party.

103. Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What to Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 WIS. L. REV. 323, 340.

104. *See* Schwartz & Scott, *supra* note 19, at 677-78.

105. *See* Bebchuck & Ben-Shahar, *supra* note 17, at 432.

106. Professor Avery Katz discusses delay as a possible response to certain types of certainty that will be resolved over time. Katz, *supra* note 13, at 1268-69.

107. Katz discusses this concept of the benefits of early investment. *See id.* 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, 1267-70 (1980).

However, it is far more likely that parties will begin relying on negotiations even before a final agreement is ever reached, leading to a potential holdup problem if they do not reach a private agreement to compensate the investing party.

III. THE ALEATORY VIEW OF RELIANCE INVESTMENTS

Traditionally, under the aleatory view of contracts, which resulted from the "knife-edge"[108] view of contract liability,[109] 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.[110] The law denied compensation to parties investing in an asset (pre-contract) on the theory that investors "should take the risk of wasted investments into account before making them."[111]

The idea that each party invests and gambles on success seems reasonable on one level, and has been justified on the efficiency ground that imposing liability during preliminary negotiation "might discourage parties from entering negotiations."[112] Moreover, where each side is bestowing value on the other and, in effect, investing in the possibility of a deal, these investments in precommitment action may be offsetting values in which the implicit solution is that "I'm gaining as much as I'm giving."[113] Non-protection for large one-sided investments during preliminary precontractual negotiation, however, may pose other contracting risks. Although perhaps each party should have to take the risk that ordinary preliminary search costs that benefit oneself should be non-compensable,[114] a default rule of non-reimbursement (without an express agreement) may not be optimal, since a rule denying reimbursement would discourage trade in some instances. Investments may pose a risk in con-

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108. Schwartz & Scott, *supra* note 19, at 675.

109. Farnsworth, *supra* note 3, at 221. As Professor Farnsworth explained, 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 [the] negotiations." *Id.*

110. *Id.* at 221-22.

111. Hermalin et al., *supra* note 6, at 60.

112. Farnsworth, *supra* note 3, at 221.

113. Email from Ronald J. Coffey, Professor of Law, Case Western Reserve University School of Law, to Juliet P. Kostritsky, Professor of Law, Case Western Reserve University (May 7, 2008, 15:04 CST). An example of a case where each party invests sunk costs post-contract is discussed in Brian JM Quinn's recent article. Quinn, *supra* note 89, at 2. In that case, since the success of the venture depended on both parties investing and there was the risk that either party would defect from the investments needed to create a successful national cable company, @Home used multiple strategies to promote cooperation. One was the economic lock-in, which initially made switching costly. As long as the cost of switching was high, the partners would refrain from defecting, allowing @Home to recoup the investment in cable infrastructure by partnering with Comcast in such a way that @Home would acquire subscribers who would take the broadband service. The presence of such reciprocal transaction-specific investments, with the economic-lock-in effect, helped to mitigate opportunistic defection. *Id.*

114. This would especially be true if the investments were not transaction-specific. *See* WILLIAMSON, *supra* note 4, at 61-62. An exception would apply if the parties reached an agreement expressly providing compensation.

tracting—particularly if (1) they are transaction specific; (2) they are made before the other party has invested, formed a contract, or entered into a preliminary agreement; (3) they are invested primarily to benefit the other party;[115] and (4) if the success and risks of the investment relate largely to factors over which the promisor has control or which relate to the promisor's business needs or its business capacities and not those of the promisee—since a promisee may find it difficult to assess the probability of a deal being successful. If unaddressed, this risk will act as a drag on gains from trade.[116]

Differences in the nature of risks that parties would be willing to assume as part of the cost of doing business may exist. Parties 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.[117] If, however, a party makes investments known as "cooperative investments,"[118] which benefit the noninvesting 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*.[119]

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 holdup that occurs with sequential investment.[120] 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 ignore the potential problem that arises with sequential investment.[121] Sequential investment can occur (1)

115. *See* Che & Hausch, *supra* note 34, at 126 (discussing cooperative-type investments).

116. Vernon Smith, *Constructivist and Ecological Rationality in Economics*, 93 AM. ECON. REV. 465, 466 (2003).

117. Farnsworth, *supra* note 3, at 221 (quoting William Lacey (Hounslow) Ltd. v. Davis [1957] 1 W.L.R. 932 (Q.B.))

118. *See* Che & Hausch, *supra* note 34, at 126.

119. *See* Yeon-Koo Che & Tai-Yeong Chung, *Contract Damages and Cooperative Investments*, 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." Che & Hausch, *supra* note 34, at 125. Therefore, a contract cannot curb the opportunism that 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. *Id.* 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." *Id.* 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. 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, non-cooperative investments, are made. *Id.*

120. *See* Schwartz & Scott, *supra* note 19, at 676-78.

121. William P. Rogerson, *Contractual Solutions to the Hold-Up Problem*, 59 REV. ECON. STUD. 777, 777 (1992). The aleatory view was accepted without critical analysis of

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 its private advantage.

This Article suggests that courts analyzing the normative question of whether reliance should be compensated should pay particular attention to whether the danger of holdup with sequential investment is present, regardless of whether it occurs because one party has acted strategically for private gain in delaying a simultaneously agreed-to investment, or because there is an incentive by putative offerors to delay investment to resolve 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 is willing to invest in a gamble when there is 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 the risk of holdup. For that reason, the aleatory view of contract that denies all compensation for precontractual reliance should be reexamined.

IV. THE HOLDUP PROBLEM

To fully understand the problem of sequential investment in precontractual negotiation, the holdup problem, and the law's possible responses, one must examine (1) 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. Holdup may occur at several stages of the bargaining process. If a party invests sunk costs during precontractual negotiation without a binding commitment from the other party, the other party may exploit that investment by holding out for a higher price—a larger share of the surplus. The investing party risks losing all of the investment if no deal is consummated and so is vulnerable to this kind of pressure.[122] Hobbes himself identified this vulnerability as fundamen-

its underlying assumptions, so it is hard to know whether the aleatory theory of reliance investment continues to make sense once the holdup problem is accounted for. *See* Johnston, *supra* note 15, at 388.

122. Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. 481, 492 (1996). Holdup 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," the parties' ability to deal with strategic behavior by simply terminating becomes impossible. WILLIAMSON, *supra* note 4, at 32. It is for that reason that Williamson thinks

tal to explaining the need for enforcement in contract.[123] Because these investments may be unverifiable[124] or uncertain ahead of time, *ex ante* contracting on such reliance investments may be impossible.[125] Contracting *ex ante* may be particularly difficult when one party is afforded discretion to "gear up" or "work hard," and it is clear that the party urging such investment broadly wants investments that will place the noninvesting party in the position of being ready to proceed should a contract materialize, but the exact nature of such desired investments is fuzzy, in part because it is the non-investing party who is most familiar with the business that will utilize the investments.[126]

One way to provide incentives to make efficient investments when *ex ante* contracting is difficult 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.[127] Yet where the projects undertaken have an unverifiable surplus, such efforts to reward and protect reliance investments will not work.[128]

Without such *ex ante* contractual protection, the investing party has to depend on *ex post* arrangements.[129] However, the postponement makes the investing party vulnerable to his expenses not being recouped in the surplus.[130] 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.[131] In a 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

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that "[g]overnance structures that attenuate opportunism and otherwise infuse confidence are evidently needed." *Id.* at 63.

123. Thomas Hobbes, Leviathan, or, The Matter, Form, and Power of a Commonwealth, Ecclesiastical and Civil 69 (2d ed., London, George Routledge & Sons 1886) (1651).

124. Sergei Guriev & Dmitriy Kvasov, *Contracting on Time*, 95 Am. Econ. Rev. 1369, 1369 (2005).

125. *See* Battigali & Maggi, *supra* note 56, at 801.

126. *See* Schwartz & Scott, *supra* note 19, at 677-78.

127. *Id.* at 678.

128. *Id.*; *see also* Che & Hausch, *supra* note 34, at 125 n.1 (detailing difficulties in controlling opportunism in contracts when "specific investments often take a nonmonetary, intangible form such as human capital investment").

129. *Id.* at 677-78.

130. *Id.*

131. *See* Williamson, *supra* note 4, at 32-33 (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. To solve this problem, Jason Johnston has proposed a rule making the non-investing party liable for pretrade performance (a form of reliance) in order to encourage those who are pessimistic about a trade occurring to speak up. Johnston, *supra* note 15, at 397. This Article suggests that the problem is one of uncertainty that makes the noninvesting 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 rule because the soliciting party is often uncertain about whether a trade will occur but needs and is benefited by an investment.

no value outside the potential bargain with B[132]—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.[133]

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.[134] 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.[135] These analyses evaluate a reliance decision as a cost-benefit analysis that occurs at a moment in time.[136]

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,[137] 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.[138] Craswell argues that judicial decisions often reach results consistent with the protection of efficient reliance.[139]

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132. 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 13, at 1276 n.76.

133. 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* holdup, has been studied. *See* Tom K. Lee & Ivan P.L. Png, *The Role of Installment Payments in Contracts for Services*, 21 RAND J. OF ECON. 83, 83-84 (1990). Lee and Png suggest that installment payments can incentivize greater initial efforts, as would a law-supplied rule implying an installment payment scheme to provide incentives to enter contracts where the danger of holdup would otherwise deter such contracts. *Id.* at 95.

134. *See e.g.*, Craswell, *supra* note 122, at 484, 491-92.

135. *Id.* at 493.

136. *See also* Katz, *supra* note 13, at 1269.

137. 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 holdup problem looms large. *See* Craswell, *supra* note 122, at 491.

138. *Id.*

139. *Id.* at 507.

Under this cost-benefit approach, a promisee will not want to invest too early when the probability of a trade occurring is low[140] but will not want to delay investment too long since some of the benefits of investing in the deal early would be lost.

A significant drawback to the cost-benefit 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 holdup problem.[141]

The notion that a party will invest efficiently given the probabilities of a future trade occurring is only true if one ignores that, if there is no enforceable commitment from the other party, an investing party is in a vulnerable position once the investment is made. Once a promisee has invested first before a contract is formed, he becomes subject to holdup by the other party and will have a reduced incentive to invest.[142] Anticipating this possibility, a promisee may forego a trade even if there are gains from the trade. Even if a bargain is struck later, the investing party will not be able to capture all of the gain in the bargain.[143] Whoever invests first is subject to this loss, and under such circumstances "investment will be inefficient."[144] This is because the party "would invest only until the marginal cost equaled [the] fraction of the expected gain."[145]

A different but equally problematic version of the holdup problem can also occur if "the *distribution* of *ex ante* costs across the parties is sufficiently 'mis-matched' with the distribution of surplus."[146] In that case, an investing party may be disinclined to invest because the amount that it

140. *Id.* at 493. *See also* Katz, *supra* note 13, at 1268.

141. Craswell, *supra* note 122, at 493 (discussing the "distortion" in incentives problem).

142. 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 nonnegative return by agreeing to reimburse his partner for investment costs if the project is not pursued." Schwartz & Scott, *supra* note 19, at 683. Contracting difficulties, however, may make this impossible, particularly where the party investing is given broad discretion to perform by gearing up or working hard. Such discretionary actions make contracting costly, if not impossible. *Id.* at 682-83.

143. 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 122, at 492.

144. Vladimir Smirnov & Andrew Wait, *Hold-Up and Sequential Specific Investments*, 35 RAND J. ECON. 386, 386 (2004).

145. Schwartz & Scott, *supra* note 19, 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 would encourage efficient reliance. However, these solutions are dependent on an assumption of no renegotiation, which cannot be guaranteed, so these solutions will not solve the underinvestment problem. *Id.*

146. Luca Anderlini & Leonardo Felli, *Transaction Costs and the Robustness of the Coase Theorem*, 116 ECON. J. 223, 229 (2006).

receives in surplus will not cover the investment.[147] As Craswell deftly explains:

> [A]ny 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.[148]

This structural hazard of holdup 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 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 compensate [only] the promisor for the investment [costs]. . . ."[149] 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, could theoretically, following the sinking of such costs, tell the promisor that he will not proceed, but such a "threat to exit unless his investment costs are reimbursed is not credible."[150]

In any project, the parties choose when to begin investing. Each party can invest at the same time, or one party can defer investment until after 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 problems of holdup, or incentives to invest, or create a new problem of follow-up opportunism.[151]

Sometimes sequential investment may be necessary as an antidote to a certain type of holdup problem. If a financer lends funds to a new and untested entrepreneur (a species of the uncertainty problem) at the same time that the entrepreneur makes contractual promises to repay, the financer may decline to lend, as lending will yield a negative return.[152] The

147. *Id.* at 230. Anderlini and Felli explain that "the parties will pay the costs only if the distribution of the surplus generated by the negotiation will allow them to recoup the cost *ex post*." *Id.* That may not occur if there is a mis-match between investment and distribution of the surplus. *Id.* at 229. The authors point to a famous incident involving a decision by a small research company (that had an operating system for PCs that IBM was interested in acquiring rights 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. *Id.*

148. Craswell, *supra* note 122, at 492.

149. Schwartz & Scott, *supra* note 19, at 666.

150. *Id.* at 666 n.12.

151. Smirnov & Wait, *supra* note 144, at 388.

152. *Id.* at 392 (discussing D.V. Neher, *Staged Financing: An Agency Perspective*, 66 REV. ECON. STUD. 255 (1999)).

financer will be subject to a risk of holdup 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 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 more favorable terms. 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. This is the problem posed by a kind of investment in which one party invests everything up front, leading to a moral hazard/holdup problem. To alleviate the problem, the financer could tie lending to the entrepreneur to the stages when assets are built up in the new company, thereby rendering the financer less subject to holdup.[153] Once the assets are established, the financer will have the ability to realize monies to cover any default by the borrower.[154] In such a case, deferred investment is therefore a private strategy to curb holdup 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.[155]

The promisee sinking costs that leave him vulnerable to hold up will act as a disincentive to reliance investment if there is no reimbursement for such reliance costs.[156] 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 reduce the costs of a hold up. That may involve formulating a liability default rule that compensates the investing party.

In the next section, the Article will trace how the threat of hold up permeates both precontractual negotiation (the *Hoffman* type case) and preliminary agreements that involve an express agreed to sequence of simultaneous investment. It argues that the two phases both involve a uni-

153. *Id.*
154. *Id.*
155. For a discussion of opportunism and its costs if uncontrolled, see WILLIAMSON, *supra* note 4, at 63 (including the risk that "gains [can] be dissipated by costly subgoal pursuit").
156. Bebchuck & Ben-Shahar, *supra* note 17, at 425. Contrary to what one might expect, the problem of underinvestment can occur even if both parties invest. *Id.* at 432.

fied threat and should therefore be considered part of one problem demanding judicial attention.

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—that of one party acting opportunistically following preliminary agreement on some terms and an agreement by both parties to invest simultaneously, following which one party chooses to delay its investment.[157] The delay gives one party the advantages associated with sequential investment and constitutes a form of holdup.[158] As the authors point out, one party may have "an incentive to defect from any such agreement"[159] because "by delaying her decision whether to invest until *after* the promisee has invested . . . [t]he promisor benefits from defection if the project turns out to be unprofitable because she *will not have sunk costs in a losing deal.*"[160]

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.[161] Depending on the parties' intentions, these preliminary agreements may be either (1) fully enforceable;[162] (2) not binding at all if the parties have indicated their intent that no enforceable contract would exist absent a further formal agreement;[163] or (3) binding only in the sense of committing the parties to bargain in good faith towards a profitable outcome.[164]

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157. Schwartz & Scott, *supra* note 19, at 666-67.

158. *Id.* at 682.

159. *Id.* at 666.

160. *Id.* (emphasis added).

161. *Id.* at 664. *See also* Johnston, *supra* note 15, 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.* at 449-50.

162. 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.* at 467. *See also* United States v. P.J. Carlin Constr. Co., 224 F. 859, 862-23 (2d Cir. 1915).

163. *See e.g.*, R.G. Group, Inc. v. Horn & Hardart Co., 751 F.2d 69, 71, 75 (2d Cir. 1984); *see also* Feldman v. Alleghency Int'l, 850 F.2d 1217, 1222 (7th Cir. 1988) (cited in PFT Robertson, Inc. v. Volvo trucks N.A., Inc., 420 F.3d 728 (7th Cir. 2005), wherein Judge Easterbrook explained *Feldman* as holding that "Illinois is averse to enforcing tentative agreements that are expressly contingent on the signing of formal or final documents")

164. Schwartz & Scott, *supra* note 19, at 664. *See also* Teachers Ins. & Annuity Ass'n v. Tribune Co., 670 F. Supp. 491, 498 (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. Johnston, *supra* note 15, at 468. However, such tests have resulted in "doctrinal ambiguity." *Id.* 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." *Id.* at 474-75.

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.[165] 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.[166] These interim 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.[167] 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.[168] The law-supplied obligation of good faith discourages the problem of holdup that might otherwise exist.[169]

Schwartz and Scott have reinvigorated the study of these preliminary agreements contexts by identifying the problem of holdup.[170] Such holdup demanded new scrutiny. In their recent article, they note that

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165. *Teachers Ins.*, 670 F. Supp. at 498; *see also* Charles L. Knapp, *Enforcing the Contract to Bargain*, 44 N.Y.U. L. Rev. 673, 681 (1960).

166. Schwartz & Scott, *supra* note 19, at 664-65. Schwartz and Scott argue that the emerging new legal rule requires a party 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," in part because of the lack of clarity about the scope and content of the good faith obligation. *Id.* at 667. Schwartz and Scott would award reliance costs whenever there has been a breach of the agreed-on investment sequence. *Id.* 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 holdup. 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 upon investment sequence and no preliminary agreement. Rather than limit the obligation to compensate for reliance investments to an *ex ante* agreement to invest simultaneously, the law should look at when intervention is justified to prevent holdup 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 not involving 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. This might be the situation in a case involving no preliminary agreement at all, as in *Wood v. Lucy*, 118 N.E. 214, 214-15 (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 in the context of precontractual negotiations that do not result in any preliminary agreement or any agreed-on investment sequence.

167. Schwartz & Scott, *supra* note 19, at 667.

168. *Id.* at 696 (hypothesizing good incentive effect from liability rule in terms of encouraging duty to invest simultaneously following preliminary agreement).

169. 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. *Id.* at 686-87.

170. *Id.* at 682, 685.

holdup occurs when one party invests and the other party, who had promised to invest simultaneously, delays its investment.[171] That delay would subject the investing party to *ex post* holdup because the investing party may suffer when the other party declines to invest simultaneously.[172] Such delay by one party can subject the investing party to the prospect of a negative return on the transaction.[173] Because there is some unknown probability of such hold up occurring,[174] parties will simply decline to invest or transact[175] as a means of self-protection. This results in lost gains from trade.[176]

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 (and the investment is needed for a successful project) but has deferred investment for strategic reasons.[177] The authors provide case law evidence that courts reach results to protect reliance investment in such fact patterns.[178]

The identification of hold up by Schwartz and Scott as a reason for protecting reliance expenditures advances the understanding of one problem that arises when parties rely after reaching preliminary agreements and agreements to invest simultaneously, and one party subsequently "defects" from this plan.[179] Prior judicial determinations of the compensability of reliance investments following preliminary agreements turned on ascertaining the parties' intent, but that approach failed to provide adequate guidance to courts.[180] Although many courts have apparently reached results consistent with Schwartz and Scott's thesis,[181] 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* holdup.

171. *Id.* at 686.
172. *Id.*
173. *Id.* at 685.
174. *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.
175. *Id.* at 686.
176. 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.
177. *Id.* at 685-86. 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. *Id.* at 695. If the practice declined to invest in training after promising to do so, then the doctor would be subject to hold up. *Id.*
178. For a list of cases, see *id.* at 694-702.
179. 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 make a preliminary agreement that he otherwise would have rejected." *Id.* at 686.
180. *Id.* at 675.
181. For a list of cases, see *id.* at 694-702.

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 logically be applied to other cases of reliance not involving agreements to invest simultaneously. If so applied, it suggests a broad justificative framework. That framework suggests that 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.[182] Schwartz and Scott, 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.[183] 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.[184] Liability would be optimal since the assumption is that the greatest gains from trade would have been realized from simultaneous investment. When one party defers investment for private gain (the same problem that a principal faces with a shirking agent[185]), that behavior acts as a drag on gains from trade that should be controlled.

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 that 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.[186] What prompts Schwartz and Scott to

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182. *See* Bebchuk & Ben-Shahar, *supra* note 17, at 431-32.

183. Schwartz & Scott, *supra* note 19, at 704.

184. *Id.* at 686-87 (pointing to the fact that a "portion of the buyer's investment cost . . . is verifiable *ex post*," even if not *ex ante* contractible).

185. *See, e.g.*, Wood v. Lucy, 118 N.E. 214, 214-15 (N.Y. 1917).

186. Schwartz & Scott, *supra* note 19, at 669. When Schwartz and Scott argued that *Hoffman* is "wrong as a matter of doctrine," *id.* at 670, they did so partly on the basis that the *Restatement* itself contains only a single definition of "promise" and there is no separate section between promises that induce unbargained for reliance and promises that are "the product of a bargained-for exchange." *Id.* at 669-70. The fact that the *Restatement (Second) of Contracts* makes no distinction within Section 2 itself can best be understood by the fact that a separate section exists on the definition of an offer in Section 24. RESTATEMENT (SECOND) OF CONTRACTS §§ 2, 24 (1981). When a promise reaches the point where it constitutes an offer, 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 Section 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 Sections 24 and 71. Had they intended the word "promise" in Section 90 to have the more fully developed meaning of an offer, they could have done so, as they did in

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[187] and would have the negative effect of discouraging buyers from pursuing efficient projects. The decision to impose liability for breaches of agreed-on investment plans cannot be answered reflexively without invoking a normative framework. That framework is built on certain assumptions about how parties are likely to behave in the absence of any rule and what effect it will have on the parties' goal of maximizing welfare. In certain cases one party will benefit from delay, especially when the likelihood of success is high and the investment cost is significant.[188] 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 consequentialist framework, investors would anticipate that non-investors would act opportunistically and would not believe promises by non-investors to refrain from such behavior.[189] Consequently, investors would forego opportunities as the only means of protecting themselves against the possible negative returns that occur when sellers defer investment.[190]

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 parties to refuse to participate at all because they fear the breach of their counterparty's promise to invest simultaneously. Efficient deals therefore will not take place.[191] 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 expenses should be adopted more broadly to apply whenever there is a structural problem posed by sequential investment, at least where private solutions may be more costly or less effective than law-supplied rules. This problem of hold up is particularly likely to occur when the putative promisor seeks

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Section 87. In Section 87 the drafters used the word "offer" to refer to cases in which the *Restatement* will enforce offers that induce reliance, thereby suggesting that Section 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 Section 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 constitute an actionable promise under Section 90 even if it did not constitute an offer.

187. Thus, there may be social advantages for both parties to invest simultaneously.
188. Schwartz & Scott, *supra* note 19, at 685.
189. *Id.* at 686 (discussing the problem of credibility of promises to invest).
190. *Id.* at 685-86.
191. *Id.* at 686.

investment from the promisee to alleviate uncertainty about the promisee.[192] 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 that will permit some other uncertainties to be resolved or will allow one party to hedge. The parties may not be in a position early on to agree on what each must invest[193] 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.[194] Contracts remain incomplete and fail to provide certain contractual protection for investments made. Another problem is that the best timing for the investment may not be clear ahead of time,[195] 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 *ex post*.[196] Then, even if contractual solutions were unavailing, parties could leave the compensation issue to *ex post* negotiations. Such arrangements, however, could discourage investment because they would present the classic holdup problem since in those cases, "the investing party generally does not appropriate the full marginal returns on the investment."[197]

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.[198] 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 holdup prospect.[199] 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: the investing party will be subject to the other party appropriating part of the benefit in the negotiated surplus.

192. This would be true even if there is no agreement to invest simultaneously.

193. This makes the investments non-contractible.

194. Che & Hausch, *supra* note 34, at 125 n.1 (detailing impediments to direct contracting on the investments including the fact that "specific investments often take a non-monetary, intangible form, such as human capital investment"). *See also* Rogerson, *supra* note 121, at 777 (discussing need to make "non-contractible specific investments prior to the transaction in order to prepare for it").

195. Rogerson, *supra* note 121, at 777.

196. Schwartz & Scott, *supra* note 19, at 678-79.

197. Guriev & Kvasov, *supra* note 124, at 1369.

198. *See* Bebchuck & Ben-Shahar, *supra* note 17, at 431-32.

199. The problem may be even more severe if there is a "mis-match" in surplus. *See* Anderlini & Felli, *supra* note 146, at 230.

In this recurring situation one can conceptualize the position of the promisee and the putative promisor as one in which the promisee grants the putative promisor the authority to proceed to collect enough information, but only if the promisor will commit not to act opportunistically 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.[200] That promise would also be difficult to make credible in part because courts might not enforce such a vague promise.[201] 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 "nonnegative return by agreeing to reimburse the partner for investment costs if the project is not pursued."[202] When such investments are "noncontractible," for example, when the promisor urges the promisee to "gear up" or "work hard," that solution will not work.[203] The particular problem of holdup occasioned by sequential investment, which occurs when one party seeks 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* holdup 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 negotiations.[204] When other solutions to guard against holdup 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. Once those investments are made, the investing party is subject to the holdup problem occasioned by sequential investment. If the parties proceed to a final deal, but 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.

Because the putative promisor stands to benefit through a reduction in uncertainty about the promisee from the sunk costs taken by the

200. *See* Schwartz & Scott, *supra* note 19, at 686.
201. Williamson, *supra* note 4, at 63.
202. Schwartz & Scott, *supra* note 19, at 683.
203. *Id.*
204. *See* Juliet P. Kostritsky, *Reshaping the Precontractual Liability Debate: Beyond Short Run Economics*, 58 U. Pitt. L. Rev. 325, 368-69 (1997) (discussing the costs of interim payments in incremental bargaining).

counterparty, the sequence of the investment subjects the promisee to the risk of hold up, the costs of private solutions negotiated on a case by case basis are costly or not feasible,[205] and the risk is a generalized one affecting many preliminary negotiations. Therefore, the law should and does impose a generalized default rule making the soliciting party responsible for the transaction-specific costs of the other party.[206] The putative promisor benefits from this default rule,[207] and it is presumably one that he would bargain for 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 discourage trade (unless parties can control such hazard at a reasonable cost) can occur at 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.[208]

The risk, however, may also affect pre-contractual reliance that is distinct from the reliance on a preliminary agreement.[209] The results of the case law are consistent with a 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. This Article suggests that courts implicitly consider the same elements when (1) they determine whether there has been a breach of the obligation of good faith in preliminary agreement cases and (2) whether to impose liability in the precontractual liability cases. This universe of cases thus shares a unifying justificative framework[210] 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 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.

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205. *See supra* notes 192-204.

206. *See supra* note 80.

207. *See* Kostritsky, *supra* note 93, at 943 n.202.

208. Schwartz & Scott, *supra* note 19, at 686.

209. For a complete treatment of the available theories available to plaintiffs seeking compensation for investments, see Farnsworth, *supra* note 3 (detailing unjust enrichment, promissory statements, fraud, and general obligation as possible theories for precontractual reliance recovery actions).

210. *See* Ronald J. Coffey, *Interventional Implementation, BAI Methodology* (unpublished manuscript, on file with author) (exploring fundamental attributes of justificational analysis for legal intervention in private agreements); *see also* Peter M. Gerhart, *An Introduction to Justificational Analysis* (Aug. 1, 2008) (unpublished manuscript, on file with author).

The problem of moral hazard thus exists outside the distinct factual scenario identified by Schwartz and Scott and presents itself at all phases of negotiation. It exists whenever one party "has a greater ability than the other to delay a material portion of her work."[211] 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, the promisee must provide information in the form of investment (by 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.[212]

Promisors are all genuinely uncertain about qualities of promisees and often they will not be able to assess accurately the chances for trade or distinguish among possible contracting partners until they receive information from promisees in the form of the reliance investment.[213] 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 the cost to the investing party because it inevitably subjects the other party to hold up vulnerability.[214] What promisees require for investment is a commitment that they will be compensated for their reliance investments if promisors encourage them to invest;[215] otherwise, they will hesitate to invest because of the risk of holdup. The liability rule that makes the promisor liable for induced reliance provides a law-supplied safeguard. It parallels protection the law affords against strategic behavior that occurs 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 constructive conditions, a party who had *not* expressly stipulated that its performance was conditional on the other party's performance could be forced to go forward with its own performance, leaving itself vulnerable to the risk 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 conditioned on the other party's similar performance—guaranteed against such risk.[216]

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211. Schwartz & Scott, *supra* note 19, at 666 n.11.
212. *See supra* text accompanying note 92.
213. *See infra* cases in note 263.
214. *See* Schwartz & Scott, *supra* note 19, at 683.
215. This limitation may curb the problems of excessive reliance.
216. *See* Kingston v. Preston, (1773) 99 Eng. Rep. 437, 438 (K.B.).

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. Rather, it is the inherent structural risk that arises whenever the promisor solicits information and the promisee invests, leaving the investing party vulnerable to holdup.

One commentator, Jason Johnston, who has been concerned with the same problem of providing solutions to encourage efficient reliance, has suggested the 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.[217] The aim is to discourage overly optimistic messages.[218] Johnston's solution advocates a rule making promisors liable for pre-trade performance in order to flush out those promisors who are actually pessimists (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.[219] In some ways, until that performance starts, sellers will all look the same;[220] the only way for the sellers to distinguish themselves in a meaningful way to buyers is to begin performing.[221] Because buyers need such information 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.[222] A liability rule would encourage pessimists to speak out and to issue a pessimistic statement reflecting the actual low probability of a deal.[223] 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.[224]

This Article suggests a default liability rule[225] founded on a different rationale. It seeks to solve the holdup 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 know what the probability of a successful trade is and will solicit

217. Johnston, *supra* note 15, at 499.

218. *See id.* at 494.

219. Jason Johnston provides this insight. *Id.* at 494. This will eliminate competitors.

220. *Id.* at 494 (explaining that sellers of services that are complex may remain indistinguishable to buyers until they actually start performing).

221. *Id.*

222. *Id.* at 498.

223. *Id.* at 495.

224. *Id.* at 494.

225. This suggested liability rule is not new. *See* Kostritsky, *supra* note 93. 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.

investments in order to clarify that probability.[226] The problem is not necessarily one of misrepresenting the facts about the probability of trade since the facts are not yet known. Instead, it is the inherent structural risk that arises whenever the promisor solicits information and the promisee invests, leaving the promisee vulnerable to holdup, and the non-investing party is relieved from actually paying anything for the 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. Certainly, the promisor could easily add such a disclaimer for such sunk costs. Adding such a disclaimer would be no more costly than the flip-side equivalent of requiring the promisee to negotiate for the inclusion of an express clause that imposes liability for sunk costs or a general form clause obligating the promisor to refrain from acting opportunistically. However, unlike the general form clause where the promisee might have trouble detecting whether the promise is a credible one, the promise to refuse to cover costs would be credible as the promisor would have no incentive to deny liability since it would discourage the promisee from relying. All promisors need promisees to rely early on. The liability 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 holdup a party who invests.

This liability rule will address a problem that is likely to arise in all cases of solicited sunk costs when it is doubtful that the promisor has yet any accurate assessment of the probability 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 investment from promisees who would otherwise decline to invest. This rationale is not tied to the concealment issue but is grounded in efficiency concerns.[227]

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226. 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. *See* Craswell, *supra* note 122. 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. *See* Katz, *supra* note 13, at 1303-04.

227. Johnston also desired to promote the instrumental end of efficiency, but he aimed to do so through a rule that will make pessimists disclose actual low probabilities of trade. *See* Johnston, *supra* note 15, at 397.

VI. THE HIDDEN ELEMENT AND CONNECTING THREAD IN RELIANCE CASE LAW IN TWO PHASES OF BARGAINING: THE CASE LAW REVISITED

A liability default rule[228] protecting reliance investments made in the precontractual period of negotiation and 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.[229] 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 sunk costs,[230] 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 makes, non-redeployable reliance investments to help the promisor determine whether to proceed further, and if so, on what terms.[231] In many of these cases the law protects these investments through the application of promissory estoppel case law.[232] In some cases, the law also protects such reliance and guards against the holdup problem through the creative application of other doctrines, such as restitution.[233]

Because many recent scholars have posited the demise of promissory estoppel as a viable cause of action,[234] and some recent commentators

228. This Article does not purport to decide which amongst several intermediate liability rules would be optimal. *See* Bebchuck & Ben-Shahar, *supra* note 17, at 435-41 (discussing alternative liability regimes). Instead, it seeks to (1) demonstrate that there is support for imposing liability in at least a subclass of reliance cases that are brought to trial and (2) 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.

229. *Id.* at 432.

230. Schwartz & Scott, *supra* note 19, at 666.

231. Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267 (Wis. 1969).

232. 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 19, at 668.

233. *See* Farnsworth, *supra* note 3, at 231-33.

234. Prior analyses of the demise of promissory estoppel include several empirical studies. Sidney W. DeLong, *The New Requirement of Enforcement Reliance in Commercial Promissory Estoppel: Section 90 as Catch-22*, 1997 WIS. L. REV. 943, 943; Robert A. Hillman, *Questioning the "New Consensus" on Promissory Estoppel: An Empirical and Theoretical Study*, 98 COLUM. L. REV. 580, 588 (1998); *see also* Phuong N. Pham, Note, *The Waning of Promissory Estoppel*, 79 CORNELL L. REV. 1263, 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 19, 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.* at 671 n.30 (emphasis added). As they explain it, their "initial" search yielded

280 cases. *Id.* at 671. They then proceeded to isolate cases involving "reliance in the absence of any agreement by the parties regarding terms" and then found that when the court failed to find an agreement, plaintiffs had a failure of rate of 87%. *Id.*

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 when it appeared in a case also involving the particular search terms "preliminary negotiation," the search would undercount the number of reliance cases. This undercounting is consistent with my own study, which yielded 352 cases in the same time period as the search conducted by Schwartz and Scott, 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 that appears 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 database 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). These lists of cases are available on request from the author.

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 a 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 Indus., Inc., No. 1:06-CV-06090, 2007 U.S. Dist. LEXIS 14451, at *26 (E.D. Cal. Feb. 14, 2007) (finding that where an alleged oral requirements contract is never reduced to writing, a promissory estoppel claim is sufficient to withstand the defendant's motion for summary judgment). But in other cases the absence of a 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 unlikely to prevail. Schwartz & Scott, *supra* note 19, at 671. While the cases may have involved an absence of agreement, one cannot necessarily draw the conclusion that to succeed a plaintiff would have to show an agreement. Later in the Article, and also in footnote 263, I highlight the types of cases in which, despite the absence of agreement, a plaintiff bringing a reliance claim prevails. I tie the success of those cases into a larger analytical framework exploring how uncertainty and sequential investment, and the problem of holdup, 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 do not prevail on reliance claims absent a showing of an agreement. *Id.* 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 many of the non-preliminary agreement 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 if it 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 "necessary condition to a promisee's recovery" would have been stronger. *Id.* at 668. For example, *Abt Associates, Inc. v. JHPIEGO Corp.*, 104 F. Supp. 2d 523 (D. Md. 2000), a case cited by Schwartz & Scott, *supra* note 19, at 672 n.31, is a weak case not because it lacks a traditional agreement, but because the plaintiff cannot demonstrate any detriment. In *Abt Associates*, 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, promissory estoppel, which grants recovery for broken promises, was not available. *Id.* at 533. The *Abt Associates* case seems to be a particularly weak one since the court found no "demonstrable detriment"; there was an initial presubcontract "which was fully performed"; 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 pre-subcontract provided compensation to the plaintiff. *Id.* at 536, 531. Thus, *Abt Associates* 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 Capitol Distrib., Inc. v. Guiness Bass Import Co., 290 F.3d 877, 879 (7th Cir. 2002) (cited by Schwartz & Scott, *supra* note 19, at 672 n.31) (finding that a statement by beer company that plaintiff was the "leading candidate," and a question by the defendant inquiring whether plaintiff "would be willing to pay 2 to 9 times earnings . . . to gain an exclusive" right did not constitute an actionable promise so promissory estoppel cause of action would not lie); Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A., No. 03 Civ. 1537, 2003 U.S. Dist. LEXIS 23062, at *23 (S.D.N.Y. Dec. 22, 2003) (cited by Schwartz & Scott, *supra* note 19, at 672 n.31) (finding that where letter of intent contained an express denial of any motivating factors for the purchase of notes other than those included in the express materials and such signed materials, including the offering memoranda, contained express disclaimers of any reliance on defendant's representations, plaintiff's reliance was unreasonable); Fimon v. Kenroc Drywall Supplies, Inc., No. C7-02-1588, 2003 Minn. App. LEXIS 311, at *1 (Minn. Ct. App. Mar. 18, 2003) (ruling against plaintiffs on a 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 conversation with the [defendant] corporation's president about their ownership interest," cited no specific promises—thereby making reliance unreasonable, took no risks in the start up, and 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 263.

To prove the claim that absent agreement or deceit, plaintiffs cannot prevail on a promissory estoppel claim, Schwartz and Scott 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 *Beer Capitol*, because there is no promise, or only 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. *See Beer Capitol*, 290 F.3d at 880.

Alternatively, to demonstrate the proposition that, absent an agreement, plaintiffs *cannot prevail* on a promissory estoppel claim, Schwartz and Scott could point to case outcomes in which the plaintiff met all of the elements of a promissory estoppel claim but lost *nonetheless* because there was "no agreement." *See* Jody Kraus, *The Methodological Commitments of Contemporary Contract Law*, 12-15 (Law & Econ. Research Paper Series, Working Paper No. 01-2, 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=269975 (discussing efficiency theorists' interest in rationalizing case outcomes). Schwartz and Scott 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 jusitifiable reliance, and detriment (loss), but then lose because the courts seem to require, either explicitly or implicitly, the showing of an agreement, it is hard to understand the support for their thesis that agreement is a precondition to recovery in precontractual negotiation cases. Cases like *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 have argued that "[c]ourts actually make some form of agreement a necessary condition to a promisee's recovery,"[235] this Article re-examines recent case law[236] to see if 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 envisioned by Schwartz and Scott.[237] 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 sequential investment holdup problem that would otherwise occur. If a subset of precontractual negotiation cases presenting the sequential investment/holdup problem is isolated analytically from the "preliminary agreement" cases,[238] 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.[239]

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no agreement, discussed in *infra* note 263, suggest that agreement is not a *sine qua non* of a promissory estoppel recovery.

235. Schwartz & Scott, *supra* note 19, at 668.

236. 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. I read cases identified by my research assistants as relevant and meeting the criteria I had outlined. I also Shephardized important cases such as *Hoffman v. Red Owl Stores, Inc.*, 133 N.W.2d 267 (Wis. 1969) and *Esquire Radio & Electronics, Inc. v. Montgomery Ward & Co.*, 804 F.2d 787 (2d Cir. 1986) 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, as important paradigm cases in their theory of when reliance claims succeeded in cases involving preliminary agreements. Schwartz & Scott, *supra* note 19.

237. *See id.* at 666-67.

238. 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 made 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. *Id.* at 694. The courts are trying to ascertain whether the parties have reached an 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.

239. It is not completely clear what Schwartz and Scott 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 statute 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 claims tend to fail when one of the elements of promissory estoppel 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, 879-80 (2002) (finding that statement that plaintiff was "leading candidate" for a distributorship was not actionable promise).

Success is also unlikely if the agreement specifically indicates that reliance expenditures in the precontractual period will not be compensated (a type of disclaimer) or that the agreement is not legally binding or if there is an absolute right to terminate. *See, e.g.*, Universal Reinsurance Co. v. St. Paul Fire and Marine Ins. Co., No. 95 CIV. 8436, 1999 WL 771357, at *1-2 (S.D.N.Y. Sept. 29, 1999). 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 when the court finds the reliance to be unreasonable and there is no evidence that the defendant, in order to hedge or reduce its own uncertainty, solicited reliance investments by the plaintiff. For example, see Indus. Maxifreight Servs., LLC v. Tenneco Auto. Operating Co., Inc., 182 F. Supp. 2d 630, 636 (W.D. Mich. 2002), where the court found reliance by lessor on lessee's promise to lease was unreasonable in light of unrebutted evidence of repeated statements by lessee that home office approval was needed for the lease. Schwartz and Scott cited *Maxifreight* as evidence of case data that "show that, absent misrepresentation or deceit, there generally is no liability for inducing reliance investments." Schwartz & Scott, *supra* note 19, at 672. *Maxifreight* really concerned a case in which the plaintiff's alleged reliance took place largely "prior to the initial lease discussions." *Maxifreight*, 182 F. Supp. 2d at 636. The case therefore 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.

Schwartz and Scott cited *Galaxy Networks, Inc. v. Kenan System Corp.*, Nos. 97-56386, 97-56435, 2000 WL 714554 (9th Cir. June 2, 2000), as a case that "granted the defendant's motion for summary judgment on the plaintiff's breach of contract claims." Schwartz & Scott, *supra* note 19, at 672 n.31.

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 clearly intended to reach a fully enforceable future agreement that did agree to all material terms. *Galaxy*, 2000 WL 714554, at *2. Because Schwartz and Scott treated the case as one in which "there is no legal obligation until such future agreement is made," it really says very little about how a court would approach the question of liability when parties were not at the point where they were able to agree on certain terms but reserve agreement on others for the future. *Id.* (citation omitted). Cases like *Hoffman*, which 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 intend the agreement on some terms to be enforceable as stand alone clauses or whether those terms are not enforceable until a binding complete agreement is reached. In such negotiations, there is always a risk that a party who got the counterparty to agree to some terms would then try to enforce those terms without regard to whether the parties ever reached an agreement on the remaining terms. Enforceability of the individual clauses can bind a party to a term that they would never have agreed to unless other pieces of the agreement were forthcoming. *See* PFT Robertson, Inc. v. Volvo Trucks N. Am., Inc. 420 F.3d 728, 731-32 (7th Cir. 2005) (opinion by Easterbrook, J.) (cited in Schwartz and Scott, *supra* note 19, at 664 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 rather a case from an earlier stage of negotiations involving a possible hold up due to sequential investment. Therefore, the plaintiff's loss in a claim 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 that involved promises and reliance but not a claim by to enforce separately agreed on material terms, absent the more complete agreement without which the interim agreement might not make sense.

The difficulty with some of the cases cited by Schwartz and Scott to support the proposition that "courts actually make some form of agreement a necessary condition to a promisee's recovery"[240] is that the cases do not support the proposition if broadly interpreted. Instead, the proposition 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 attempted to recover on the basis of an interim agreement when there was no final contract embodying agreement on all of the terms. If the case does not have a fact pattern involving preliminary agreement on some points with final agreement postponed on others because the parties understand that they would not be bound until the final, complete agreement, then a court is free to reach a different result (*i.e.*, liability). In such cases, courts do not seem to require that a promisee in a reliance cause of action under Section 90 establish an "agreement" as a precondition to recovery.

PFT Roberson Inc. v. Volvo Trucks is a case of the first kind—the parties were negotiating toward a final agreement—and the court denied recovery to the plaintiff who tried to argue that certain interim emails were binding.[241] In *PFT Robertson*, an operator of long-haul trucks that derived its trucks and maintenance from Freightliner began negotiations with Volvo when its initial fleet agreement with Freightliner was terminated.[242] Those negotiations consisted partly of emails signifying agreement on some individual issues, though no comprehensive final agreement was ever reached or signed by the parties.[243] The truck operator later argued that the emails at least raised a jury question as to "whether there [was] a contract" on each of the individually agreed to terms.[244]

Judge Easterbrook found that because it was clear that the parties were negotiating toward a final "global"[245] agreement, their emails reciting agreement on some individual terms did not demonstrate an intention by

If expenses are not transaction specific, do not involve significant expense, can be redeployed, or are merely preparatory, or if 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 the cases cited by Schwartz and Scott indicates that the plaintiffs brought weak claims. In some cases the plaintiffs brought a claim in which the promise was ambiguous or really not a promise at all, and it was not clear why the plaintiffs brought the case. In other cases the plaintiffs brought claims that might be justified by the actual language of Section 90, but the claims failed because case law has grafted on 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.

240. Schwartz & Scott, *supra* note 19, at 668.
241. 420 F.3d 728, 729 (7th Cir. 2005).
242. *Id.*
243. *Id.* at 728.
244. *Id.* at 732.
245. *Id.* at 730.

the parties to create binding and enforceable agreements on such individual terms in advance of a comprehensive agreement.[246] Summary judgment was therefore appropriate.[247]

But citing a case like *PFT Roberson* to support a proposition, as Schwartz and Scott have,[248] that preliminary negotiations in which the parties "have discussed a deal but have not agreed to one"[249] 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[250] but 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 Judge Easterbrook explains, be equivalent to

> [l]etting one side accept the favorable terms without the compensatory ones [and] would be 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.[251]

Judge Easterbrook found no liability on the individually-created points of interim agreements when the parties were negotiating toward a final contract and made their agreement subject to further resolution at the stage of the final agreement. This 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 rather 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 recovery[252] 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. This Article posits that the statement by Schwartz and Scott proves too much when it suggests that the absence of agreement would mean no liability.[253] In actuality, 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 was to be no contract

246. *Id.* at 731-32.
247. *Id.*
248. Schwartz & Scott, *supra* note 19, at 664 n.4.
249. *Id.* at 664.
250. *PFT Robertson*, 420 F.3d at 731.
251. *Id.* at 732.
252. Schwartz & Scott, *supra* note 19, at 664.
253. *Id.*

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, or 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 in these contexts. Here, Schwartz and Scott are willing to admit that there might be liability, although their overall thesis is that agreement is a precondition for recovery in preliminary negotiation cases.[254] In fact, Schwartz and Scott admit that there may be liability for induced reliance if a misrepresentation or promise is present.[255] If so, and liability exists on the basis of induced reliance on promises, and those cases do not involve an agreement, then the statement 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 absent a final 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) or an explicit side agreement/payment to prevent opportunistic exploitation of sunk costs, promisees will underinvest and the promisor's ability to reduce uncertainty in preliminary negotiation would be diminished. Because the default rule can be rationalized as part of an implicit contract,[256] 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 and have an express or implied desire to postpone enforceability until a forthcoming formal contract is achieved. The presence of letters of intent or exchanged drafts, 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

254. *Id.*

255. *Id.* at 664 n.4.

256. For a discussion of implicit contracting and the literature on that topic, see Juliet P. Kostritsky, *supra* note 93, at 905 n.28.

same time, the court's goal in finding bad faith is to prevent opportunistic behavior. The law provides a safeguard through a liability rule as a way of protecting 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.

The emerging case law on breaches of promises to invest simultaneously made at the same time 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. The focus should instead 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. They have advanced several arguments about promissory estoppel claims: that they rarely succeed in the case law,[257] that liability has gone too far,[258] that the current doctrinal scheme is too uncertain,[259] that promissory liability will chill negotiation,[260] or that there is only a "myth of pre-contractual reliance."[261]

Contrary to the belief of recent scholars who argue that judicial protection of precontractual reliance investments absent an agreement is merely a "myth,"[262] courts routinely protect transaction-specific precontractual reliance investments when they are solicited by promisors in cases where the investments in precontractual negotiations 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 and reliance cases in which the plaintiff presents a strong or plausible case. At the same time, reliance cases

257. Hillman, *supra* note 234, at 580, 588-89.

258. Schwartz & Scott, *supra* note 19, at 669-70.

259. *Id.* at 663.

260. Johnston, *supra* note 15, at 493.

261. Robert E. Scott, Hoffman v. Red Owl Stores *and the Myth of Precontractual Reliance*, 68 OHIO ST. L.J. 71 (2007).

262. *See id.* Certainly cases do exist in which there are agreements and reliance. Often these involve contracts that are not enforceable under the statute of frauds, where the court chooses to protect the promisee's reliance.

have been artificially segregated by recent authors into two separate categories: those involving reliance in precontractual negotiations, and those involving reliance following a binding preliminary agreement reached 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 gains 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[263] if

263. Cosgrove v. Bartolotta, 150 F.3d 729, 732-735 (7th Cir. 1998) (finding that plaintiff proved reliance sufficient to support jury's award of damages for promissory estoppel where plaintiff promised to make a $100,000 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 where defendant benefited greatly because (1) it was able to secure whatever legal services were needed; (2) had a commitment to receive $100,000 in the event that it did not receive a bank loan; and (3) the pledge of a $100,000 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 a 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. Inc. v. Reilly Indus., Inc., No. 1:06-CV-06090, 2007 U.S. Dist. LEXIS 14451, at *16-26 (E.D. Cal. Feb. 14, 2007) (finding that where a defendant's promise to plaintiff to supply a product for a year if plaintiff purchased as much as in the 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 that a claim of promissory estoppel could survive summary judgment where plaintiff, in reliance on expectation of defendants' three to five million-dollar investment, filed a restated certificate of incorporation as directed by defendant, convinced its shareholders to subordinate their class of shares to defendants,' convinced its 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 $100,000 and defendant was also 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 based on promissory estoppel could survive summary judgment 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 Sys. Inc., 321 F. Supp. 2d 902, 922-24 (S.D. Ohio 2004) (finding that where plaintiff wanted a delivery contract with a shipping company and was given repeated assurances that a route would be available, plaintiff relied by purchasing a van and took other steps such as

finding back up drivers, and plaintiff's steps permitted defendant to hedge during an initial period of uncertainty while deciding on which driver would be best for the available routes, plaintiff withstood defendant's motion for summary judgment by prevailing on a claim of promissory estoppel); Nutrition Mgmt. 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); Robinson v. Detroit News, Inc., 211 F. Supp. 2d 101, 107-09 (D.D.C. 2002) (finding that plaintiff's promissory estoppel claim withstood summary judgment when defendant hires plaintiff despite uncertainty about her transactional skills and promised to train her in needed skills; plaintiff's reliance allowed defendant to hedge while it determined if others are available to do transactional work); Zeman v. Lufthansa German Airlines, 699 P.2d 1274, 1283-86 (Ala. 1985) (denying summary judgment to the defendant in a promissory estoppel action where defendant made promises that induced action by the plaintiff and that also allowed defendant to postpone any contract until uncertainty about whether the plaintiff could finish the construction of apartments to accommodate plaintiff's airline crews); Schade v. Dietrich, No. 1 CA-CIV. 8478, 1987 Ariz. App. LEXIS 667, at *3-40 (Ariz. Ct. App. Jan. 15, 1987) (finding that 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); Sprouts for Better Living, LLC v. Lake Hills Shopping Ctr., No. CV040408837S, 2005 WL 2008871, at *3 (Conn. Super. Ct. 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); Chrysler Corp. v. Chaplake Holdings, Ltd., 822 A.2d 1024, 1033 (Del. 2003) (finding that where defendant was unsure of how expansion plans for selling more Lamborghinis would develop and offered assurances to plaintiff that continued exclusivity in selling rights would depend on plaintiff's demonstrating capacity for expansion and plaintiff relied on promises by making significant investments in "operational capacity," court affirmed jury verdict for promissory estoppel as plaintiff's investments permitted the defendant to hedge by having plaintiff ready for increased sales if the expansion plans went through); Ramone v. Lang, No. Civ. A. 1592-N, 2006 WL 905347, at *14-19 (Del. Ch. Apr. 3, 2006) (finding plaintiff was entitled to reliance damages for claim of promissory estoppel where he put out flyers and made plans for a swim camp at a pool that he intended to lease from or buy with defendant, and where defendant was uncertain that he could get zoning approval for the project, frequently represented to the media and city officials that the plaintiff would be involved in the project, and plaintiff's good reputation helped defendant obtain zoning approval and buy the building); Christiana Marine Serv. Corp. v. Texaco Fuel & Marine Mktg. Inc., No. 98C-02-217WCC, 2004 Del. Super. LEXIS, at *3 (Del. Super. Ct. Jan. 8, 2004) (finding that where defendant wanted plaintiff to act as defendant's exclusive provider of bunker transportation and 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 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, and defendant did not need to pay, and fees and secured reduced rate promissory estoppel judgment affirmed); Kirkpatrick v. Seneca Nat'l Bank, 515 P.2d 781, 785-88 (Kan. 1973) (finding that where defendant bank lacks information about whether to shut down a line of credit for a customer/debtor and defendant solicited accounting services from plaintiff to clarify financial situation of customer and promises payment, promissory estoppel justified judgment for plaintiff; plaintiff's services permitted defendant to hedge pending resolution of uncertainty about the finances of the debtor); Dickson v. Comair, Inc., No. 2001-CA-002354-MR, 2003 WL 21471979, at *1, 7 (Ky. Ct. App. June 27, 2003) (finding that summary judgment was granted against plaintiff in error where defendant, an airline carrier unsure of the commitment of its supervisors, assured plaintiff that if she relinquished her twelve years of seniority to become a supervisor that the seniority could be reinstated if her job were ever effectively eliminated); Jackson v. Morse, 871 A.2d 47, 49-53 (N.H. 2005), *aff'g in part, vacating in part*, No. Civ. 03-264-JD, 2003 WL 21735448 the other elements are present, including a definite promise, justifiable reliance, and demonstrable detriment.

This section will look at cases involving preliminary agreements and precontractual reliance to see how these cases are resolved. 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 different stages of the contracting process is the prevention of opportunism and holdup. It can occur when one party who has entered into a preliminary agreement *chooses* to delay investment for strategic reasons, thereby leaving the investing party vulnerable to holdup. Holdup can also occur at the beginning of the negotiating process where no preliminary agreement exists because the uncertainties are too great and one party invests at the other party's request, leaving the investing party unable to recoup all those costs as the requesting 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 its own investment while securing sunk costs invested by the promisee, suggests that a liability default rule should govern these cases.[264] It would mitigate the potential for lost trades and underinvestment that inevitably accompany a sequential investment sequence where the promisor has the ability to defer 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

(D.N.H. July 28, 2003) (finding plaintiffs are presumptively entitled to expectation damages on their claim of promissory estoppel where defendant, uncertain of whether plaintiffs would choose to invest their funds with him, promised to make up the shortfall if value of investment account was below $62,000 dollars so long as plaintiffs agreed to give him total control of the account, and plaintiffs relied on this promise by giving him total control of the account); Taylor Box Co. v. SAR Group Ltd., No. CA. 2002-1033, 2005 WL 705991, at *4-7 (R.I. Super. Mar. 25, 2005) (finding defendant liable, based on promissory estoppel, for expenses incurred by plaintiff manufacturer even though no agreement or contract where defendant, uncertain of whether it could find a manufacturer for a DVD box that was a "better value" than its current box, told plaintiff that it would order 2,000 boxes, and in ongoing conversations led plaintiff to believe there was a deal). *See also infra* notes 309-34.

Older cases that fit this pattern of allowing recovery when a defendant solicits actions that are valuable to the defendant in allowing it to hedge (and postpone a commitment on the ultimate project) until a later point in time include: Goldstick v. ICM Realty, 788 F.2d 456 (7th Cir. 1986) (discussing defendant's promise, which induced plaintiffs to release claim for legal fees and allowed defendant to hedge on any commitment to the plaintiff while the defendant secured valuable information and removed an obstacle to a transaction with a third party); Chrysler Corp. v. Quimby, 144 A.2d 123 (Del. 1958) (finding that defendant's assurances secured cooperation of plaintiff and allowed defendant to identify the shareholders of a dealership). *See also* cases cited in Kostritsky, *supra* note 93, at 943 n.202.

264. *See* Smirov & Wait, *supra* note 144, at 399 (suggesting that "[t]he disadvantage of staging [sequencing of investment] is that it reduces the payoff of the first mover").

two parties enter into an agreement to invest simultaneously and one party breaches the agreement because it would be more privately beneficial to do so (the paradigm problem identified by Schwartz and Scott). 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 counterparty to encourage the counterparty to continue to invest, without which the counterparty would be reluctant to invest, especially when the investments are transaction specific. Promises may lack credibility; 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, such as one to invest simultaneously, and make it unprofitable to keep the promise.[265] 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 that 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 types 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,[266] "legal doctrines invoked in preliminary agreement cases are also used to support *unrelated* claims of precontractual liability."[267] They argue that these types of claims should be separated to avoid confusion.[268] 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 holdup that occurs when parties agree on a simultaneous reliance investment and one defects from the agreement in order to invest sequentially and enhance private gain.

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265. Schwartz & Scott, *supra* note 19, at 686.
266. The preliminary agreements are often incomplete agreements to agree that may be fully binding or unenforceable depending on the circumstances.
267. Schwartz & Scott, *supra* note 19, at 663 (emphasis added).
268. *Id.* at 663.

Other scholars discussing 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.[269] 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,[270] 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.[271]

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 investment exists) or in a broader set of cases (if needed to promote honest disclosure regarding the probability of a trade).[272]

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 risk of holdup and the concomitant possibility for underinvestment. These considerations suggest that in all types of precontractual cases, unless the promisor can make a credible commitment to not act strategically, a legal default rule protecting such reliance and safeguarding against holdup is likely to improve welfare.[273] When reliance cases involve a solicited reliance investment that 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, there seems to be a large disparity in what the promisee is giving up and what the promisor is gaining, and the risk attached to the promisee's investment is linked to factors affecting the promisor—matters over which the promisee has little control—the promisee's claim is and should be likely to succeed.

A putative promisor who is deciding whether and on what terms to commit to an ultimate fully orthodox contract may place great value on the ability to delay a commitment to the promisee. There are many rea-

269. *See generally* Johnston, *supra* note 15.
270. *Id.* at 491. 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.
271. *Id.*
272. *Id.*
273. *See supra* note 60 and accompanying text.

sons why a putative promisor might want to delay the point of commitment when he is considering making investments that might be costly to undo. There might be value in waiting until more information is available that will shed light on future facts affecting the profitability of the deal or that will clarify the quality and nature of the promisee with whom the putative promisor is negotiating. Uncertainty about these matters "might affect the desirability or timing of the expenditure [of the promisor]. . . ."[274]

Financial economists have studied the value of a firm obtaining the flexibility that allows it to hedge with an option. The option allows a firm to "avoid[ ] the loss it would have made if it had invested in the first period and then seen the price go down."[275] The greater the uncertainty about the future, the more valuable it is to have an option to defer.[276] In fact, the value of the option is lowest when the value of future project is more certain; then the option worth is close to zero.[277] At that point, when more information is available, the party with the option then simply decides whether to exercise the option given the price. The value of an option which allows one to defer investment no longer has much value once the future is certain.

There are different ways that companies can develop or acquire these real options to invest. In some cases, the option comes about as a result of a contract.[278] Companies can also achieve flexibility through adopting technologies that will allow them to make switches in the future, depending on what developments occur in the future.[279]

The key insight[280] from capital investment analyses is that companies derive great value from the flexibility to postpone investment. Companies often do not want to commit to begin an irreversible investment until after they have acquired new information.[281] That insight suggested that former analyses of investment decisions based on net present value were

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274. *See* AVINASH K. DIXIT & ROBERT S. PINDYCK, INVESTMENT UNDER UNCERTAINTY 6 (1994). This possibility of waiting for additional information is a factor that might make a corporation inclined to delay investment by holding onto "an 'option' analogous to a financial call option—it has the right but not the obligation to buy an asset at some future time of its choosing." *Id.*

275. *Id.* at 10. Those who devised formulas to determine whether investments would be beneficial for corporations ignored the very real value of "flexibility to deter, abandon, or otherwise alter a project." LENOS TRIGEORGIS, REAL OPTIONS: MANAGERIAL FLEXIBILITY AND STRATEGY IN RESOURCE ALLOCATION 7 (1996).

276. DIXIT & PINDYCK, *supra* note 274, at 13. As Dick Craswell explains, "the option value of remaining uncommitted is one of all of the costs and benefits (it's a long list) that goes into answering the question of just when it becomes optimal for one party to become committed." Email from Richard Craswell, *supra* note 37; *see also* Katz, *supra* note 13, at 1269.

277. Conversation with Professor Emeritus Ronald J. Coffey, Case Western Reserve University School of Law (Feb. 2008).

278. Trigeorgis gives an example of a contractual option: "Suppose that a large oil company has a one-year lease to start drilling on undeveloped land with potential oil reserves for up to a year." TRIGEORGIS, *supra* note 275, at 9-10.

279. *Id.* at 13.

280. DIXIT & PINDYCK, *supra* note 274, at 6.

281. *Id.*

inaccurate because they omitted the value that could be obtained by waiting.[282] If these insights are applied to the precontractual negotiations context where uncertainties are great, they suggest two conclusions. First, if there is a great deal of volatility and uncertainty, promisors do not want to commit and it may be more valuable to wait. The above should be powerfully antagonistic to enforcing the ultimate contract. Second, these insights suggest that there is real value to a putative promisor in having an option to defer the ultimate contract until more information comes in or until uncertainty about the quality of the counterparty is reduced.

If there is value to the putative promisor in having an option to invest until more information comes in, it suggests that the promisor would be willing to pay for that valuable right of flexibility. That suggests a liability default rule for the privilege of flexibility might be appropriate if there are costs associated with explicit options and reason to believe that the costs of opting out are low (an explicit disclaimer of Section 90 liability). It may explain why courts seem to be willing to compensate promisees who invest in a way that affords putative promisors flexibility and permits the promisors to hedge pending the resolution of uncertainty. Even if the option is not explicitly paid for, the value that companies attach to the option to defer suggests that courts may be correct in forcing the putative promisors to pay for the option.

The default rule protecting reliance in precontractual negotiations 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 simultaneous 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.[283]

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

282. *Id.*

283. 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. Those matters turn on analysis of the parties' intent and contract language, which should preclude the invocation of an implied bargain.

one party refuses to invest despite an agreement to do so.[284] As the authors point out, one party may have "an incentive to defect from any such agreement,"[285] explaining that "by delaying her decision whether to invest until after the promisee has invested . . . [t]he promisor benefits from defection if the project turns out to be unprofitable because she will not have sunk costs in a losing deal."[286] Parties who defect from an agreement to invest simultaneously when doing so will benefit one of them at the expense of the other party, will also fail to maximize the parties' surplus.[287]

Although the precise situations are different and involve reliance occurring at different stages of the negotiation process, the cases and factual scenarios can be connected by an implied intention to be responsible for reliance costs of a party who becomes subject to holdup 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. If the party soliciting investment may use the information (from the reliance) for its own benefit without paying for it and without promising to pay for it, the investing party will be unable to recoup the investment, which will deter investment. That same deterrent effect will operate in the agreements to invest simultaneously—when the investing party worries about defection by his investing partner and therefore fails to invest, the *ex post* holdup problem occurs.

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 delay a material portion of her work."[288] 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 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.[289]

284. Schwartz & Scott, *supra* note 19, at 666.

285. *Id.*

286. *Id.*

287. Schwartz and Scott assume that there are some instances where simultaneous investment would maximize surplus, so a defection from that regime would fail to maximize surplus. *See id.*

288. *Id.* at 666 n.11.

289. *See id.* at 666 n.12.

In preliminary negotiations, 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."[290] 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."[291]

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 holdup. This is particularly so where the promisor has information about itself that affects the probability of a deal being consummated—information that the promisee lacks access to and which the promisor may want to conceal—thus impairing the promisee's ability to decide on the efficiency of the investment.

A discussion of the cases examining this proposition follows.

A. Factual Scenarios Representing Successful Claims

Chrysler Corp. v. Chaplake Holdings, Ltd.[292] typifies a class of cases in which plaintiffs are successful in promissory estoppel claims involving pre-contractual negotiations without a preliminary agreement.[293] 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 suc-

290. *Id.*

291. *Id.*

292. 822 A.2d 1024 (Del. 2003).

293. *See also* Cosgrove v. Bartolotta, 150 F.3d 729 (7th Cir. 1998); School-Link Tech., Inc. v. Applied Res., Inc., 471 F. Supp. 2d 1101 (D. Kan. 2007) (holding that a defendant's counterclaim for promissory estoppel survives where plaintiff, a vendor that wished to use defendant's kiosks in a project, was unsure that it could produce the kiosks itself and, in reliance on plaintiff's promises that defendant would be the sole kiosk supplier, defendant produced 1500 kiosks); Roeder v. Pacificorp Fin. Servs., Inc., No. CV-05-1578-ST, 2006 U.S. Dist. LEXIS 79996 (D. Or. Oct. 27, 2006) (holding defendant's counterclaim for promissory estoppel survives where counterparty, uncertain whether a new project would be successful, told claimant "to go back and work hard" and promissory estoppel claimant, believing that he would be receiving a long term incentive plan, took on compensation at below market value, traveled significantly, and worked long hours); Tour Costa Rica v. Country Walkers, Inc., 758 A.2d 795 (Vt. 2000) (affirming a promissory estoppel claim 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). See also older cases in this line, Esquire Radio & Elecs., Inc. v. Montgomery Ward & Co., 804 F.2d 787 (2d Cir. 1986) (allowing recovery on promissory estoppel 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 Corp. v. Quimby, 144 A.2d 123 (1958).

ceed, 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 one that the defendant does not pay for expressly.

In *Chrysler v. Chaplake Holdings*, the plaintiff had an exclusive right to sell high end Lamborghini cars in a broad market that included the Channel Islands, the U.K., and Ireland.[294] Although the plaintiff only sold thirty cars annually, that small number still earned it the honor of being the "largest Lamborghini dealer in the world,"[295] given the total annual sales of 250 cars.

During the 1980s, Chrysler developed an expansion plan that would increase production from 250 to 5,000 units per year by doubling the number of high end Lamborghinis produced and also bringing on a new, lower priced, model that would achieve higher volume sales. The top management of Chrysler was involved in the expansion plan and "had absolute control" over it.[296] Chrysler wanted to reach the goal of producing 5,000 cars per year[297] within a five year window. However, there was uncertainty at Chrysler about how long the plan would take to achieve the goal[298] and whether the goal was in fact achievable.[299] Chrysler was concerned that even if it ratcheted up the production of low and high end Lamborghinis, the dealer network might not be able to handle an increased number. To alleviate the uncertainty about whether the plan would fail if the dealership capacity for selling a larger number of cars faltered, Chrysler assured the plaintiff that it would maintain its exclusive dealership only if it took steps to demonstrate an increased ability to handle a larger volume of cars.[300]

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 a larger volume of cars including adding staff, increasing showroom size in various locations, and making other capital improvements. Credit Suisse also authorized an increase in its overdraft facility to fund the plaintiff's plan.[301] In early 1990, after the plaintiff had built a new distribution center, acquired new facilities, secured financing,

294. 822 A.2d. at 1027.
295. *Id.* at 1028.
296. *Id.*
297. *Id.*
298. *Id.* at 1029 (detailing Iacocca's extension of the time frame for expansion from five to six years).
299. One Chrysler representative testified that "'if and when we get to 3,000 a year' then Chrysler might consider expanding its existing dealer network." *Id.* at 1028 n.4.
300. *Id.* at 1028.
301. *Id.* at 1029.

and added staff, a representative of Chrysler endorsed the plan.[302]

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.[303] Chrysler started to explore "an exit strategy"[304] due to increased doubts about its own plan's feasibility but continued to offer assurances to the plaintiff that "production for both the Diablo [high end] and the P140 [low end] was on schedule."[305]

Despite the assurances, Chrysler delayed production, and ultimately the delays in production "eroded . . . profitability" for the plaintiff.[306] These delays deprived the plaintiff of an income stream that could help service its debt obligations and the bank called the plaintiff's loan[307] 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.[308] 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. The plaintiff's sunk cost subjected it to the possibility of a hold up. Once the investments were sunk, the plaintiff would lose the 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 is representative of other similar cases, which are often successful claims for plaintiffs and have been overlooked in the scholarly literature.

Taylor Box Co. v. SAR Group Ltd.[309] is another example of a plaintiff prevailing on a promissory estoppel claim in the context of negotiations without a preliminary agreement or contract. The defendant faced uncertainties as to whether or not a particular box design would be desired by the client, and whether a better box could be produced quickly enough to

302. *Id.*
303. *Id.* at 1030.
304. *Id.* at 1030 n.6.
305. *Id.* at 1030.
306. *Id.*
307. *Id.*
308. *Id.* at 1038.
309. Taylor Box Co. v. SAR Group Ltd., No. 2002-1033, 2005 R.I. Super. LEXIS 7, at *18-19 (Super. Ct. R.I. Mar. 25, 2005).

meet a deadline. The defendant solicited sunk costs from the plaintiff by authorizing the plaintiff to start the manufacturing process for a custom box. The court viewed promissory estoppel as an alternative to a breach of contract claim.[310]

The plaintiff, Taylor Box, was a custom box manufacturing company. The defendant, Audette, approached Taylor Box and its president, Daniel J. Shedd, about making a "better value" DVD box for its customer.[311] The parties met in April of 2001, and the defendant made it clear in this meeting that the project was urgent. Audette specified that he "needed the product by mid-June."[312]

Over the next week, Taylor Box made a prototype box, looked into pricing,[313] and provided quotes. Audette, by his actions, conveyed to Taylor Box that a deal was imminent.[314] The defendant ordered 2,000 boxes, referenced a time period when it expected the plaintiff to deliver, and agreed to a one-time setup charge in order to develop the specialty dies that Taylor Box needed to produce the boxes. The plaintiff immediately ordered the material needed to produce the boxes and apprised the defendant of the order for the material.[315] Shedd, a representative of the plaintiff, testified that Audette told him that the defendant's client had "approved the design."[316] Audette admitted in court, however, that he never secured the contract with his customer and that he did not reveal that fact to the plaintiff.[317]

After the mid-June delivery date had passed, Audette continued to make comments that led Taylor Box to believe that the project was still going forward. In July, however, Audette indicated to the plaintiff that "the project was going forward but it was a budget issue with his client."[318] The plaintiff did not hear anything more from Audette, and in October, sent over a $10,000 cancellation charge.[319] Audette indicated that he would refuse to pay the cancellation charge and, indeed, it was never paid.[320]

Audette contended that because he understood that he would need to put down a fifty percent deposit to have a contract with Taylor Box, and he had not done so, there was no contract.[321] Audette also claimed that it was his understanding nothing could happen with the contract until his client approved a preproduction sample, in addition to the prototype that

310. *Id.* at *9.
311. *Id.* at *2.
312. *Id.* at *1-2.
313. *Id.* at *2-3.
314. *Id.* at *3 (delivery within 4-6 weeks contemplated).
315. *Id.* at *4.
316. *Id.* at *3-4.
317. *Id.* at *6.
318. *Id.* at *8.
319. *Id.* at *9.
320. *Id.* at *7-10.
321. *Id.* at *9.

had already been approved.[322] The Rhode Island Superior Court did not believe Audette's view of the facts because it would have been unreasonable to require Taylor Box to set up an entire manufacturing line before having a contract.[323]

Taylor Box sued Audette for breach of contract, seeking $28,000.[324] The court noted that the plaintiff brought an alternative claim of detrimental reliance.[325] "Although not so stated, this [was] essentially a claim based on the doctrine of promissory estoppel."[326]

In a non-jury trial, the judge found for the plaintiff Taylor Box on the basis of promissory estoppel and ordered judgment in the amount of $10,960.35.[327] The plaintiff had a clear and unambiguous promise of an eventually perfected contract and the repeated promises that the deal would go forward.[328]

There were many uncertainties that affected the negotiations in this case. The defendant lacked experience with the production of specialty boxes[329] and was uncertain as to whether Taylor Box could produce a box that was satisfactory to its customer. Apparently Audette was uncertain that its customer would even want a new box, matters over which the plaintiff would have little control and little advance knowledge. While these uncertainties were being resolved, the defendant solicited sunk costs from Taylor Box in starting the project. In reliance upon the defendant's willingness to pay set up costs and ongoing assurances, the plaintiff moved forward with production.[330] The defendant stood to benefit because he had a dedicated company—Taylor Box—working on the boxes under an expedited time frame.

The plaintiff's sunk costs subjected it to holdup possibility because it would lose the investment altogether if no deal materialized and would have to share the surplus with the defendant if a deal were consummated—and a deal would not materialize unless the plaintiff began the work. The urgent tone of the meeting clearly caused Taylor Box to believe that it needed to start the project quickly or risk losing the possible contract. As a result of ongoing assurances, Taylor Box "kept the project 'alive' for about six months."[331] It was not possible to return the materials after such time, because many of the items were transaction specific.[332] Thus, the court's finding, imposing liability for the plaintiffs, was an appropriate result. It mitigated the problems of holdup and reduced trade that would otherwise occur if there were no contractually negoti-

322. *Id.* at *6.
323. *Id.* at *6 n.1.
324. *Id.* at *9.
325. *Id.* at *9-10.
326. *Id.* at *10.
327. *Id.* at *19.
328. *Id.* at *18-19.
329. *Id.* at *4-5.
330. *Id.* at *7.
331. *Id.* at *18.
332. *Id.* at *18.

ated protection, no evidence of a small community with actions transparent enough to serve as the basis for reputational or other non-judicial sanctions, and no evidence that "there are private strategies and natural incentives (*i.e.*, all the mechanisms of implicit—that is, not judicially enforceable—contracting) that might adjust matters between those who are economically bestowing benefits on one another. For example, the options may be reciprocal."[333] In such cases if the parties have not each taken pre-commitment actions that might form the basis for a kind of implicit contract that rests on the assumption that "'I'm gaining as much as I'm giving,'"[334] there might be reason for judicial intervention.

B. Cases from Other Doctrinal Areas that Protect Reliance

An example of a case in 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.*[335] Though decided on a theory of *quantum meruit*, the case ended by protecting the investments 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.[336] 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.[337] 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, which might have occurred unless the plaintiff took certain steps, including making an investment on the second tract.[338]

In that case, a contractor began work on the construction of a trailer park at the request of the defendant.[339] The defendant owned one tract of land and was negotiating for the acquisition of a second tract owned by a third party.[340] The defendant negotiated a contract of construction with the plaintiff that would employ the plaintiff to construct the park on both tracts of land.[341] 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.[342]

333. Ronald J. Coffey, Email from Professor Emeritus of Law, Case Western Law School to Juliet P. Kostritsky, Professor of Law, Case Western Law School (May 7, 2008, 15:04 CST) (on file with author).
334. *Id.*
335. Earhart v. William Low Co., 600 P.2d 1344 (Cal. 1979).
336. *Id.* at 1345.
337. *Id.* at 1346.
338. *Id.*
339. *Id.* at 1345.
340. *Id.*
341. *Id.* at 1346.
342. *Id.*

During the period when the defendant was unsure whether it would secure the financing on 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 the trailer park began.[343] The defendant then requested that the plaintiff begin work on the mobile home park.[344] The defendant did not know at that juncture whether it would acquire the second tract of 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. The plaintiff's investment helped to preserve the right to build 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 the hiring of another contractor as an excuse.[345] 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 under a *quantum meruit* theory.[346] Normally *quantum meruit* would require that which is to be disgorged as an unjust enrichment benefit the defendant, who could argue that the benefit was to a third party, not to the defendant.[347]

The court nevertheless found a benefit to the defendant, basing its decision on an "extraordinarily broad concept of benefit"[348] developed in the case law that looked to the theory "that performance at another's request may itself constitute a benefit."[349] In reaching that conclusion and rejecting the narrow concept of "direct benefit" that the trial court had applied, the court looked to a dissenting opinion by Chief Justice Traynor of the California Supreme Court, in which he argued that direct benefit should not be the governing issue.[350] Chief Justice Traynor advocated a rule granting a plaintiff *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."[351]

Although Professor Farnsworth may be correct that the notion of benefit applied in *Earhart* is "artificial,"[352] 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

343. *Id.*
344. *Id.*
345. *Id.* at 1344.
346. *Id.* at 1347.
347. *Id.*
348. Farnsworth, *supra* note 3, at 224.
349. *Earhart*, 600 P.2d at 1348.
350. *Id. at 1350.*
351. *Id.* at 1350-51 (citing Coleman Eng'g Co. v. N. Am. Aviation, Inc., 420 P.2d 713, 729 (1966)).
352. Farnsworth, *supra* note 3, at 224.

no direct tangible benefit exists, 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 hedge or 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

As noted above, Alan Schwartz and Robert 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 subsequently defers that investment in a way that disadvantages the other party, should be compensable.[353] The delay is often considered by courts to be 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.[354]

It may be useful to examine the cases considered by Schwartz and Scott illustrating protection for investment reliance following a binding preliminary agreement in order to see if there is a common justificative framework that can explain or justify when the law should intervene to protect reliance investments, particularly where the danger of sequential investment is present. In both reliance following a preliminary agreement and 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.[355]

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 Re-*

353. Schwartz & Scott, *supra* note 19, at 662.
354. *Id.*
355. *Id.* at 665.

search.[356] In that case the plaintiff, a doctor, joined the defendant's urology practice.[357] The plaintiff's employment contract with the practice 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.[358]

After the year expired, the parties negotiated but could not reach an agreement on terms.[359] 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.[360] The legal question for the court was whether the defendant had breached its good faith obligation when it negotiated but failed to reach terms.[361]

In deciding whether the court's decision to deny relief to the doctor was appropriate, Schwartz and Scott considered whether either of 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 have violated of the obligation of good faith that would govern a binding preliminary agreement.[362] The court had to consider what the scope of good faith entailed when the parties were negotiating the terms of a buy-in of the new partner to the corporation. To determine the scope of the obligation of good faith and whether it was breached, Schwartz and Scott rightly focused on the difficulties of contracting and the risks that each party faced *ex ante* when the corporation hired the doctor.[363] Those difficulties in turn explained 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 *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.[364] To deal with these uncertainties, the parties put off the negotiation of the ultimate agreement until the end of the first year but

356. *Id.* at 694.

357. Kandel v. Ctr. for Urological Treatment and Research, P.C., No. M2000-02128-COA-R3-CV, 2002 WL 598567, at *1 (Tenn. Ct. App. Apr. 17, 2002).

358. This obligation to bargain in good faith was explicit. *Id.* at *1.

359. *Id.* at *1.

360. *Id.* at *2.

361. *Id.* at *4.

362. Schwartz & Scott, *supra* note 19, at 695.

363. *Id.*

364. *Id.*

committed to invest right away.[365] 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 each party 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.[366]

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.[367] 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.[368] The court found no breach. Schwartz and Scott explained that such an outcome is justifiable because each party was committed to furnish certain investments simultaneously and each party performed its obligation to invest in the practice.[369] The corporation invested in training the doctor/plaintiff, who in turn made an investment of human capital.[370] Since neither party failed to invest, neither party was subject to holdup, as would have been the case, Schwartz and Scott argued, if the practice had failed to invest in training even after the doctor has undertaken the sunk cost of moving.[371]

Since each party met its obligations to invest simultaneously, the doctor could not successfully argue that the corporation had breached its duty of good faith.[372] The corporation had an obligation not to withhold an investment in such a way that would subject the other party to holdup, but if the corporation invested in training, it 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

365. *Kandel*, 2002 WL 598567, at *1.
366. Schwarcz & Scott, *supra* note 19, at 696.
367. *Kandel*, 2002 WL 598567, at *7 (describing the offered terms).
368. *Id.* at *1.
369. Schwartz & Scott, *supra* note 19, at 695.
370. *Id.*
371. *Id.* at 696.
372. *Id.* at 695.

such risk, and so the good faith obligation should not be interpreted to mandate agreement on terms.[373]

The authors thus suggested that where there is a promise to invest simultaneously and one party delays investment, a cause of action should lie because of the possibility that one party will be subject to hold up by the other party.[374] 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 invested simultaneously but failed to reach agreement on the ultimate terms,[375] as in *Kandel*, no cause of action should lie because liability is not necessary to induce efficient investment. What is needed to induce efficient investment is legal protection against a particular form of holdup—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 assumed was that his work in the practice over a year's duration would demonstrate that even with training from his employer, he did not appear to be a desirable partner.

In the cases at the center of this Article, no preliminary agreement on the type or order of investment that each party will make existed, in part because it was 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.[376] The particular rule suggested by Schwartz and Scott and examined in cases like *Kandel*, permitting a promisee to recover sunk costs "if his promisor deviated from an agreed investment sequence"[377] would not technically apply to a preliminary negotiation which lacks a preliminary agreement or an agreement to invest. Nevertheless, there is a similar danger of holdup 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 situation "when [d]efection from a preliminary agreement to invest simultaneously thus disadvantages the promisee."[378] The logic suggests that the law should compensate parties for reliance investments made in precontractual negotiations when doing so would protect the investing party from

373. *Id.* at 696.
374. *Id.* at 686-87.
375. This would likely be the case where the investment demonstrated that the doctor's worth was not as high as expected. *Id.* at 696. This would demonstrate "that trade was inefficient *ex post.*" *Id.* at 696 n.97.
376. 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.
377. Schwartz & Scott, *supra* note 19, at 667.
378. *Id.* at 666.

the holdup risk that occurs 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 determine if a full-fledged offer should be made. 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, especially if the promisee's lack of knowledge about the promisor's project makes pricing a bargain over the investment costly.

VII. CONCLUSION

This Article has examined the precontractual negotiation period for two purposes: (1) to examine whether 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 suboptimal. Uncertainty about the future makes it hard to reach a complete contract, without which one party may be reluctant to invest, since the investment will be lost if the deal does not materialize, the contract itself will not 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 the investing party to holdup 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 was no contract. Following the adoption of 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.[379]

Recently, two scholars, Alan Schwartz and Robert 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

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379. *See generally* Hoffman v. Red Owl Stores, Inc., 133 N.W.2d 267 (Wis. 1965); IAN AYRES & RICHARD SPEIDEL, STUDIES IN CONTRACT 462 (2008).

party subsequently delays investing for strategic reasons.[380]

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 stages of the negotiation if the law can mitigate the effects of opportunistic hold up through a liability rule.

380. *See generally* Schwartz & Scott, *supra* note 19.